Scottish Government

Report on the 2010/11 audit

AUDIT SCOTLAND

Prepared for the Auditor General for Scotland and the Scottish Government
November 2011

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Key messages

Auditors' reports

Unqualified opinions were provided on the Scottish Government Consolidated Accounts, the Scottish Consolidated Fund accounts and the Non Domestic Rating White Paper accounts.

The Auditor General for Scotland prepared a number of reports highlighting the following issues for the attention of the Scottish Parliament: the repayment of European Funding (consolidated accounts), uncertainty over the valuation of an IT system (Disclosure Scotland) and a reduction in the value of software assets (Crown Office and Procurator Fiscal Service).

The signed consolidated accounts were laid in the Scottish Parliament and published on 4 October 2011. Unaudited accounts were submitted in line with agreed timetables and working papers and responses provided by officials were of a good standard, allowing us to conclude our audit in line with the agreed timetable.

Financial position

Budget rules were amended for 2010/11 to operate a single budget total for the Scottish Administration for the first time. Notwithstanding the additional flexibility offered by this change, spending in all portfolios included in the consolidated accounts was within the individual budget set for each. Overall outturn for the Scottish Administration was within the limit set and within 1% of the final budget. Budget management during the year was effective.

In March 2011 the UK Government announced the replacement of previous End Year Flexibility rules. The Scottish Government agreed a carry forward of £130 million from 2010/11 to 2011/12 with HM Treasury, reducing the 2010/11 budget in the Spring Budget Revision. A new Budget Exchange Scheme for the Devolved Administrations will be introduced from 2011/12.

The financial challenges facing the Scottish public sector are well documented, with public bodies facing deep and prolonged cuts in funding. This brings immediate challenges for the Scottish Government - in partnership with other public sector organisations - to reduce expenditure and ensure long-term sustainable public services.

The Scottish Government is required to achieve a significant reduction in its Administration budget in the next four years. Much of this fall is planned for the next two years, providing an immediate challenge in reducing costs quickly without impacting unduly on organisational performance. Plans are in place to cut the costs of the Senior Civil Service by the required level.

The Scottish Government is employing voluntary exit schemes to help it achieve the required reductions in staff costs and to reshape the organisation. Early progress has been made in line with targets, but it will become more challenging to reduce staff numbers.

It is critical that the Scottish Government develops the necessary capacity to successfully manage the risks and opportunities for the Scottish budget presented during the period of transition to new financial powers. Initial changes have been made to establish a fiscal responsibility division, and further development is under consideration.

Governance and accountability

The last year has been a time of significant change to both the Scottish Government's governance structures and the people leading the organisation. Arrangements and responsibilities are increasingly settled across key areas, after a period of transition. During this time the Scottish Government has been able to deliver on some key activities. The extent of change and reduction in staff numbers has been challenging to management and staff in ensuring there is sufficient capacity in priority areas. The Scottish Government will need to keep the effectiveness of new arrangements under review as they bed in.

The Scottish Government is currently conducting a review of the role of its non-executive directors. This is expected to be completed by the end of 2011 and will provide an opportunity to consider the alignment of audit and risk committees to changed portfolios.

Overall, key internal controls were operating effectively and adequate systems of control are in place. We have identified the need to improve controls in some specific areas including European funding and travel and subsistence. Internal audit resources have been under increasing pressure. Internal audit plays a key role in the system of internal control, particularly in a period of such organisational change. We understand that the resourcing of the Internal Audit Division will be reviewed following completion of an audit needs assessment.

Best value, use of resources and performance

As at the end of October 2011 the Scottish Government was reporting improving performance against the purpose targets and national indicators included in the National Performance Framework.

The Scottish Government has adopted a new business strategy and has improved its approach to risk management significantly during the last year. Work is continuing to manage progress against business objectives through directorate plans and to further develop and embed effective risk management.

The results of Procurement Capability Assessments and the level of savings reported by the Scottish Government indicate that improvements are being made in public sector procurement. The Scottish Government has set out some key commitments to improve asset management, and there is much to be done if this agenda is to be successfully implemented.

Key performance challenges facing the Scottish Government include the management of budget reductions, the need for better information to support decision making, 'whole systems' approaches to service delivery and improved performance management.

Introduction

1. This report is the summary of our findings arising from the 2010/11 audit of the Scottish Government. The purpose of the annual audit report is to set out concisely the scope, nature and extent of the audit, and to summarise the auditor's opinions (i.e. on the financial statements) and conclusions and any significant issues arising. The report is divided into sections which reflect the extent of our public sector audit model.

2. A number of reports have been issued in the course of the year in which we make recommendations for improvements (Appendix A). We do not repeat all of the findings in this report, but instead we focus on the financial statements and any significant findings from our wider review of the Scottish Government.

3. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officials have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that the Scottish Government understands its risks and has arrangements in place to manage these risks. In some cases management had already identified the issues highlighted and action is underway. The Strategic Board and Accountable Officer should ensure that they are satisfied with the proposed management action and have a mechanism in place to assess progress.

4. This report is addressed to Scottish Government and the Auditor General and should form a key part of discussions with audit and risk committees, as soon as possible after the formal completion of the audit of the financial statements. Reports should be made available to stakeholders and the public, where appropriate. Audit is an essential element of accountability and the process of public reporting.

5. This report will be published on our website after consideration by Scottish Government Audit and Risk Committee.

6. The management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to our attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

7. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.

8. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
   - whether they give a true and fair view of the financial position of audited bodies and their expenditure and income
   - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements
   - the regularity of the expenditure and income (except for local government bodies).

9. Auditors review and report on, as appropriate, other information published with the financial statements, including the management commentary, statement on internal control and the remuneration report. Where required, auditors also review and report on the Whole of Government Accounts return. This section summarises the results of our audit on the financial statements.

Audit opinions

10. On 15 September the Auditor General for Scotland provided his unqualified opinion on the Scottish Government Consolidated Accounts.

11. The Scottish Government is required by Ministerial Direction to follow the 2010/11 Government Financial Reporting Manual (the FReM). We confirm that financial statements have been properly prepared in accordance with the FReM.

Reports under section 22(3)

12. Section 22(3) of the Public Finance and Accountability (Scotland) Act 2000 enables the Auditor General for Scotland to prepare a report on accounts for laying before the Scottish Parliament. In 2010/11 the Auditor General prepared the following reports in respect of entities included in the Scottish Government's consolidated accounts in relation to this provision:
    - a report on the audit of the Scottish Government consolidated accounts to bring to Parliament's attention repayment of European funding (see paragraphs 81 to 84)
    - a report on the audit of Disclosure Scotland, outlining the circumstances of an 'emphasis of matter' paragraph drawing attention to uncertainty surrounding the £21.3 million valuation of an IT system in the financial statements (see paragraphs 14 to 16)
    - a report on the Audit of the Crown Office and Procurator Fiscal Service to bring to the Scottish Parliament's attention a £2.3 million reduction in the value of software assets

reflected in the accounts. A project to replace an existing system was brought to an end because management considered revised projects costs to be unaffordable.

Accounting issues

Accounts submission

13. The unaudited schedules for the core accounts and the consolidated accounts were submitted in line with agreed plans. The unaudited sub-consolidation pack for health was also received by the agreed deadline. Working papers and responses provided by staff in Finance were of a good standard and allowed us to conclude our audit within the agreed timetable and provide our opinion on 15 September. Matters arising from the audit were reported to the Scottish Government Audit and Risk Committee on 12 September 2011. The signed consolidated accounts were laid in the Scottish Parliament and published on 4 October 2011.

Disclosure Scotland - Protecting vulnerable groups IT system

14. The independent auditor's report on the financial statements of Disclosure Scotland included the following emphasis of matter paragraph which drew attention to uncertainty surrounding the £21.3 million valuation of an IT system in the financial statements:

"*In forming my opinion on the financial statements, which is not modified, I have considered the adequacy of the disclosures made in … the financial statements relating to the transfer of assets from the Scottish Government to Disclosure Scotland on 28 February 2011 and the related commentary in the Statement on Internal Control. The performance of the assets transferred to support the introduction of the Protecting Vulnerable Groups legislation fell significantly short of the standard anticipated, which created uncertainty as to the appropriate value of the assets. A recovery plan is in place to deliver the required standard of performance at no extra cost to Disclosure Scotland. On that basis, Disclosure Scotland has not carried out an impairment review and records the asset at the cost transferred less one month's depreciation*."

15. Accounting standards indicate that asset values should be reviewed and adjusted to their "fair value". The issue in question was whether the value of the associated assets should be impaired to reflect their underperformance. The auditor of Disclosure Scotland concluded that it was reasonable to adopt the principle of recording the IT asset at contract value of £20 million, given that the costs of the recovery plan to Disclosure Scotland are zero. We agreed that it was not necessary to impair the asset included in the balance sheet of the consolidated accounts.

16. There is some uncertainty surrounding the final outcome on the recovery plan. In view of this and the materiality of the amounts involved to the accounts of Disclosure Scotland, the auditor of Disclosure Scotland concluded it was appropriate to include an emphasis of matter paragraph in the independent auditors report to explain the position to users of the financial statements. We concluded, given the immateriality of the amounts involved to the Consolidated Accounts that it was not appropriate to include a similar paragraph in the Auditor

General's report on these accounts. The Auditor General did, however, report to the Scottish Parliament under section 22(3) of the relevant Act in relation to this issue. The success of remedial action should be kept under review in considering the future value of this asset.

NHS Scotland Equal pay claims

17. The National Health Service in Scotland has received in excess of 10,000 claims for equal pay. Developments over the past year have slowed the progress of claims and led to a reduction in the number of claims going forward. The NHS Scotland Central Legal Office (CLO) has stated that claims still do not provide sufficient detail about the comparator jobs to allow an estimate to be made of the likelihood of the success of the claims or of any financial impact that they may have.

18. Given this advice, auditors of NHS bodies have agreed that disclosure of an unquantified contingent liability remains appropriate for the 2010/11 financial statements of affected NHS Boards. The Scottish Government Health Directorates, the CLO and other NHS Boards aim to assess potential liabilities as soon as possible, taking into account the progress of legal cases.

Scottish Consolidated Fund and Non Domestic Rating Account

19. We have given unqualified opinions on the financial statements of both the Scottish Consolidated Fund and the Non Domestic Rating financial statements for the year ended 31 March 2011.

Whole of Government accounts

20. The Whole of Government Accounts (WGA) programme led by HM Treasury continues to progress towards production of accounts covering the whole of the UK public sector. The 2009/10 WGA financial statements will be published by the end of 2011 and are expected to attract significant interest and publicity. The WGA financial statements for 2010/11 will be published by HM Treasury during 2012.

21. The main legislative authority for WGA is the Government Resources and Accounts Act 2000. The Act does not apply in Scotland, and there is no sub-consolidation of all Scottish bodies. However, the Scottish Government has agreed to provide HM Treasury with equivalent information. The Scottish Government provides WGA information for the entities included in the consolidated accounts. Larger NDPBs and local government bodies also supply WGA information.

22. We audit the information returned by the Scottish Government and confirm that it is consistent with the consolidated accounts. For the 2010/11 accounts process, we were content that the required information had been provided.

Accounting outlook

23. The main change in the financial reporting framework (FReM) next year (2011/12) is that grants and donated assets should be recognised immediately, unless there is a condition that the recipient has not satisfied that would lead to repayment. Most grants and donated assets should be recognised as income, but grants from a sponsoring department to an NDPB should be credited to general reserves. As a consequence, the government grant reserve and donated asset reserve will no longer exist.

24. Looking further ahead, from 1 January 2013 changes to international financial reporting standards (IFRSs) will become effective and will be considered for application to the central government sector by the Financial Reporting Advisory Board. This includes the introduction of:

- IFRS 9 - financial instruments (replacing IAS39)
- IFRS 10 - consolidated financial statements (replacing IAS27)
- IFRS11 - joint arrangements (replacing IAS31)
- IFRS12 - disclosure of interest in other entities (replacing IFRS12)
- IFRS 13 - fair value.

25. As changes are made to the financial powers available to the Scottish Government and the manner in which the organisation works with the remainder of the public sector, the form of the financial statements will need to be kept under review.

Financial position

26. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based. Auditors consider whether audited bodies have established adequate arrangements and examine:

- financial performance in the period under audit
- compliance with any statutory financial requirements and financial targets
- ability to meet known or contingent, statutory and other financial obligations
- responses to developments which may have an impact on the financial position
- financial plans for future periods.

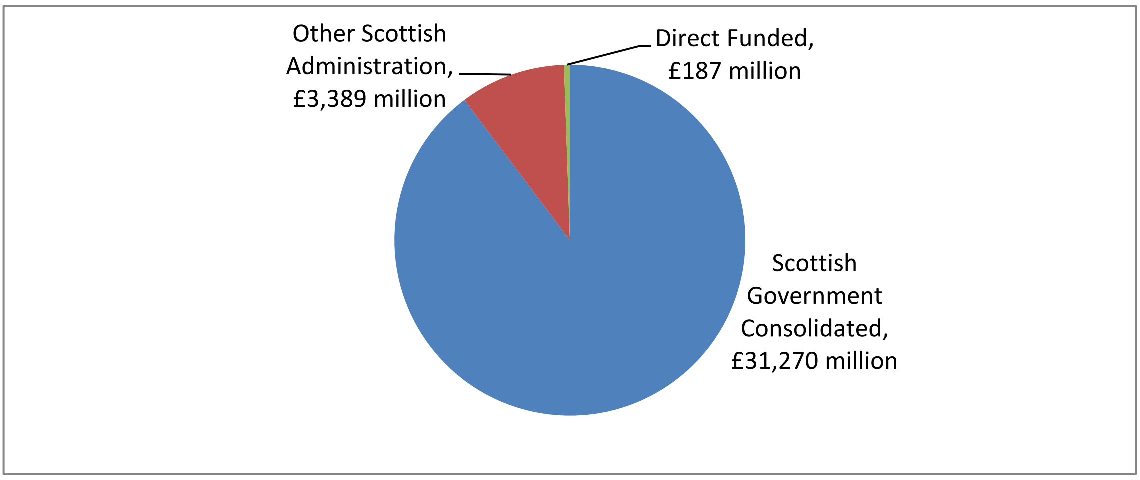
27. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results 2010/11

Scottish Budget for 2010/11

28. The Budget (Scotland) Act 2010 makes provision for financial year 2010/11 for the use of resources by the Scottish Administration and certain bodies whose expenditure is payable out of the Scottish Consolidated Fund. The final budget approved by the Scottish Parliament permitted total managed expenditure of £34,846 million. The majority of this relates to spending programmes and administration costs covered by the Scottish Government Consolidated Accounts, but amounts are also allocated to other parts of the Scottish Administration and Direct Funded bodies as shown in exhibit 1.

Exhibit 1: The Scottish Budget 2010/11



Source: Audit Scotland from the Budget Scotland Act 2010

29. Budget rules were amended for 2010/11 to operate a single budget total for the Scottish Administration for the first time. While budgets were specified for each of the purposes of the Scottish Administration, the Scottish Government was permitted to exceed any of these individual totals as long as it contained its overall spending with the overall limit. This permitted greater flexibility in in-year budget management, helping to lessen the risk of significant underspending.

Outturn reported in the Consolidated Accounts

30. The final budget for the expenditure included in the Scottish Government's Consolidated Accounts for 2010/11 was £31,270 million. Total net expenditure during the year was £30,940 million, resulting in an overall underspend of £330 million (2009/10 £253 million). Within this total, resource was underspent by £294 million, and capital was underspent by £36 million against respective budgets. Notwithstanding the additional flexibility offered by changes to the budget act, spending in all portfolios was within the individual budgets for each as set out in table 1.

Table 1: Scottish Government outturn against budget 2010/11

Portfolio	Actual Spend £m	Budget £m	Over/ underspend £m
Office of the First Minister	262	269	(7)
Finance and Sustainable Growth	2,356	2,456	(100)
Health and Wellbeing	12,211	12,269	(58)
Education and Lifelong Learning	2,824	2,945	(121)
Justice	1,838	1,845	(7)
Rural Affairs and the Environment	485	512	(27)
Local Government	10,570	10,570	-
Administration	276	285	(9)
Crown office and procurator fiscal service	118	119	(1)
Total	30,940	31,270	(330)

Source: Scottish Government Consolidated Accounts 2010/11

31. Overall, outturn was within 1% of budget and budget management during the year was effective. Explanations for significant variances are disclosed in the consolidated accounts.

Outturn on Scottish Administration budget

32. Spending in the consolidated accounts must be taken together with other expenditure set out in Schedule 1 of the budget act in order to determine whether the Scottish Administration has remained within the statutory budget limit. The outturn against budget for all relevant purposes is summarised in table 2.

Table 2: Scottish Administration entities outturn against budget 2010/11

Entity	Actual Spend £m	Budget £m	Over/ underspend £m
Scottish Government Consolidated	30,940	31,270	(330)
General Register Office for Scotland	29	29	-
National Archives of Scotland	10	10	-
Teachers' and National Health Service Pension Schemes	(2,482)	3,253	(5,735)
Office of the Scottish Charity Regulator	3	3	-
Scottish Courts Service	94	94	-
Total	**28,594**	**34,659**	**(6,065)**

Source: Audited Accounts 2010/11

33. The net position for all of the Scottish Administration is an underspend of £6,065 million, meaning that spending has been contained within the limit set. The underspend was mainly due to unbudgeted changes to pension costs included in the accounts of NHS and teachers superannuation schemes. These arose as a result of a policy decision taken by the UK Government to change the indexation of pension benefits from the Retail Prices Index to the Consumer Prices Index measure of inflation. Accounting rules mean that significant one-off income credits totalling £5,410 million were recognised in pension fund accounts, reflecting a reduction in the cost of future pension benefits.

Implications for Total Managed Expenditure

34. The extent to which any underspend against the Scottish Administration's budget remains available in subsequent financial years is governed by complex budgeting rules.

35. Total Managed Expenditure (TME) is the total budget agreed with HM Treasury, and is used by the UK Government to manage its spending on the Scottish Block. This varies slightly from the budget approved by the Scottish Parliament, largely for technical reasons relating to differences between how it budgets for and accounts for some items of expenditure. A reconciliation of the two amounts is included at note 26 of the consolidated accounts. The

Scottish Parliament also approved a modest (£97 million) over-allocation of budgets in 2010/11, recognising that a degree of expenditure slippage was likely during the year and wishing to minimise the impact of this on overall spending totals.

36. In assessing actual TME for the year, it is necessary to consider the spending of the Scottish Government reflected in the consolidated accounts, other expenditure of the Scottish Administration and the spending of direct funded bodies (Forestry Commission, Food Standards Agency, Scottish Parliamentary Corporate Body and Audit Scotland). A number of technical adjustments then require to be made, reflecting differences between accounting rules and UK budget rules.

37. Under budget rules TME is categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL). AME is not subject to firm multi-year limits and generally any under/ over spend against AME budgets in one year will be adjusted for in subsequent years without affecting the Scottish Government's spending power. DEL is subject to greater control.

38. In March 2011 the UK Government announced the replacement of previous End Year Flexibility arrangements with a new Budget Exchange Mechanism. The 2010 Comprehensive Spending Review Settlement letter allowed the Devolved Administrations to plan an in-year DEL reduction in 2010/11 to reflect an anticipated underspend with an equivalent DEL increase in 2011/12. The Scottish Government agreed with HM Treasury a carry forward of £130 million, reducing the 2010/11 budget in the Spring Budget Revision.

39. In June 2011 the Cabinet Secretary provided a statement to the Scottish Parliament on the provisional outturn for 2010/11. He reported that the fiscal DEL underspend was £12 million, about 0.04% of the fiscal DEL budget. This amount is returnable to the UK Government.

40. A new Budget Exchange Scheme for the Devolved Administrations will be introduced from 2011-12. This will operate for the remaining years covered by the 2010 Spending Review. This enables Devolved Administrations to carry forward 0.6% of Revenue DEL and 1.5% of capital DEL from one year to the next. Any underspend in excess of this amount will be returnable to the UK Government.

Outturn reporting

41. In 2009/10 the Auditor General for Scotland provided a report under Section 22(3) of the Public Finance and Accountability (Scotland) Act that highlighted the variances between the outturn (actual income and expenditure reported in the accounts) and the budget approved by the Scottish Parliament. The report provided an explanation of the variances and concluded that there was scope for the Scottish Government to provide more detailed financial information to Parliament on outturn against budget.

42. It is appropriate that responsibility for reporting against budget lies primarily with the Scottish Government. This year improvements have been made to the Consolidated Accounts to the way in which budget variances are reported. There remain opportunities to further enhance

the financial information reported to Parliament, in particular by providing more detailed analysis of outturn against budget to subject committees.

43. The 2009/10 report also drew attention to a change to the Budget Act, highlighting that it was important that this change did not result in less detailed information to support the Parliamentary scrutiny process. During 2010/11, we confirm the Scottish Government continued to provide the same level of information to support Parliamentary scrutiny of the proposed budget as it had done in previous years.

44. The change to the Budget Act means that the outturn on the consolidated accounts is not sufficient on its own to determine whether the overall budget limits for the Scottish Administration have been met, and this has to be considered alongside the outturn on the accounts of other bodies covered by Schedule 1 of the Budget Act. Current arrangements are that each set of accounts is laid before the Scottish Parliament separately. The aggregated position has not yet been provided to Parliament. If one or more of the individual budget lines had been overspent, the implications of this for the overall Scottish Administration budget limit are not reported within any of the laid accounts. Finance officials are proposing that the Cabinet Secretary for Finance and Sustainable Growth lay a statement reporting on the outturn position overall against the Budget Act approvals.

Refer Action Plan No. 1

Financial outlook

Scotland's spending review and future budgets

45. The financial challenges facing the Scottish public sector are well documented, with public bodies facing deep and prolonged cuts in funding. The Scottish Government published its proposed budget for 2011/12 in November 2010, and its proposed budget and spending review for 2012/13 to 2014/15 in October 2011. Over the next four years annual DEL spending for Scotland is planned to fall from £29.2 billion in 2010/11 to £28.6 billion in 2014/15. This is equivalent to a real terms reduction of 12.3% during the period, with the largest fall in the first year – a 7% real terms cut in DEL budget between 2010/11 and 2011/12.

46. The Government Economic Strategy estimates that based on current constitutional and financial arrangements public spending in Scotland will continue to fall in real terms until 2016/17 and that it could take until 2025/26 for the Scottish Government budget to return to 2009/10 levels.

47. The scale of budget cuts brings immediate challenges for the Scottish Government – in partnership with the rest of the Scottish public sector - to reduce expenditure but also to ensure long-term sustainable public services. The Scottish Government's financial plans for the next four years set out its priorities for spending and provide detail of budgeted and planned spending across all programmes. These provide all Scottish public bodies with a degree of certainty about the resources that will be made available to them, assisting in longer

term financial planning across the Scottish public sector. Crucially, financial plans will also help ensure that the Scottish Government lives within its means.

48. The reduction in public spending comes at a time that demand for public services is increasing, and this is likely to continue into the future. This places an additional burden on the capacity of public bodies to provide efficient and quality services. They also face a number of significant cost pressures including increasing backlog maintenance and repair costs and rising energy costs. These, together with existing financial commitments, will make it difficult to reduce costs while maintaining service standards.

49. As well as setting out its spending priorities, the Scottish Government has an important role in providing leadership and support to public sector bodies as they seek to reduce costs, improve efficiency and deliver on national priorities. It also needs to ensure that manages its own operating costs within the Administration budget while delivering the Government's purpose, supporting Minsters in their work, and ensuring the proper stewardship of public money. We comment on key aspects of these activities in the last section of this report.

The administration budget

50. The Scottish Government is required to achieve a significant reduction in its Administration budget in the next four years, reducing spending by a total of £68 million (26%) in cash terms. Much of this fall is planned for the next two years, providing an immediate challenge in reducing costs quickly without impacting unduly on organisational performance. Plans are in place to cut costs of the Senior Civil Service by the target level. Key aspects of this are reductions in core staff numbers and maintaining downward pressure on pay rates, in accordance with Ministerial pay policy. The Scottish Government is also seeking to reduce overhead costs, making savings on areas such as travel expenditure, in order to minimise the reduction in staff numbers it has to make.

Preparing for increased fiscal autonomy

51. In September 2011 the Scotland Bill completed its second reading in the House of Lords, having previously been considered by the House of Commons and debated by the Scottish Parliament. One of the key aims of the Bill is to introduce accountability of the Scottish Parliament for the revenue it raises alongside its current accountability for spending decisions. The Bill remains subject to continuing Parliamentary scrutiny by both the UK and Scottish Parliaments. What seems clear is that further financial powers will be devolved to the Scottish Parliament and will be available to future Scottish Governments.

52. The current provisions of the bill include:

- creation of a Scottish rate of income tax by cutting 10p from every income tax rate, reducing the Scottish block grant in proportion and obliging the Scottish Parliament to set a new rate to meet its spending plans
- allowing Scottish Ministers to borrow up to £500 million for revenue purposes and up to £2.2 billion for capital spending (with smaller annual limits also applying)

- devolving control over landfill tax, stamp duty and the power to create new taxes (subject to the agreement of the UK Parliament).

53. It is proposed that these powers will be phased in up to 2016, with transitional arrangements in place to manage adverse shocks or windfall gains to the Scottish budget. Ultimately, these new powers will provide a range of new policy levers to the Scottish Government – but will also introduce new risks over its finances relating to factors such as the performance of the economy, the robustness of tax revenue forecasts and demographic changes (such as the relative distribution of taxpayers between different tax bands). The Bill proposes a policy of ‘no detriment’ to the Scottish budget as a result of changes to the tax system made by the UK government, but it is as yet unclear how these will operate in practice.

54. Much remains to be concluded in relation to the Bill, and the Scottish Government has proposed a greater devolution of powers in a number of areas. It has also planned a referendum on key constitutional questions during the lifetime of the current Parliament.

55. However until these issues are finally settled, it is critical that the Scottish Government develops the necessary capacity within the organisation to successfully manage the risks and opportunities for the Scottish Budget both during the period of transition and once the confirmed powers are fully established. Initial changes have been made within the Finance Directorate to establish a Fiscal Responsibility Division. Further development of organisational capacity is also under consideration.

56. The Scottish Government has argued for early access to borrowing for capital purposes. The UK Government has indicated that as part of the Scotland Bill it will make part of the borrowing for capital purposes proposed under the Bill available in pre-payments for approved projects by 2012. An early task for the Scottish Government will be to manage the use of such new borrowing powers within its overall budget framework.

Refer Action Plan No. 2

Governance and accountability

57. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

58. Through its accountable officers, the Scottish Government is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

59. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:

- corporate governance and systems of internal control
- the prevention and detection of fraud and irregularity
- standards of conduct and arrangements for the prevention and detection of corruption.

60. In this part of the report we comment on key areas of governance.

Corporate governance

Roles and relationships

61. The last year has been a time of significant change to both the Scottish Government's governance structures and to the people involved in leading the organisation. The extent of change has been influenced by a number of key drivers including the need to respond to reducing resources, the development of the organisation to best support Ministers in the implementation of their policies and the departure of a number of senior officials and non-executive directors. Overlaying this is the outcome of the May 2011 election, with the establishment of a majority government and changes to Ministerial responsibilities.

62. Key changes to the corporate governance of the organisation have included:

- realignment of ministerial portfolios in the summer of 2011 - increasing the number of portfolios from eight to ten and Cabinet Secretaries from five to eight. Key changes have included separate portfolios for Parliamentary Business & Government Strategy, Culture & External Affairs and Infrastructure & Capital Investment and the disaggregation of the Office of the First Minister portfolio
- a change in Permanent Secretary in June 2010, with Sir Peter Housden having replaced Sir John Elvidge on his retirement

- other changes to the Directors General serving on the Strategic Board, with three of the six current Directors General having been appointed in the last year. All of the current Directors General have been appointed to the role since April 2010
- changes to the non-executive members serving on key Boards and Committees, including the appointment of three of the four current non-executive members of the Strategic Board in the last year and changes to the chair and membership of the Scottish Government Audit and Risk Committee
- realignment of the respective roles of the Strategic Board and the Executive Team. The Strategic Board now meets quarterly, with the Executive team - which reports to the Strategic Board and is responsible for delivery of the business strategy - meeting 6 times a month
- the establishment of three Boards with oversight responsibility for three key aspects of the business strategy – performance, people and resources
- consolidation and realignment of Directorate responsibilities.

63. Taken together, these changes represent a renewal of many of the Scottish Government's corporate governance arrangements. Arrangements and responsibilities are increasingly settled across key areas, after a period of transition that has provided significant challenges to all those involved. During this time the Scottish Government has been able to deliver on some key activities including preparation of the spending review and a managed reduction in staffing levels. New arrangements continue to bed in and the Scottish Government will need to keep their effectiveness under review.

Refer Action Plan No. 3

Non-executive directors

64. The Scottish Government has a number of independent non-executive directors. Their role is to provide an effective assurance and challenge function to the Executive Team, with primary responsibility to Parliament and Ministers remaining with Accountable Officers. There are non-executive members of the Strategic Board, Performance, People and Resources Boards and Audit and Risk Committees (ARCs). In addition all non-executive directors meet together quarterly. This provides an opportunity for discussion, the sharing of perspectives and experiences and to receive updates on developments within the Scottish Government.

65. In the past year there has been a significant turnover in non-executive directors as previous office holders came to the end of their appointment period. In recognition of this an induction event was held in late 2010. This was well attended, covering key aspects of the no-executive role, governance arrangements and the context within which the organisation currently operates.

66. Currently however there is no formal personal development planning in place for non-executive directors, although we understand that individuals will shortly be consulted on their development needs and what training they would consider to be beneficial.

67. We regularly attend all ARCs. It is evident that non-executive directors play an important part in the organisation, bringing valuable experience and an independent perspective to their roles. Their responsibilities also mean that they are able to bring their involvement across a number of different Boards and ARCs to bear, helping to promote and maintain understanding and knowledge sharing. However, there remains some inconsistency between ARCs about the scope of their considerations and the manner in which they interrelate with other parts of the Scottish Government and the wider public sector. Following changes to portfolio structures, there is also some misalignment with the existing ARC structure and the Scottish Government recognises the need to address this.

68. It is important that organisations have arrangements in place to consider the effectiveness of their Boards and Committees, and act to make improvements where these are necessary. During the year, the Scottish Government introduced risk registers for each ARC supporting members to consider how well they were addressing the issues identified. In addition the Scottish Public Finance Manual requires an annual report to be provided by each portfolio ARC to the Scottish Government ARC. There was a degree of inconsistency between committees on the extent and nature of this activity, and there is scope to further improve self-assessment arrangements.

69. The Scottish Government is currently conducting a review of the role of its non-executive directors and the structure of portfolio ARCs. This is expected to be completed by the end of 2011 and will provide an opportunity to consider these issues.

Refer Action Plan No. 4

Organisational restructuring

70. In 2009 the Scottish Government reviewed the shape and working practices of the organisation. The original report *Shaping Up*, published in January 2010, made a range of recommendations to deliver improvements in the organisation, structures and ways of working. Work to ensure the organisation is best placed to deliver on its objectives has continued in the context of budget and staffing reductions. In August 2010, the programme was refocused to give priority to work that would:

- support restructuring and reduce the organisation’s costs
- support more flexible resourcing, increasing organisational performance and productivity
- support leadership and expected behaviours and build the organisational and individual resilience through challenging times.

71. During 2010/11, the Scottish Government carried out some work to further review and reshape the organisation, to address the current policy and financial challenges. The first phase of the restructuring exercise came into effect on 5 January 2011. This stage focussed on changes at Directorate level, to allow more flexibility, based on networks to encourage communication and collaboration. Work is continuing to implement current restructuring plans and develop new proposals to achieve further savings. Four strands of work are currently in progress:

- promoting flexibility in staff deployment – the flexible consultancy team is developing plans to promote flexible deployment across the organisation as well as providing project-based resource for particular business priorities
- embedding the right leadership behaviours – this work is moving into a programme of implementation and engagement across the organisation
- management remits for senior leaders – a group of Directors have work underway to review the remits of senior staff. The remits will seek to reinforce individual accountability, strengthen performance management and embed commitment to the SG's outcomes approach
- streamlining systems and processes – to reduce bureaucracy and costs. This work stream is engaging individuals across the organisation to identify priorities for change.

72. The reshaping within the Scottish Government has resulted in significant changes in the roles and responsibilities of key staff across the organisation. In addition, the early release scheme will result in a significant loss of knowledge throughout the organisation. Large numbers of staff are also being redeployed within the Scottish Government. The extent of change and the reduction in staffing numbers has been challenging for management and staff in ensuring that there is sufficient capacity in priority areas. There is a risk, at least in the short term, that the above changes will result in a weakening of the overall control environment. We will continue to monitor progress of the programme during our 2011/12 audit.

Refer Action Plan No. 7

Systems of internal control

Internal Control Framework

73. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, our wider responsibilities require us to consider the financial systems and controls of bodies as a whole. The extent of our work is informed by an assessment of risk.

74. The Statement on Internal Control sets out the Principal Accountable Officer's responsibility for reviewing the effectiveness of the system of internal control and the processes in place to support him in doing so. He concluded that no significant issues were reported to him via these processes and outlined key developments during 2010/11 and areas where action is progressing.

75. In his annual report on 2010/11, the Head of Internal Audit provided his opinion that based on the internal audit work undertaken during the year that he was able to provide substantial assurance on overall arrangements for risk management, control and governance.

76. As part of our audit we reviewed the high level controls in all of the Scottish Government's central systems that impact on the financial statements. Our overall conclusion was that key controls were operating effectively and that adequate systems of internal control were in

place. Some control weaknesses were identified in specific areas as set out in more detail in paragraph 85.

Statement on Internal Control

77. Arrangements for the preparation of the Statement on Internal Control are well established and generally functioned well during the year. The final statement is based on a pyramid of assurance that includes reviews by each Accountable Officer supported by the work of Audit and Risk Management Committees.

78. The timing of assurance processes did, however, mean changes were being made to the statement right up to the point the accounts were signed. This constrains audit review and introduces a risk that any issues raised are not able to be resolved without delay to the conclusion of the audit.

Refer Action Plan No. 5

Internal Audit

79. The establishment and operation of an effective internal audit function forms a key element of effective governance and stewardship. We seek to rely on the work of internal audit wherever possible. We concluded that the Internal Audit Division (IAD) operates in accordance with the Government Internal Audit Manual and that we could place reliance on their work during 2010/11.

80. Internal audit resources have been under pressure as a result of increasing demands to undertake European Community related work. Two members of staff also retired from the organisation at the end of the financial year in response to voluntary exit schemes, and the staffing complement reduced as a result. In response to these pressures, IAD recently recruited two staff to undertake on the spot inspections required by European Regulations. Moving forward it is important that the key role that internal audit plays in the organisation's system of internal control continues to be recognised, particularly in a period where the organisation is undergoing such significant change. We understand that the resourcing of IAD will be reviewed following completion of the current Audit Needs Assessment.

Refer Action Plan No. 3

European funding

81. The Auditor General for Scotland prepared a report under section 22(3) of the Public Finance and Accountability (Scotland) Act 2000 on the Scottish Government's Consolidated Accounts. This brought Parliament's attention to actual and potential repayment of European Union funding. These repayments represent an estimated £102 million loss of European Funding to Scotland. They arose because Scottish Government procedures at the time did not meet the standards required to ensure that the use of funds complied fully with EU legislation.

82. The main issues identified relate to:

- deficiencies in control over regional assistance funding identified by European Commission audits undertaken between 2003 and 2005
- deficiencies in control over assistance under the Common Agricultural Policy identified by European Commission audits undertaken between 2005 and 2009
- an interruption of regional assistance payments while checks agreed with the Commission as part of an improved control framework were undertaken. This has now been lifted
- the 'de-commitment' of some expenditure where its eligibility was uncertain as a result of significant weaknesses in control over the appraisal of capital grant applications.

83. The Scottish Government has made some important changes to the control environment in these areas since the time of the original audits, and the Permanent Secretary has described some of these in the Statement of Internal Control. Recent reports by internal audit have indicated that progress has been made. The effectiveness of arrangements and the extent to which they comply with requirements will be tested through an ongoing programme of European Commission audits. We will continue to monitor progress through the annual audit, including our work as part of the consortium auditing the European Agricultural Fund Accounts.

84. Looking forward, it is important that the Scottish Government continues to address identified concerns about its management and control of European funding programmes. It should also ensure that it learns the lessons from its experience of previous programmes and applies these in the design and operation of similar programmes in the future.

Refer Action Plan No. 6

Travel & subsistence

85. Our review of the controls in place within the Travel & Subsistence (T&S) section identified that staff at the grade of branch head B3 and above can approve their own expenses claims. Staff at these grades do not, therefore, have their expense claims independently checked as a matter of routine. Sample checks are taken on 5% of claims. In our view, this is an insufficient level of review and approval, and the Scottish Government should consider requiring staff at all grades to have their expense claims countersigned.

Data handling

86. We reviewed arrangements for data handling, including the actions taken by the Scottish Government to address the recommendations of the *Data Handling in Government* (DHiG) report published in June 2008. The key findings from this work, reported in detail in November 2010, highlighted the key risk areas:

- a consolidated organisation-wide Information Asset Register (IAR) had not been implemented, although this was a key recommendation of the DHiG report
- the Scottish Government had not fully developed the "leadership role" recommended by the DHiG report

- a full analysis of compliance to the Security Policy Framework (SPF) covering all areas of the devolved Scottish administration had not been performed
- resource challenges within the Office of Security and Information Assurance (OSIA) during the course of 2010 had resulted in delays to the delivery of a number of security improvement and awareness projects.

87. During the course of 2011 the effects of the early release scheme further increased resource pressures within the OSIA team, with a number of experienced team members leaving over a short period of time. These pressures have led to further delays in a number of strategic areas while priority was given to continued delivery of the team's operational workload.

88. Staff resource issues within the OSIA team have been largely resolved, and that the resulting team stability and a number of strategic developments are now proceeding. Key areas of progress include:

- a pilot of the IAR system has been completed by a small number of departments, and a number of information assets are now registered in the database
- an Information Asset Owners (IAOs) handbook has been prepared as the basis of training to be delivered to all SG IAOs over the coming months, and it is anticipated that the IAR will be fully operational throughout all SG departments by mid-2012
- a full analysis of the level of compliance with the SPF covering all aspects of the devolved Scottish administration has been prepared. This includes a number of suggested actions that will be used by the OSIA team as they develop the SG's leadership and security guidance role.

89. We will continue to monitor progress in this area.

Prevention and detection of fraud and irregularities

90. The Scottish Government is responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements.

91. The Scottish Public Finance Manual (SPFM) is issued by the Scottish Ministers to provide guidance to the Scottish Government and other relevant bodies on the proper handling of public funds. Robust procedures following the requirements of the SPFM are in place within the Scottish Government.

92. Work is currently in progress to update the organisation’s Fraud Management Strategy, resultant policy and processes by the end of 2011; working with partners across the Scottish Government family to ensure the policy and processes are implemented, observed and embedded into the business. A network of Counter Fraud Champions (CFC), coordinated by the Home Office through the National Fraud Authority was established in January 2011, drawn from every UK department and the devolved administrations, to work collaboratively to address a number of areas. The Director, Procurement and Commercial was appointed during 2011 as the CFC for the Scottish Government.

National Fraud Initiative in Scotland

93. In conjunction with the Audit Commission, Audit Scotland has conducted data matching exercises (the National Fraud Initiative or 'NFI') since 2000. One of the primary purposes is to help public sector bodies to prevent and detect fraud and error in their financial systems. The last exercise (NFI 2008/09) led to outcomes valued at around £21 million in Scotland. To date, the exercise has been worth £58 million to the public purse and the Parliament's Public Audit Committee has been very supportive of NFI in Scotland. Across the UK, the cumulative outcomes are more than £660 million.

94. The NFI exercise is conducted every two years and the 2010/11 NFI exercise is currently underway. This is the first year the exercise has been extended to central government bodies. It is being undertaken in Scotland using new powers for data matching which are contained in the Criminal Justice and Licensing (Scotland) Act 2010. These clarify the legal framework and allow the scope of data matching to be extended in Scotland. In line with the approach in other sectors, it is mandatory for payroll data to be submitted.

95. The Scottish Government's participation in this year's exercise has led to a relatively small number of data matches (potential areas for investigation) with 182 matches from around 8,500 employees paid through the Scottish Government payroll function. The Scottish Government has decided, based on risk, to investigate all of the recommended cases (which in general represent higher value matches) and at the time of this report had reviewed 15 of the 24 such cases. No cases of fraud have been identified to date. We have been advised that all reviews will be completed by the end of 2011.

96. We welcome the Scottish Government's participation in the NFI, both in respect of the assurance it provides in relation to its own activities and the wider leadership role that the organisation plays. Steps have recently been taken to improve the overall direction and oversight of the conduct of the exercise within the Scottish Government. The organisation's approach to NFI has been documented and arrangements have been established to report outcomes to senior officials and the Corporate Audit and Risk Committee.

Standards of conduct

97. In July 2011, the Bribery Act came into force, replacing the offences of common law. The Act creates two general offences covering the offering, promising or giving of an advantage, and requesting, agreeing to receive or acceptance of an advantage. It also introduces a corporate offence of failure to prevent bribery by persons working on behalf of a business.

98. The Scottish Government has produced detailed guidance about the Act and procedures organisations can put in place to prevent bribery, as well as a set of illustrative case studies. We will monitor progress in implementing this guidance as part of our 2011/12 audit.

Governance outlook

99. The current environment of significant organisational change, reducing resources and increasing expectations is one in which the organisation's governance and internal control arrangements will be tested.

100. Recent improvements to risk management arrangements (see paragraphs 113 to 117) will help ensure that the Scottish Government is better placed to deal with these challenges, but will take some time to fully bed in. It is important that internal audit continues to be effective, and that officials throughout the organisation fully understand and meet the requirements placed on them to ensure that effective control is exercised over the organisation's use of resources.

101. There has been significant change to corporate governance arrangements and to the individuals leading the organisation. New ways of working will take some time to be fully developed and embedded. The review of the role of non-executive directors provides an opportunity to ensure that their contribution and effectiveness is maximised, and is appropriately aligned to the organisation's objectives and structures.

Best Value, use of resources and performance

103. Accountable officers have a specific responsibility to ensure that arrangements have been made to secure Best Value. The Auditor General may require that auditors consider whether accountable officers have put in place appropriate arrangements to satisfy their corresponding duty of Best Value.

104. As part of their statutory responsibilities, the Auditor General and the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:

- a performance audit which may result in the publication of a national report
- an examination of the implications of a particular topic or performance audit for an audited body at local level
- a review of a body's response to national recommendations.

105. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.

106. This section includes commentary on the Best Value and Performance Management arrangements within the Scottish Government. We also note any headline performance outcomes/ measures used and comment on relevant national reports and the organisation's response to these.

Performance management

Overview of performance

107. In November 2007 the Scottish Government introduced a National Performance Framework. This sets out the Government's purpose, strategic objectives and national outcomes that describe in more detail what the government wants to achieve over a ten year period. The Framework also sets out 11 purpose targets and 45 national indicators to be used in measuring progress toward overall aims. The Scotland Performs website reports progress against targets and indicators, and is updated on an ongoing basis as indicated on the website's calendar of updates.

108. Performance data is now available across all targets and indicators for the first time this year, with the remaining five national indicators now able to be reported. The Scottish Government reports whether performance against each target and indicator is improving, being maintained or worsening, alongside detailed data.

109. As at the end of October 2011 the Scottish Government was reporting improving performance against 7 purpose targets, maintained performance against 3 targets and worsening performance against 1 of the targets (matching the growth rate of small independent EU countries). In headline terms, this is an improved position from that highlighted in our 2009/10 annual audit report (3 improving, 3 maintaining, 5 declining).

110. Reported performance in relation to the 45 national indicators also indicates an improving position. As at the end of October 2011, 23 indicators showed improving performance, 16 indicators showed maintained performance and 6 showed declining performance (21 improving, 11 maintaining, 8 declining and 5 unreported in our 2009/10 report). Detailed analysis of available data is available from the Scotland performs website.

Business strategy

111. In 2010/11 the Strategic Board adopted a business strategy that sets out how the organisation intends to work to support Ministers, comply with the Civil Service Code, operate a culture of continuous improvement and respond to sustained pressure on budgets. This provides a framework for business planning within Directorates and the intention to align delivery objectives with the National Performance Framework.

112. Progress against business objectives is being managed through directorate plans. Indicators are being developed for success criteria set out in the business strategy.

Risk management

113. The Scottish Government has developed its approach to risk management significantly during the last year. The Strategic Board approved changes to the approach to risk management in October 2010: approving a revised risk management strategy and policy, and identifying the Director General Finance as the risk champion for the Scottish Government.

114. Following further work to develop the approach, the document *Our Approach to Risk Management* was prepared in March 2011. This set out the organisation's risk appetite, and provided guidance on how risks should be identified, assessed and recorded in risk registers alongside the planned response to identified risks. Roles and responsibilities for risk management have been defined together with reviewing and reporting arrangements.

115. Following an initial implementation of the revised approach in the early part of 2011/12, a review was undertaken using a workshop approach to consider how well the revised approach was operating. This identified a number of issues for improvement, including the need to refocus the Strategic Risk Register on the overarching risks. In response, improved arrangements for monitoring and review at a senior level have been established including:

- monthly re-evaluation and discussion of the strategic risk register by the Executive Team
- quarterly consideration of the strategic risk register by the Strategic Board
- an expanded role for Audit and Risk Committees to consider the strategic and portfolio risk registers at each meeting.

116. Revised arrangements represent a significant improvement in the Scottish Government's approach to risk management. New arrangements for senior level review and oversight have been implemented relatively recently, and their effectiveness should be kept under review. Work also needs to continue to ensure that underlying elements of the approach to risk management, continue to be developed and embedded to ensure that the policy aim to ensure that risk is identified and managed at all stages in the development and delivery of objectives is met.

Refer Action Plan No. 3

117. A Centre of Expertise for Risk Management has been established within the finance directorate to provide additional guidance and support to help embed good risk management across the organisation. A senior risk manager has been appointed to support this work.

Best value & efficiency

118. In March 2011 the Scottish Government issued new guidance for accountable officers on Best Value in Public Services. This requires public bodies to take a systematic approach to self-evaluation and continuous improvement. It clarifies the themes organisations need to focus on to deliver on Best Value responsibilities, and notes that implementation should be appropriate and proportionate to the priorities, operating environment, scale and nature of the business.

119. On behalf of the Auditor General and the Accounts Commission, Audit Scotland has identified a set of principles that form the basis for a consistent approach to the audit of Best Value across the public sector, although its application differs to reflect the different accountability regimes and reporting arrangements in place in different sectors. These are contained in Best Value toolkits. Working closely with Scottish Government officials, we use these toolkits to consider how well the organisation is responding to Best Value responsibilities in particular areas.

Use of resources – Information management

120. In November 2010, working closely with senior management in Information Services and Information Systems (ISIS) we completed a review of Information Management arrangements based upon our Best Value – Use of Resources toolkit. The findings were based upon a review of the controls and practices in place covering the core information systems and central processes managed by ISIS.

121. On consideration of the results, officials concluded that restricting the scope of this review to key corporate systems did not give an accurate reflection of the information management practices and controls used in other areas within the Scottish Government. An updated toolkit was therefore prepared by management and we completed our review of this in June 2011.

122. We are pleased to report that the additional information provided during this follow-up review indicates that overall the Scottish Government demonstrates "better practice" with regard to information management (i.e. sound performance in all areas, with some elements of good

and best practice). Particular examples where additional information has improved the assessment include:

- the governance structure for information management has been improved, with the recently formed Information Systems Investment Board (ISIB) having oversight of all ICT investments made by the Scottish Government
- a programme of Post Implementation and Project Evaluation Reviews has been re-introduced, to ensure that lessons learned from significant projects are fully understood and shared
- performance measures and quality reviews are in place to ensure the effectiveness of the information management processes that are core to the business of government (e.g. preparing cabinet papers, managing ministerial correspondence).

Use of resources – workforce management

123. In our Annual Audit Plan we highlighted that we intended to submit our report on the Best Value - People Management toolkit by August 2011. Whilst our audit work has progressed well during the year we were advised by the Scottish Government in June that support for this project had to be suspended. This was in order to free up resources to support the newly elected government in taking forward its priorities over the first 100 days. The Scottish Government also believe that this extended timeframe will enable us to consider the People Strategy which is currently being developed to underpin the Scottish Government's Business Strategy.

124. It is hoped that we will be able to resume this audit by the end of 2011 and report this as an early output from our 2011/12 audit. As organisational changes continue to be addressed by Scottish Government it is of increased importance that a People Strategy is developed that is fit for purpose.

Workforce reduction

125. The Scottish Government is employing voluntary exit schemes to help it achieve required reductions in staff numbers and to reshape the organisation. Exit opportunities are offered to all staff in the Scottish Government and members of the Senior Civil Service working in Non-Ministerial Departments and Agencies. A decision was taken to run an initial early exit scheme in August 2010, and in all four exit schemes were operated during the course of 2010/11. During 2010/11 a total of 1,039 departures were agreed across the organisations included in the consolidated accounts, costing £49 million. Around half (516) of these departures were agreed within core Scottish Government departments, at a cost of £26.5 million.

126. Progress in reducing staff numbers and costs is monitored closely by the Scottish Government's Strategic Board. Significant early progress has been made, but clearly it will become more challenging to continue to reduce numbers. A rolling voluntary early severance programme was introduced in August 2011, to help to achieve the target to reduce the costs of the Senior Civil Service by at least 25% by 2014/15 (with 2010/11 as the base year).

127. The terms of exit arrangements offered to staff are in accordance with the provisions of the Civil Service Compensation. After an initial sift, all applications for early release are considered for decision by the Scottish Government Voluntary Exit Panel against defined criteria. This includes consideration of the financial case and organisational implications. Clearly, there is a significant challenge in maintaining sufficient capacity, skills and experience within the organisation while reducing staffing to the extent required. Paragraphs 70 to 72 provide commentary on restructuring within the Scottish Government.

Refer Action Plan No. 7

Procurement

128. Effective public procurement is more important than ever in the current economic climate. The Scottish Government has a critical role in overseeing public procurement reform, working with its partners to provide strategic direction, monitor progress, coordinate activity and provide advice and guidance. An effective approach will help reduce the strain on the Scottish Government's budget through increasing value for money, while helping the achievement of other policy objectives such as support for the economy.

129. In July 2009 our report *Improving Public Sector Purchasing* assessed the impact of the Public Procurement Reform Programme, which was aimed at improving purchasing practice and making annual savings of around 3%. We have considered the progress that has been made since this report was published.

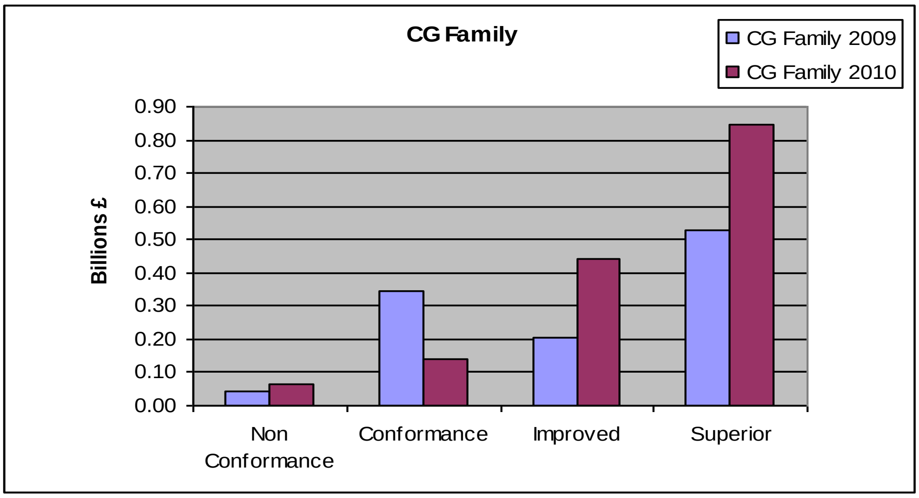
130. In November 2010, the Scottish Government report *Efficiencies from Procurement* summarised the improvements that had been made and the strategy for further improvements. It reported that public sector organisations had delivered over £800 million of savings, with £312 million of this amount saved in 2009/10. The report expressed an expectation that public bodies would continue to deliver savings in the future with savings of at least £200 million over the next three years from 2011/12.

131. Working with its partners, the Scottish Government undertakes annual procurement capability assessments (PCA) in over 150 public bodies across the public sector. The aim of the process is to identify best practice and gaps in procurement capability, helping to plan improvement across the Scottish public sector and by individual public bodies. The results of this 2010 exercise suggest that this process is having a positive impact in improving procurement performance throughout the public sector. There have been significant improvements in the procurement practices of central government bodies, with much more spend by bodies with 'improved' and 'superior' status (exhibit 3).

132. Taken together, the results from the PCA exercise and the savings reported by the Scottish Government so far indicate that Scottish Government's overall strategy has led to improvements being made within the public sector. However, our review also highlighted some areas where further improvements could be made. There are 18 public bodies which are still are still not conforming to the minimum standards set of the PCA process. Some PCA criteria, notably performance measurement and sustainability, have not improved as quickly

as other areas. Some departments within Scottish Government have not participated in the PCA process.

Exhibit 3: Summary of PCA results - central government sector



Source: Scottish Government

Asset management

133. The Scottish Government has recognised that improving the management of assets across the public sector is crucial to maximising value for money. It set out some key commitments to improving asset management in the Scottish Spending Review including:

- work with key stakeholders to develop a Scotland-wide implementation programme for asset management
- take forward an Asset Management Strategy for the central civil estate to reduce the size of the estate by at least 25 per cent by 31 March 2016 and to achieve similar reductions in operating costs
- work with NHS Scotland to reduce running costs, rationalise the estate and dispose of surplus assets
- use an updated Infrastructure Investment Plan to highlight asset management opportunities in other key sectors, including transport, justice and further and higher education
- address barriers to effective asset management.

134. The Cabinet Secretary for Finance and Sustainable Growth invited the Scottish Futures Trust (SFT) to undertake some initial work to develop proposals for improving asset management. In September 2011 the SFT published two reports on improving asset management in the central and local civil estate. The review of asset management within central government highlighted a range of recommendations including creation of a new central property unit, improved information, improved estates management and a rationalisation of office space by 25%.

135. There is much to be done to improve current arrangements if this agenda is to be successfully implemented.

Refer Action Plan No. 8

Use of consultants

136. In January 2009 our report *Central Government's use of consultancy services* looked at the planning, management and spending on consultants by the Scottish Government, non-departmental bodies and central government agencies. The report recognised some good practice in the way these organisations procured consultancy, but concluded that with better planning and management the public sector could get better value for money. The Scottish Government developed some revised guidance on the use of consultants that reflected emerging findings from the report and potentially helped to address some of the reports recommendations. As part of our 2010/11 audit we followed up the recommendations of this report within the Scottish Government, considering how effectively it was dealing with the main issues raised.

137. The Scottish Government has a clear policy on when consultants should be used, documented in the Scottish Procurement Directorate consultancy procedures. These also set out a three part test to determine whether a service is consultancy.

138. A number of controls are in place to ensure that consultants are used appropriately. These include the requirement to prepare a business case for senior officer approval prior to the purchase of consultancy services, formal sign off by the buyer on completion of the project and post project review. Internal audit reported, however, that for a significant proportion of consultancy payments tested the guidance had not been followed. In response, procurement and finance business managers have been tasked with promoting the guidance. There are also plans to require senior officers to sign off on compliance with the consultancy procedures in their 2011/12 certificates of assurance.

139. Internal audit also found that a number of consultancy payments had not been recorded as such within the Scottish Government's Finance system. This is potentially serious as the Public Services (Scotland) Act 2010 requires a statement of expenditure on external consultancy to be published as soon as is practicable after the end of the financial year. In response to this issue, the SG is updating their consultancy procedures and identifying how they can better promote the use of the guidance and correct account codes.

140. The Scottish Government has detailed guidance in place on contract and supplier management, detailed in their Procurement Journey document. Their consultancy procedures do not, however, outline the approach to be taken if variations in the consultancy contract cause costs to exceed those initially approved. The SG has agreed that additional clarification on variations to contracts will be included in the next revision of the consultancy procedures.

141. A post project review template has been designed to gather lessons learned from the consultancy purchase. This is to be used by business areas to inform their understanding of the reasons they buy consultancy and the factors that contribute to project success or failure.

We found that that lessons learned and benefits realised are not routinely shared with other business areas. It is also not clear how a SG wide view is obtained on why consultants are used and what skills are bought in most often. Since the completion of our work the Scottish Government have launched an initiative to improve the delivery of Programme and Project Management in July 2011.

142. The Scottish Government has also launched a new internal consultancy team in January 2011 to offer resources for time critical projects. This may mean there will be less reliance in future on external consultants. The team has been promoted through the SG's intranet and is likely to be highlighted in the next version of the consultancy procedures.

Performance audits and outlook

143. Performance audit reports published on behalf of the Auditor General are submitted for consideration by the Scottish Parliament's Public Audit Committee (PAC). The PAC may agree to note the report; ask the audited body to provide further information, usually in writing; or hold its own inquiry. Where a PAC inquiry takes place, the Scottish Government is expected to respond to the resulting PAC report by detailing how it intends to take action to implement any recommendations made.

144. Local auditors and audited bodies' own audit committees have a clear role to play in holding officials to account to ensure that any agreed action takes place as planned. Even when no PAC inquiry takes place, audited bodies' audit committees can support the principles of public accountability by scrutinising how officials have responded to the recommendations contained in the Auditor General/Accounts Commission report.

145. In the period April 2010 to the end of October 2011, Audit Scotland published 19 performance audit reports on behalf of the Auditor General or jointly, for the Auditor General and the Accounts Commission (Table 3). The vast majority of these reports contain findings or recommendations which are of direct relevance to the Scottish Government. All national performance audit reports are now sent to members of the relevant portfolio audit committees and are included in our audit committee progress updates following consideration at the PAC. Where there is significant interest in our national reports, staff from our Performance Audit Group also now attend the relevant audit committee to present the report and answer any questions.

Table 3: Performance Audit Reports published since April 2010

Published April - October 2010	
Using locum doctors in hospital	The role of boards
The Gathering 2009	National concessionary travel
Emergency departments	The Scottish Police Services Authority

Getting it right for children in residential care	
Published November 2010 - March 2011	
Improving energy efficiency: a follow-up	The cost of public sector pensions in Scotland
Financial overview of the NHS in Scotland	Maintaining Scotland's roads: a follow-up
Edinburgh trams: Interim report	
Published April - October 2011	
Community Health Partnerships	Overview of Scotland's justice system
Transport for health and social care	Modernising the planning system
Scotland's public finances: Addressing the challenges	A review of telehealth in Scotland

Source: Audit Scotland www.audit-scotland.gov.uk

146. There are a number of common themes running through many of these reports. The following paragraphs summarise some of the reports' main findings and recommendations under these.

The management of budget reductions

147. *Scotland's public finances: Addressing the challenges* provides an overview of the financial environment currently facing the public sector in Scotland. It outlines what the public sector is doing to reduce its costs as a consequence of the reduction in the Scottish Government's budget and emphasises the need for public bodies to focus on long-term financial sustainability. The report also sets out some of the potential issues and risks which public sector leaders and elected representatives need to take account of in planning and delivering public services in the years ahead. In particular, the report includes a self-assessment checklist designed to help public bodies consider whether they are doing enough to ensure long-term financial sustainability and what further action is required.

148. In a similar vein, the Man*agement of the Scottish Government's capital investment programme* report commented on the £1.2 billion real terms cut in the Scottish Government's capital budget between 2010/11 and 2014/15 and the difficult decisions the Scottish Government will need to make about the affordability and relative priorities of projects included in its current infrastructure investment plan. The report's recommendations included the need for the Scottish Government to:

- regularly and systematically assess the ongoing affordability of its capital investment programme
- assess the overall appropriateness of using alternative finance as part of a wider investment strategy
- review and update the Infrastructure Investment Plan to reflect the reduction in capital budgets

- establish a more active role for the Infrastructure Investment Board in providing information to ministers on priorities and the balance of associated costs, risks and rewards within the capital programme in light of reducing capital budgets.

149. The Permanent Secretary now makes bi-annual reports to the PAC updating it on progress with major capital projects. The latest report in June 2011, detailed a range of action being taken in response to the Auditor General's report including improving project cost and time estimating, making routine use of post-project evaluations and strengthening governance of the capital programme.

The need for better information to support decision making

150. A number of our recent reports have highlighted the need for public bodies to improve the information they have on costs, activity, productivity and quality of services. The importance of having robust information to control costs, drive productivity improvements and monitor performance is enhanced at a time of reducing budgets when the future shape and delivery of public services is likely to undergo significant reform.

151. The *National concessionary travel* report commented that when the scheme was being developed the Scottish Parliament considered the proposals with only limited financial information available covering only partial costs for the first two years of the scheme without any details of long-term cost implications. The report recommended that the Scottish Government should provide comprehensive financial estimates, including risk assessments, in support of all legislation that has significant financial implications.

152. The *Management of the Scottish Government's capital investment programme* offered assurance that delivery of major projects to budget and on time had improved in recent years. However, this assurance was qualified because of incomplete information in many cases. For 11 out of 55 major projects examined (20 per cent), public bodies could not provide a cost estimate at initial approval stage, either because project costs were not estimated at this time or data was unavailable. Similarly, 21 of 55 projects (38 per cent) could not provide a time estimate at initial approval stage.

153. Overall, these findings were worse than those of our 2008 report, when the performance of an earlier portfolio of projects was reviewed. The report recommended that public bodies should improve early-stage estimating of the cost and time of projects by ensuring assessments and quantifications of risk and uncertainty are carried out. It also recommended that the Scottish Government should develop comprehensive information on the whole life costs of all capital projects and assess their impact on future revenue budgets.

154. In addition, the *Transport for health and social care* report was unable to identify accurately how much was being spent on transport for health and social care. While the report identified that over £93 million was spent in 2009/10 on providing transport to health and social care services, this was a considerable underestimate as data on costs, activity and quality is poor. The report recommended that the difficulties this presents in making efficient and effective use of available resources should be addressed by the Scottish Government led short-life working group established to review the delivery of effective patient transport services.

'Whole systems' approaches to service delivery

155. Two recent performance reports commented on the need for 'whole systems' approaches to improve efficiency and service delivery.

156. *An overview of Scotland's criminal justice system* report commented that joint working among criminal justice bodies has improved in recent years and the Scottish Government is working to improve collective ownership of the system through the Justice Outcomes Group (now the Justice Working Group). But the complexity of the processes, the need for a separation of powers and the different roles and accountabilities of the bodies involved mean that the criminal justice system has not always been managed as an integrated process. In particular, while the length of time taken to process cases has improved, the report found that cases having to repeat a stage in the process was costing around £10 million per annum, often because the procurator fiscal or defence agent were not fully prepared or because evidence had not been shared. The report recommended that the Scottish Government and criminal justice bodies build on the recent progress in joint working and, as a matter of urgency, collectively identify, agree and implement actions to deliver the necessary improvements.

157. The *Transport for health and social care* report highlighted that transport services for health and social care are fragmented and there is a lack of leadership, ownership and monitoring of the services provided. The report concluded that if organisations worked better together to plan and deliver transport this would contribute to fewer cancelled appointments, less disruption to services as people arrive on time for their appointment, shorter journeys and people getting the most out of the care and support provided to them. The report included a checklist intended to allow partners to help improve planning, delivery and impact of transport for health and social care through a joined-up consistent approach.

The challenges of partnership working

158. The Cabinet Secretary for Finance, Employment and Sustainable Growth's statement on the Strategic Spending Review published in September 2011 highlighted that one of the principal themes to the Scottish Government's public sector reform agenda was to focus on improving outcomes through a greater emphasis on integration of services driven by better partnership, collaboration and effective local delivery.

159. *Scotland's public finances: Addressing the challenges* highlights some of the challenges inherent in partnership working, while the *Review of Community Health Partnerships* report provided some practical examples of the type of issues which need to be addressed if better partnership working is to be achieved.

160. The CHP report concluded that a more systematic, joined-up approach to planning and resourcing is required to ensure that health and social care resources are used efficiently. It recommended that the Scottish Government should:

- work with NHS boards and councils to undertake a fundamental review of the various partnership arrangements for health and social care in Scotland to ensure that they are efficient and effective and add value

- work with NHS boards and councils to help them measure CHP performance, including the effectiveness of joint working. This should include streamlining and improving performance information for SOA, HEAT and other performance targets to support benchmarking
- update and consolidate guidance on joint planning and resourcing for health and social care. This should cover the use of funding, staff and assets to support NHS boards and councils develop local strategies for joining up resources across the whole system.

161. *Maintaining Scotland's roads: A follow-up* report found that the condition of Scotland's trunk roads and local authority maintained roads was worsening and less money (in purchasing terms) was now being spent on road maintenance than in the past. However, while some councils can point to examples of joint or collaborative working taking place, there is no methodology in place to allow councils to measure the benefits of sharing services. The Scottish Government has now acted on the report's central recommendation that it should consider a national review on how the road network is managed and maintained with a view to stimulating service design and increasing the pace of examining the potential for shared services.

Governance and performance measurement

162. The *role of boards* report examines the role and work of boards in 67 public sector bodies and 39 colleges which are audited by the Auditor General. As well as containing a series of questions for boards and individual board members to ask themselves about how well they are working, the report included a number of recommendations for the Scottish Government and other public bodies to:

- clarify lines of accountability between public bodies, the Scottish Government and the Scottish Parliament
- review the time commitment and pay of non-executives and chairs to ensure they are realistic and consistent
- ensure that all non-executives receive formal induction training setting out their roles, the key issues facing the organisation and how it operates
- review the skills and expertise needed for the future and that the performance of all non-executives is formally and regularly assessed
- ensure that the board's scrutiny efforts are focused on organisational performance, financial management and risk management.

163. The report also found that there was a need to improve the performance information provided to boards and to ensure it was linked to financial information. A number of other reports, including *Using locum doctors in hospitals*, *The Scottish Police Services Authority*, *National concessionary travel* and *Modernising the planning system*, also commented on the need to develop better performance measures to assess delivery against policy objectives.

Reports in the public interest

164. The *Edinburgh trams: Interim report* was published in response to significant public and media concerns about the project's costs and timetable to delivery. The report was a factual commentary which did include a detailed review of the various works contracts which are in place. The report also did not express any opinion of the project's management, the cause or cost of time overruns or the performance of any of the contractors involved.

165. As well as reporting the project's progress and costs to date, the report also reviewed the project's governance arrangements. While most of the recommendations are aimed at the City of Edinburgh Council and its arms-length company Transport Initiatives Edinburgh, a key recommendation to the Scottish Government was for it to consider whether Transport Scotland should use its expertise in managing major transport projects to be more actively involved in the trams project. Ministers have agreed that experienced project managers from Transport Scotland will now fill key senior roles in a new governance structure and that the Scottish Government is to have a more direct role in the final delivery of the Edinburgh trams project.

Appendix A: audit reports

External audit reports and audit opinions issued for 2010/11

Title of report or opinion	Date of issue	Date presented to Audit Committee
Planning:		
Annual Audit Plan – Scottish Government	16 March 2011	7 March 2011
Corporate Governance:		
Key financial controls report	23 March 2011	6 June 2011
Overview of Internal Audit	23 March 2011	6 June 2011
Audit Opinions:		
Independent auditor's opinion on the NHS sub-consolidation	22 July 2011	26 Aug 2011
Independent auditor's opinion on the Scottish Government Consolidated Account	15 Sep 2011	12 Sep 2011
Independent auditor's opinion on the Scottish Government Consolidated Fund	12 December	TBA
Non Domestic Rates	25 November	TBA
Report on financial statements to those charged with governance	9 Sep 2011	12 Sep 2011
Performance:		
People Management Toolkit	Delayed to 2011/12	Delayed to 2011/12
Final Reports:		
Scottish Government	05 December 2011	12 December 2011
Scottish Consolidated Fund	30 November 2011	TBA
Non-Domestic Rates	28 November 2011	TBA
Whole of Government Accounts:		
Report and certification letter to NAO and Scottish Government	30 November 2011	TBA

Appendix B: action plan

Key Risk Areas and Planned Management Action

Action point	Recommendation	Planned management action	Responsible officer	Target date
1.	**Outturn reporting** The change in the Budget Act means that the outturn on the consolidated accounts is not sufficient on its own to determine whether the overall budget limits for the Scottish Administration have been met. There remain opportunities to further enhance outturn information reported to Parliament. ***The Scottish Government should review how it reports to Parliament on outturn***.	Finance officials are preparing a summary statement and will discuss with the Cabinet Secretary for Finance and Sustainable Growth the appropriate way of bringing this to the Parliament's attention.	DG Finance	First quarter 2012
2.	**Increased fiscal autonomy** It is critical that there is sufficient capacity within the organisation to manage the risks and opportunities for the Scottish budget arising from increased fiscal autonomy. An early task will be to manage the use of new borrowing powers within the overall budget framework. ***The Scottish Government should establish arrangements to oversee the use of new financial powers***.	A Programme Board was established in June 2011 to oversee the implementation of the financial provisions in the Scotland Bill, once enacted, including new taxation and borrowing powers. The UK Government proposes these should begin to operate from April 2015. The Board is chaired by DG Finance and includes senior officials from other relevant Directorates. A programme team has also been established to plan and carry out the necessary work, reporting regularly on progress to the Board.	DG Finance (SRO) Deputy Director, Finance – Fiscal Responsibility (Programme manager)	A series of milestones has been set between March 2012 and March 2015: Stamp Duty Land Tax and Landfill Tax from April 2015; borrowing powers from 2015 and the Scottish Rate of Income Tax from April 2016 in shadow form.

Action point	Recommendation	Planned management action	Responsible officer	Target date
3.	**Corporate Governance** There have been significant changes to the corporate governance of the organisation. Internal audit resources have been under pressure and new risk management arrangements have been recently implemented. ***The Scottish Government should keep the effectiveness of corporate governance arrangements under review***.	Corporate governance arrangements are kept under review and revisited when circumstances change.	Executive team	Ongoing
4.	**Audit & Risk Committees** There are inconsistencies between ARCs in the scope and focus of their activity, and the manner in which they conduct self-assessments. The structure of ARCs is no longer aligned to new portfolios. ***The Scottish Government should consider highlighted issues in its review of the role of non-executive directors***.	The current review of non executive directors does encompass the alignment of Audit and Risk Committees. This review is due to report to Strategic Board on 7 December, with a view to implementing from 1 January 2012.	DG Finance	From 1 Jan 2012
5.	**Statement on internal control** The timing of assurance processes constrains audit review of the SIC and introduces a risk of delay to sign-off. ***The Scottish Government should review the timetable for finalising the SIC***.	The planning for the 2011-12 accounts will build in an earlier process for the production of the draft governance statement, but the final senior management review and assurance processes necessarily take place close to the date of the SGARC meeting to approve the accounts and the statement therefore remains subject to change until the	Deputy Director, Finance - Corporate Reporting	Jan 2012

Action point	Recommendation	Planned management action	Responsible officer	Target date
		date of signing of the accounts.		
6.	**European funding** Deficiencies in control led to repayment and potential repayment of European funding. ***The Scottish Government should continue to address identified concerns about the management and control of European funding programmes***.	CAP expenditure RPID will continue to address identified concerns through a programme of business improvement work primarily concerned with SRDP capital expenditure and the Land Parcel Identification System. Furthermore, RPID will continue to implement schedules of corrective action following audits. Monitoring will be via RPID's governance structures. Lessons learned will be applied to the new programmes from 2014.	Director, Rural Payments and Inspections	Ongoing and review by 31 Dec 2012
		Structural Funds A detailed Management Control system has been developed and agreed with the European Commission. In conjunction with Internal Audit, the SG, as Certifying Authority, will carry out a process of rolling reviews of this system to ensure that it is fit for purpose and is further developed into a more proactive management system which will in turn lead to an improved quality of assurance.	Deputy Director, European Structural Funds	Ongoing and review by 31 Dec 2012

Action point	Recommendation	Planned management action	Responsible officer	Target date
7.	**Workforce capacity** There is a significant challenge in maintaining sufficient capacity, skills and experience within the organisation while reducing staffing to the required extent. A People Strategy is currently being developed. ***The Scottish Government should ensure that it has a clear strategy for ensuring sufficient workforce capacity in areas that are important to its overall priorities***.	The Scottish Government has embarked upon 2 major programmes, launched on 16 November 2011, which will help it meet the challenges ahead. The People Strategy is about having the right people, in the right place, with the right skills at the right time. It sets out the way of working we need now and in the future to achieve this and create the culture and environment that enables individuals to thrive, develop, grasp opportunities and enjoy their work. Workforce 2015 is a programme of organisational reform and development to ensure the SG continues to deliver an excellent service to Ministers, whilst living within more constrained resources in the future. This programme of work will initially focus on establishing the plan for how we will transition from now to the organisation of 2015, ensuring that our workforce remains affordable and that we take the opportunity to deepen our outcome-based approach - particularly through increasing the flexible and transparent deployment of our people to best match our priorities and offer a wider range of career	DG Learning & Justice DG Communities & Governance	First quarter 2012

Action point	Recommendation	Planned management action	Responsible officer	Target date
		development opportunities.		
8.	**Asset management** There is much to be done to improve asset management arrangements to meet the commitments set out in the Scottish Spending Review. ***The Scottish Government should establish plans to improve its asset management to deliver on key aims***.	A programme to deliver more effective use of public sector assets is underway, drawing significantly on the resources and expertise of the Scottish Futures Trust. The programme will report to the Cabinet Sub-Committee on Public Service Reform.	DG Finance	Ongoing