A REPORT BY THE AUDITOR GENERAL FOR SCOTLAND UNDER SECTION 22(3) OF THE PUBLIC FINANCE AND ACCOUNTABILITY (SCOTLAND) ACT 2000

THE 2010/11 AUDIT OF THE SCOTTISH GOVERNMENT CONSOLIDATED ACCOUNTS

1. I have audited the Scottish Government Consolidated Accounts for the year ended 31 March 2011 and have given an unqualified audit opinion on these. I have decided to issue this report to bring to Parliament's attention repayment[1] of European Union (EU) funding of £51 million (relating to programmes running between 1994 and 2006) and further likely repayments currently estimated at £51 million (relating to programmes from 2000).

2. These repayments represent a loss of European funding to Scotland. They arose because Scottish Government procedures at the time did not meet the standards required to ensure the use of funds complied fully with EU legislation.

3. I submit these accounts and my report (audit opinion) in terms of sub-section 22(4) of the Public Finance and Accountability (Scotland) Act 2000, together with this report which I have prepared under sub-section 22(3) of the Act.

4. Note 14 on pages 107 to 110 of the accounts provides details of a range of provisions created by the Scottish Government. Provisions are created where an organisation recognises the likelihood that events that have already taken place will require the organisation to make payments in the future, but that the amount or timing of these is uncertain. If payments are ultimately made these are set off against the amounts already accounted for and the level of provision falls. Where new circumstances arise, more funds are allocated and the provision increases.

5. The provisions reflected in the accounts cover various categories of expenditure. The category of "other provisions" includes provisions for the repayment of EU funding income. At the end of 2009/10 the provision for EU funding repayments was £90 million. During the 2010/11 financial year £31 million was repaid (reducing the level of provision) and other likely repayments totalling £12 million were recognised (increasing the provision). The total provision for EU funding repayments at 31 March 2011 was therefore £71 million.

European Funding Programmes

6. The EU provides funding to support policy objectives established by the European Parliament and the Council of Ministers. The Scottish Government is responsible for managing the use of this funding in Scotland in line with rules set out in European Regulations. This funding and the spending associated with it are part of the Scottish Budget and reflected within the Scottish Government Consolidated Accounts.

7. EU funding is provided through expenditure programmes covering fixed budget periods. The current programme period runs from 2007 – 2013. Previous programmes ran from 1994 – 1999 and 2000 – 2006. In Scotland, the most significant programmes are:

   - Regional assistance supported by European Structural Funds - the European Social Fund (ESF) and the European Regional Development Fund (ERDF) - to support infrastructure improvement, business research and innovation, skills improvement and the promotion of lifelong learning; and
   - Assistance under the Common Agricultural Policy (CAP) supported by the European Agricultural Guarantee Fund and the European Agricultural Fund for Rural Development to support rural communities and land managers, including farmers.

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[1] - Amounts repaid by offsetting against funding received in current year.

8. Expenditure made by the Scottish Government is reimbursed at regular intervals throughout each financial year, subject to subsequent corrections that may be made as a result of audits undertaken by the European Commission. Table 1 sets out the level of spend supported by these funds in 2010/11. Assistance for Rural Development is funded on a joint basis (approximately 50:50) between European and National funds, while structural funds are funded on a joint basis (approximately 50:50) between European funds and project sponsors. All other rural programmes are 100% funded from European funds.

Table 1 Scottish Government Expenditure on EU programmes 2010/11

	Expenditure (£m)
Regional assistance	
ESF - Helping people enter the labour market and improving the skills of the workforce.	38.8
ERDF - Supporting economic regeneration and safeguarding jobs.	75.2
Total	114.0
CAP assistance	
EAGF - Single farm payments & Scottish Beef Calf schemes.	505.2
EAFRD - Scotland Rural Development Programme.	172.4
Total	677.6

Financial management of EU Funds

9. Rules for the financial management of EU Funds are laid down by the Council of Ministers. These provide for the European Commission to be responsible for the overall management of the Funds and for designated payment and management authorities to be responsible for making payments to final beneficiaries and for satisfying themselves on the eligibility of applications for assistance. The Scottish Government is the payment and management authority for Scotland.

10. European regulations set out a range of checks to be applied to the management of programme funding. These include a number of mechanisms to ensure that Member States (and management and payment authorities) carry out their work properly. These mechanisms include consideration of the accounts of each paying agency and the conformity of individual transactions with EU rules.

11. Where the checks in place identify that the Scottish Government has not conformed with EU rules in incurring expenditure the European Commission may apply financial corrections. These recover funding directly from payment authorities, protecting the EU budget against the risk of ineligible expenditure being charged to it. Financial corrections are a strong incentive for payment authorities to improve their management and control systems and thus to prevent or detect and recover irregular payments to final beneficiaries.

12. Any financial correction that is applied in agreement with, or enforced by, the European Commission in relation to closed programmes will mean that funding will be lost to Scotland – and that any affected payments to final beneficiaries have to be met from Scottish funds rather than EU funds.

Financial corrections reflected through provisions in the accounts

Regional assistance

13. The changes to the level of provision during 2010/11 reflect the settlement and repayment of some £31 million of financial corrections related to regional assistance funding. This is in addition to some £14 million of corrections settled in earlier years and £6 million which has been settled in the early part of 2011/12. This means that, arising from the findings of European Commission audits undertaken between 2003 and 2005, a total of some £51 million of income has been repaid (Table 2). Financial corrections relating to the 2000 – 2006 programmes represent around 3.6% of the £1.07 billion of structural funding received under these programmes.

Table 2 financial corrections of EU funding from European Structural Funds

	Programme	European Commission Concerns	Correction (£ million)	Settled
1.	1994 – 1999 ERDF Highlands & Islands	Compliance with public procurement rules, weak audit trails, ineligible expenditure and rationale behind funding decisions.	9.3	2008/09
2.	2000 – 2006 ESF Highlands & Islands	Insufficient quality and quantity of verifications of expenditure.	4.78	2009/10
3.	2000 – 2006 ESF Objective 3	Quality and volume of financial checks, lack of control and problems with verification and compliance checks.	31.0	2010/11
4.	1994 – 1999 ERDF West	Errors relating to state aid, procurement procedures, recording of staff costs and other irregularities.	3.95	2011/12
5.	2000 – 2006 ESF All except south.	Ineligibility of costs incurred by intermediate bodies.	2.4	2011/12
	Total		51.43	

14. The largest financial correction relates to controls over payments from the European Social Fund for assistance under Objective 3[2] of the 2000 - 2006 European Structural Funds programme. The European Commission initially suspended payments from the fund in 2008 to allow it to investigate concerns over the eligibility of expenditure and the effectiveness of the systems and procedures operated by the Scottish Government. The Commission's investigation found what it considered to be serious failings in the management and control systems, including the quality and volume of financial checks, the lack of control over intermediate bodies, and problems with verification and compliance checks in the period prior to 2006.

15. Following an extended period of further investigation, consideration and discussion with Scottish Government officials, the Commission accepted a proposal from Scottish Ministers to make a financial correction of £31 million to reflect the value of non-compliant payments made by the Scottish Government. EU funding has been subsequently reduced by that amount. The financial correction agreed was settled during 2010/11 and is reflected in a

[2] Supporting the adaptation and modernisation of policies and systems of education, training and employment.

reduction in the changes to the level of the provision in Note 14 to the financial statements. The payment suspension was lifted on settlement.

Assistance under the CAP

16. The provisions for EU funding repayments included £51 million at the end of 2010/11 to reflect potential financial corrections from the European Agricultural Guarantee Fund (EAGF). These are likely to arise from the findings of European Commission audits undertaken between 2005 and 2009 which identified concerns about the quality of control systems and procedures operated by the Scottish Government. The largest potential correction is likely to be incurred in relation to the quality of some inspections, the accuracy of the Land Parcel Identification System and other checks on the eligibility of land receiving Area Based Aids.

17. The Scottish Government is in ongoing discussions with the European Commission to limit the amount involved and the provision represents the current best estimate of the financial correction that is likely. Nonetheless there remains some uncertainty about the ultimate resolution and the extent of any financial corrections that will be incurred.

Other European funding issues

Regional assistance payment interruption

18. In November 2010 the Scottish Government's internal audit service[3] reviewed arrangements in place to comply with responsibilities for the management of the 2007 – 2013 European Structural Funds programmes. The review concluded that there were insufficient prepayment checks on payment applications. The European Commission considered that this represented evidence of a serious deficiency and interrupted interim payments, withholding these until the Scottish Government had completed all the required checks on payment applications that it had submitted to the EU.

19. The accumulated amount due from the EU at 31 March 2011 totalled £137.6 million, and was included in the 2010/11 financial statements to reflect funding not yet received on ESF and ERDF payments made to third parties. The required prepayment checks were concluded in the first quarter of 2011/12 and following confirmation from internal audit the European Commission lifted the payment interruption, with payments all having resumed by August 2011.

De-committed CAP expenditure

20. The Scottish Government removed (de-committed) €16.7 million from its last annual European Agricultural Fund for Rural Development (EAFRD) accounts[4]. This reflected uncertainties over the eligibility of some expenditure arising from significant weaknesses in control over payments relating to the appraisal of capital grant applications. An amount of €2.8 million was de-committed in the previous year, for similar reasons.

21. The Scottish Government took this action to allow time to undertake detailed eligibility checking of the projects concerned and has since undertaken a 'cleansing' exercise to gather further evidence to ensure all claims meet eligibility criteria. When the exercise is complete the Scottish Government intends to resubmit the eligible claims to the EU, potentially receiving funding for these in due course.

22. There is some uncertainty about the extent to which EU rules will allow previously de-committed expenditure to be resubmitted. The European Commission plan to undertake an

[3] Undertaken in the role of Audit Authority of the programme under Commission Regulation (EC) 1083/2006.
[4] For year ended 15 October 2010.

audit in Scotland in October 2011 to further consider the issues involved. The European Commission has indicated that the position is unresolved and that the Scottish Government should take no action until the audit is complete. I intend to monitor the outcome of this.

Action taken

23. European Structural Funds issues have been under consideration by the European Commission stemming from EU audits undertaken between 2003 and 2005. Since this time the Scottish Government has been active in working to limit the financial consequences of control concerns through additional audit work that sought to provide the Commission with evidence to reduce the size of the corrections incurred. This resulted in significant elapsed time between the potential for financial correction being identified by the Commission, and final confirmation of the application of corrections and the amounts involved. A significant amount of work was involved in this additional evidence gathering and post-hoc checking, which limited the agreed settlement to £51.43 million. A similar approach is being applied to responding to potential EAGF disallowances, with additional evidence being gathered for consideration by the European Commission.

24. Financial corrections represent a loss of EU funding to Scotland, and related payments to final beneficiaries require to be met from Scottish funds rather than EU funds. This stemmed directly from inadequacies in certain management and control systems operated by the Scottish Government at the time. Significant effort has been invested in gathering evidence to support the Scottish Government's case for limiting the financial corrections ultimately incurred. While this approach has been effective in limiting the amounts repayable, it has meant that the resources applied have not been available for other purposes.

25. Issues and risks associated with the Scottish Government's management of EU Funds have been reported within Annual Audit Reports over a number of years. These have drawn attention to major weaknesses in controls, but have recognised progress that has been made through time in addressing these.

26. The Scottish Government has made some important changes to the control environment since the time of the original audits. The Scottish Government describes these in the Statement on Internal Control set out on pages 25 to 29 of the accounts. 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. Any continuing or additional deficiencies these identify may lead to further financial corrections in the future. I will continue to monitor progress through the annual audit.

27. 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 lessons from its experience of previous programmes and applies these in the design and operation of similar programmes in the future.

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Auditor General for Scotland
3 October 2011