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Executive Summary

Introduction

In 2007/08 we examined the key strategic and financial risks being faced by the Scottish Government. We audited the financial statements and we also reviewed aspects of performance management and governance. This report sets out our key findings.

Financial Statements

We gave an unqualified opinion on the financial statements of the Scottish Government for 2007/08. We also concluded that in all material respects, the expenditure and receipts shown in the financial statements were incurred or applied in accordance with applicable enactments and relevant guidance, including the limits authorised by the Budget (Scotland) Act 2007.

The signed accounts were laid in the Scottish Parliament and published on 30 September. This was four weeks earlier than for the 2006/07 consolidated accounts and is a significant achievement by the Scottish Government.

Financial Position

The consolidated accounts’ final outturn for the 2007/08 financial year was £27,893 million, against a net resource budget of £28,168 million, representing an underspend of £275 million (just under 1% of the Scottish Government’s overall budget). This compares to a final outturn for 2006/07 of £25,664 million and an underspend of £256 million. All Portfolios remained within their Budget Act limit.

Since devolution, the Scottish Government’s unspent balances held by HM Treasury had gradually accumulated until they reached £1.5 billion at 31 March 2007. The Scottish Government reached an agreement during 2007/08 where it can draw down these balances over the period to 31 March 2011. The agreement means that, in normal circumstances, the Scottish Government will not be able to access any underspends incurred during this period until the next spending review period. This reinforces the need for Directorates to be able to report promptly potential underspends to enable other parts of the organisation to bring forward existing spending plans or to develop new ones, in accordance with existing priorities, to utilise any unspent balances.

Governance

Corporate governance

Our 2007/08 audit included a review of the Scottish Government’s revised governance arrangements, introduced following the Taking Stock review (December 2006) and the election of a new Government (May
The review acknowledged that the Scottish Government is going through a period of considerable change and that a significant amount has been achieved. In particular, the Strategic Board has played a key role in driving forward changes in culture, leadership and behaviour. Arrangements are still evolving and there is a need to continue work underway to ensure a shared understanding of the roles of various individuals and groups in the new structure, further develop the approach to risk management, and ensure consistent application of the Business Planning Tool.

Financial management and budgetary control

Last year we highlighted our continuing concern about the role and status of the Scottish Government’s finance function and organisational barriers that impacted on its ability to act more strategically and efficiently across the organisation. Since then there have been a number of encouraging developments including the appointment of a new Director General for Finance and Corporate Services, the introduction of a new scheme of financial delegation and the reorganisation of the finance programme management division within the Finance Directorate to support Portfolio accountable officers. In addition, Audit Scotland endorses the recent decision to re-instate the Scottish Government Director of Finance to full membership of the Strategic Board. The tight financial settlement, coupled with significantly reduced scope for end year flexibility until the next spending review period and a range of pressures on public sector expenditure, increases the need for sound financial management going forward. We will review the Scottish Government’s developing financial management and budgetary control arrangements as part of the 2008/09 audit.

Internal control framework

The establishment and operation of an efficient and effective internal audit function forms a key element of effective governance and stewardship. We reviewed the Scottish Government Internal Audit Division and concluded that it continues to comply with Government Internal Audit Standards and that we are able to place reliance on their work for the purposes of our audit.

With the specific exception of the payroll system, we have concluded that the Scottish Government’s financial systems and procedures operate adequately to enable us to place reliance on them, and to limit the risks of material misstatement of the accounts, error or fraud. With respect to the Scottish Government’s payroll system, we concluded that only limited reliance could be placed on the system due to a number of weaknesses in key controls during the period. The Scottish Government’s Change and Corporate Services Director is leading the work to address our concerns.

Over the past two years we have drawn attention to significant weaknesses in the Scottish Government Rural Payments Inspections Directorate’s key controls and the preparation of accounts detailing the Scottish element of expenditure funded by the European Agriculture Guarantee Fund and the European Agricultural Fund for Rural Development. While progress is being made to address these weaknesses, it is important that this is maintained as there is a risk that the EU may not fully fund its share of the costs. This risk is increased by the fact that the Scottish Government now has to bear the costs of any disallowance.
Performance

Best Value
Achieving best value is about ensuring sound governance, good management and public reporting on performance and we comment on aspects of the Scottish Government’s arrangements in this report. Audit Scotland is committed to ensuring that best value auditing across the public sector adds value to existing arrangements, is proportionate and risk-based. We intend to adopt an audit framework that is consistent across central government, health and local government, although the application will vary to reflect different accountability arrangements. Development work will continue during 2008/09 and will include consultation with stakeholders, including the Scottish Government.

Public Performance Reporting
During the year, the Scottish Government launched its Scotland Performs website setting out progress against the targets and performance indicators established in the National Performance Framework. Scotland Performs provides significant potential for improving how the Scottish Government publicly reports its performance. It is important that robust performance data is generated and the website is kept up-to-date with the latest performance information. We will consider how the Scottish Government is addressing this developing area as part of the 2008/09 audit.

Efficient Government
In 2006/07 the Scottish Government reported cash and time-related efficiency savings of £1,001 million against plans of £867 million. The 2007/08 outturn is expected to be reported shortly. Early indications are that reported savings will exceed plans.

In March 2008, the Scottish Government published a new efficiency delivery plan. The plan calls for public sector bodies to make cash-releasing savings of 2% per annum amounting to £1.6 billion by the end of the current Spending Review period (31 March 2011). In the context of the tighter financial settlement, failure to achieve sustainable efficiencies may impact adversely on the quality of public services.

Looking forward
The final part of our report notes some key risk areas for the Scottish Government going forward. Among the key risks not previously mentioned above are the introduction of International Financial Reporting Standards, public service reform and financial pressures in the public sector, including equal pay claims in the NHS.

October 2008
Introduction

1. This report summarises the findings from our 2007/08 audit of the Scottish Government. The scope of the audit was set out in our Audit Plan, which was presented to the Scottish Government Audit Committee (SGAC) on 12 February 2008. This plan set out our views on the key business risks facing the organisation and described the work we planned to carry out on:

- financial statements;
- governance; and
- performance.

2. This report completes our audit by giving an overview of the work we carried out and a summary of our key findings. We have structured the main body of the report to cover the three topics listed above, as well as our view on emerging risk areas for 2008/09.

3. During the year we undertook a range of reviews including governance and accountability arrangements following the introduction of a new management structure within the Scottish Government, ring-fenced funding to local government, core financial systems and substantial work on the financial accounts systems. Other risk areas and planned management actions have or are being separately reported to the Scottish Government in the relevant topical reports.

4. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officials and non-executives of the Scottish Government during the course of our audit. This report will be published on our website, www.audit-scotland.gov.uk.
Financial Statements

5. In this section we summarise the key outcomes from our audit of the Scottish Government consolidated financial statements for 2007/08, and comment on the main financial management and accounting issues arising. The financial statements are an essential means by which the organisation accounts for its stewardship of the resources available and its financial performance in the use of those resources.

Our responsibilities

6. Our audit plan sets out our responsibilities in detail. In summary, we audit the financial statements and give an opinion on:

- whether they give a true and fair view of the financial position and expenditure and income for the period in question;
- whether they and the part of the Remuneration Report to be audited were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
- the consistency of the information which comprises the Introduction/Background, details of Ministers and Senior Officers and the Operating and Financial Review, included within the Annual Report, with the financial statements; and
- the regularity of expenditure and receipts.

7. We also review the statement on internal control by:

- considering the adequacy of the process put in place by the Permanent Secretary as Principal Accountable Officer to obtain assurances on systems of internal control; and
- assessing whether disclosures in the statement are consistent with our knowledge of the Scottish Government.

Overall conclusion

8. We have concluded that the financial statements give a true and fair view of the state of affairs of the Scottish Government and the consolidation of the entities within the consolidation accounting boundary as at 31 March 2008.
9. We have also concluded that:

- the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Public Finance and Accountability (Scotland) Act 2000 and directions made thereunder by the Scottish Ministers;

- information which comprises the Introduction/Background, details of Ministers and Senior Officers and the Operating and Financial Review, included within the Annual Report, is consistent with the financial statements;

- the expenditure and receipts shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers, the Budget (Scotland) Act covering the financial year and sections 4 to 7 of the Public Finance and Accountability (Scotland) Act 2000; and

- the sums paid out of the Scottish Consolidated Fund for the purpose of meeting the expenditure shown in the financial statements were applied in accordance with section 65 of the Scotland Act 1998.

10. In line with agreed plans, the draft schedules for the core Scottish Government Portfolios were submitted for audit on 13 June and the draft consolidated account was received on 4 August. The good standard of the supporting papers and the timely responses from Finance staff allowed us to conclude our audit within the agreed timetable and provide our opinion to the Scottish Government Audit Committee (SGAC) on 23 September, four weeks ahead of last year. This was a significant achievement by the Scottish Government Finance staff.

11. A small number of adjustments for financial misstatements were made to the draft consolidated accounts. The accounts were not adjusted to correct a number of other financial misstatements which, individually and cumulatively, were not sufficiently material to impact on the audit opinion. In accordance with auditing standards, the unadjusted errors have been separately reported to SGAC and the Principal Accountable Officer in our International Standards on Auditing (ISA) 260 report.

Financial position

Outturn 2007/08

12. The Budget (Scotland) Act 2007, as amended by the Spring and Autumn revisions, prescribed both the financial limits on the use of resources by the Portfolios of the Scottish Government and how these resources can be used. The final approved net resource budget for the Scottish Government was £28,168 million. The net outturn for the year ended 31 March 2008 was £27,893 million (2006/07 £25,664 million), resulting in an overall underspend of £275 million (2006/07 £256 million). The split of the underspend between resource and capital was £247 million and £28 million respectively. The net outturn by Portfolios is highlighted in Exhibit 1.
13. The Scottish Government met all eight Portfolio expenditure limits prescribed in the Budget (Scotland) Act 2007. The most significant underspends in 2007/08 were incurred by the Health and Wellbeing, the Education and Lifelong Learning (ELL) and the Finance and Sustainable Growth (FSG) Portfolios.

14. The Health and Wellbeing Portfolio’s underspend relates mainly to slippage on project expenditure at NHS Boards (£23 million) and higher than expected income from NHS National Insurance Contributions (£72 million). This latter issue, which is described in more detail in our ISA 260 report, arose from the external audit of HM Revenue and Customs (HMRC) which identified that the Scottish Government had not received its correct share of NHS National Insurance Contributions (NIC) in 2007/08. HMRC paid the Scottish Government an additional £71.6 million in July 2008 which was accrued to the 2007/08 accounts. The Scottish Government relies on the information provided by HMRC when setting its budget for NICs, but by the time it was made aware that it was due additional income, it was too late for the Scottish Government to seek Parliamentary approval to amend the budget. It is worth noting, however, that because NIC income receivable is budgeted for outside the DEL and AME budgets, the Scottish Government could not spend the additional NIC income receivable.

15. The Scottish Government should, therefore, engage with HMRC to improve communications over the estimated levels of NICs and to reduce the risk of a similar situation arising again. It should also consider alternative ways of accounting for NICs so that the impact of significant variations from budget are minimised.

**Action Point 1**
16. For the ELL Portfolio, there were a number of significant offsetting variances with underspends being incurred in the Schools programme mainly due to smaller than expected Public Private Partnership claims from local authorities (£11 million), lower than expected take-up of demand-led grant schemes and delays in capital projects funded from the Children and Young People programme (£21 million). Underspends in the Students Awards Programme arose due to loans advanced being less than budgeted (£12 million). These and other underspends in the Other Lifelong Learning programme (£25 million) were offset by a planned increase in grant of £54 million to the Scottish Further and Higher Funding Council.

17. Underspends on the FSG Portfolio were mainly due to lower than expected expenditure in the Other Transport programme and non-cash roads depreciation, partly offset by increased road structural repairs and routine and winter maintenance.

### Wider financial management

18. The mechanism for funding the devolved administrations is set out in a statement of funding policy published periodically by HM Treasury. An important feature of this mechanism is that budget allocations are made covering a three year period. This provides the devolved administrations with greater flexibility to carry forward unspent provision into future years. Normally, end-year flexibility (EYF) enables unspent provision to be carried forward from one year to the next and is intended to encourage good financial management.

19. Since devolution, the Scottish Government’s unspent balances held by HM Treasury had gradually accumulated until they reached £1.5 billion at 31 March 2007. Following meetings in autumn 2007, HM Treasury has agreed a mechanism whereby the Scottish Government can draw down these balances over the period ending 31 March 2011. The agreed drawdown is shown in Exhibit 2.

<table>
<thead>
<tr>
<th>Dearborn</th>
<th>Caldwell</th>
<th>2007/08</th>
<th>2008/09</th>
<th>2009/10</th>
<th>2010/11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>1,529</td>
<td>874</td>
<td>574</td>
<td>174</td>
<td></td>
</tr>
<tr>
<td>Drawdown for 2007/08</td>
<td>655</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resource drawdown -cash</td>
<td>150</td>
<td>130</td>
<td>120</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resource drawdown – non cash</td>
<td>34</td>
<td>33</td>
<td>33</td>
<td></td>
<td></td>
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<tr>
<td>Capital drawdown</td>
<td>116</td>
<td>237</td>
<td>21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total proposed drawdown</td>
<td>300</td>
<td>400</td>
<td>174</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing balance</td>
<td>874</td>
<td>574</td>
<td>174</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>
20. This agreement is, however, conditional on the understanding that while underspends arising during the current Spending Review period are potentially available for drawdown in the following Spending Review period, further drawdown in the period ending 31 March 2011 would only be considered in “exceptional and genuinely unforeseeable circumstances”. As a result, the 2007/08 DEL underspend of £42 million reported by the Cabinet Secretary for Finance and Sustainable Growth in June 2008 may not be available to the Scottish Government until April 2011 (as a result, this amount is not included in Exhibit 2 above).

21. The agreement with HM Treasury means that it will not normally be in the Scottish Government’s interests to underspend against its budgets. This reinforces the need for sound financial management and for Directorates to be able to promptly report potential underspends to allow other Directorates to bring forward existing spending plans or to develop new plans in accordance with existing priorities so as to utilise any unspent balances created.

Spending plans 2008/09 to 2010/11

22. The Scottish Government’s Spending Review was published in November 2007 setting out its expenditure plans for the three years 2008/09 to 2010/11. This is the tightest financial settlement for Scotland set by the UK Government since devolution and as a result, the plans include:

- a target to include 2% cash-releasing efficiencies each year over the next three years;
- access to £874 million of EYF balances held at HM Treasury across the three years; and
- an over-allocation within the spending plans of £100 million, £100 million and £24 million in 2008/09, 2009/10 and 2010/11 respectively.

23. Although the over-allocation is intended to accommodate possible slippage in projects, which has regularly occurred in previous years, it is not without risks. Under this scenario it is possible that budgets for individual projects may not be exceeded but total outturn could still exceed resource availability. Good financial monitoring will therefore be needed to ensure that outturn does not exceed the total resources available to the Scottish Government.

Issues arising from the audit

24. As required by auditing standards we reported the main issues arising from our audit of the financial statements to SGAC on 23 September 2008. The key issues reported are set out below. A separate report is made to the Scottish Government Director of Finance to provide details of more minor matters which do not need to be reported here. We also prepare summary reports for each Portfolio on specific issues relating to them.
Accounts preparation

25. Although accounts preparation procedures are generally sound, there are some issues which, while not material from the overall perspective of the accounts, nevertheless represent areas of good house-keeping which the Scottish Government should address. We have highlighted most of these issues for a number of years, including:

- delays with the completion of reconciliations between the corporate payroll system and the SEAS general ledger and in rectifying errors highlighted in payroll reconciliations;
- while the Scottish Government has made significant efforts to encourage the clearance of suspense accounts (for example the net balance held in suspense fell from £15.6 million as at 31 March 2007 to £52,000 as at 31 March 2008), there are still a number of areas, such as payroll suspense accounts, where it needs to continue efforts to investigate and clear outstanding balances; and
- the Scottish Government needs to ensure that a more consistent approach is taken by finance teams to review accrual submissions provided by directorates to ensure completeness and reasonableness.

Action Point 2

Group audit

26. The financial statements of the Scottish Government consolidate the accounts of the core Scottish Government, the Crown Office and Procurator Fiscal Service, Executive Agencies and NHS Health Boards. The consolidation process again worked smoothly with no specific matters we would wish to report here. A number of other issues arose from the audits of Executive Agencies and NHS Health Boards. Those that are considered significant or material to the Consolidated Accounts have been reported separately to SGAC and the Principal Accountable Officer in our ISA 260 report.

27. The accounts of a number of NHS bodies contain significant levels of accruals arising from the Agenda for Change programme, mainly relating to staff who have yet to be assimilated into the new arrangements. In addition, some 12,000 NHS staff are seeking compensation for claimed discrimination under the pay arrangements that preceded Agenda for Change. Resolution of these claims has been held up pending the results of a challenge to the Agenda for Change pay evaluation system on the basis that it perpetuates discrimination. Until the outcome of this challenge is determined, NHS bodies are unable to assess the likelihood that claims will be successful or what their value could be. The Scottish Government should work with NHS bodies to form a view of the potential liabilities as soon as possible.

Action Point 3
Related parties disclosure

28. As highlighted in last year’s report, the Ethical Standards in Public Life etc (Scotland) Act 2000 requires that relevant public bodies maintain a register of members’ interests. This supports the promotion of the highest standards in public life and helps to ensure that potential conflicts of interest are avoided. Although the Act does not specifically cover the Scottish Government, and in particular its non-executive members, we recommended that good practice would be to maintain a register of interests covering the management group (now the Strategic Board). The establishment of such a register would more readily allow the Scottish Government to review and disclose in the accounts material transactions with related parties, including senior managers and non-executives, in compliance with the Financial Reporting Manual (FReM).

29. The Scottish Government responded in March 2008 by establishing processes to record interests, hospitality and gifts received for all Senior Civil Servants on the new eHR system. To date, however, only six staff have input information and there is no evidence of this being reviewed in preparing the Related Party Transactions note in the accounts. Similarly, the Cabinet Secretariat's Office had not contacted non-executive directors to ask that they update their interests as part of year-end procedures.

30. The FReM also requires the disclosure of related party transactions with Ministers. Again, the Scottish Government has not undertaken a specific review for any such potential transactions and therefore none are disclosed within the financial statements. The Ministers’ register of interest, however, can be found on the Parliament’s website.

Action Point 4

Regularity assertion

31. The Public Finance and Accountability (Scotland) Act 2000 imposes a responsibility on auditors to certify that, in all material respects, the expenditure and receipts shown in the accounts were incurred or applied in accordance with applicable enactments and guidance issued by the Scottish Ministers. We have been able to address the requirements of the regularity assertion through a range of procedures, including written assurances from the Principal Accountable Officer as to his view on adherence to enactments and guidance. No significant issues were identified for disclosure.

Scottish Consolidated Fund

32. We have given an unqualified opinion on the financial statements of the Scottish Consolidated Fund for 2007/08. We have, however, qualified our regularity opinion due to a breach of cash limits set out in the Budget (Scotland) Act 2007. The Budget (Scotland) Act 2007 prescribes, for the financial year 2007/08, cash limits on payments from the Scottish Consolidated Fund to certain bodies, including the Food Standards Agency (FSA) in respect of its activities in Scotland. The payment to the FSA on 20
March 2008 resulted in a technical breach of their cash limit by £50,000. Although the FSA repaid the £50,000 in June 2008 and the sum involved is very small compared to total payments of £26,807 million made out of the Scottish Consolidated Fund in 2007/08, without Budget Act approval the excess payment made in March is deemed irregular.

33. The March payment to the FSA followed the required procedure for all payments from the Scottish Consolidated Fund, including the procedures of the Scottish Administration and authorisation by the Auditor General for Scotland. The error arose due to a failure to take proper account of the 2007/08 Spring Budget Revision, approved by the Scottish Parliament on 4 March 2008, which reduced the FSA’s cash limit. Procedures are to be reviewed to ensure that this situation does not recur.

Non Domestic Rating White Paper Account

34. We have confirmed that the Non Domestic Rating (NDR) financial statements properly present the receipts and payments of the Scottish Ministers in respect of Non-Domestic Rating for the year ended 31 March 2008 and the balance held at that date, and have been properly prepared in accordance with Schedule 12 of the Local Government Finance Act 1992 and directions made thereunder by the Scottish Ministers.

35. We have also confirmed that the receipts and payments shown in the accounts were incurred or applied in accordance with any applicable enactments and guidance issued by Scottish Ministers, sections 4 to 7 of the Public Finance and Accountability (Scotland) Act 2000. The sums paid out of the Scottish Consolidated Fund for the purpose of meeting the expenditure shown in the accounts were applied in accordance with Section 65 of the Scotland Act 1998.

Auditor General Reports on Accounts

36. The Auditor General has concluded that there are no matters arising from the 2007/08 audit of the Scottish Government’s accounts which require to be reported to Parliament under Section 22(3) of the Public Finance and Accountability (Scotland) Act 2000.

37. The Auditor General has, so far, produced one Section 22(3) report on the accounts of bodies falling within the consolidation accounting boundary during this year. The report on NHS Western Isles drew attention to the action being taken to address on-going financial pressures and recent improvements in corporate governance arrangements. The report notes, however, that senior staffing continues to be a risk due to the high turnover of chief executives in recent years.

38. Following consideration of a similar Section 22(3) report on the 2006/07 accounts of NHS Western Isles, the Scottish Parliament’s Audit Committee published its own report in May 2008. The Committee considered that significant progress had been made to address previous weaknesses in the Board’s governance arrangements. However, much remained to be done in terms of developing a
sustainable clinical strategy, re-establishing partnership working with staff, the wider NHS and the local community, and moving towards financial balance. In particular, the Committee considered the Scottish Government could have done more to ensure that NHS Western Isles’ clinical strategy was financially sustainable and that there is a need for both bodies to work together to identify recurring savings. The Committee also considered there was a need for the Scottish Government to review arrangements for the recruitment, training and support given to health board members.

39. The Scottish Government broadly accepted the Committee’s recommendations although it was firmly of the view that its role is to develop policies and frameworks and provide resources to NHS Boards in order that they can deliver high quality, safe and sustainable services to local communities. As such, it is the responsibility of NHS Western Isles to develop a coherent clinical strategy. The Committee invited the Permanent Secretary and the Director General Health and Wellbeing Portfolio to give evidence on the Government’s response and this took place on 8 October 2008.
Governance

Overview of arrangements

40. This section sets out our main findings arising from our review of the Scottish Government’s governance arrangements. This year our reviews included:

- changes in governance and accountability arrangements following the establishment of Portfolios during 2007/08;
- key systems of internal control;
- internal audit; and
- arrangements for the payment of ring-fenced grants to local authorities.

41. We also discharged our responsibilities as they relate to prevention and detection of fraud and irregularity, standards of conduct, and the organisation’s financial position.

Statement on Internal Control

42. The Principal Accountable Officer is required to provide a Statement on Internal Control which he signs as part of the Scottish Government Consolidated Accounts. He is supported in this by Directors and Directors General who provide Certificates of Assurance covering their portfolio responsibilities. The Certificates of Assurance are themselves based on an assurance framework which is detailed in the Scottish Public Finance Manual.

43. The draft Statement on Internal Control was not received by us until 17 September 2008. We consider that good practice is to provide a draft Statement of Internal Control at the same time as the draft consolidated accounts. The Scottish Government has agreed to bring forward preparation of the draft Statement of Internal Control for 2008/09.

Action Point 5

44. The Statement on Internal Control provided by the Principal Accountable Officer reflected the Certificates of Assurance provided by the Directors and Directors General, the report from the Head of Internal Audit and the main findings from external audit work. Our review concluded that the statement complies with the relevant guidance and is not inconsistent with other information we are aware of from the audit.
Governance and accountability arrangements

45. Our 2007/08 audit included a review of the Scottish Government’s revised governance and accountability arrangements, introduced following the Taking Stock review (December 2006) and the election of a new Government (May 2007). We focused on governance and accountability structures, performance-monitoring and risk management arrangements and presented our findings to the Strategic Board on 11 September.

46. The review recognised that the Scottish Government is going through a considerable change process and that a significant amount has been achieved. There have been fundamental changes in almost all aspects of the Scottish Government’s governance structure. In particular, the Strategic Board has played a key role in driving forward changes in culture, leadership and behaviour. Arrangements are, however, still evolving and there are a number of areas requiring further development including:

- defining, mapping and communicating the respective roles and responsibilities of individuals and groups, including identifying any gaps or overlaps in governance and risk management arrangements following the ending of Departmental Management Boards;

- reviewing the role of non-executives in the new structure to clarify and communicate expectations regarding their challenge and scrutiny functions;

- improving links between performance and financial/resource information – linking inputs, outputs and outcomes. Financial reporting has improved but now needs to move beyond a comparison of actual against budget;

- agreeing deadlines for the development of the new Business Planning Tool. This tool provides the Scottish Government with significant increased capacity but there is scope to make more consistent use of it across the organisation;

- introducing an overarching Scottish Government corporate plan and Scottish Government annual report to enhance the public reporting of performance; and

- reviewing and communicating the role of the Scottish Government Audit Committee, Portfolio Audit Committees and Programme Boards within overall risk management arrangements. Given the organisational changes during the period of transition, risk management arrangements may not have been applied consistently and the Scottish Government intends to regularise the application of risk management processes during 2008/09.

47. An action plan is currently with the Scottish Government for consideration and we will follow-up the actions taken as part of the 2008/09 audit.
Financial Management and Budgetary Control

48. Last year we highlighted our continuing concerns about the role and status of the finance function and organisational barriers that impacted on its ability to act more strategically and efficiently across the Scottish Government. Since then there have been encouraging developments including:

- the appointment of a new Director General for Finance and Corporate Services;
- the Scottish Government Director of Finance has been a member of the Strategic Board from September 2008;
- the establishment of a formal framework in May 2008 for the delegation of financial responsibilities from Directors General to Directors and relevant managers;
- the introduction of an enhanced chart of accounts; and
- the reorganisation of the finance programme management division within the Finance Directorate to support Portfolio accountable officers.

49. Our audit plan for 2007/08 included a commitment to follow-up on earlier work on financial management and budgetary control. We have deferred this work until 2008/09, however, to allow these recent developments to take effect.

Systems of internal control

50. We reviewed the high level controls in a number of the Scottish Government’s systems that impact on the financial statements. Key controls within systems should operate effectively and efficiently to accurately record financial transactions and prevent and detect fraud or error. This supports a robust internal control environment and the effective production of financial statements. Our audit covered central financial systems, specific portfolio systems and information and communication technology.

Central financial systems

51. We reviewed the following key systems:

- the operation of the main accounting system (SEAS);
- accounts payable systems (including the operation of EASEbuy);
- the central aspects of the accounts receivable system, and cash and banking systems (including the reconciliation of the main bank account);
- the central aspects of the operation of the Real Asset Management System fixed asset system;
the central aspects of the operation of the payroll and subsistence systems.

52. Excluding payroll, our overall conclusion is that key controls across the Scottish Government’s central systems and procedures are operating adequately.

53. With respect to the Scottish Government’s payroll system (ePayFact), we have obtained sufficient assurance for our audit opinion. We increased transaction testing as we were only able to place limited assurance on the key controls operating within the system. The same conclusion was reached in our 2006/07 audit. It is imperative that the Scottish Government implements promptly its action plan to address the identified weaknesses. We will follow this up as part of the 2008/09 audit.

**Action Point 7**

**Portfolio systems**

54. We reviewed the high level controls for a number of key Portfolio programme expenditure areas:

- Student Awards, Graduate Endowment and Individual Learning Accounts (excluding controls operated by Learndirect Scotland);
- European Structural Funds; and

**Student Awards, Graduate Endowment, Individual Learning Accounts and European Structural Funds**

55. Our conclusion is that the key controls over the Student Awards, Graduate Endowment, Individual Learning Accounts and European Structural Funds systems were working adequately. A number of relatively minor control issues were identified which, if addressed, would improve the internal control environment but they did not prevent us placing reliance on the overall control systems in place.

**Common Agricultural Policy Market Support**

56. The Scottish Government Rural Payments Inspections Directorate (SGRPID), part of the Rural Affairs and Environment Portfolio, is responsible for the preparation of accounts detailing the Scottish element of expenditure funded by the European Agricultural Guarantee Fund (EAGF) and European Agricultural Fund for Rural Development (EAFRD). EAGF expenditure is wholly funded by the EU, whereas EAFRD expenditure is partially funded by the EU with the balance coming from the Scottish Budget. Audit Scotland acts as the Certifying Body for the audit of the annual accounts which are submitted to the EU for each Fund, for which the accounting year end is 15 October. Our review of
controls over Common Agricultural Policy Market Support expenditure is carried out in order to provide assurance for both the audit of the Scottish Government’s Consolidated Accounts and the European Agricultural Funds Account audit.

57. Over the past two years we have drawn attention to significant weaknesses in SGRPID’s key controls and in the accounts preparation process. In both years these problems required the SGRPID to seek an extension to the deadlines for submission of accounts to the EU. We are pleased to report that significant progress is now being made in addressing previously identified weaknesses. While much remains to be done, the foundations for improved control and efficiency are being put in place.

58. It is particularly important that the Scottish Government continues to make progress with these actions as there is a risk that EU auditors may disallow certain scheme expenditure such that the EU may not fully fund its share of the costs. This risk is increased by the fact that the Scottish Government now has to bear the cost of disallowance (previously the cost of disallowance was borne by Westminster). We will continue to monitor and report on SGRPID’s progress in addressing these issues as part of our formal reporting arrangements to the EU.

Action Point 8

Information and Communication Technology

59. In 2007/08 we undertook a number of reviews of ICT controls at the Scottish Government, including:

- Central financial systems, in particular SEAS and payroll;
- Computer Services Review follow-up;
- Information security;
- Case Management and Administration System (Innovation Support) follow-up; and
- Electronic Human Resources Management System (eHR).

60. The results of this work were generally satisfactory with a number of areas of good practice identified. Progress had been made in respect of most areas which we examined last year although some actions were still outstanding. For example, the formal adoption of an Information Management Strategy had been temporarily suspended due to other work on data handling in the Scottish Government. Individual reports on our findings were provided to the Scottish Government and we will follow these up as part of the 2008/09 audit.
Internal Audit

61. The establishment and operation of an effective internal audit function forms a key element of effective governance and stewardship. We therefore seek to rely on the work of internal audit wherever possible and as part of our risk assessment and planning process for the 2007/08 audit we assessed whether we could place reliance on the Scottish Government Internal Audit Service (IAS). The review covered:

- the extent of IAS’s compliance with Government Internal Audit Standards (GIAS) in planning and undertaking their work; and

- a detailed evaluation of specific internal audit work to determine the extent to which we can rely on this work for the purposes of our audit.

62. We concluded that the IAS continues to comply with GIAS in adopting a risk based audit approach in planning and undertaking their work. We identified a number of areas of good practice, including the separation of the Head of Internal Audit role from other responsibilities within the Finance Directorate, as well as a few areas for improvement in the management and governance arrangements for the internal audit function. However, none of these affected our overall assessment and we were able to place reliance on the work of IAS for the purposes of our audit of the Scottish Government.

Ring-fenced grants to local authorities

63. This review took place in an environment where most ring-fenced grants are being subsumed within general Revenue Support Grant from 2008/09. The review, therefore, sought to provide an overview of the different arrangements in place in 2007/08, while considering the scope for recommendations in implementing the new concordat between the Scottish Government and local authorities.

64. We found wide variations in the Scottish Government’s governance arrangements for individual grant schemes and arrangements for the payment of ring-fenced grants. Objectives were not always linked to clear statements of expected outputs and outcomes. Many ring-fenced grants were not subject to regular evaluation of their impact and the outcomes achieved and there is a need to better link financial monitoring to the delivery of grant scheme objectives. Many of the findings from our review resonate with the Scottish Government’s proposals for Single Outcome Agreements including:

- having a sound basis for allocating resources between local authorities;

- developing clear performance measures, against which delivery of policy objectives can be measured; and

- regular reporting of local authorities’ performance on National Priorities and evaluation of impact and outcomes.
Performance Management

65. Public audit is more wide-ranging than in the private sector and covers the examination of, and reporting on, performance and value for money issues. As part of our audit we are required to plan reviews of aspects of the arrangements to manage performance, as they relate to economy, efficiency and effectiveness in the use of resources.

66. Accountable officers also have a duty to ensure the resources of their organisation are used economically, efficiently and effectively. These arrangements were extended in April 2002 to include a duty to ensure ‘best value’ in the use of resources.

Best Value developments

67. The positive impact of the best value concept in local government led Scottish Ministers to introduce a non-statutory best value duty on all public sector accountable officers (i.e. across health and central government) in 2002. This was reinforced by refreshed Ministerial guidance in 2006, highlighting the importance that the Scottish Government places on best value as a means of supporting public service reform. That position was again re-iterated in the Scottish Government’s recent response to the Crerar scrutiny review which credited the best value regime as a key driver of modernisation and improvement in public services.

68. Audit Scotland is committed to extending the best value audit regime across the whole public sector and significant development work is taking place. Our guiding principles are to ensure that best value auditing adds value to existing arrangements, is proportionate and risk-based. We intend to adopt an audit framework that is consistent across central government, health and local government, although the application will vary to reflect different accountability arrangements. Development work will continue during 2008/09 and will include consultation with stakeholders, including the Scottish Government.

69. In essence, achieving best value is about ensuring sound governance, good management and public reporting on performance and we comment on aspects of the Scottish Government’s arrangements throughout this report.

Public performance reporting

70. The Scottish Government is continuing to develop its approach to performance management based on a National Performance Framework and outcome agreements. In support of this the Scottish Government has developed a new electronic tool and website Scotland Performs to communicate to the public on Scotland’s progress. This will include progress on overall delivery of the Administration’s
purpose for government, the five strategic objectives for Scotland and other aspects of the outcomes based National Performance Framework.

71. At this early stage of development, data is not always available to determine whether the Scottish Government is on track to achieve the targets set out in the National Performance Framework. Rather, Scotland Performs contains information on ‘direction of travel’ which will be updated as better performance information becomes available.

72. Currently, the Scottish Government is reporting improving performance in respect of five out of 11 purpose targets while performance is being maintained in the remaining six. In particular, the Scottish Government is reporting improved performance in respect of raising GDP and reducing emissions. Of the 32 national indicators (out of 45) where a performance assessment is provided, performance is improving in 18, being maintained in five, and declining in nine. Audit Scotland will review how Scotland Performs develops in the future as a means of providing information on the performance of Scottish Government.

**Efficiency**

73. The Scottish Government reported achieving its efficiency targets for 2006/07. While time-releasing efficiency savings fell short (£249 million reported as achieved against plans of £258 million) this was more than made up by cash-releasing efficiency savings (£752 million reported as achieved against plans of £609 million). The NHS, Local Government and improved procurement continue to be significant contributors to the overall level of efficiencies reported. The Health and Wellbeing Portfolio reported cash-releasing efficiencies of £291 million and time-releasing efficiencies of £67 million. Assumed local government efficiency savings and procurement savings were reported as being £278 million cash-releasing and £36 million time-releasing. The Scottish Government expects to publish shortly outturn against 2007/08 plans. Early indications are that reported savings will substantially exceed plans.

74. In March 2008, the Scottish Government published a new efficiency delivery plan covering the period 2008-2011. The plan calls for public sector bodies to make cash-releasing savings of 2% per annum amounting to £1.6 billion in 2010/11. The 2% target may only be met through cash-releasing gains, but any efficiencies in excess of the 2% may include time-releasing gains and a savings project may contain elements of both types of gain. In a change from the previous three-year efficiency programme, non-recurring efficiencies may now be counted towards the target. Audit Scotland has not audited the efficiency savings reported as being achieved in 2006/07 and is currently considering its audit approach to this area following its previous report in December 2006.
National studies

75. The Public Reporting Group within Audit Scotland carried out a number of studies during the year. Details of those published recently are included at Appendix B.

76. One of the studies published during 2007/08 was a performance overview of sport in Scotland which included preparations for the 2014 Commonwealth Games. The Auditor General and the Accounts Commission are also considering whether a future study should address the Scottish Government’s and the City of Glasgow Council’s preparations for the Commonwealth Games. In anticipation that this study will go ahead, we will keep under review the Scottish Government’s Commonwealth Games governance and monitoring arrangements as part of the 2008/09 audit.
Looking Forward

The Scottish Government faces a number of challenges in 2008/09, which include:

- **Revised governance arrangements within the Scottish Government** – as reported in our review of governance and accountability, the Scottish Government has made significant progress in introducing revised governance arrangements following its structural changes. The challenge will be to maintain progress and embed the new arrangements into the culture of the organisation. In particular, progress needs to be made to ensure a shared understanding of the roles of various individuals and groups in the new set-up, develop the approach to risk management and ensure consistent application of the Business Planning Tool.

- **Financial pressures in the public sector** – The Spending Review 2007 resulted in the tightest financial settlement for Scotland set by the UK Government since devolution. Spending plans therefore include targets to achieve cash-releasing efficiency savings, agreed access to accumulated balances held at HM Treasury at the expense of reduced end-of-year flexibility and an over-allocation of spending plans against available resources. This means that there is likely to be increased pressure on budgets for 2008/09 and the immediate future. A number of specific financial pressures also exist such as public sector pay claims and the continuation of demand-led policies such as concessionary fares where demand may outstrip estimated take-up and the funding provided. Other financial pressures may also arise, such as the potential impact of equal pay claims in the NHS.

- **Financial management and reporting** – The financial pressures which are likely to be faced increase the importance of the Scottish Government continuing to develop its financial management and reporting skills and capabilities. The challenge for the Scottish Government remains to prioritise spending, identify efficiencies and review future commitments to ensure delivery of key targets and objectives. There is a need to better link financial reporting with the outputs and outcomes expected from expenditure.

- **Scottish Futures Trust** – The Trust was launched in September 2008 as a means to secure external finance for public sector infrastructure investment. Details of the Trust's governance and audit arrangements have still to be fully worked through.

- **Scotland Performs** – Scotland Performs is an exciting development which provides a significant opportunity to improve the way the Scottish Government publicly reports its performance. It is important that the Scottish Government develops robust mechanisms for generating performance data and that the website is kept up-to-date with the latest performance information. We will consider how the Scottish Government is addressing this developing area as part of the 2008/09 audit.
- **Best Value** – The Scottish Government needs to ensure that it has the mechanisms in place to enable it to demonstrate continuous improvement and that the principles of best value are embedded. Over the next year, Audit Scotland will be looking to further roll-out its approach to the audit of public bodies’ arrangements to secure best value.

- **Public service reform** – The Scottish Government has already began to implement its plans to de-clutter the public sector delivery landscape with the wind-up of a number of Executive Agencies and the bringing of their functions back into the core Scottish Government. It is important that clear plans are developed for the management of this process to ensure the minimum of disruption to the delivery of objectives and public services.

- **Data handling** – The Scottish Government carried out a review of data handling arrangements in Scotland, in response to failures in UK government bodies’ procedures and practices during 2007. The review considered current policies and procedures on data protection, consistency with government standards and local arrangements for implementation of procedures. An interim report published in April 2008 made some initial recommendations and a final report was published in June 2008. We will monitor the Scottish Government’s response to the review and action taken as part of our 2008/09 audit.

- **Strategic Waste Fund** – Applications to the Strategic Waste Fund to develop alternatives to landfill continue to lag behind the availability of funding. Failure to achieve EU targets for reducing the amount of waste sent to landfill in Scotland to less than 0.88 million tons per annum by July 2013 could result in the EU levying significant financial penalties on the Scottish Government (potentially 500,000 Euros per day if the target is not met).

- **Common Agricultural Policy Market Support** – The Scottish Government needs to continue with efforts to improve controls and accounts preparation procedures associated with expenditure funded by EAGF and EAFRD so as to reduce the risk of scheme disallowance.

- **International Financial Reporting Standards (IFRS)** – As part of the UK Budget 2007 the Chancellor announced that the timetable for IFRS implementation was to be extended by a year with central government accounts in Scotland to become IFRS compliant with effect from the 2009/10 financial year. The agreed timetable is for the Scottish Government and other Scottish central government bodies to produce by 28 November 2008 a shadow IFRS-based restated balance sheet as at 1 April 2008 for audit by 28 February 2009. Shadow IFRS-based accounts for the financial year in 2008/09 are to be produced by 30 November 2009 for audit by 28 February 2010. This process may require significant resource to complete. It will be important that implementation of the Scottish Government’s plan to manage the transition is monitored closely and that it maintains close liaison with Audit Scotland during this process.
# Appendix A: Action Plan

## Accounting and budgeting for National Insurance Contributions

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<thead>
<tr>
<th>Action Point</th>
<th>Issue</th>
<th>Response and agreed action</th>
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<tbody>
<tr>
<td>1</td>
<td>The Scottish Government should engage with HMRC to improve communications over the estimated levels of National Insurance Contributions (NICs) and to reduce the risk of a similar situation arising again. It should also consider alternative ways for accounting for NICs so that the impact of significant variations from budget are minimised.</td>
<td>Health Finance colleagues to liaise with HMRC to discuss procedures and with Financial Reporting Unit to consider alternative ways for accounting for NICs and discuss with Audit Scotland.</td>
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## Accounts preparation

<table>
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<th>Action Point</th>
<th>Issue</th>
<th>Response and agreed action</th>
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| 2 | The Scottish Government should address a number of areas of good house-keeping which support the production of the accounts. These include:  
- prompt completion of monthly and year-end reconciliations  
- investigation and clearance of outstanding suspense account balances  
- the accuracy of accruals information submitted by directorates and their review by finance teams. | The Finance Directorate will review processes and procedures in this area. |
<p>| 3 | The Scottish Government should work with NHS bodies to form a view of the potential liabilities associated with equal pay as soon as possible. | Health Finance colleagues will continue to work with NHS bodies in this area. |
| 4 | While the systems are in place to support the generation of related party information for inclusion in the accounts, the Scottish Government needs to reinforce compliance with established procedures. | HR colleagues have refreshed guidance and reminded SCS colleagues of the reporting requirements. |
| 5 | Processes and procedures for the production of the Statement of Internal Control and supporting certificates of assurance should be reviewed so as to ensure the SIC is made available for audit at the same time as the draft consolidated accounts. | There is an assurance framework in place which is defined by the requirements set out in the Scottish Public Finance Manual. Finance Directorate will review the guidance and process for 2008/09 including communication of requirements and key deadlines. Senior Management will be reminded of the importance of robust and timely completion. However, it should be noted that due to the timing of Portfolio Audit Committees, a draft SIC will be produced to accompany the draft consolidated accounts which will be subsequently revised if necessary to reflect any further post-balance sheet changes. |</p>
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<tr>
<th>Action Point</th>
<th>Issue</th>
<th>Response and agreed action</th>
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<tr>
<td>Governance</td>
<td>The Scottish Government should respond to the draft action plan prepared following our review of its revised arrangements and continue to develop its governance arrangements accordingly.</td>
<td>Agreed</td>
</tr>
<tr>
<td>Central financial systems controls</td>
<td>The Scottish Government should implement promptly its action plan to address identified weaknesses in the key controls over ePayFact.</td>
<td>The Scottish Government is committed to implementing these action plan points led by the Director of Change and Corporate Services.</td>
</tr>
<tr>
<td>Common Agricultural Policy Market Support</td>
<td>The Scottish Government should continue to make progress with actions to improve the key controls and accounts preparation process associated with EAGF and EAFRD expenditure. Regular progress reports should be submitted to the Rural Affairs and Environment Portfolio Audit Committee.</td>
<td>The Scottish Government Rural Payments and Inspections Directorate will continue to progress actions to improve the key controls and accounts preparation process associated with the EAGF and EAFRD expenditure.</td>
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Appendix B: Auditor General for Scotland published reports

Accounts Commission and Auditor General for Scotland

A review of free personal and nursing care (published 01/02/2008)

78. Free personal and nursing care (FPNC) needs to be better planned, managed and funded for it to continue to benefit older people in the future. Demand for FPNC will grow with the projected increase in the older population in Scotland.

Improving the schools estate (published 20/03/2008)

79. Since 2000, over £5 billion has been committed by the Scottish Government and councils to improving Scotland’s school estate. About a third of schools are reported to be still in poor condition. The Scottish Government and councils now need to draw up detailed plans to make sure that all the remaining schools are fit for 21st century education.

The National Fraud initiative in Scotland 2006/07 (published 15/05/08)

80. Almost £10 million worth of fraud and errors have been identified following a national detection exercise by Audit Scotland working together with other public bodies.

Auditor General for Scotland

Overseas staff in the NHS – pre-employment checks (published 29/11/2007)

81. This report looks at whether NHS boards are following their own procedures on pre-employment screening of staff recruited from outside the European Economic Area. It found that boards have a very high level of compliance with their stated procedures with over 90% of personnel files containing evidence of pre-employment checks.

Overview of Scotland’s health and NHS performance 2006/07 (published 14/12/2007)

82. The performance of the NHS is improving against key targets although further work is needed for delayed discharges and reducing older people’s readmissions to hospital. Boards are also managing their finances better but face continuing cost pressures in the future, such as service redesign, pay modernisation and rising drug costs. The service needs to improve performance reporting so the impact of public spending is clear.
A performance overview of sport in Scotland (published 29/04/2008)

83. Fewer people are regularly taking part in sport and many facilities need improvement. However, good progress has been made in improving elite athlete performance, with 283 Scots winning medals in international competitions by 2007, against a target of 250. Hosting the 2014 Commonwealth Games provides a good opportunity to promote sport in Scotland.

Managing increased prisoner numbers in Scotland (published 08/05/2008)

84. Almost £300 million has been spent over the past six years on improving conditions in Scotland’s prisons but the number of places has stayed the same. Because the number of places has remained largely unchanged in recent years 11 of Scotland’s 14 prisons are overcrowded and more than one-fifth of prisoners are sharing cells designed for one person.

Review of major capital projects – How Government Works (published 24/06/2008)

85. This was the first systematic review of major public sector capital projects in Scotland. The report says that those involved in decision making must be able to properly scrutinise and challenge proposals for major projects. This means clearer and more accurate information about costs, value for money and timescales.

Review of the new General Medical Services contract (published 03/07/2008)

86. The new contract for GP practices should have been better planned and will take time to improve care for patients. However, there is evidence of improvement in the care of some patients. In the first three years of the new contract, general medical services cost £160 million more than was allocated to NHS boards to pay for these services.

A review of palliative care services in Scotland (published 21/08/2008)

87. This report looked at the provision of care for people with terminal illnesses provided both by ‘generalists’ such as GPs, hospital doctors, district nurses, care workers, and friends and families, and by ‘specialists’ such as hospice staff and specialist palliative care teams. The report says most people are cared for by generalist staff. Currently, specialist care mainly focuses on people with cancer and its availability also varies significantly across Scotland.

Day surgery in Scotland – reviewing progress (published 04/09/2008)

88. The NHS in Scotland has made steady progress in carrying out more surgical procedures as day surgery since targets were first introduced in the 1990s. There is wide variation in performance among health boards but, overall, the NHS is meeting the national targets in more than half of the 19 more common day surgery procedures covered in the review. But more operations could still be carried out in this way, potentially freeing up about £8 million a year.