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Dear Kenneth,

ANNUAL UPDATE ON CONTINGENT LIABILITIES

Thank you for your letter of 20 March in response to the annual update on Contingent Liabilities issued to the Committee on 8 February 2024. I am pleased that the Annual Update provides a valuable overview of the status of ongoing Contingent Liabilities and I welcome the opportunity to provide further clarity on the active management of Contingent Liabilities, including the cumulative risks involved.

The Scottish Public Finance Manual (SPFM) is clear that the risk of a transaction is to be considered in light of the overall risk profile of the Scottish Government's existing investments and that the risk exposure should be monitored both at the time of a transaction and throughout Scottish Government involvement. These processes are embedded within the annual budget monitoring and accounts cycles, and are rooted in the ongoing continual assessment of individual contingent liabilities including:

- A comprehensive log of the contingent liabilities reported in the annual accounts is maintained and the basis of their assessment reviewed. Each quarter, business areas are commissioned to reassess their position with regard to these recorded liabilities which supports a further central analysis of any emerging issues. The structure of the log and detail captured therein is regularly reviewed with a view to identify improvements to strengthen and consolidate our strategic overview of the aggregate exposure to the Scottish Government.
- The monthly financial management and budgeting process is designed to capture any new (or changes to existing) information including assessments on the likelihood of a contingent liability crystallising. Regular communication as part of monthly monitoring is held between central finance and business areas to discuss any issues.

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- Business areas will also engage with central finance to report any significant change or crystallisation that occurs out with the standard monthly process, with finance ensuring this is captured and reported appropriately. Business areas are responsible for the ongoing monitoring of existing contingent liabilities within their area and own the direct relationships with relevant counterparties to ensure appropriate updates are received on a timely basis.
- Facilitation of both Continued Professional Development training events and internal training sessions with central finance and policy areas. This has focussed on ensuring that individuals understand how to identify, measure and monitor contingent liabilities, while also ensuring a clear understanding of how they should be disclosed in the Annual Report and Accounts in line with the Government Financial Reporting Manual, which applies International Financial Reporting Standards to the Central Government context.
- Across all of these processes, central finance acts as an independent challenge and support function on accounting assessments made. The assurance processes ensure that developments are factored into budgets for the financial year and into considerations of the final outturn position.

We recognise that the aggregate exposure in relation to our contingent liabilities is significant. When assessed individually, we are able to consider both the potential exposure and any mitigations that exist to limit this exposure, such as comprehensive security packages. On an individual basis, very few present a significant exposure net of any associated mitigations and as such are appropriately managed at a local level and independently challenged centrally through the processes detailed above.

We also recognise that the aggregate exposure is growing (for example new decommissioning programmes in respect of offshore renewable energy installations agreed every year) and that it is important that our approach to managing these risks evolves as our exposure increases. We have been considering improvements to our current processes to ensure that Accountable Officers have more assurance on aggregate exposure, including potential impact on current and future year budgets, and to ensure we have a formal and documented process for review, approval and reporting of contingent liabilities in addition to arrangements already in place, which are detailed above.

We aim to strengthen reporting structures in place, which will provide Accountable Officers with additional assurance on:

- Aggregate exposure from contingent liabilities and the potential impact on the wider balance sheet risk and future year budgets.
- The scrutiny and review of individual contingent liabilities, including risk exposure and actions to mitigate risk.
- The formal audit trail underpinning the approval of Contingent Liabilities and our approach to meeting the commitments of the written agreement with the finance and public administration committee.

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The steps we take to strengthen our assurance on contingent liabilities will of course be of interest to the Committee and we hope to be able to provide an update on the progress we have made further into the 2024-25 financial year.

I hope that the Committee finds this update helpful.

Yours sincerely,

Deputy First Minister

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