Public Audit Committee

2nd Meeting, 2023 (Session 6), Thursday, 19 January 2023

The 2021/22 audit of the Scottish Government Consolidated Accounts

Introduction

1. At its meeting today, the Public Audit Committee will take evidence from the Auditor General for Scotland (AGS) on his report on The 2021/22 audit of the Scottish Government Consolidated Accounts, which was published on 1 December 2022.

2. The AGS has prepared a note on the key messages from the report which, along with a copy of the report, can be found in the Annexe.

3. The Committee will decide any further action it wishes to take after it has taken evidence from the AGS.

Clerks to the Committee,
16 January 2023

Annexe

BRIEFING PAPER BY THE AUDITOR GENERAL FOR SCOTLAND

1. The Auditor General's report on the 2021/22 audit of the Scottish Government Consolidated Accounts was laid in the Parliament on 1 December 2022. The report is made under section 22 of the Public Finance and Accountability (Scotland) Act 2000. The Consolidated Accounts are a key component of the Scottish Government's accountability to the Scottish Parliament and the public. The report is presented to support the Parliament's scrutiny of public finances in Scotland. The audit opinion on the 2021/22 accounts is unqualified.

2. The 2021/22 financial year is the second in which significant amounts of funding to support the Covid-19 pandemic response are reflected in the Scottish Government's financial performance. The Scottish Government's Consolidated

Accounts for 2021/22 show that total net expenditure during 2021/22 was £49,237 million. This was £884 million (2 per cent) less than in 2020/21 reflecting the reducing additional amounts of public spending committed to responding to the Covid-19 pandemic. Overall, total spending was £1.988 million (3.9 per cent) less than budget.

3. The largest variances relate to underspends in the Education and Skills portfolio (£806 million), the Finance and Economy portfolio (£536 million), and the Net Zero, Energy and Transport portfolio (£475 million). The Scottish Government has reported the main reasons for the underspends in the Consolidated Accounts.

4. The Scottish Government is facing an intensely challenging period in managing its finances. The constraints on public finances caused by the current economic pressures, combined with stretching policy commitments, mean its ability to achieve financial sustainability in the years ahead is at risk. The Scottish Government's 2022 resource spending review and medium-term financial strategy highlight many of the fiscal and economic challenges facing the public sector in Scotland. The Scottish Government will need to ensure its policy choices and spending commitments are fully costed and transparently reported in forthcoming budgets.

5. The volume of challenges being faced by the Scottish Government meant there continued to be considerable strain placed on staffing capacity and wellbeing. This is likely to intensify in the years ahead given the Scottish Government's intention to limit the size of the public sector workforce to pre-Covid levels by 2026/27 and hold the total public sector pay bill at 2022/23 levels. A comprehensive workforce strategy is required to ensure that its approach to staffing levels is appropriately planned and coordinated across the organisation.

6. In recent years, the Scottish Government has taken a direct role in providing financial support to private companies. A framework has been developed by the Scottish Government which outlines its principles and approach for decisions about future investment in private companies. There is scope to further strengthen this framework so that it better outlines intentions over risk tolerance, risk appetite and the expected public benefit of future interventions. This framework should help the Scottish Government provide assurance to Parliament over its strategic objectives in entering any future agreements and the decision-making process involved.

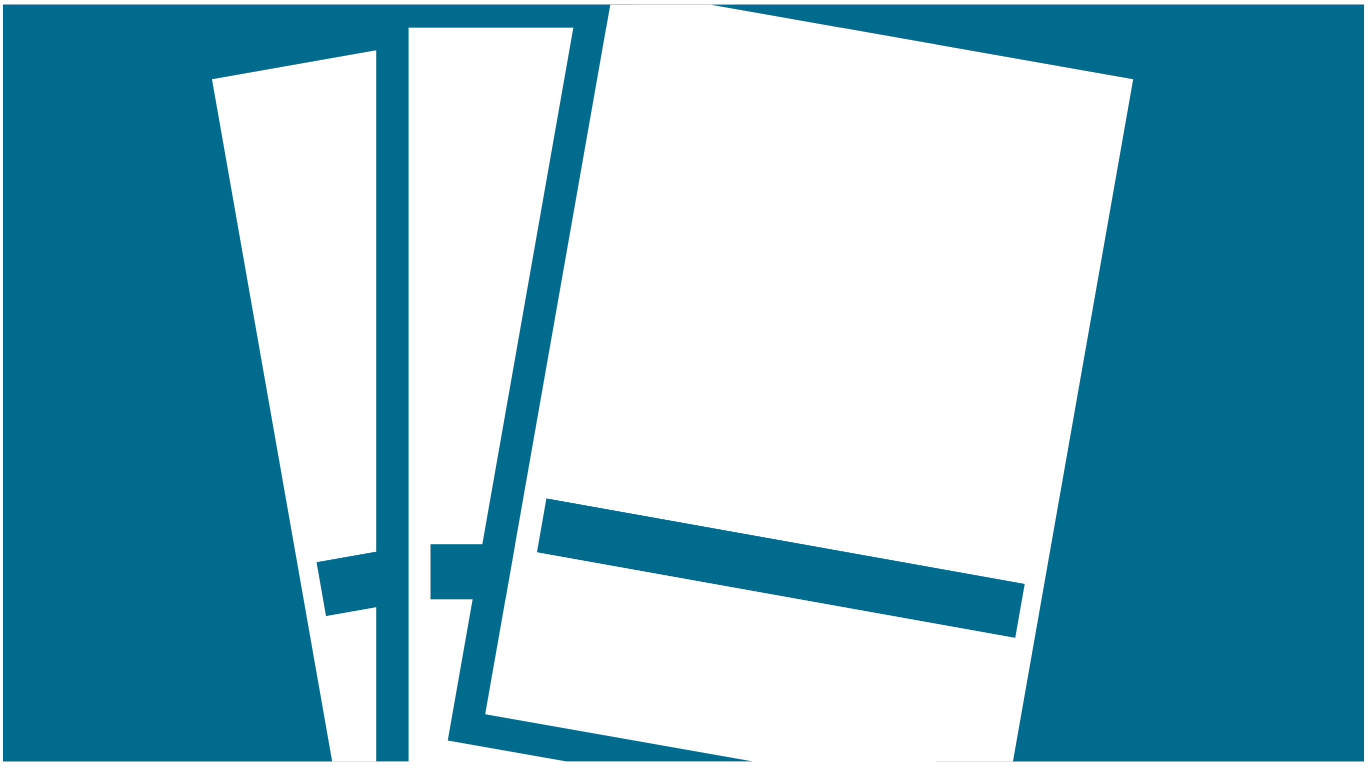
7. The quality and transparency of the Scottish Government's financial and performance reporting needs to be improved. It is difficult to assess the overall health of Scotland's public finances without a devolved public sector consolidated account. Similarly, it is difficult to assess whether the Scottish Government is delivering its intended aims in support of national outcomes without defined, measurable performance targets. Robust and transparent financial and performance is vital in supporting the long-term decision-making required for essential public sector reform.

8. The Annual Audit Report was submitted to the Scottish Government in November and will be finalised shortly once management responses to our

action plan are received. The report will be made available to the Committee at this point.

Annexe

The 2021/22 audit of the Scottish Government Consolidated Accounts



AUDITOR GENERAL

Prepared for the Public Audit Committee by the Auditor General for Scotland
Made under section 22 of the Public Finance and Accountability (Scotland) Act 2000
December 2022

Contents

Introduction

1. I provide this report on the 2021/22 audit of the Scottish Government Consolidated Accounts under section 22(3) of the Public Finance and Accountability (Scotland) Act 2000. My report is intended to support the Scottish Parliament in its important scrutiny role of the Government's finances. The report contains key information from the 2021/22 Consolidated Accounts and explains what they show about the Scottish Government's management of its budget. It also provides information on governance and financial and performance reporting.

2. Responding to the threat posed by the Covid-19 pandemic continued to be the primary focus of the Scottish Government throughout the 2021/22 financial year. Plans to support and protect public health alongside the development of economic recovery activity dominated decision-making including committing significant additional amounts of public spending during the year to support its ongoing response.

3. In addition to the challenges around Covid-19, the cost-of-living crisis emerged during the year as a result of higher food and global energy prices. The impact of Russia's invasion of Ukraine in February 2022 increased prices further and will continue to add pressure on the spending power of the Scottish Government's budget in the years ahead.

4. The economic and fiscal challenges facing the Scottish Government cannot be underestimated. Policy ambitions such as meeting climate change targets, reducing child poverty, delivering social security benefits, the resettlement of Ukrainian families, sustaining the NHS and establishing a National Care Service all have significant cost implications that are exacerbated in the current economic climate. Good use of public money together with sound governance and financial planning remain essential to ensuring that maximum value can be delivered within a financial sustainability environment.

5. In January 2021, the Scottish Government published its draft 2021/22 Scottish Budget which set out its spending priorities and plans for the year. This was subsequently revised through two separate budget revisions during the year which reflected additional monies available to support the Covid-19 response, taking the Scottish Government's total budget for the year to £51.2 billion. The Scottish Government's Consolidated Accounts for 2021/22 provide information on how this budget was managed and where money was spent and are a key component of the Scottish Government's accountability to the Scottish Parliament and the public.

6. The accounting boundary for the Consolidated Accounts reflects the areas for which the Scottish Government has direct responsibility and accountability, including the core portfolios, supporting administration, the executive agencies and NHS bodies. It does not include bodies where the Scottish Government holds significant shareholdings such as Ferguson Marine (Port Glasgow) Holdings Limited, Caledonian Maritime Assets Limited (CMAL), Scottish Futures Trust, Prestwick Airport or the Scottish National Investment Bank. These are reflected as investments within the Consolidated Accounts. Other public bodies such as local authorities are also outwith the Scottish Government accounting boundary.

7. The Consolidated Accounts:

- cover around 90 per cent of the budget approved by the Scottish Parliament
- report the amounts the Scottish Government spent against each main budget heading, and the reasons for any significant differences
- show the amounts distributed to other public bodies including local government
- report the assets, liabilities and other financial commitments of the core Scottish Government, and bodies within the consolidated boundary, carried forward to future years
- contain a performance report, in which the government gives an account of its performance during the year.

Key messages

- The 2021/22 financial year is the second in which significant amounts of funding to support the Covid-19 pandemic response are reflected in the Scottish Government's financial performance. The 2021/22 Consolidated Accounts show that the Scottish Government's total net expenditure for the year was £49.2 billion including £5.8 billion of Covid-19 related funding. These funds were used to support the NHS, businesses, local government and the wider economic response to the disruption caused by Covid-19 during the year.
- Overall, total spending was £1,988 million less than budget. The resource budget was underspent by £1,822 million (3.7 per cent) against a budget of £49,023 million and capital was underspent by £166 million (7.5 per cent) against a budget of £2,202 million.
- My independent audit opinion is unqualified. This means in my opinion, I am content the Scottish Government Consolidated Accounts show a true and fair view, following accounting standards, and that the income and expenditure for the year is lawful.
- The Scottish Government is facing an intensely challenging period in managing its finances. It has strengthened its focus on longer-term financial planning but the constraints on public finances caused by significant economic pressures, combined with stretching policy commitments, mean its ability to achieve financial sustainability in the years ahead is at risk.
- The Scottish Government's 2022 resource spending review and medium-term financial strategy highlight many of the fiscal and economic challenges facing the public sector in Scotland. The Scottish Government will need to ensure its policy choices and spending commitments are fully costed and transparently reported in forthcoming budgets. This will support effective scrutiny of spending plans and intended outcomes and will increase the likelihood of a sustainable financial position being achieved, particularly when tough choices are required.
- The volume of challenges faced by the Scottish Government throughout the year meant there continued to be considerable strain placed on staffing capacity and wellbeing. This is likely to

intensify in the years ahead given the Scottish Government's intention to limit the size of the public sector workforce to pre-Covid levels by 2026/27 and hold the total public sector pay bill at 2022/23 levels. A comprehensive workforce strategy is required to ensure that its approach to staffing levels is appropriately planned and coordinated across the organisation.

- In recent years, the Scottish Government has taken a direct role in providing financial support to businesses such as Burntisland Fabrications Limited, Ferguson Marine Engineering Limited, Prestwick Airport and the Lochaber Aluminium Smelter (Liberty Group). Financial support for these four companies has not delivered expected outcomes and is unlikely to achieve value for money. A framework has been developed by the Scottish Government which outlines its principles and approach for decisions about future investment in private companies. There is scope to strengthen this framework so that it better outlines intentions over risk tolerance, risk appetite and the expected public benefit of future interventions.

- The Scottish Government needs to do more to improve the quality and transparency of its financial and performance reporting. The continuing absence of a devolved public sector consolidated account means it is difficult to assess the overall health of Scotland's public finances at a time of greatest need. Similarly, the absence of defined, measurable performance targets means it is difficult to assess whether the Scottish Government is delivering its intended aims in support of national outcomes. Robust and transparent financial and performance reporting provides information about the impact of past decisions on future budgets, performance and intended outcomes. This is vital in supporting the long-term decision-making required for essential public sector reform.

- The Scottish Government has continued to strengthen aspects of its governance arrangements during 2021/22. There remained a strong focus on the impact of the Covid-19 pandemic on the organisation as well as an increased focus on performance and delivery towards the end of the year. Risk management processes continued to improve but more work is required to ensure planned actions are robust and realistic in addressing risks.

- The Scottish Government has committed to improving its sponsoring arrangements of public bodies, but I remained concerned as to whether the timescales will be met and whether actions planned will fully address each recommendation.

Financial management

Scottish Government budget performance 2021/22

8. The Consolidated Accounts show that total net expenditure during 2021/22 was £49,237 million, £1,988 million less than budget (Exhibit 1). The resource budget was underspent by £1,822 million (3.7 per cent) against a budget of £49,023 million and capital underspent by £166 million (7.5 per cent) against a budget of £2,202 million.

Exhibit 1

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

The Scottish Government consolidated total was £1,988 million under budget in 2021/22.

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Health and Social Care	18,462	18,398	64
Social Justice, Housing and Local Government	16,290	16,411	(121)
Finance and Economy	2,080	2,616	(536)
Education and Skills	3,781	4,587	(806)
Justice and Veterans	3,084	3,123	(39)
Net Zero, Energy and Transport	4,061	4,536	(475)
Rural Affairs and Islands	876	948	(72)
Deputy First Minister and Covid Recovery	63	72	(9)
Constitution, External Affairs and Culture	355	354	1
Crown Office and Procurator Fiscal Service	185	180	5
Scottish Government consolidated total	**49,237**	**51,225**	**(1,988)**

Source: Scottish Government Consolidated Accounts 2021/22 (page 110). Further information on individual portfolio spending performance can be found in pages 111 to 122 in the Consolidated Accounts.

9. High-level reasons for significant variances between actual and budgeted spend are included in the Consolidated Accounts (pages 111-122). The largest variances relate to underspends in the Education and Skills portfolio (£806 million), the Finance and Economy portfolio (£536 million), and the Net Zero, Energy and Transport portfolio (£475 million). The Scottish Government reported that the underspend in the Education and Skills portfolio relates predominantly to the costs of providing student loans which uses a complex economic model and which is affected by interest rate movements. This underspend represents a non-cash saving which cannot be used to fund expenditure elsewhere.

10. The variances for the Finance and Economy portfolio included underspends in relation to Covid-19 business support grants, self-isolation grants and lower demand on business ventilation funds. Similarly, underspends in the Net Zero, Energy and Transport portfolio were attributed to demand for energy programmes being severely impacted by Covid-19 as well as delays caused by supply chain issues for energy projects.

11. My independent auditor's report is set out at pages 106-109 of the Consolidated Accounts. My opinion on the 2021/22 financial statements is unqualified. This means, in my opinion, I am content the Scottish Government Consolidated Accounts show a true and fair view and have been properly prepared to follow accounting standards and that the income and expenditure for the year is lawful.

12. The Scottish Government allocated £5.8 billion funding to support its Covid-19 response activity during 2021/22. This formed a significant part of the Scottish Government's financial response to supporting the health service, businesses, local government and the wider economy during the year.

13. High-level details are provided in the Scottish Government's accounts over how this money was spent during the year (pages 46-51). The highest spending portfolios were Health and Social Care (£2.6 billion), Social Justice, Housing and Local Government (£1.5 billion) and Finance and Economy (£789 million). Although this information is welcome, it does not provide the public with a comprehensive understanding of how Covid-19 funding was allocated including clear lines of sight between budgets, funding announcements and spending levels. Similarly, it does not provide information on how any underspends were reallocated or added to reserves. The recovery from Covid-19 will continue for some years to come so transparency over how funding was spent remains important.

14. It is the Scottish Government's responsibility to ensure it can appropriately assess the levels of error and fraud that may exist within its accounts. I reported in 2020/21 that the Scottish Government needed to regularly assess and improve its estimates of fraud and error in Covid-19 grant schemes and assure themselves that controls to detect and prevent fraud and error are working in practice. During 2021/22, the Scottish Government continued to strengthen the internal controls and utilised established systems and processes to minimise risk.

15. In the Governance Statement (page 69), the Scottish Government has outlined how it obtained assurance on grants to local authorities for the payment of these large support schemes including its own estimate of fraud and error. The Scottish Government estimates this to be no more than one to two per cent of payments, similar to its estimate in 2020/21. Review of fraud levels at local government level has been informed through engagement with local internal auditors and other delivery partners. I am content that the estimate is not unreasonable, and I am pleased to see the Scottish Government being more proactive in its assessment of fraud and error and their disclosures within the Consolidated Accounts.

Social Justice, Housing and Local Government portfolio

16. The 2021/22 financial year is the third full year that Social Security Scotland, an executive agency, is consolidated into the Scottish Government's accounts as a separate component audited body. The relevant expenditure is disclosed within the Social Justice, Housing and Local Government portfolio outturn statement (page 112).

17. The 2021/22 accounts of Social Security Scotland include benefit expenditure of £3,320 million administered by the Department for Work and Pensions (DWP) under agency agreements with Scottish ministers. Due to these delivery arrangements, Social Security Scotland cannot directly assess the levels of fraud and error in these benefits and is instead reliant on the DWP's annually published estimates.

18. The estimated overpayments as a result of fraud and error in relation to each type of benefit that is delivered by the DWP, ranged from 1.5 to 5.2 per cent of expenditure. This means an estimated £67.5 million of overpayments were made in Scotland. As a result, the auditor qualified their regularity opinion as these overpayments were not incurred in accordance with relevant legislation and regulations. Further details can be found in the 2021/22 Annual Audit Report of Social Security Scotland.

19. The auditor also commented on the need for Social Security Scotland to develop its estimate of the level of fraud and error within benefits administered by Social Security Scotland itself. While the auditor concluded that the absence of an estimate of the level of fraud and error in 2021/22 was not a significant financial statements audit issue, this assessment is becoming urgent as the value of benefits administered by Social Security Scotland increases rapidly over the coming years.

20. In May 2022, I published a report on Social security: Progress on implementing the devolved benefits. I reported that the Scottish Government has continued to successfully deliver new and complex social security benefits in challenging circumstances which is a significant achievement. There is a conscious focus on the needs of service users, building on the principles of dignity, fairness, and respect. The challenge will be to continue to deliver further benefits within agreed budgets while ensuring the financial sustainability of the service going forward.

21. As a component audit, the qualified audit opinion on the Social Security Scotland accounts requires me to assess the potential impact of its inclusion within the Scottish Government's Consolidated Accounts. I concluded that, for 2021/22, the likely amount of error and fraud incurred is not significant enough to influence the economic decisions of the users of the accounts and therefore I have not qualified my opinion in respect of this matter.

Crown Office and Procurator Fiscal Service

22. The Scottish Government's Consolidated Accounts include special payments of £11 million made by the Crown Office and Procurator Fiscal Service (COPFS) during 2021/22 (page 104) which relates to specific legal cases brought against the Lord Advocate by individuals in connection with the acquisition and administration of Rangers Football Club. Provisions for liabilities and charges (page 162) include £24 million in respect of the same cases.

23. Exhibit 1 (page 7) above records that COPFS overspent its annual budget by £5 million due to unplanned costs arising from ongoing court proceedings against the COPFS. The Scottish Government authorised the overspend.

24. To date the COPFS has accounted for £60 million of unplanned costs in connection with these claims against the Lord Advocate. Some cases have been resolved, with sums paid to the pursuers totalling £35.5 million to March 2022 with a further £24.5 million provided in respect of cases still to be finalised. In February 2021, the Lord Advocate made a statement in the Scottish Parliament about this matter and has committed to further public accountability and to a process of inquiry once all litigation has concluded.

Capital and resource borrowing

25. Under the terms of the Scotland Act 2016, Scottish ministers can borrow up to £3 billion for capital purposes, with an annual borrowing limit of 15 per cent (£450 million) of the overall borrowing cap. In 2021/22, the Scottish Government borrowed £150 million. This was less than the £450 million outlined by Scottish ministers as part of the 2021/22 Scottish budget. The loan will be repaid to the National Loans Fund over 20 years. This is in line with timescales outlined in the Fiscal Framework. The Scottish Government has advised that 2021/22 borrowing was used to support its overall capital programme although no detail of the assets being purchased through the loan is provided within the Consolidated Accounts. As I have reported in recent years, the Scottish Government needs to increase transparency over its capital borrowing plans including how these relate to individual projects within its programme. This will help support Parliament's scrutiny of its capital investment programme.

26. In 2021/22, the Scottish Government borrowed to fund resource expenditure for the second year running. During the year it borrowed £319 million from the National Loans Fund to be repaid over five years. The £300 million limit for resource borrowing was revised to £600 million for financial years 2021/22 to 2023/24 due to the conditions for a Scotland-specific shock being met. The Scottish Government can only apply this borrowing to meet forecast error in relation to receipts or demand-led Social Security spending.

27. As at 31 March 2022, the total principal level of capital borrowing outstanding was £1,309.9 million, with interest of £174.3 million applying over its remaining life. Resource borrowing outstanding at 31 March 2022 was £505.5 million with interest of £16 million accruing over the five-year repayment period.

28. Resource borrowing is repaid over a shorter time period (five years) than capital borrowing which is up to twenty-five years. Due to the accumulation of annual borrowing in recent years, loan repayments are increasing and totalled £95 million in 2021/22. The Scottish Government will need to continue to manage this financial pressure of repayments alongside all other financial pressures in the years ahead.

29. Details of the overall loan, repayments and interest payments are outlined on pages 55 and 56 of the Consolidated Accounts. The Scottish Government's borrowing and associated repayments are made via the Scottish Consolidated Fund (SCF). Borrowed amounts and repayments are made between the SCF and HM Treasury with the corresponding adjustments made to funding received by the Scottish Government from the SCF. This means there is no associated liability disclosed in the Statement of Financial Position within the Scottish Government's Consolidated Accounts. Details of the amount of borrowing and the associated liability are set out within a separate account prepared for the SCF.

Overall financial position

30. The Consolidated Statement of Financial Position (page 123) is one of the primary financial statements in the Consolidated Accounts. It summarises what is owned and owed by the core Scottish Government and those public bodies within the consolidated boundary. This shows taxpayers' equity – an accounting measurement of the amount of taxpayers' money applied that has continuing public benefit. It shows how much of this has arisen from the application of parliamentary funding (arising from the Scottish Block Grant, borrowing and devolved taxes) and how much resulted from changes in the value of physical assets over time.

31. Taxpayers' equity has increased in each of the last five years from £32.6 billion to £37.6 billion, largely due to an increase in physical assets (such as property and roads) and financial assets (such as loans and investments). Total liabilities (such as payments for private-financed projects) have increased from £9.9 billion in 2020/21 to £10.9 billion in 2021/22. It is important to note that the position does not reflect all the assets and liabilities of the Scottish public sector. Key assets and liabilities are excluded such as resource and capital borrowing, local government borrowing, and all public sector pension liabilities funded from the Scottish budget. This demonstrates the need for the development of a public consolidated account for the devolved public sector in Scotland (see paragraph 54).

Financial support to private companies

32. I have reported previously about the Scottish Government's direct role in providing financial support to private companies. This is in addition to support provided through its enterprise agencies, Scottish Enterprise, Highlands and Islands Enterprise and South of Scotland Enterprise. The financial support has included:

- **Prestwick Airport**. Purchased by the Scottish Government in November 2013 and has had loan support of £43.4 million up to 31 March 2022 which is currently valued at £11.6 million. Total interest accrued is £7.4 million which has been impaired to nil.
- **Ferguson Marine (Port Glasgow) Holdings Limited**. Acquired by the Scottish Government in December 2019. The existing voted loans (£97.7 million) were terminated and the difference between the valuation of the ferry vessels (£74.8 million) and the valuation of the outstanding loans (£22.9 million) was written-off through the Scottish Government 2020/21 Consolidated Accounts. During 2021/22, the Scottish Government wrote off £52 million from the capital value. The value of vessels 801 and 802 in the Consolidated Accounts at 31 March 2022 was £78 million.
- **Burntisland Fabrications Limited (BiFab)**. In 2018/19, the Scottish Government converted £37.4 million commercial loans into equity in BiFab which was valued at nil in 2019/20. During 2019/20 and 2020/21, the Scottish Government provided further loans of £13.5 million which were subsequently written off.
- **Lochaber Aluminium Smelter – Liberty Group**. In December 2016, the Scottish Government issued a 25-year financial guarantee contract to SIMEC Lochaber Hydropower Limited. The Scottish Government receives an annual fee in return for the guarantee. The annual exposure to the Scottish Government is between £14 million and £32 million, over the lifetime of the contract. The Scottish Government has assessed that the level of provision required for their guarantee was £114 million as at 31 March 2022, factoring in the value of its security package held as part of the guarantee agreement. I have concluded for 2021/22, the Scottish Government's approach to setting the level of provision against the potential exposure through the guarantee is reasonable.

33. There remains significant uncertainty regarding the financial stability of the GFG Alliance group which impacts on the likelihood of a call on the guarantee. In March 2021, Greensill Capital (UK) Limited, a major provider of working capital to GFG Alliance, went into administration. This impacts on the Lochaber smelter as it is a subsidiary of Liberty Industries UK Limited, alongside Liberty Steel Limited, under GFG Alliance. The situation is further complicated as the hydro power station that supplies the smelter is owned by GFG Alliance through its other main group of companies, SIMEC. GFG continue to publicly state their commitment to investing in the area and I am aware that GFG Alliance submitted plans for a new £94 million recycling and casting facility which were approved by the Highland Council in September 2021. I will continue to monitor the position in relation to the financial guarantee and the planned investment.

The strategic approach to financial interventions

34. In recent years, I have highlighted the need for the Scottish Government to learn lessons from its experience of recent financial interventions in private companies. I noted that in adopting a framework for investment, it is important that the Scottish Government clearly outlines its plans for future investment in private companies to ensure there is greater transparency over the value of financial support provided, the risks involved and the expected outcomes for the public.

35. In March 2022, the Scottish Government published its Business Investment Framework to outline its principles and approach for decisions about future investment in private companies. The framework forms part of its investment guidance within the Scottish Public Finance Manual. I welcome the publication of the framework. It should help the Scottish Government provide a structure to future investment decision-making and highlight the many areas that require consideration before funds are committed.

36. There is scope to further develop the framework by, for example, strengthening financial control over interventions and expanding commercial outcomes to include impact on the public such as jobs and future growth opportunities. The framework should also make a direct link between risk tolerance and risk appetite for investment considering the financial capacity of the Scottish Government. There is also scope to strengthen the guidance by removing some of the flexibilities in the application of the principles.

37. During 2022, the Strategic Commercial Assets Division (formerly the Strategic Commercial Investments Division) was formed. The roles and responsibilities of the Division mirror those of its predecessor which was slow to develop. Its main purpose is to consolidate expertise and knowledge and increase capacity to respond to cases that arise seeking support or intervention from the Scottish Government. The Division is not expected to be fully established until December 2022.

European Structural and Investment Funds

38. The Scottish Government is responsible for managing two European Structural and Investment Funds for the period 2014 to 2020; the European Social Fund (ESF) and the European Regional Development Fund (ERDF). The Funds remain operational with access to funding available until June 2024.

39. In November 2019, the EC placed the ESF programme in suspension after the Scottish Government was unable to resolve all outstanding issues by this deadline. While programmes are suspended, the Scottish Government's claims to the EC for reimbursement of funds will not be paid until all issues identified are resolved.

40. In 2020/21, the Scottish Government recognised that implementing the agreed methodology will likely result in greater expenditure over the course of the programme than can be reclaimed from the EC. As a consequence, and in line with accounting standards, the Scottish Government wrote off £16 million in the 2020/21 Consolidated Accounts in respect of grant payments already made. This estimate was reviewed and revised downwards to £14 million in 2021/22.

41. The Scottish Government has reviewed the level of provision required relating to the future under-recovery of costs and has provided a further £14 million in 2021/22 resulting in the recognition of a total provision of £43 million at 31 March 2022.

42. Formal agreement from the EU lifting the suspension was received on 31 October 2022 as the conditions for lifting the suspension were met.

43. Following the UK's withdrawal from the European Union, ESF and ERDF funding will be replaced by UK Government-led funding programmes including the Shared Prosperity Fund, Community Renewal Fund, Community Ownership Fund and the Levelling-up Fund. Guidance setting out the requirements of the Shared Prosperity Fund was issued in August 2022. The UK Government has committed to match previous EU funding. Under the Withdrawal Agreement, the UK will continue to participate in the Multiannual Financial Framework programmes, like ESF, until it ends in 2024.

Financial and performance reporting

Financial reporting

44. In May 2022, the Scottish Government published its first Resource Spending Review (RSR) since 2011. The RSR sets out indicative spending plans for five years up to 2026/27 aimed at delivering on its Programme for Government and Bute House Agreement commitments. It also highlights the economic and fiscal challenges facing the government over the medium term. High-level spending plans are outlined for each government portfolio and include a number of assumptions and expectations such as current tax forecasts under a central scenario, the delivery of three per cent efficiency savings from all public bodies and maintaining public sector pay costs at around 2022/23 levels.

45. In May 2022, the Scottish Government also provided an update to their 2021 Capital Spending Review (CSR). The 2022 CSR covers the three-year period from 2023/24 to 2025/26. The CSR highlights plans for additional capital borrowing to fund the capital programme to support the implementation of the Government's Infrastructure Investment Plan. The Review also notes an element of over-programming to maximise the use of available funding: the management of the capital programme will be essential to ensure the Scottish Government takes full advantage of the funding available.

46. Also in May 2022, the Scottish Government produced its fifth Medium-Term Financial Strategy (MTFS). The strategy aims to provide an assessment of the medium-term outlook for Scotland's public finances covering years 2022/23 to 2026/27. The 2022 Strategy sets out its assessment of Scotland's economic and fiscal outlook, as well as a broad spending outlook considering the effects of changing funding levels for government spending as outlined in the RSR.

47. Together, the MTFS, RSR and CSR give a welcome focus on medium and longer-term financial planning. Since their publication, the financial pressures facing the Scottish Government have intensified as tougher economic conditions such as higher inflation and increased interest rates have emerged in recent months. Public sector pay issues remain unresolved in key sectors such as nursing and midwifery, rail transport and teaching which will likely add further pressures both in the current financial year and beyond. Demand for health and social care services remains unsustainable while the number of people accessing social security benefits is significant, adding considerable pressures to already constrained budgets.

48. In recent months, the Scottish Government has worked with NHS bodies and local authorities to consider ways to ease financial pressures. This involved exploring options to utilise funding held in reserves by local authorities and health and social care integration joint boards. For example, the Scottish Government has provided councils with a capital grant of £120.6 million in 2022/23 and 2023/24 which councils are able to substitute with monies currently sitting in their reserves or planned revenue expenditure. This aims to release revenue-related aspects of earmarked reserves to help fund local government pay awards. Similarly, in February 2022, £619 million of Covid-19 funding was distributed to integration authorities to be held in earmarked reserves. The Scottish Government has since indicated that, due to changes in public health policies in recent months, this funding is unlikely to be required and therefore plans to reclaim surplus reserves from integrated joint boards later this year to apply them elsewhere.

49. Using reserves to smooth financial commitments over several years is an important component of good financial management. Accessing reserves may provide some short-term relief to financial pressures, however, the use of reserve balances to support recurring pressures is not sustainable in the longer term. There is a need for greater transparency over the Scottish Government's policy and approach to using reserves to manage existing cost pressures, particularly where there are funding implications for the wider public sector. This should include an assessment of reserve balances held by public bodies, their intended purpose as well as any plans to access monies held. The associated opportunities and risks of accessing reserves should be clearly articulated and documented. This will allow greater parliamentary scrutiny over the Scottish Government's financial decision-making, particularly when there are significant and immediate cost pressures.

Scotland Reserve

50. The Scotland Act 2016 allows the Scottish Government to build up funds when devolved revenues are higher than forecast, smooth all types of spending (including carrying-forward underspends), assist the management of tax volatility and determine the timing of expenditure. The Scotland Reserve applied from 2017/18 onwards and is split between resource and capital.

51. The Reserve is capped at £700 million and annual drawdowns from the Reserve are limited to £250 million for resource and £100 million for capital. These drawdown limits were removed for years 2021/22 to 2023/24 as the Scottish Fiscal Commission forecast a Scotland-specific economic shock.

52. The Scottish Government's policy is to apply any underspends for use in the following financial year. The 2021/22 provisional outturn statement (published June 2022) notes that £608 million was used to support expenditure in 2021/22 with a further £650 million due to be applied in 2022/23 and will be confirmed following the audit of the 2021/22 consolidated accounts.

53. There is publicly available information about the Scottish Government's approach to the Scotland Reserve. There is also information available about the intended drawdowns from the Reserve to support annual spending plans. The Reserve balance is not disclosed within the Scottish Government consolidated accounts. There is an opportunity for the Scottish Government to increase transparency in the Consolidated Accounts and raise awareness about the balances held within the Scotland Reserve and the movements of funds into, and out of, the Reserve each year. This will strengthen the Scottish Government's financial reporting and provide the Parliament and the public with a better understanding of the Reserve's purpose, its application in supporting spending plans and also its limitations.

Public sector consolidated account

54. In 2016, the Scottish Government committed to producing a consolidated account to cover the devolved public sector in Scotland including total assets, investments, and liabilities such as local government borrowing and public sector pension liabilities.

55. Some progress has been made in the preparation of the devolved public sector account. In 2020/21, the Scottish Government committed to a two-stage process. The first stage, which combines the Scottish Administration level together with the other directly funded bodies, was to be submitted for audit by Spring 2022. A draft version was provided for comment in April 2022 with a response provided in early July. The second stage plans to explore further the use of the UK Whole of Government Accounts process to obtain information about NDPBs, other public bodies and local authorities.

56. There have been delays in finalising the 2020/21 UK Whole of Government Account which forms the basis for these accounts due to ICT issues at HM Treasury. In addition, Scottish Government finance staff availability has impacted progress. Progress in finalising the stage one draft account for audit remains slow with the Scottish Government prioritising the preparation of the 2021/22 Consolidated Accounts. The Scottish Government needs to revise its timetable for completion, taking account of both ICT issues and staff availability.

57. The consequences of the pandemic, challenging global economic conditions, the cost of living crisis together with existing pressures in public services, all pose significant risks to the sustainability of Scotland's public finances. The need for a public consolidated account to provide a comprehensive and transparent assessment of the state of Scotland's public finances has never been greater. This is important for decision-making over the longer term as it will provide information about the impact of past decisions on future budgets, the potential risks to financial sustainability, the scale of assets and liabilities and the opportunity to re-think how public finances are managed as the Scottish Government seeks to deliver public service reform.

58. The Scottish Government needs to move swiftly towards fulfilling their commitments to producing this important account.

Performance reporting

59. The 2021/22 Consolidated Accounts include a performance report and an accountability report in line with the basic requirements of the Government Financial Reporting Manual (FReM).

60. The Scottish Government's performance report (pages 4 to 58) summarises financial performance for the year, with emphasis on performance against budget. It also contains some specific performance information which is required by current guidance on supplier payment performance, and signposts where more information is available on sustainability and environmental performance.

61. The performance analysis section provides the reader with a range of information on each portfolio's policy aims, the key challenges and financial results, what was delivered during the year and associated primary and secondary outcomes.

62. I noted last year that the information provided required to be refined further to ensure greater accessibility and transparency to the reader. Some limited improvements have been made, but it remains difficult to form an overall picture of the performance of the Scottish Government from the various strands of information presented. In the absence of defined, measurable targets, it is difficult for the reader to assess whether the Scottish Government is delivering its intended aims in support of national outcomes.

63. The performance report needs to reflect clear targets and progress towards achieving them. An assessment should also be made of the achievement towards priority outcomes and strategic objectives. This should help demonstrate the Scottish Government's own contribution to the delivery of national outcomes outlined in the National Performance Framework which is for all of Scotland, not just the Government. Key performance indicators should be identified together with performance during the year to give the public a clear understanding of the Government's achievements in the year. The lack of good indicators and milestones make monitoring the impact of policy and spending decisions more difficult. It also makes it harder for the Parliament and the public to scrutinise the Government's performance and assess whether spending is achieving maximum value.

Governance

64. A Governance Statement (pages 59-85) prepared by the Permanent Secretary is a key feature of the Consolidated Accounts. It forms part of a wider accountability report and summarises how the core Scottish Government organisation is controlled and directed. The statement confirms that the Scottish Government complies with relevant guidance on corporate governance. It also highlights the main risks and opportunities for the organisation and any significant internal control issues in 2021/22. I am content that the Governance Statement is consistent with the financial statements and has been prepared in accordance with guidance issued by the Scottish ministers.

65. The Scottish Government continued to strengthen aspects of its governance arrangements during 2021/22. There remained a strong focus on the impact of the Covid-19 pandemic on the organisation as well as an increased focus on performance and delivery towards the end of the year. Risk management processes continued to improve, most notably, in risk identification and escalation. Further work is required to ensure that actions proposed to manage and mitigate risks are robust and anticipated future risk levels and timescales are realistic. The volume of challenges faced by the Scottish Government throughout the year meant there continued to be considerable strain placed on staffing capacity and wellbeing. This is likely to intensify in the years ahead given the Scottish Government's intention to limit the size of the public sector workforce to pre-Covid levels by 2026/27. A comprehensive workforce strategy is required to ensure that its approach to staffing levels is appropriately planned and coordinated across the organisation.

66. There were several changes to the Scottish Government's Corporate Board during the year. In January 2022, a new Permanent Secretary took up post and shortly prior to this, in November 2021, two interim Directors General were appointed for Net Zero and Economy, splitting the previous remit of Director General Economy. Recruitment is under way for appointing to these posts on a permanent basis.

67. Established assurance arrangements are in place to provide and support the new Permanent Secretary in his role as principal accountable officer. Quarterly assurance group meetings are held with directors general, directors and NXDs, together with various corporate groups covering areas such as infrastructure investment, performance, people and place. There are also weekly Executive Team meetings and quarterly meetings of the Corporate Board. The Scottish Government's Audit and Assurance Committee, chaired by an NXD, oversees the assurance process. Following the appointment of the new Permanent Secretary, the Executive Team's role and responsibilities were reviewed. The Executive Team now meets weekly but in different 'modes', aimed at addressing the key priorities and issues facing the Scottish Government. These different modes include delivery (weekly meetings to consider priorities, risk and finance); strategy (fortnightly meetings covering corporate matters) and people (fortnightly meetings covering workforce matters). I welcome this development and the renewed focus it aims to have on addressing key priorities and issues.

68. This new approach to the running of the Executive Team provides an opportunity for a further review of governance arrangements within the Scottish Government. Many of the main governance groups referred to above are attended by the same individuals (both executive and non-executive) and cover similar topics, themes and risks. This introduces risks of duplication, inefficiency, or the potential for blurred lines of responsibility between the different roles and remits of each group. The role of the Audit and Assurance Committee is paramount in ensuring that efficient and effective arrangements are in place to support its role in providing advice, support and challenge to the Permanent Secretary, and in doing so, promoting good governance across the organisation. Such a review would offer the Scottish Government the opportunity to consider further its governance and operational structures, streamline its decision-making processes, and assess senior membership and attendance to ensure it can fully support the various demands, both internal and external, on the organisation in the years ahead. This is particularly important during a continuing period of change and uncertainty.

Sponsorship of public bodies

69. The Scottish Government's arrangements for sponsoring public bodies remains an area of concern. Last year, I reported that the Public Bodies Support Unit (PBSU) had restarted its support and training role for sponsors, board members and accountable officers.

70. During 2021, the Scottish Government commissioned an external consultant to conduct a review of the Scottish Government's relationships with public bodies. The report made 14 recommendations which were accepted by the Scottish Government. The Permanent Secretary has committed to all recommendations being implemented by the end of 2022. The PBSU has been proactive in attending each DG-led assurance group and the Audit and Assurance Committee to outline required actions. The Permanent Secretary expects all Directors General to have established the recommendations as best practice and will seek assurance of that. In addition, steps are being taken to ensure matters of concern within sponsored bodies are escalated through the assurance group process to ensure visibility across the Scottish Government.

71. I am pleased to see the commitment shown by the Scottish Government to addressing the recommendations made in the report. I remain concerned as to whether actions will fully address each recommendation or whether actions identified will be delivered within the timescales planned such as: the development of further guidance on establishing new public bodies; self-assessment checklists for sponsored bodies; training modules on risk, managing difficult relationships and difficult situations; and the roll out of 'stress-test' exercises. The report referred to significant levels of churn resulting in inexperienced staff in sponsorship roles as well as many vacant posts amongst sponsor teams meaning that the delivery of actions, leading to improvements across the Scottish Government, will be very challenging.

72. More significantly, it will take a much longer timeframe for the Scottish Government to be able to fully demonstrate the impact of actions taken in response to the recommendations. This largely stems from the cultural and behavioural changes needed to foster good relationships with public bodies over time. Similarly, the benefits realised from improvements in training and support offered to sponsor teams will take time to evidence. I will continue to review the impact of actions taken in forthcoming audit work.

Corporate transformation

73. The Governance Statement (page 77) refers to corporate transformation being an urgent priority for the Scottish Government. Corporate transformation is a way for the Scottish Government to achieve greater efficiencies in the longer term. I am aware that there is uncertainty over available funding to deliver the whole programme and no committed timeline for the project.

74. As part of this corporate transformation, the Scottish Government intends to implement both a human resources and financial planning system during 2023 to replace the current main accounting and e-HR systems. The new system is to be rolled out to both core Scottish Government and its 36 shared-service clients with an estimated cost of £55 million over the next seven years. This includes payments to partners who manage different aspects of the system. The project is currently in the design phase prior to moving to build phase.

75. I am aware of a number of challenges around this project. These include capacity and capability of staff resources and slower progress than originally planned due to design and validation issues. The expectation is that the new HR module will be introduced between July and September 2023, followed by the introduction of a new finance system and associated modules by the end of 2023.

76. There is a risk that corporate transformation will not deliver fully on its stated aims within planned timescales and within cost estimates. It is essential that there is clarity over how this programme is funded and when it is expected to be fully implemented. I will continue to monitor progress on this transformation programme including the new human resources and financial planning systems and their implementation across each of its clients.

Conclusion

77. The Consolidated Accounts remain a critical component of the Scottish Government's accountability to the Scottish Parliament and the public. They are particularly important during times of significant challenges and uncertainty, none more so than recovering from the Covid-19 pandemic, the impact of the war in Ukraine, rising prices and addressing financial pressures as they emerge such as public sector pay deals.

78. The unprecedented impact on public finances and the economy means the Scottish Government will need to manage further turbulence over the next few years. Strong financial management, effective longer-term financial planning and good governance remain essential to ensure the Scottish Government can minimise the effects of any further disruption.

79. Looking ahead, the Scottish Government should:

- continue to strengthen its focus on longer-term financial sustainability. In doing so, it should ensure its policy choices and spending commitments are fully costed and transparently reported in forthcoming budgets. It should also ensure greater transparency over its policy and approach to using reserves to help manage existing cost pressures, particularly where there are funding implications for the wider public sector
- take the opportunity to increase transparency in the Consolidated Accounts and raise awareness about the balances held within the Scotland Reserve, the movements of funds into, and out of, the Reserve each year. This will provide the Parliament and the public with a better understanding of the Reserve's purpose, its application in supporting spending plans and its limitations
- support better parliamentary scrutiny of its capital investment programme by increasing transparency over its capital borrowing plans including details of the underlying assets being purchased through loans
- further develop its framework for investment in private companies by, for example, strengthening financial control over interventions and expanding commercial outcomes to include outcomes for the public such as jobs and future growth opportunities. The framework should also make a direct link between risk tolerance and risk appetite for investment considering the financial capacity of the Scottish Government
- fulfil its commitments to producing public sector consolidated accounts. The need for a public consolidated account to provide a comprehensive and transparent assessment of the state of Scotland's public finances has never been greater

- ensure greater accessibility and transparency of its performance reporting within the Consolidated Accounts. The performance report needs to reflect clear targets and progress towards achieving them. An assessment should also be made of the achievement towards priority outcomes and strategic objectives. This will help strengthen accountability and scrutiny of the Scottish Government's own performance
- undertake a further review of governance arrangements within the Scottish Government to consider risks of duplication, inefficiency, or unclear lines of responsibility within its governance structure. Such a review would offer the Scottish Government the opportunity to consider its governance and operational structures, streamline its decision-making processes, and assess senior membership and attendance to ensure it can fully support the various demands, both internal and external, on the organisation in the years ahead
- develop a comprehensive workforce strategy to ensure that its approach to staffing levels is appropriately planned and coordinated across the organisation
- provide clarity over how its corporate transformation project will be funded and when it is expected to be fully implemented. The Scottish Government should ensure that the essential human resources and financial planning systems are implemented effectively, to time and to budget and, include plans to ensure its successful delivery for each of its clients.

The 2021/22 audit of the Scottish Government Consolidated Accounts

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