Economy, Jobs and Fair Work Committee budget scrutiny: Audit Scotland briefing

Introduction

1. In 2016, the Finance and Constitution Committee established a Budget Process Review Group to carry out a fundamental review of the budget process in light of the Scottish Parliament's new financial powers. The Group published its final report in June 2017, making detailed recommendations to significantly change the existing budget process.

2. A key aspect of the findings is that the scrutiny of public finances moves towards a whole-cycle approach rather than its current annual focus that follows the publication of the draft budget. This would provide more space and time for year-round scrutiny of value for money decisions and inform future spending proposals. Longer-term planning and a clear financial strategy are fundamental elements for effective policy decision making.

3. As part of this evolving approach to budget scrutiny by the subject committee we have produced this written briefing to help inform the Committee's scrutiny of the budget. It brings together information from our financial audits on issues that the Committee has displayed an interest in. This includes information from the audits of the Scottish Government Consolidated Accounts, Scottish Enterprise, and Highlands and Islands Enterprise on financial sustainability, value for money and transparency. This is the first time we have prepared a submission for the Committee to support budget scrutiny and we would welcome comments from the Committee on the content, coverage and timing of this submission to inform future briefings.

Portfolio budget outturn

4. The Scottish Government Consolidated Accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget (Exhibit 1). The Economy, Jobs and Fair Work portfolio was £19 million underspent against the budget. This was made up of a £22 million underspend on the resource budget, and a £3 million overspend on the capital budget. The most significant areas of underspend were against the demand-led budgets such as capital grant and other grant schemes for renewable energy and energy efficiency. This reflects the challenges of managing the timing of expenditure on such schemes.

Exhibit 1

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

The Scottish Government consolidated total was £85 million under budget in 2016/17.

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Finance and the Constitution	91	104	(13)
Health and Sport	13,353	13,241	112
Education and Skills	3,146	3,190	(44)
Economy, Jobs and Fair Work	320	339	(19)
Justice	2,405	2,415	(10)
Communities, Social Security and Equalities	10,959	11,021	(62)
Environment, Climate Change and Land Reform	203	223	(20)
Culture, Tourism and External Affairs	264	272	(8)
Rural Economy and Connectivity	2,835	2,839	(4)
Crown Office and Procurator Fiscal Service	113	115	(2)
Administration	181	196	(15)
Scottish Government consolidated total	**33,870**	**33,955**	**(85)**
Other Scottish Administration	3,442	3,460	(18)
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Directly-funded bodies	160	165	(5)
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: *The 2016/17 audit of the Scottish Government Consolidated Accounts*

Relevant issues within the portfolio

Capital borrowing

5. The treatment of Private Finance Initiative, Public Private Partnership and Non-Profit Distributing (NPD) investment projects in the Consolidated Accounts is based on accounting standards. Such projects are generally treated as 'on-balance sheet' capital investment in the accounts and the Scottish Government has applied the correct accounting treatment.

6. In July 2015, the Office for National Statistics (ONS) decided that the Aberdeen Western Peripheral Route (AWPR), which was a Scottish NPD investment project, should be classified as a public sector project in the National Accounts. In accordance with HM Treasury Consolidated Budgeting Guidance, budget treatment of these projects is determined by their position in the National Accounts. In November 2016, the ONS confirmed a similar classification for three further projects (Edinburgh Sick Kids Hospital, Dumfries & Galloway Royal Infirmary and the National Blood Centre). This classification means that capital budget cover is required at the point of initial investment, rather than revenue budget cover for the annual payments over the lifetime of the contract.

7. This resulted in charges against fiscal DEL budgets which required to be managed within budget limits. This meant that spending plans had to accommodate NPD expenditure within overall annual budget limits. In both 2015/16 and 2016/17, the Scottish Government agreed with HM Treasury that it could record these amounts against its capital borrowing limit. In 2016/17, the Scottish Government used its total capital borrowing limit of £333 million for this purpose. Although this did not result in actual borrowing, it removed the Scottish Government's power to borrow for capital purposes in 2016/17.

8. Looking ahead the draft Scottish budget estimates further capital spending of £190 million for these four projects in 2017/18. In March 2017, following discussions with officials, HM Treasury confirmed to the Scottish Government that any capital pressures arising from NPD projects as a result of the ONS classification would have to be absorbed within capital DEL limits with capital borrowing powers to be used as intended. The additional capital borrowing powers introduced in 2017/18 from the Scotland Act 2016 provides the Scottish Government with more flexibility in responding to spending pressures across its capital programme.

Financial guarantees

9. The Consolidated Accounts also provide information about some categories of asset, debt or financing activity not shown on the statement of financial position, largely because of the high level of uncertainty involved. This includes potential liabilities, contingent assets and liabilities and government guarantees. A contingent asset is a possible asset and a contingent liability is a possible obligation, whose existence will be confirmed only by uncertain future events not wholly within the Scottish Government’s control.

10. The Scottish Government has reported various contingent assets and liabilities in the Consolidated Accounts. Only some of the liabilities can be quantified, with amounts totalling an estimated £429 million. Some of these amounts may need to be funded from future budgets, but this is by no means certain. Similarly, the Scottish Government has a number of financial guarantees where the likelihood of settlement is more remote and therefore is not classed as a contingent asset or liability. For example, in December 2016 the Scottish Government entered into a guarantee relating to the hydro plant and aluminium smelter at Lochaber in relation to a power purchase agreement. In 2016/17 this guarantee was valued at £21.4 million. Although settlement is remote, this reflects the Scottish Government's increasing activity and risk appetite in providing financial support and guarantees to support policy objectives.

European Structural Funds

11. The Scottish Government manages four European structural fund programmes (two programmes funded by the European Social Fund and two funded by the European Regional Development Fund). These programmes provide financial assistance to, for example, help improve transport links, support business growth and improve skills.

12. In the report last year on the 2015/16 Consolidated Accounts, we highlighted that the European Commission had lifted the suspensions and interruption imposed on the 2007-13 programmes. While the suspensions and interruptions remained in place, amounts due from the EC accumulated. Following their removal, £165 million receipts were received during 2016/17. The 2016/17 Consolidated Accounts show that the £14 million provision created in 2015/16 crystallised into a liability of £31 million as a result of the 2007-13 programme closure representing grant payments received over and above expenditure declared to the EC.

13. Closure of the 2007-13 programmes also identified that the Scottish Government overpaid project sponsors a total of £16 million as a result of errors identified by Internal Audit and the subsequent application of penalties. The Scottish Government has started to raise invoices for these amounts owed to them by sponsors. The Consolidated Accounts include an unquantified contingent asset as there remains uncertainty over whether the amounts will be recovered as they may be subject to appeal.

Scottish Enterprise and Highlands and Islands Enterprise

14. Scottish Enterprise and Highlands and Islands Enterprise work to support economic growth. The auditors concluded that, in each case, the annual accounts give a true and fair view of activity within 2016/17. The auditors reported that both bodies have effective financial management and appropriate governance arrangements.

15. The outturn for 2016/17 for both bodies was within budget. The budgets were adjusted at the start of the year for savings assumed to arise from working closely with other bodies within the Strategic Forum. This forum has now been replaced following the enterprise and skills review. In 2016/17 Scottish Enterprise's budget was reduced by £17.3 million, and Highlands and Islands Enterprise by £3.2 million for Strategic Forum savings. Scottish Enterprise's auditors commented that keeping within budget was achieved largely by the rescheduling of uncommitted loans and investments and deferring other planned expenditures.

Challenges ahead

16. The auditors for both Scottish Enterprise and Highlands and Islands Enterprise reported that the bodies have effective financial management processes in place, but more could be done to plan for the medium to longer term. Auditors highlighted uncertainties arising from the enterprise and skills review and noted, more generally, that the risk of managing the financial position over the next few years is increasing. The ability to manage budget outturn through controlling uncommitted activity is reducing as elements such as staff costs represent a larger proportion of budget spend.

17. The auditors of Scottish Enterprise recommended that following the Enterprise and Skills Review, it should prepare a long term financial strategy (5 years +) supported by clear and detailed financial plans (3 years +). Plans should set out scenario plans (best, worst, most likely); with a much clearer assessment of the impact of budget assumptions on activity and any residual risks. Scottish Enterprise accepted this recommendation and has agreed to complete the action required by March 2018.

18. Following an audit recommendation last year Highlands and Islands Enterprise prepared a five year rolling financial plan covering the period 2016/17 to 2020/21. Auditors reported that it was detailed in relation to transformational projects but it did not consider alternative scenarios in relation to income and costs and the impact that these might have on its activities and spending in other areas. This limits its use in assessing Highlands and Islands Enterprise's financial sustainability. Highlands and Islands Enterprise accepted an audit recommendation to develop such scenarios within its financial plan, and agreed to implement this by end December 2017.

Supporting Reports

19. The annual audit reports for each of the bodies included within the submission can be found on our website:

- The 2016/17 audit of the Scottish Government Consolidated Accounts, and scrutiny by the Public Audit and Post-legislative Scrutiny Committee
- Scottish Enterprise Annual Audit Report 2016/17
- Highlands and Islands Enterprise Annual Audit Report 2016/17

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