The Scottish Parliament
Pàrlamaid na h-Alba

Liz Ditchburn
Director General Economy
Scottish Government

Public Audit and Post-legislative Scrutiny Committee
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The Scottish Parliament
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3 October 2017

Dear Ms Ditchburn,

Thank you for providing oral evidence at the Committee's meeting of 7 September[1], where we discussed the Auditor General's update report on CAP futures.

We were disappointed by the written submission provided by the Scottish Government in advance of the meeting. Considering the number of issues highlighted by the Auditor General and the long-standing problems faced by rural communities, we believe that more detail should have been provided as to how officials intended to progress or respond to the recommendations made. Further, the convener wrote to the permanent secretary last December to express concern that her previous written submission to the Committee on CAP Futures contained very little information on the lessons learned by the Scottish Government[2].

Financial penalties

One recommendation made by the Auditor General was that the Scottish Government should complete a detailed assessment of the risk of financial penalties. Your written submission stated that, "… the assessment of risk from financial penalties is now an embedded feature of our governance arrangements and this is a key feature of our decision making processes".

[1] Official Report, 7 Sep 2017
http://www.parliament.scot/parliamentarybusiness/report.aspx?r=11062&mode=pdf
[2] http://www.parliament.scot/S5_Public_Audit/2016_12_22_PAPLS-Perm_Sec_CAP_Futures_follow_up.pdf

This appeared to fall short of the Auditor General's recommendation and we therefore discussed the possibility of financial penalties in some detail – we are obviously very keen to avoid any detriment to taxpayers and public service-users.

As we understand it, financial penalties (also known as 'disallowance') may arise from two sources:

- missing payment deadlines;
- control weaknesses in the administration and management of EU funds.

Audit Scotland has estimated that these financial penalties may amount to as much as £60m. This is based on its identification of various issues and weaknesses arising from its audit of the European Agricultural Funds Accounts (EAFA)[3].

In oral evidence, the Scottish Government's director of agriculture and rural economy stated—

"We do not make any assessment of disallowance, as we believe that we follow the regulations to the letter of the law. We do not consider that we will face any disallowance. Of course, every year we do face disallowance … ."

She later added, "Undoubtedly, the Scottish paying agency will suffer disallowance at some level, although I think that £60 million is at the high end of what it will be … ."

While it therefore seems that Scotland will indeed face disallowance, we understand that you will not comment publicly on its possible level. However, given the potential risk to the public purse, we asked Audit Scotland to provide us with further information on its audit of the EAFA (which is attached to this letter). We ask you to state whether you disagree with any aspects of Audit Scotland's assessment as, if so, this may help us to understand better the likelihood of Scotland facing a financial penalty.

Late payments

Audit Scotland's assessment includes a sum for late payment penalties. In oral evidence, the Scottish Government said it anticipated penalties of between £500,000 and £700,000 across both the voluntary coupled support schemes and the young farmers scheme[4]. It was later clarified that these are in relation to the current year, 2016, and that the estimated penalty for 2015 is £5m[5]. £1 million has now appeared in the SG consolidated accounts for 16/17, however, the Scottish Government does not know the final numbers for later years[6]. Given this uncertainty, we request

[3] Paragraphs 57 to 64 of the Auditor General's update
[4] Official Report, column 5
[5] Official Report, column 15
[6] Official Report, column 20

updates on late payment penalties when more detailed information becomes available.

Governance
We also discussed the new governance arrangements established by the Scottish Government, and look forward to receiving further information on these. In particular, we want to be assured that there is an appropriate level of IT expertise throughout, and that there is no risk of an overly-complicated or overly-bureaucratic decision-making process being created.

IT updates
We note your view that CAP is more than an IT project. However, the independent technical review recently undertaken by Fujitsu highlighted a large number of significant IT problems and the full cost of addressing these is not known. Further, you acknowledged that the Scottish Government, "… continue[s] to suffer from some delays in IT delivery, with slippage in critical elements of functionality impacting on our ability to make payments"[7].

Given this context, we request quarterly updates explaining the progress that is being made – including the associated costs – on resolving any significant ongoing or outstanding IT challenges. Our interest is in seeing evidence of a fully functioning payments system and we do not wish to receive overly technical updates.

Disaster recovery
A specific issue highlighted in the Fujitsu review was the disaster recovery of IT systems.

The Auditor General recommended that the Scottish Government, "Develop and test a disaster recovery solution covering the whole IT system taking account of the level of risk that the Scottish Government is prepared to accept." In response, the Scottish Government's written submission said, "There are appropriate disaster recovery solutions in place for our two separate platforms."

New system
In oral evidence, you clarified that the new system has a full disaster recovery system in place "that meets the required standards", but that it has not been fully tested. You also stated that the Scottish Government "would still like to be able to carry out a full scheduled emergency exercise on the futures system", although the director of agriculture and rural economy later said that it would be "inappropriate to take the system down to do a full disaster recovery".

As discussed in oral evidence, please provide further information on what is meant by "required standards". Please also clarify whether the Scottish Government will

[7] Official Report, column 4

undertake a full disaster recovery and, if it does, keep us informed of the most significant results.

Legacy systems
There are also legacy IT systems, which are not as advanced as the new system referred to above. These do not have the same full disaster recovery system but they do have "full data and systems back-up". We note your comments about the cost and merit of establishing a full disaster recovery system for legacy systems when some of those systems will be working for only a couple of months[8].

We would welcome an update on your assessment of the costs and benefits of doing so, and on the mitigations that could be put in place to improve the disaster recovery of the legacy systems.

We also request confirmation of the time that would currently be required to recover legacy systems in the event of a disaster and the possible risks that would arise within that period for making accurate and timely payments. We also seek confirmation of whether the full data and systems back-up that you referred to meets any relevant industry standards.

Future workloads
In discussing disaster recovery, the director of agriculture and rural economy stated: "Will the 2017 payment year be any better than 2016? That might not be the case in terms of staff workload."

It would be helpful if you could explain what is meant by this statement, in particular, whether staff and unions have raised any concerns about future workload, and whether there are any implications for knowledge transfer (which was the subject of one of the Auditor General's recommendations).

Finally, a number of specific issues were raised in oral evidence on which you committed to providing further information—

- any available information at this stage on the comparative performance of Scotland relative to the rest of the UK (see column 6 of the Official Report);
- an update on the benefits realisation plan (column 25);
- proposed additional information for inclusion in the monthly CAP updates provided by the Scottish Government (column 26);
- confirmation of whether:

[8] Official Report, column 23

    - grants to farmers are made net of any existing loans;
    - there have been any bad debts on the loans to date and, if so, the provision that has been made (columns 28 and 29).

- an update on the knowledge transfer programme between contractors and Scottish Government staff (column 32).

Next steps

We would be grateful if you could reply to this letter by 31 October 2017.

We have copied this letter to the Auditor General and the Rural Economy and Connectivity Committee.

Yours sincerely,

Jackie Baillie MSP
Acting Convener of the Committee

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AUDITOR GENERAL

Ms Jackie Baillie
Acting Convener
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26 September 2017

Dear Convener

Common Agricultural Policy Futures programme: An update. Audit Scotland's assessment of financial penalties

On 29 June 2017, I briefed the committee on my update report on the Scottish Government's Common Agricultural Policy Futures programme. During the session we explained how we had estimated our updated assessment of possible financial penalties of up to £60 million. The Committee subsequently took evidence from the Scottish Government on 7 September 2017 and later requested Audit Scotland provide written evidence setting out the methodology we had used to reach our assessment of potential financial penalties.

Please find a summary explaining our methodology attached to this letter.

I hope this information is helpful to the Committee.

Yours sincerely

Caroline

Caroline Gardner
Auditor General for Scotland

Written response to the Public Audit and Post-Legislative Scrutiny Committee

Audit Scotland's assessment of potential financial penalties in relation to the management of Common Agricultural Policy

Background

Under EC regulations financial penalties (known as disallowance) can be incurred for:

- Missing payment deadlines
- Control weaknesses in the administration and management of EU funds which puts those funds at risk.

Disallowance applies for each year that payments are made. Our assessment in our May 2016 report was for the SAF 15 payments (£40 million - £125 million), and the estimate of up to £60 million in our June 2017 report was an update of this range.

Overall, the £60 million estimate includes:

- Weaknesses in controls identified during our 2015/16 European Agricultural Funds Accounts (EAFA) audit. – up to 10% of pillar 1 and 2 European funding - up to £40 million
- Late payment for SAF 15 payments – up to £9 million
- Failure to meet other deadlines (e.g. letter of entitlements) – up to £20 million

We looked at these estimated ranges as a whole and used our judgement to provide a possible range of up to £60 million.

Our assessment is in relation to SAF 2015 (that is, relating to payments made between December 2015 and October 2016, and applies to that year only. It does not include an assessment of financial penalties for subsequent years, for example, in relation to application and payments made between December 2016 and June 2017, and up to October 2017. Further penalties are possible in relation to this, and subsequent audit findings.

More detail is provided for each of these categories below.

Penalties associated with missing payment deadlines

EC regulations require member states to pay 95.24% of pillar 1 payments by 30th June each year. This is on a member state basis meaning that England, Scotland, Northern Ireland and Wales have to meet this level collectively to avoid penalties. Failing to do so would result in financial penalties being applied by the EC to the member state, i.e. to the UK as a whole.

The regulations set out a sliding scale of penalties to be applied to any payments made after this date as follows:

- July 10%
- August 25%
- September 45%
- October (to 15th) 70%
- After October 100%

As an example, if £40 million in pillar 1 payments were made in July only £36 million would be reimbursed from EU funds. It would then be up to DEFRA to decide how to apportion any penalties charged to the member state for late payments amongst the individual paying agencies.

For 2015 payments, that is, those made between December 2015 and October 2016 (the EC offered an extension to the penalty free payment window was extended from June 2016 to 15 October 2016).

Our understanding is that the EC has not finalised penalties in relation to this period but we know that the Scottish Government has stated it is anticipating disallowance of up to £5 million for this.

Our assessment also factors in the potential for late payment penalties (estimated range of £1 million up to £9 million) in relation to SAF 2015 and failure to meet other deadlines such as the April 2016 deadline for issuing letter of entitlements (estimated range of up to £20 million). Both these estimates were informed by programme documents.

Control weaknesses identified during the course of audit

European agricultural funds, and the schemes from which they are funded, are subject to audit. These can be split into three main types:

- Annual Certification Audit for the European Commission. This is the annual audit of European Agricultural Funds Accounts. Audit Scotland undertakes this audit work in Scotland as part of the UK consortium led by the NAO.
- European Commission audits. The Scottish Government is generally subject to two or three European Commission audits per year. The main focus of these audits is on the control systems being applied in the administration of all schemes.
- European Court of Auditors (ECA) audits. The ECA audit the accounts of the EC. It reviews a sample of CAP payments made to farmers across Europe to assess compliance with the various rules and regulations, and to determine the overall level of errors or irregularities in the European Commission's accounts

Any failures to comply with EC regulation or weaknesses in controls identified during the course of these audits can result in financial penalties being incurred. If the Commission considers that actions to control and administer payments have not been compliant it will notify the paying agency of a penalty. The Commission will base its assessment of penalties on the level of the potential risk to EU funds, or apply a flat-rate penalty where it cannot make a reasonable estimate. The flat-rate penalty is applied to the expenditure considered to be at risk and is set out in guidelines and statute; i.e. it will be applied to the value of a particular scheme where the weaknesses were identified.

Penalties can take a number of years to be confirmed and finalised and are subject to negotiation. The Scottish Government can try to reduce the penalty by showing the risk of loss to the funds has been overestimated by the EC, or that it has taken action to mitigate the identified risks. If the EC is not satisfied with a paying agency's progress to address weaknesses it can suspend agricultural payments completely.

Our assessment of disallowance risk.

Our May 2016 report set out the main causes of financial penalties (paragraph 57) and provided a range of possible disallowance for each. We also highlighted the main risks as we saw them at that point in time, some of these related to potential weaknesses in controls. There were a number or uncertainties at this time because the payment window had not closed, and our 2015/16 EAFA audit work was ongoing.

We used the following matrix (**Exhibit 1**) as set out in the EC regulations audit circular (page 20) as the basis of our assessment [1].

1 http://ec.europa.eu/transparency/regdoc/rep/3/2015/EN/3-2015-3675-EN-F1-1.PDF

Exhibit 1

Key controls / Ancillary controls	None is deficient	One	Two	Three or more	One / more is absent or ineffective	Control system completely absent/gravely deficient
		Not in the number, frequency and depth required				
None is deficient	N/A	5%	5%	10%	10%	25% or more
One has completely failed	2%	5%	7%	10%	10%	
Two have completely failed	2%	7%	7%	10%	10%	
Three or more have completely failed	3%	7%	7%	10%	10%	

Since then, we have concluded on our 2015/16 EAFA audit. Our June 2017 report summarises the findings from this (paragraphs 57 to 64). We identified a number of issues in relation to how the system was operating and weaknesses in controls. Our judgement was that three or more key controls were weak. This was a weaker assessment than in previous years.

We used this assessment and applied the EC matrix (**Exhibit 1**) to refine our assessment. **Exhibit 2** sets out the potential ranges using the percentages from the EC matrix with the values based on the audited EAFA accounts:

Exhibit 2

	Pillar 1 EAGF	Pillar 2 EAFRD	Total
Total funds 2015/16 (Euro)	523,665,818	22,897,350	546,563,168
Total funds 2015/16 (£)	387,041,406	16,923,431	403,964,837
2%	7,740,828	338,469	8,079,297
3%	11,611,242	507,703	12,118,945
5%	19,352,070	846,172	20,198,242
7%	27,092,898	1,184,640	28,277,539
10%	38,704,141	1,692,343	40,396,484
25%	96,760,352	4,230,858	100,991,209

Our judgement was that potential financial penalties in relation to our 2015/16 EAFA audit findings could fall in the range up to £40 million across both funds. However, if the EC judges the system gravely deficient up to £100 million is possible.

In summary, our updated assessment of £60 million takes into consideration:

- Control weaknesses identified during our 2015/16 EAFA- up to £40 million
- Late payment penalties for SAF 15 payments – up to £9 million
- Failure to meet other deadlines – up to £20 million

We looked at these estimated ranges as a whole and used our judgement to provide a possible range of up to £60 million.