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The Skills Development Scotland Co. Limited

Annual audit report to The Skills Development Scotland Co. Limited and the Auditor General for Scotland

Year ended 31 March 2011

30 June 2011

Contents

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About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

This report is for the benefit of The Skills Development Scotland Co. Limited and is made available to Audit Scotland (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes, but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

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Executive summary

We have completed our audit for 2010-11 and have issued unqualified audit opinions on the financial statements and the regularity of transactions included within these financial statements.

The Skills Development Scotland Co. Limited ("SDS") was established in response to the Scottish Government's *Skills for Scotland* strategy and brings together skills and training services previously provided by Scottish Enterprise and Highlands and Islands Enterprise, together with similar services provided by the former Scottish University for Industry.

2010-11 was the third full year of operations and during this period key themes have been the continued development of operating structures and arrangements within the organisation. This has included the harmonisation of employee arrangements and, in particular, in 2010-11 has included consolidation of the retirement benefits arrangements. This has resulted in a number of one-off costs to SDS both in cash and accounting terms during the year, as well as in terms of management resource. This was substantially complete by the year end and is reflected in the financial statements.

Despite having to deal with a number of issues key to the business, such as pensions consolidation and IT outsourcing, SDS performed well against key business indicators; modern apprentice starts were increased 7% on the prior year, Individual Learning Accounts were up 17% and the number of adults using SDS's services was up 10%. Demand for SDS services remains high and the Company continues to play a key role in the Scottish Government's plans for economic recovery.

Management is investing in new ways of delivering services and this has included the development of the My World of Work website. Total costs of £1 million have been capitalised in the year in relation to this and further expenditure of a similar level is expected in 2011-12.

The outsourced IT arrangements went 'live' in April 2010 and have operated throughout the financial year. Internal audit has reviewed arrangements and to date, no significant issues have been identified, albeit there were some service delivery problems as may be expected.

The outturn for the year is a surplus of £23.1 million. This is primarily a result of the pensions credit resulting in the basis of future increases in pension payments announced by the UK Government in July 2010. The underlying result was a surplus of £2.56 million. The remaining surplus reflects timing differences between the draw-down of grant-in-aid income and expenditure and is in line with management expectations. The income for the year includes around £11 million of European grant funding, around half of which was still outstanding at the date of reporting.

As in prior years, SDS is deemed to have met its efficiency savings target for the year by meeting the budget. The small underlying surplus demonstrates that this was achieved.

A balanced budget has been set for 2011-12. Although grant-in-aid is broadly in line with 2010-11, the main allocation has been reduced by £21 million, but this has been largely offset by further allocations totalling £19 million. These further allocations are for specific purposes (including modern apprenticeships) and therefore reduce SDS's fiscal flexibility. Management anticipates similar levels of European funding in 2011-12 to 2010-11, but notes that there are significant risks around the sustainability of this funding in the longer term.

Improvements have continued this year in procurement arrangements, previously an area of weaknesses. Our follow-up work to Audit Scotland's report *Improving public sector purchasing* evidenced this.

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Headlines

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practise* ("the *Code*"). This specifies a number of objectives for our audit.

This report summarises our work for the year ended 31 March 2011.

We wish to record our appreciation of the continued co-operation and assistance extended to us by Skill Development Scotland staff during the course of our work.

The action plan in appendix one includes a number of recommendations, none of which are considered to be 'high' risk.

Priorities and risks	
Management has made significant progress to enhance arrangements around procurement through the introduction of the *Licence to Practise* training programme for all team leaders. Significant risks continue to exist, but internal processes reduce the likelihood and potential impact on the Company.	Page 4
Financial statements	
We have issued unqualified audit opinions on the 2010-11 financial statements and the regularity of transactions reflected in those financial statements.	-
A number of technical accounting matters were considered during the audit process; particularly in accounting for retirement benefits.	Page 7
Use of resources	
The Company met its financial targets through effective financial planning and management throughout the year.	Page 9
We performed follow up work on Audit Scotland's national reports on *Improving public sector purchasing* (published July 2009) and *Use of consultancy services* (published January 2009). We found that management's arrangements in relation to procurement have improved considerably in recent years and in relation to consultancy services arrangements are also positive.	Page 11
Governance	
There have been no significant changes and the statement on internal control continues to confirm the existence of a comprehensive framework of internal control.	Page 12
Internal audit completed their plan and reported significant risk recommendations during the year.	Page 12
Arrangements to prevent and detect fraud are embedded in internal controls, in particular this includes the work of the compliance team in reviewing national training programmes.	Page 12

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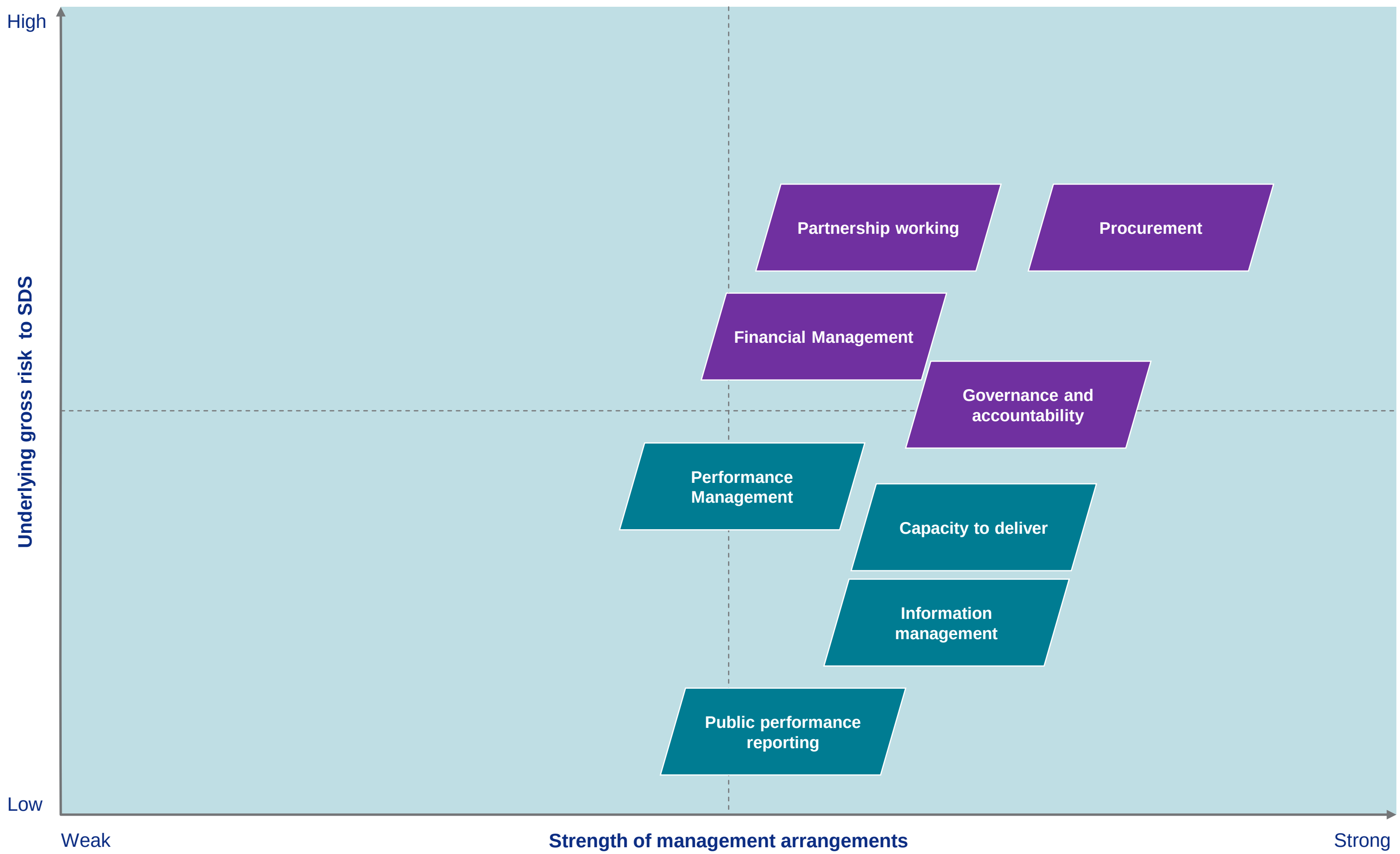
Summary of arrangements

Competing risks and pressures continue to present new and recurring challenges. Overall, the impact of sector priorities present a moderate level of risks to the Company. Controls to mitigate risks are, in the main, towards strong.

The diagram summarises the potential underlying risks to achievement of strategic objectives, compared to the strength of management arrangements to mitigate these risks. The following pages summarises those areas where we believe that significant risks are inadequately managed, together with those where management arrangements are likely to mitigate or eliminate these risks to a greater or lesser extent.



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Assessment of significant risks

Arrangements in respect of procurement, partnership working, public performance and governance and accountability reporting are likely to mitigate the impact of significant risks.

Procurement	In prior years, procurement was identified as an area of weakness at SDS and with potential for improvement. Significant work has been undertaken by management to improve arrangements in both 2009-10 and 2010-11, including process improvements and staff training through a 'license to practice' scheme. SDS's commitment to improving procurement practice is demonstrated by the achievement of a Scottish Government procurement capability assessment (PCA) score of 75% in 2010-11, improved from 52% in 2009-10. The 2009-10 score was categorised as "improved performance", and the 2010-11 score was categorised as "superior performance". No individual sections scored throughout the course of the PCA were categorised below "conformance".	Both internal audit and ourselves have reported previously a number of weaknesses in procurement systems and processes. These areas have been improved by a number of actions that have been taken by management and improvements have been evidenced by the most recent PCA review which was considerably improved on the prior review.
	■ In our view there have been significant risks in this area in the past which have been reduced through management actions. ■ In response to the 2010 PCA, a procurement improvement action plan for 2011-12 was devised with oversight through the finance and operations committee. This improvement plan is now part of an ongoing work plan that is embedded within the Company's overall procurement strategy and shows a desire to drive further improvements in this area.	
Partnership working	The Company continues to demonstrate positive partnership working practices. Successful IT collaboration with Scottish Enterprise has continued in 2010-11. Highlands and Islands Enterprise and Scottish Criminal Cases Review Commission have also now joined this arrangement. SDS continues to work closely with training providers across the country funding learning and skills training.	As the IT agreement with Atos Origin is directly with SDS, there are risks around ensuring quality of service and value for money to other partners to the arrangement. A number of measures have been put in place to mitigate this risk, including regular quality of service reviews and quarterly benefits tracking.
	■ In our view, risks exist but actions have been identified and processes implemented to address these.	

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Assessment of significant risks (continued)

Governance and accountability	Six new non-executives were appointed to the SDS board in August 2010 and an advisor was appointed in February 2011. Three non-executive members left as planned during the year. The director of human resources has also recently resigned from SDS. Management do not plan to replace this post, but will restructure management arrangements instead.	We anticipate that the financial experience of the new members and advisor will increase scrutiny of financial matters and therefore strengthen the level of governance and accountability. The loss of the director of human resources will reduce the corporate knowledge surrounding SDS's development, although the other directors will have this knowledge. The restructuring of management arrangements is currently under consideration.
	■ In our view, governance and accountability is likely to be enhanced due to the new appointments. ■ We believe that there are risks around the management restructure but management are in the process of addressing these risks.	
Public performance reporting	This is an area of key and increasing importance in the public sector and is a way for SDS to continue to demonstrate transparency. SDS includes the financial statements and other key corporate information on its website. A report has also been recently included analysing the School Leaver Destination Return for 2009-10. The format of the Director's report in the financial statements was refreshed this year. Management are beginning to focus on 'outcomes' versus 'inputs' to measure performance and evidence the effectiveness of SDS's work.	As a public sector organisation, particularly in these difficult economic times, it is important that SDS provides the public with relevant information on its services and performance. It is important from a public perception point of view that the funding is seen to have a direct impact on the improvement of people's lives and this is effectively communicated. We note that levels of public performance reporting have increased and that management is currently considering the format of an annual review to be published later in 2011. This will be a key means of communicating performance. The refresh of the Director's report should clarify to readers the link between the financial statements and SDS's operations and services.
	■ Although not an area often associated with significant risks, this is an area which management should continue to focus on to ensure SDS has a positive image in the eyes of the public.	

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Financial statement level risks

Risks were identified around retirement benefits and the recoverability of accrued ESF income; no audit adjustments were required and matters were concluded in a timely manner.

Areas of HIGH audit risk			
Area	Value (£'000) 2010	Value (£'000) 2011	KPMG comment
Retirement benefits	(20,830)	(3,723)	The process to consolidate the Company's retirement benefits arrangements was substantially completed during the year and is reflected in the 2010-11 financial statements. As part of our audit procedures, we have reviewed the calculations, disclosures and underlying data used by SDS's actuaries, including contributions and membership information. On reviewing the draft actuaries' report, the day before the first draft of the financial statements were finalised, and in discussion with management, it was identified that there were inaccuracies in the report. Following detailed investigation by management, the source of these was identified and a revised report was prepared which has been correctly reflected in the financial statements. ■ Amendments to the actuaries' report and financial statements were necessary and have been made. ■ Financial statements disclosures in this respect are complete and accurate.
Recoverability of accrued income	2,856	11,569	The financial statements include £11.6 million of accrued income at the year end, £10 million of which relates to European Social Fund ("ESF"). At 13 June 2011, around £5 million of this remained outstanding and had yet to be claimed by the Company, although claims were due for submission by 2 May 2011. Confirmation was received by management from the Scottish Government that late submission would not affect SDS's ability to obtain this funding (subject to the spend being audited) and reliance has been placed on this. However, a risk remains that this may not be the case for future late claims. Internal audit also identified risks in this area and have reported these separately to management. ■ No adjustment to the financial statements was necessary.

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Financial statements preparation and audit process

Draft financial statements were provided in line with the agreed timetable.

Adjustments were made to the retirement benefits entries prior to the finalisation of the financial statements.

Systems and controls

Preparation of the financial statements

- Draft financial statements were provided on 16 May 2011, in line with the agreed timetable. These were primarily complete and of a good standard.
- Some supporting information was initially received on 16 May 2011, but some other schedules took longer to produce.
- The standard of requested analyses was good and there was evidence of accountability and ownership of working papers across the finance department.

Control environment

- Overall, management's approach to preparing the financial statements is efficient, but some improvements could be made in respect of payroll, accounts payable and the management of European Social Fund claims.

Retirement benefits

- Management was proactive in arrangements in relation to retirement benefits accounting and, whilst there were revisions required to the actuarial report, this has helped ensure a timely resolution of the audit. The audit process and discussions with managements identified that information provided by the scheme actuary required revision.

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Financial position

The Company reported a net surplus of £23.1 million, primarily as a result of accounting for retirement benefits arrangements.

The 2011-12 plan forecasts a breakeven position, achievement of which will be dependent on the receipt of funding from the European Social Fund.

The Company met its financial target for the year: to achieve financial balance. The result for the year was a surplus of £23.1 million (£2.6 million, excluding retirement benefits adjustments).

The 2011-12 financial plan forecasts a cumulative outturn break even position against the revenue resource limit. Achievement of the plan will be challenging due to increased efficiency savings targets set out for the year.

Result for the year

	2010-11 £'000	2009-10 £'000	Variance £'000
Grant-in-aid	198,638	203,005	(4,367)
European income	11,945	1,244	10,701
IT services	7,078	2,941	4,137
Careers guidance	1,628	2,149	(521)
Miscellaneous	1,336	1,003	333
Total income	**220,625**	**210,342**	**10,283**
Operating expenditure	(168,014)	(172,301)	4,287
Cost of sales	(10,913)	(7,363)	(3,550)
Administrative expenses	(19,350)	(20,993)	1,643
Total expenditure	**(198,277)**	**(200,657)**	**2,380**
Finance costs	-	(1,441)	1,441
Finance income	752	97	655
Income tax	(16)	25	(41)
Surplus	**23,084**	**8,366**	**14,718**

Total grant-in-aid drawdown has decreased over the prior year primarily due to additional funding received in 2009-10 for a voluntary severance scheme, where costs were £6 million higher than in 2010-11.

The increase in European income is due to new income streams in the year and relates to amounts received from the European Social Fund for specific projects funded by SDS, such as 'supporting business through recovery' and 'training for work'.

IT service income relates to amounts recharged to Scottish Enterprise and HIE for costs incurred from the service provider. 2010-11 was the first full year of the agreement's operation.

Operating expenditure showed a net reduction due to decreases in staff costs, mainly relating to voluntary severance scheme costs offset by a £10 million increase in national training programme expenditure.

Cost of sales increased reflecting the cost of the first full year of the IT service agreement.

Preparation of the financial statements in accordance with IFRS, the FReM and the Companies Act 2006 has resulted in a surplus being reflected in the year. In line with other NDPB's, grant-in-aid is recognised as it is physically drawn down, other than specific elements awarded to a specific year which will not be required in cash terms until a future date. This includes specific income in relation to retirement benefit obligations. Unincorporated NDPB's recognise this income as a movement in equity (as specified in the FReM), however, as an incorporated entity, SDS must follow the Companies Act and accordingly reflects grant-in-aid as turnover in the statement of comprehensive income. This can result in the creation of a surplus in (2010-11 and 2009-10) or a deficit (as in 2008-09) as expenditure is accounted for in the period to which it is incurred.

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Financial position (continued)

The Company met its financial target for the year.

The 2011-12 plan forecasts a breakeven position, achievement of which will be dependent on the receipt of funding from the European Social Fund.

Efficiency savings

When annual grant in aid funding is allocated, efficiencies are effectively incorporated into the budget setting process. SDS is considered to have delivered the required levels of efficiencies by achievement of the savings required from the legacy organisations from which it was formed, against a 'base-line' budget from costs in those organisations.

Through achievement of the net underlying surplus of £2.6 million for 2010-11 (excluding retirement benefit adjustments), SDS has therefore met efficiency targets for the year.

The original budget allocation for 2011-12 was reduced by £21 million which has been replaced by £19 million of income to be used on two additional national training programme projects to meet overall targets for modern apprenticeships and employability. This has been reflected in financial plans and again, achieving financial balance will constitute SDS meeting efficiency targets for the year.

Financial plans for 2011-12

Management has budgeted a breakeven position for 2011-12. Zero based budgeting has not been adopted due to the nature of the SDS business model. A large proportion of costs, such as national training programmes and staff costs are semi-fixed, hence there is an immediate requirement for resource.

The 2011-12 budget anticipates total grant-in-aid of £200.1 million and ESF income of £11.5 million. The remaining income of £10.9 million consists of invoicing to partners for the shared IT service costs and general invoicing.

Expenditure	2011-12 Budget £'000	2010-11 Budget £'000
National training programmes	135,213	113,000
Business enhancement projects	6,000	17,000
Staff costs and salaries	44,177	48,870
Infrastructure, management and administration	10,250	13,000
Information technology and systems	15,086	5,200
Individual learning accounts Scotland	10,285	12,000
Other invoicing	1,515	430
Total planned spend	**222,526**	**209.500**

Review of significant movements:

NTP planned spend has increased mainly due to additional grant in aid of £19 million being awarded for specific spend on modern apprenticeships and employability.

Business enhancement projected spend has been reduced due to the deferral of projects take into account the anticipated £21 million reduction in income.

Staff costs are anticipated to be lower as the 2010-11 budget included significant severance cost expenses in addition to £6 million retirement benefits costs. In addition, savings are expected in 2011-12 following the in year severance scheme.

Information technology costs are expected to increase as higher costs are expected relating to Scottish Enterprise and it is the first full year of the inclusion of HIE in the agreement. The costs relating to Scottish Enterprise and HIE are recouped through invoicing.

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Audit Scotland national reports

During 2010-11 we have performed follow-up work in relation to two Audit Scotland national reports: *Improving Public Sector Purchasing* and *Use of consultancy services.*

Our work has found that the Company's arrangements are generally strong in both areas.

Audit Scotland national studies

Audit Scotland periodically undertakes national studies on topics relevant to the performance of central government organisations. While the recommendations from some of the studies may have a national application, elements of the recommendations are also capable of implementation at board level, as appropriate.

Management has procedures in place to consider individual reports to the board and the risk and audit committee. In addition, where appropriate, management will carry out a self-assessment against the national study and implement local action plans as required. We have reviewed the processes in place during our audit and have not identified any issues with it.

Specific follow-up

Audit Scotland's corporate plan 2009-12 reinforces a commitment to maximising the impact of their work and to providing more evidence of impact. As part of this process auditors are required to provide information on how bodies respond to national performance audit reports. In 2010-11 more targeted follow-ups were required in respect of the SDS's actions following publication of the two reports *Improving Public Sector Purchasing* (July 2009) and *Use of consultancy services* (January 2009).

Improving Public Sector Purchasing

Our work centred around the answers to three questions to facilitate analysis of SDS's arrangements. We found evidence that SDS's arrangements have improved and this has been demonstrated by the procurement capability assessment scores which in 2010 was 75%, improved from 52% in 2009.

The senior management team seeks to drive continuous improvements in procurement. A procurement improvement plan was presented to the finance and operations committee during the year which is now embedded in the overall procurement strategy.

Improving the use of consultants

Our work on this report also centred around the answers to key questions arising from the original report. We found that SDS's overarching policy is to avoid the use of consultants where possible, subject to those instances where sufficient or appropriate resources are not available 'in-house'. SDS has considered whether certain services should be classified as consultancy; this includes actuarial and legal services. Management does not consider these services to be consultancy as they are legally required services that SDS do not have the resources or skills to provide in-house. However, management seeks to minimise expenditure in these areas as they are expensive specialist services.

We raised some minor recommendations in relation to the use of consultants, but our work has not identified any significant areas of concern.

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Corporate governance framework and supporting arrangements

Over-arching and supporting corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision-making.

Corporate governance framework	The Company maintains an integrated governance framework to provide an appropriate structure for maintaining decision-marking, accountability, control and behaviour. Although there has been no change in the overall governance framework, there have been a number of changes in board composition during the year. These should enhance governance procedures.
Statement on internal control	The statement on internal control provides details of the purpose of the framework of internal control, along with an analysis of its effectiveness. It describes a number of sources of assurance for the accountable officer and identifies areas for improvements to be focussed in the future. We have reviewed the statement on internal control and have confirmed that it is in line with guidance and reflects our understanding of SDS.
Internal controls	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls are designed appropriately and operating effectively. However, we note that minor weaknesses exist over payroll and accounts payable, where recommendations have already been agreed with management. We have separately reported an area for potential improvement in relation to ESF income.
Internal audit	Internal audit have either finalised or drafted all of their planned reports for the year. We have reviewed internal audit's files and place reliance on a number of reports, including those in respect of ESF income, NTP expenditure phases one and two, human resource overview and payroll controls, planning and delivery management and ICT contract management. These reports do not make any 'critical' recommendations, but the ESF income review highlighted some 'high' risk control weaknesses over submission of claims and made recommendations to address these.
Fraud and irregularity	Procedures and controls related to fraud are designed and implemented effectively. The compliance team is responsible for reviewing a sample of national training providers and its work did not identify any systematic issues. In 2010-11 a sample of £16.5 million of expenditure was tested and recoveries of £97,000 were received, giving an average error rate of 0.6%. Extrapolation of this suggests that up to £0.7 million may have been paid in error. These payments are not recoverable and therefore the potential error does not impact on the reported deficit for the year. One non-significant suspected fraud was identified in relation to a training provider. The training contract has since been terminated. No significant fraud or irregularity has been identified during the year.

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