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INFRASTRUCTURE, GOVERNMENT & HEALTHCARE

Scottish Enterprise

Annual audit report to Scottish Enterprise and the Auditor General for Scotland
2006-07

25 July 2007

AUDIT

AUDIT ▪ TAX ▪ ADVISORY

Contents

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It is for the benefit of only Scottish Enterprise 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.

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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 introductory section of this report.

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If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact David Watt, who is the engagement leader for our services to Scottish Enterprise, telephone 0141 300 5695, email david.watt@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Lorraine Bennett, our Head of Audit in Scotland, either by writing to her at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 222 2000 or email to lorraine.bennett@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Director of Audit Strategy, Audit Scotland, 110 George Street, Edinburgh, EH2 4LH.

Executive summary

This report summarises our work for the 2006-07 year and our findings in relation to our audit of the accounts, corporate governance and performance management arrangements.

Accounts

On 25 July 2007 we issued an audit report giving our unqualified opinion on the accounts of Scottish Enterprise and the Network for the year ended 31 March 2007 and on the regularity of transactions reflected in those accounts.

Strategic planning

Scottish Enterprise has recently completed a review of its services and products, allowing a greater focus on delivery against objectives. In March 2006 Audit Scotland recommended that Scottish Enterprise focus on broader, strategic studies that can deliver a wider picture of impact. In response, Scottish Enterprise is developing a strategic approach to evaluation across the Network, placing more emphasis on wider-ranging evaluations rather than evaluation purely at project level.

The adoption of the metropolitan approach presents new opportunities and challenges for the organisation. 2006-07 was a transitional year, with reporting and monitoring arrangements remaining under the existing framework. A new reporting framework has however been developed to reflect the revised approach and metropolitan supervisory boards have been established to resolve identified issues and drive the transition towards the new approach. An announcement by the Scottish Ministers on the future status of Careers Scotland is awaited.

A review in 2005-06 of Scottish Enterprise's strategic and operational achievements found that, comparatively, Scottish Enterprise's approach appeared to be well advanced. During 2006-07 management has made progress in addressing recommendations from the review. Performance measures have also been further developed for 2007-08 and 2008-09. A reporting framework to monitor performance has been established and the results are used in Scottish Enterprise's decision-making processes.

Financial management

Scottish Enterprise continues to face a demand for its resources and this requires robust financial monitoring. Our audit work identified that systems are in place for the regular monitoring and reporting of budgets and financial performance. The executive board and board also receive regular updates of the amount of committed expenditure and how this is being prioritised. Projects are monitored regularly by project managers, executive management and also by internal audit. In 2006-07, internal audit's overall conclusion for the major projects reviewed was that they are being well managed.

There were a number of internal and external reviews in relation to the 2005-06 financial outturn. We reviewed the progress made by management in implementing the findings from these internal and external reviews aimed at improving financial management arrangements. The status report to the March 2007 audit committee noted that generally good progress was being made and that all recommendations impacting on the 2006-07 financial year had been implemented. Our review of the processes established by management over the compilation of balance sheets, established to supplement the existing reporting activities, found that the arrangements require improving to become fully effective as a management tool.

The outturn position for 2006-07 was an underspend of £8.7 million, comprising an underspend against the 'cash' budget of £0.9 million and a £7.8 million underspend against the 'non-cash' budget. In respect of 2007-08, Scottish Enterprise's operating plan amounts to £620 million. This reflects an increase in grant-in-aid from 2006-07 of £82 million.

Governance and risk management

A formal risk management strategy has been established, with risk "champions" in each business unit responsible for maintaining a risk register. The board and audit committee receive updates on risk management on a regular basis. Management have established an internal controls assessment framework, complementing the risk management and internal audit arrangements. While no significant weaknesses were reported through this process and none are included in the statement on internal control, management acknowledge that work is underway to improve information security, business continuity and disaster recovery arrangements.

During 2006-07 internal audit concluded that there is a "satisfactory level of assurance in the areas reviewed, subject to implementation of the agreed actions." The main exceptions to this level of assurance were in respect of reviews on the customer relationship management system, overseas payroll and business gateway international. Our testing of the design and implementation of controls over significant risk points confirms that, subject to some minor weaknesses reported, controls are designed and operating effectively.

In 2006-07 Scottish Enterprise completed a restructuring of senior management responsibilities, applying its existing severance policy. Audit work confirmed that payments were made in accordance with the policy.

Efficient government and Best Value arrangements

Targets set by the Scottish Executive for 2005-06 and 2006-07 are reported as met or exceeded. In 2006-07 management reported cash releasing efficiency savings of £14.5 million (target £9.55 million) and time releasing efficiency savings of £1.5 million (target £6 million). The target for efficiency savings in 2007-08 is £18.25 million. Progress towards targets is reported to the executive board during the year. Management believe that the plans are feasible and do not jeopardise the delivery of the services or financial viability.

The executive board has approved an initial governance structure for Best Value and that will cover the nine characteristics a Best Value organisation should display. With a view to embedding Best Value in the organisation, a steering group was established in June 2006 and completed a further assessment using relevant guidance. This confirmed that Scottish Enterprise was well placed to demonstrate continuous improvement.

Introduction

Audit framework

This was the first year of our five-year appointment as external auditors of Scottish Enterprise. This report to Scottish Enterprise and the Auditor General for Scotland outlines our opinion and conclusions and highlights significant issues arising from our work.

In accordance with Audit Scotland's *Code of Audit Practice* ("the Code"), the scope of the audit was to:

- provide an opinion on Scottish Enterprise's accounts and, as required by relevant authorities, the regularity of transactions;
- review and report on (as required by relevant legislation, the Code and any guidance issued by Audit Scotland):
  - Scottish Enterprise's corporate governance arrangements as they relate to: its review of systems of internal control; the prevention and detection of fraud and irregularity; standards of conduct, and prevention and detection of corruption; and its financial position
  - Scottish Enterprise's arrangements to achieve Best Value
  - other aspects of the Scottish Enterprise's arrangements to manage its performance, as they relate to economy, efficiency and effectiveness in the use of resources.

The framework under which we operate under appointment by Audit Scotland was outlined in the audit plan for the year discussed with Scottish Enterprise's audit committee.

To assist in the development of a consistent approach to the audit across bodies, Audit Scotland publishes *Priorities and Risks Framework* guidance, setting out a number of areas for consideration during the audit process. We used the material developed by Audit Scotland in 2005-06 in our assessment of Scottish Enterprise's processes and management arrangements. Our own planning process also identified a number of other areas for specific attention.

Basis of information

External auditors do not act as a substitute for Scottish Enterprise's own responsibilities for putting in place proper arrangements to account for the stewardship of resources made available to it and its financial performance in the use of those resources, to ensure the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the effectiveness of those arrangements and, through the accountable officer, to make arrangements to secure Best Value.

Acknowledgement

We wish to place on record our appreciation of the co-operation and assistance extended to us by staff during the first year of our work in the discharge of our responsibilities.

Strategic planning

Setting the strategic agenda

Economic growth is a key priority for the Scottish Executive and Scottish Enterprise plays a vital role in delivering its success. As part of its strategic planning process, Scottish Enterprise has recently completed a review of its services and products, rationalising the incumbent product offering down to around 70 from an original 800. This has allowed greater focus on delivery of products against objectives.

The ambition to deliver evidence-based policy and operational activity is clearly articulated in the operating plan and reinforced by the demands of the board. In March 2006 Audit Scotland recommended that Scottish Enterprise should raise the quality of evaluations "to focus on broader, strategic studies that can deliver a wider picture of impact". To address this, a strategic approach to evaluation is being developed across the Network. The new approach places more emphasis on wider-ranging evaluations rather than evaluation purely at project level. The strategic agenda incorporates an evaluation framework approach that focuses upon issues for the Network and high risk, high cost projects. This allows the planning process to be more strategic and take into account the wider objectives of the organisation.

Measuring the impact of economic development

Measuring the impact of the Network on economic development is difficult. A study by Audit Scotland concluded that there is no easy way to assess the extent to which investment by an economic development agency influences overall changes in economic performance. However, without robust performance management frameworks in place, Scottish Enterprise risks being unable to fully demonstrate value for money and its contribution to economic growth.

In March 2006 Audit Scotland completed its study into whether the performance management framework for Scottish Enterprise provided a complete and accurate record of strategic and operational achievements. The review acknowledged the complexity in assessing the impact of Scottish Enterprise's investment on overall economic performance, while also recognising that comparatively Scottish Enterprise's approach appears to be well advanced. An action plan was devised and during 2006-07 has been progressed by management, with nine recommendations implemented and three ongoing.

Performance measures have been further developed for both 2006-07 and 2007-08, including thematic evaluation of programmes. The monitoring and evaluation framework for growing business strategy and industry plans is under development. New assessment measures have been introduced as part of the new priority measure for growth companies; the impact model is currently being updated with support from external advisors. External evidence and comparators are being used more when setting targets, rather than being based solely on past performance. There is a reporting framework to monitor performance and the results are used in Scottish Enterprise's decision-making processes. These developments will help to ensure that Scottish Enterprise can better measure, and consequently improve, its performance and impact on the economy.

Priority industries and metropolitan regions

In order to deliver *A Smart Successful Scotland*, Scottish Enterprise decided in 2006 to move to a "metropolitan approach", with a greater focus on projects with the greatest economic potential that align with industry demand. The adoption of this approach presents new opportunities and challenges for the organisation. 2006-07 was a transitional year, with measurement and reporting performance remaining under the existing framework. A new reporting framework has been developed to reflect the revised approach.

Adoption of a metropolitan approach will affect the governance arrangements of Scottish Enterprise and the Local Enterprise Companies. Changes have been made to the regional and local management structure and roles and responsibilities to reflect the new arrangements. The executive board, in considering the change, have identified issues surrounding the allocation process, approval process and management responsibilities. Metropolitan supervisory boards have been established to resolve these issues and to drive the transition towards the new approach.

Careers Scotland

In December 2006, the Minister requested that Scottish Enterprise make Careers Scotland a more "distinct entity" and "refocus" its activities. Following the announcement, Scottish Enterprise created a project team to drive this process forward. This involved reviewing internal governance arrangements, and the operational and financial management surrounding a potential de-merger. An internal steering committee was established and has now been replaced with an advisory board to improve the governance arrangements.

Operational management of the de-merger has been driven by a steering committee / advisory board and contingency plans have been put in place to respond to further decisions. The activities have also been refocused in the new operating plan. Funding of £1.5 million was approved to ensure that the objectives are met and the spend is monitored regularly. An announcement by the Scottish Ministers on the future status of Careers Scotland is awaited.

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Financial management

Context

To deliver the strategic priority of supporting sustainable economic growth, Scottish Enterprise requires a financial strategy which supports the longer term objectives set out in the operating plan, whilst meeting its annual resource budgets agreed with the Scottish Executive. Scottish Enterprise continues to face a demand for its resources and this requires robust financial monitoring. In particular, the introduction of the resource allocation model in 2005-06, in advance of restructuring of Network arrangements, together with the requirement to meet annual resource budgets, creates a control risk.

Budgeting arrangements

Systems are in place for the regular monitoring and reporting of budgets and financial performance to the board. Scottish Enterprise carries out regular re-forecasting of its plans and these are approved by the executive board. The principle of prioritisation to manage any slippage and underspends during the year ensures the highest ranked priority projects across the network are the initial recipients of funding. This process ensures that the most suitable projects assessed by management are being funded at the right time.

The utilisation of funds released from budgets during the year supports projects and programmes on a "reserve" list where there are firm and fixed legal commitments. Thereafter retained funding can be applied to increase existing project / programmes. The executive board and board receive regular updates of the amount of committed expenditure and how this is being prioritised. This reduces the risk of over committing, which could result in financial or reputational loss.

Projects are monitored regularly by project managers. Major projects are monitored by executive management and have also been subject to review by internal audit (Kemfine UK Limited, Centre for Biomedical Research, Ravenscraig, Prestwick International Aerospace Park, Glasgow Harbour, Kelvin Institute, public relations contracts, PPL Therapeutics and Stirling Medical). This monitoring is critical to the running of the organisation and provides robust controls over expenditure. Internal audit's overall conclusion for the major projects was that they are being well managed.

Financial monitoring and reporting

There were a number of external and internal reviews in relation to the 2005-06 financial outturn. These included recommendations that Scottish Enterprise should ensure that there was a long-term improvement in its overall financial management arrangements to better support the monitoring and financial decision-making processes. This would then allow the better management of commitments over the life-cycle of projects during the period of the operating plan.

We reviewed the progress made by management in implementing the findings from the internal and external reviews aimed at improving financial management and minimising the risk of overspends in future years. The status update report to the March 2007 audit committee noted that generally good progress was being made and that all the recommendations impacting directly on the 2006-07 financial year had been implemented. Of the 36 recommendations from the 2005-06 reviews, management reported that 30 have been implemented, with six recommendations in progress. Of the 30 recommendations implemented, for seven of these further work was required to refine the implementation of the original recommendation.

In order to supplement existing reporting arrangements, one of the principal recommendations from these reviews was that, as a minimum, quarterly balance sheets should be prepared. The objective of the recommendation was to allow management to obtain more accurate estimates of the likely cash and non-cash outturn position throughout the year.

As part of our interim audit we agreed with management that we would review the processes established over compilation of balance sheets. Our review found that, while from September 2006, quarterly balance sheets have been prepared on a 'partial' accruals basis, management had yet to establish a formalised quarterly balance sheet reporting framework, including formal detailed procedures, in addition to including the quarterly balance sheet reporting requirement in the quarter-end reporting timetable. In our view, the arrangement established during 2006-07 requires improving to become fully effective as a management tool.

Recommendation one

Again in response to the 2005-06 outturn, background information on government resource accounting has been provided to the board during the course of the year. Training for staff was also provided. Project lifecycle development guidance has been improved and up-dated to ensure the emphasis is on monitoring frameworks. Finance and planning teams have been merged to provide greater focus. In our opinion, a longer term view is now being taken in terms of business and operational planning.

2006-07 financial outturn

An analysis of the 2006-07 resource budget is summarised below.

	2006-07
	£'000
Cash budget	
Grant-in-aid	427,000
Utilisation of cash reserves	20,000
	447,000
'Non-cash' budget	35,000
Resource budget 2006-07	**482,000**

Source: Scottish Enterprise

The outturn position for 2006-07 was an underspend of £8.7 million, comprising an underspend against the 'cash' budget of £0.9 million and a £7.8 million underspend against the 'non-cash' budget.

In respect of 2007-08, Scottish Enterprise's operating plan amounts to £620 million. This reflects an increase in grant-in-aid from 2006-07 of £82 million.

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	2007-08
	£'000
Cash budget	
Grant-in-aid	509,000
Utilisation of cash reserves	10,000
	519,000
'Non-cash' budget	35,000
Resource budget 2007-08	**554,000**
Other income	66,000
Operating plan 2007-08	**620,000**

Source: Scottish Enterprise

Governance and risk management

Introduction

Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all bodies.

Through its chief executive, Scottish Enterprise is responsible for establishing arrangements for ensuring the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. The *Code* requires auditors to review and report on Scottish Enterprise's corporate governance arrangements as they relate to:

- Scottish Enterprise's reviews of its systems of internal control, including its reporting arrangements;
- the prevention and detection of fraud and irregularity;
- standards of conduct and arrangements for the prevention and detection of corruption; and
- its financial position.

Management is responsible for establishing arrangements for the conduct of its affairs, including compliance with applicable guidance, ensuring legality of activities and transactions and monitoring the adequacy and effectiveness of these arrangements in practice. Scottish Enterprise operates in a complex legislative, political and operational context and good governance assists in this process, supported by formalised structures which distinguish between strategy and oversight and operations. There is a range of policies and procedures that set the context and framework within which Scottish Enterprise operates consistent with requirements of the Management Statement set out by the Scottish Ministers.

Risk management

A formal risk management strategy is in place, approved by the board. Strategic and operational risk registers have been established and are monitored on an ongoing basis across the organisation. Risk "champions" within each business unit each maintain a risk register.

Risks are identified at a project level and there is a process to manage and mitigate identified risks. Significant risks are incorporated into the corporate risk register. Risks are prioritised according to impact and likelihood and allocated to specific directorates for monitoring and control, including internal audit. The board and audit committee receive updates on risk management on a regular basis.

Scottish Enterprise has not yet concluded the process of developing disaster recovery and business continuity plans to mitigate the risk to operations in the event of a disaster impacting the information technology systems or general infrastructure.

Training needs are assessed and delivered to meet the demands of embedding risk management and good corporate governance practices into the organisation, from board members to project managers. In order to ensure good practice the board have had a full development session delivered by CIPFA on board responsibilities. They also held a discussion on the role of the board. In addition to this training at a corporate level, Scottish Enterprise has comprehensive and high quality training available on the project lifecycle.

Systems of internal control

Statement on internal control ("SIC")

The SIC for 2006-07 provides details of the internal control environment and risk management and control framework. Management highlight that the organisation is committed to a process of continuous development and improvement and to developing systems in response to any relevant reviews and developments in best practice. While no significant weaknesses are included in the SIC, management acknowledge that work is underway to improve the information security, business continuity and disaster recovery arrangements.

Management have established an internal controls assessment framework, complementing the risk management and internal audit arrangements. This requires each significant business unit to submit signed statements of assurance to the chief executive to assist in his preparation of the SIC. A significant business unit includes all Local Enterprise Companies, internal business units and significant subsidiaries. The basis of this review is a detailed internal control checklist which, once completed, provides the context for the business unit leader to sign off the local assurance certificate. This process is coordinated by internal audit and the results were formally reported to the audit committee which considered the annual accounts. No significant control weaknesses were reported through this process.

Internal audit

At an early stage in our audit we undertook an assessment of Scottish Enterprise's internal audit arrangements. Organisational and operational areas were considered against recognised professional criteria, with positive conclusions in all nine areas evaluated. In addition, we performed detailed file reviews in areas where we formally placed reliance on the work of internal audit. This confirmed that we would be able to place reliance on areas identified within our plan.

The 2006-07 internal audit plan was substantially completed, with 2,790 days delivered compared to the planned level of 3,000. The most significant area of variance was in respect of a review of the governance arrangements – metropolitan regions, where only three days were delivered compared to the planned 50. Management's intentions are to complete this review in 2007-08 once the metropolitan regions framework has become more established. Given the importance of this new framework in the delivery of Scottish Enterprise's objectives this will be an important area of internal audit focus in 2007-08.

In relation to 2006-07, internal audit have concluded that there is a "satisfactory level of assurance in the areas reviewed, subject to implementation of the agreed actions." The main exceptions to this level of assurance were in respect of reviews on the customer relationship management system, overseas payroll and business gateway international. The findings from local reviews across the organisation are presented to the respective local audit committee.

For 2006-07 internal audit drew attention to the findings of their work at Scottish Enterprise Dumfries & Galloway requiring further attention relating to recurring weaknesses in project management. The process of continuous follow up of previous audit recommendations identified that, while action is being taken by management, progress in remedying identified control weaknesses has not progressed as planned in respect of business continuity and disaster recovery arrangements.

Internal controls

Drawing on the work of internal audit, in accordance with our plan we undertook detailed testing in relation to both entity-level and key financial controls. Our work in this area included consideration of the principal accounting systems to assess whether the related controls were designed appropriately and operating effectively to prevent or detect a material misstatement of the accounts, consideration of management's reporting arrangements and review of the IT control environment. This included a review of management progress in implementing IT-related recommendations from prior years.

While an increased focus has been placed on business continuity and disaster recovery by Scottish Enterprise, the most significant findings were in respect of a continuing need for the areas of business continuity and disaster recovery arrangements to be progressed and finalised. We also noted some weaknesses around physical access to the server room and over the access rights to the purchase order processing application and network for staff that leave the organisation.

Follow-up found that, from a total of 35 recommendations from prior year reviews, nine recommendations remain outstanding, with nine recommendations partially implemented.

Our testing of the design and operation of controls over significant risk points suggests that, subject to some minor weaknesses reported, such controls are designed appropriately and operating effectively. We have reported some areas where the control environment could be enhanced in our interim management report.

Prevention and detection of fraud and irregularity

There is a formal whistle-blowing policy governing the procedures to be followed in the event of a fraud or suspected fraud. Where management are made aware of a suspected fraud, the internal fraud response group is convened to co-ordinate an investigation. Attendance at the fraud response group depends on the nature of the alleged fraud, but will usually include senior management from finance, human resources and internal audit.

Significant frauds are reported to the audit committee, with an annual report on losses and investigations presented to the committee at the meeting where the annual accounts are considered.

There were no material instances of fraud or irregularity reported during 2006-07.

Standards of conduct

Scottish Enterprise staff are required to operate in accordance with the Civil Service Code. This is supported by an internal code of conduct setting out the required minimal ethical and behavioural expectations. There are comprehensive human resources policies and procedures providing additional guidance to staff which are readily accessible to staff on the intranet. There is also a formal register of interests for recording board members and senior managers' interests. This is regarded as best practice and assists in demonstrating consideration of independence in decision-making and the awarding of contracts.

People management

Scottish Enterprise employs around 2,400 full-time equivalent staff across the Network. Effective management of staff resources is critical to the efficient and effective running of the organisation. There are a number of criteria contained within the Management Statement that govern the staff management regime. Scottish Enterprise has embedded this into its human resource systems.

In 2006-07, the organisation completed a restructuring of senior management responsibilities applying its existing severance policy. This policy has been reviewed from time to time, including before the latest severances. Agreement was given by the Scottish Executive for the programme at a cost of £7 million. Following board approval of the intended approach, voluntary redundancy was offered to all employees in a senior management position. Individual applications were reviewed by the executive board and offers were made to those where the redundancy would be supported by a business case. Redundancy packages constituted a mix of payment in lieu of notice, severance and additional pension contributions. Payments were to be capped at fives times salary, although costs for two employees exceeded this cap. Severance arrangements for 39 employees were agreed at a total cost of £8 million, with a payback period of two years.

We understand that the Scottish Executive was advised of progress on the restructuring, including the total cost. Audit work confirmed that payments were made in accordance the severance policy. However, the level of documentation retained by management to support the approval process and the determination of the five times salary cap was less than we would have expected.

Recommendation two

Partnership working

There is an increased need for organisations in the public sector to work together and ensure that common objectives are achieved. Scottish Enterprise participates in a number of partnerships at various levels and to facilitate this has developed a number of network tools to evaluate how partnerships are performing. An assessment of importance, impact and approach to community planning and the Local Economic Forum across the Network was undertaken during 2006-07. The executive board recommended an increased resource for partnership working in 2007-08 to ensure the Network executes its community planning responsibilities effectively.

Efficient government and Best Value arrangements

Efficient government

Targets set by the Scottish Executive for 2005-06 and 2006-07 are reported as met or exceeded. In 2006-07 management reported cash releasing efficiency savings of £14.5 million (target £9.55 million) and time releasing efficiency savings of £1.5 million (target £6 million). The main movement in cash savings was an additional £3.5 million being reported as a result of reduced headcount costs (£3 million) and a reduction in external public relations costs (£0.5 million), in addition to a number of other areas performing ahead of the target. However, following a review of the customer relationship management system by internal audit, it was concluded the overall time releasing savings from that project stand at £1.5 million instead of the estimated £6 million.

The target for efficiency savings in 2007-08 is £18.25 million. Progress towards targets is reported to the executive management team during the year. The board is focused on efficiency savings, driving an "efficient government" culture through the organisation, which should ensure that the planned initiatives are feasible and will achieve the required savings. Management believe that the plans are feasible and do not jeopardise the delivery of the services or financial viability.

Following studies considering the potential for shared services across non-departmental public bodies, Scottish Enterprise has indicated a willingness to be involved and possibly lead on a number of potential projects. In addition, it is keen to support complex projects, because the gains to be achieved for the public sector as a whole, should outweigh the significant implementation issues.

Best Value

During 2005-06 Audit Scotland undertook a baseline assessment of Scottish Enterprise's position in relation to Best Value. Seven out of the nine areas were found to be 'under development' to secure Best Value, with the remaining two areas regarded as 'well developed' (responsiveness and consultation, and joint working). The executive board has approved an initial governance structure for Best Value to cover the nine characteristics a Best Value organisation should display. With a view to embedding Best Value in the organisation, a steering group was established in June 2006 and completed a further assessment using relevant guidance. This confirmed that Scottish Enterprise was well placed to demonstrate continuous improvement.

Management have determined that, in the absence of any specific direction from the Scottish Executive, Best Value should be incorporated into business activity, with internal audit monitoring progress through the internal audit process.

For 2007-08 internal audit have therefore incorporated Best Value into their plan to ensure that the initiative is driven forward.

At management's request we are currently carrying out a review of the implementation of Scottish Enterprise's customer relationship management system, including the realisation of the anticipated benefits. The results of this review will be reported to management in due course.

Accounts audit

Audit opinion

On 25 July 2007 we issued an audit report expressing an unqualified opinion on the accounts of Scottish Enterprise and the Network for the year ended 31 March 2007 and on the regularity of transactions reflected in those accounts.

We bring the following issues to your attention.

Glasgow Science Centre

The Glasgow Science Centre was previously carried in the Network accounts at cost. This was not consistent with the accounting policies, which requires properties to be reflected at market value. A valuation of the Glasgow Science Centre was carried out by independent valuers at 31 March 2007 and this valuation has been reflected in the accounts.

European Union Funding

In January 2005, the European Court of Auditors ("ECA") conducted an audit into grants given to three Local Enterprise Companies. In April 2007 ECA issued a request for further information regarding a number of European Union funded projects, which could result in a potential "clawback" of up to £10.1 million. Scottish Enterprise has considered that, on the basis of information held by it, the likelihood of a material liability is remote and has not included a provision or contingency disclosure in the accounts.

Entitlements

In meeting its strategic objectives, Scottish Enterprise regularly enters into agreements with third parties. These contractual arrangements may result in future revenue streams to Scottish Enterprise ("entitlements"). Given the potential significance of this area, we considered the process and controls established to capture and record entitlements.

Entitlement registers are maintained across the Network, but there is a lack of a consistency in the nature and quality of the registers maintained. Management are satisfied that there are sufficient controls throughout the organisation to ensure that entitlements are correctly entered into and captured in the accounts. Management have however initiated a project to enhance the corporate approach to reporting entitlements to ensure a more consistent approach. As a result of our audit work, opportunities to improve the system surrounding the process for recording entitlements were also identified and reported to management.

In October 2004 Scottish Enterprise Edinburgh & Lothian ("SEEL") entered into a development agreement with the University of Edinburgh ("the University") in respect of the Biomedical Research Park. The site was acquired by SEEL, with the University paying £3.7 million for the right to draw down title to specific plots over the next 15 years. In our view, in accordance with FRS 5 *Reporting the substance of transactions*, while formal title had not yet passed to the University, the nature of the contract is such that, as the ability to gain future economic benefits relating to this land had been transferred, the disposal should have been recognised. As there was no impact on the operating cost statement, we have not required management to process this adjustment.

Under the terms of a related 'collaboration agreement' between SEEL and the University, SEEL is responsible for contracting with external service providers to provide infrastructure and site works, for which the University will reimburse Scottish Enterprise for its proportion at the date when title to individual sites is drawn down. The agreement includes a backstop that the University will draw down all land and pay all associated costs by 2015. As part of the audit we considered the required recognition of an asset by Scottish Enterprise as a result of this agreement. The existence of the contract, and particularly the agreed end date by which all land will be drawn down, gives rise to the obligation on the University to pay for a share of the infrastructure and site work costs and as a result this requires to be reflected in the accounts of Scottish Enterprise. Management have processed an adjustment to the accounts, reducing net expenditure for the year by £1.8 million.

Recommendation three

Fixed assets

During 2006-07, for the first time, management compiled a fixed asset register to support the value of non-property fixed assets reflected in the accounts. As a result of this exercise an adjustment to the accounts was processed to write-off non-property fixed assets of £9.4 million with accumulated depreciation of £9 million. This resulted in a charge to the operating cost statement of £400,000. Management should ensure that responsibility is assigned for managing the non-property fixed asset register and that a clear framework is developed for managing and controlling non-property fixed assets.

Recommendation four

Investments

Scottish Enterprise invests in a number of companies either through ordinary shares, preference shares or loans. These investments are held across five main funds: Business Growth Fund, Scottish Co-investment Fund, Scottish Seed Fund, Residual Fund and the Scottish Venture Fund. Of these funds, two are closed, with only three remaining active. All investments in these funds are monitored through an investments register maintained by the investments team.

Investments are held at the lower of cost and net realisable value. However, the current system is not sufficiently robust to allow a regular and detailed review of each investment. Management have advised that a new system for monitoring investments is being implemented in December 2007. As part of this, a new team has been set up with the purpose of enhancing the depth of analysis over the performance of individual investments. This will allow management to obtain a more robust understanding of individual investment and any level of provision required. In addition, we identified that there is scope to enhance the investment property register.

Recommendation five

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Appendix – action plan

Priority rating for performance improvement observations raised		
Grade one: Issues that are fundamental and material to your system of internal control. We believe that these issues might mean that you do not meet a system objective or reduce (mitigate) a risk.	**Grade two**: Issues that have an important effect on internal controls, but do not need immediate action. You may still meet a system objective in full or in part or reduce (mitigate) a risk adequately, but the weakness remains in the system.	**Grade three**: Issues that would, if corrected, improve the internal control in general, but are not vital to the overall system. These are generally issues of best practice that we feel would be of benefit to you if introduced.

No.	Issue and performance improvement observation	Management response	Officer and due date
1	Formal policies and procedures over the preparation of the quarterly balance sheet have not yet been developed. It was also noted that a number of accruals, non-cash and year-end adjustments, some of which may be potentially significant, are not adjusted in the construction of the quarterly balance sheet. Management should develop and formalise full quarterly reporting procedures which detail all the adjustments that should be required to create the income statement and balance sheet on a 'full' accruals basis. These instructions should: • set out all adjustments from the year end procedures that should be reflected in the quarterly balance sheet process. This should include formally identifying adjustments which are likely to be insignificant, and identification of those that are insignificant and those to which no reasonable estimation can be made. • reflect an agreed basis for estimations. *(Grade two)*	Management plans to go beyond the areas noted in this recommendation and be in a position to produce full accounts on a monthly basis. New procedures will be implemented as part of the review of financial accounting areas.	Finance Director: Shared Services 31 December 2007
2	Consideration of the application of the severance policy found that the level of documentation retained by management to support the approval process and the determination of the five times salary cap was less than we would have expected. *(Grade two)*	We are satisfied that all key decisions were appropriate and were supported by robust governance arrangements but in future we will ensure that all relevant documentation is retained for audit purposes.	-

No.	Issue and performance improvement observation	Management response	Officer and due date
3	Entitlements that are received by the LECs are remitted back to Scottish Enterprise National and accounted for in the Network accounts. Entitlement registers are maintained across the Network but there is a lack of consistency and quality in these. Management should ensure that the project already initiated in this area leads to the adoption of a corporate approach to recording and reporting entitlements. *(Grade two)*	Agreed – appropriate action is already underway.	Finance Director: Shared Services
4	A fixed asset register for non-property assets was created at the end of the year to more accurately reflect the assets held. In order to build upon this work, management should establish a policy and framework for non property fixed assets and appoint an officer who has responsibility to oversee this area. *(Grade two)*	Agreed.	Finance Director: Shared Services 31 December 2007
5	Scottish Enterprise holds a large number of investment properties. Title deeds are held for these either internally or externally. The wording used to identify the properties is not consistent between the title deed register and the investment property resulting in it being difficult to reconcile the title deeds to the properties held. The investment property register could be improved as it does not currently cross refer to where the title deeds are held. The asset register should be updated for title deed and lease status. The investment property register should be enhanced to included details of where the title deeds are held. The title deed register should cross refer to the property it relates to. *(Grade two)*	Agreed.	Finance Director: Shared Services 31 December 2007

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