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INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Scottish Enterprise

Annual audit report to Scottish Enterprise and the Auditor General for Scotland
2007-08

23 July 2008

AUDIT

AUDIT ▪ TAX ▪ ADVISORY

Contents

Executive summary

This report summarises our work for 2007-08 and our findings in relation to our audit of the accounts, corporate governance and performance management arrangements.

Audit of the accounts

Following approval on 23 July 2008 we issued an audit report expressing an unqualified opinion on the accounts of Scottish Enterprise for the year ended 31 March 2008 and on the regularity of transactions reflected in those accounts.

Management made a number of presentational changes to the management commentary and accounts classifications and disclosures to reflect the organisational re-structuring and to ensure compliance with the requirements of the Government Financial Reporting Manual.

A European Union audit raised a number of verification and compliance issues, which could result in the European Union potentially clawing back up to £13 million of funding. As the Scottish Government (as managing agent) has included a provision for the maximum potential repayment within its own 2007-08 accounts, there is no need for Scottish Enterprise to reflect this in its own accounts.

The accounts report the impact of current market conditions on the carrying value of investment property as a non-adjusting post balance sheet event that requires ongoing monitoring.

Corporate governance

We considered corporate governance arrangements as they relate to systems of internal control, the prevention and detection of fraud and irregularity, standards of conduct and arrangements for the prevention and detection of corruption, and its financial position.

The corporate governance framework has been designed and implemented appropriately. The design and implementation of supporting, organisation-wide controls is effective. With regard to IT controls, specifically, while management has increased focus on business continuity and disaster recovery arrangements in mitigation of potential organisational loss, they have made limited progress in other areas, such as IT security.

In relation to 2007-08, internal audit concluded that there is a "satisfactory level of assurance in the areas reviewed, subject to implementation of the agreed actions for weaknesses identified".

Various internal reviews found that procurement and contract tendering arrangements during the period to 31 March 2007 had not always been conducted in accordance with internal procedures or European Union regulations. The executive board introduced revised procurement and contract tendering arrangements from 1 April 2007.

Management reported net expenditure for the year of £535.4 million, which is £2.2 million (0.4%) below the resource budget allocation. The 'non-cash' outturn was £8.9 million (25%) below the budget allocation. Management noted that measurement against the key performance indicators in 2007-08 demonstrate that Scottish Enterprise has had a very successful year.

In March 2008 (revised June 2008) the board agreed a balanced budget and reflected this in the business plan, showing a resource outturn of £339 million. In order to inform resource allocation for 2009-10 and 2010-11 management has commenced a zero based budgeting review.

Performance management

All areas of the business have now introduced a standard project progress report as part of the quarterly performance review framework. Of the 59 major projects that remained 'live' at April 2008, 51 of these projects were on track, subject to revised timescales.

Overall, we have concluded that, subject to the matters identified by internal audit and us, that the management of the (internal) organisational change process appears to have been robust with risk management, project management and communication to both the executive board and other stakeholders embedded in the process.

Organisational restructuring resulted in significant changes to the staffing structure during 2007-08. In total, 257 members of staff applied and were accepted for voluntary severance at a cost of £26 million. The governance arrangements for the scheme were appropriate.

Review of the policies and procedures over dealing with complaints and allegations confirmed that, with the exception of a formal procedure for the investigation of serious complaints, managing anonymous complaints and trend analysis of data, arrangements are designed, implemented and operating effectively.

The Best Value self-assessment questionnaire shows that Scottish Enterprise is now 'well developed' in seven of the nine areas and 'under development' in the remaining two (sustainable development, and equal opportunities).

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). For the remaining targets, a line-by-line review of expenditure and a review of information services aimed to save a further £2.6 million and £3.5 million, respectively. For 2007-08, management reported total savings of £7.2 million against the combined target of £5.1 million.

Introduction

Audit framework

This year was the second of our five-year appointment by the Auditor General for Scotland as external auditors of Scottish Enterprise. This report to Scottish Enterprise and the Auditor General provides 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 the regularity of its transactions;
- review and report on:
  - corporate governance arrangements as they relate to: review of systems of internal control; the prevention and detection of fraud and irregularity; standards of conduct, and prevention and detection of corruption; and Scottish Enterprise's financial position
  - Scottish Enterprise's arrangements to achieve Best Value
  - other aspects of arrangements to manage performance, as they relate to economy, efficiency and effectiveness in the use of resources.

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

Overview

During the year, Scottish Enterprise delivered projects and programmes against the strategic themes of: growing businesses, global connections, and skills and learning. This was achieved through grant-in-aid and utilisation of retained cash reserves. The measurement of Scottish Enterprise's overall impact is complex, reflecting the long-term nature of its work and the contributions made by partners and customers. Actual performance for 2007-08 was either within or in excess of the forecast range of key performance indicators set in the year's business plan.

On 26 September 2007, the Cabinet Secretary for Finance and Sustainable Growth announced the government's economic strategy for Scotland. In order to improve efficiency and effectiveness the government is aiming to eliminate duplication and unnecessary bureaucracy. Two objectives have been pursued in designing the structures to implement the economic strategy:

- establish a clear focus within enterprise agencies on fulfilling their core purpose of assisting enterprise development in Scotland; and
- creating greater cohesion in the provision of local economic and enterprise development services in Scotland.

Accordingly, there is to be a focus on better and closer working with the agencies that have responsibility for the Scottish economy.

This announcement resulted in significant restructuring of Scottish Enterprise, with the Local Enterprise Companies ceasing to operate from 1 April 2008. While they remain as legal entities and may hold assets for administrative purposes, all operations formerly carried out by them are now directly delivered through Scottish Enterprise. All Careers Scotland activities and most skills and training activity have been transferred to Skills Development Scotland. Scottish Enterprise continues to deliver skills interventions that are specific to business growth. Responsibility for the provision of local business support through Business Gateway operations and local regeneration activities are in the process of transferring to local authorities.

In line with practice at other public sector bodies, we have used *Priorities and Risks* guidance produced by Audit Scotland in support of the implementation of our risk-based audit methodology.

Responsibilities of the Board and its auditors

External auditors do not act as a substitute for Scottish Enterprise's own responsibilities, through its accountable officer, for putting in place proper arrangements to account for its 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 accountable officers, to make arrangements to secure Best Value.

We have structured the report around the headings audit of the accounts, governance arrangements and performance management arrangements.

Acknowledgement

We wish to record our appreciation of the continued co-operation and assistance extended to us by your staff.

Audit of the accounts

- We have issued unqualified opinions on the accounts.
- Management made a number of presentational changes to the management commentary and accounts classifications and disclosures to reflect the organisational re-structuring and to ensure compliance with the requirements of the Government Financial Reporting Manual.
- A European Union audit raised a number of verification and compliance issues, which could result in the European Union potentially clawing back up to £13 million of funding. As the Scottish Government (as managing agent) has included a provision for the maximum potential repayment within its own 2007-08 accounts, there is no need for Scottish Enterprise to reflect this in its own accounts.
- The accounts report the impact of current market conditions on the carrying value of investment property as a non-adjusting post balance sheet event that requires ongoing monitoring.

Reporting arrangements and timetable

In accordance with the agreed timetable, draft accounts were available for audit on 26 May 2008. This allowed for timely completion of the audit and consideration and approval of the accounts on 23 July 2008.

Audit opinion

Following approval on 23 July 2008 we issued an audit report expressing an unqualified opinion on the accounts for the year ended 31 March 2008 and on the regularity of transactions reflected in those accounts. Prior to finalisation, we agreed with management a number of presentational changes to the management commentary and accounts classifications and disclosures to reflect the organisational re-structuring and to ensure compliance with the requirements of the Government Financial Reporting Manual.

We bring the following issues to your attention.

European Union funding

In initiating projects that meet certain criteria, Scottish Enterprise is entitled to claim European Union funding. Two verification and compliance visits took place at Scottish Enterprise Glasgow in January and September 2006 to review two projects in the 2000-06 West of Scotland Objective 2 Programme. A separate visit to Scottish Enterprise Dumfries and Galloway also took place. A number of issues were raised within the subsequent reports to the then Scottish Executive, as managing authority, in February 2007. The key issue raised was in relation to evidence held to support grant payments made to third parties.

Scottish Enterprise management undertook an assessment of how much funding had been claimed by the group from the European Union that may not comply with the rules. The assessment was that up to a maximum of £13 million of funding could potentially be clawed back. The Scottish Government (as managing agent), in agreement with Scottish Enterprise, has included a provision for the maximum potential repayment to the European Union within its 2007-08 accounts, there is no need for Scottish Enterprise to reflect this in its own accounts.

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

Fixed assets

Scottish Enterprise's accounting policy for investment properties and land is to reflect these in its accounts at market valuation as advised by external valuers. A revaluation of the portfolio was carried out as at 31 March 2008. As part of our procedures we had discussions with the valuers to assess their methodology. These discussions included the potential impact of current market conditions on the valuation, recognising that an element of the portfolio is held for residential development. Scottish Enterprise subsequently requested that the valuers advise further on this matter. An assessment of the impact was reflected in the accounts as a non-adjusting post balance event.

Recommendation one

As a result of the organisation restructuring, Scottish Enterprise is examining its existing operating property portfolio, including its headquarters, with a view to securing operational efficiencies while remaining close to its customers. This review commenced during 2007-08 and remains ongoing as at the date of approval of the accounts. Management confirmed that as part of the preparation of the 2007-08 accounts they had considered, in accordance with Financial Reporting Standard 11 *Impairment of fixed assets* and determined that there had been no decisions taken which would result in impairment to the carrying value of its fixed assets.

During 2006-07 management compiled, for the first time, a fixed asset register to support the value of non-property fixed assets reflected in the accounts. Management should ensure that in the context of the recent reorganisation and the potential ongoing impact on Scottish Enterprise's fixed asset base, 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 two

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. At 31 March 2008 these funds consisted of 389 investments in 198 companies (excluding Local Enterprise Companies and their subsidiaries) with a carrying value of £41 million recognised in the 2007-08 accounts.

In response to external audit observations as part of the 2006-07 audit, management confirmed that the system for monitoring investments was being updated to allow a detailed review of each investment. While due for completion in December 2007, the implementation of the new system remains ongoing.

Recommendation three

Approval is required from the Scottish Government for all investments that result in Scottish Enterprise holding in excess of 30% of the company. Our audit testing highlighted that one investment exceeded this threshold by 0.6% (£2,862), with no evidence of Scottish Government approval.

Recommendation four

Entitlements

In meeting its strategic objectives, Scottish Enterprise regularly enters into agreements with third parties. These contractual arrangements may result in future revenue streams or future liabilities to Scottish Enterprise ("entitlements"). During 2007-08, management initiated a project to enhance the corporate approach to reporting entitlements to ensure a more consistent approach across the network. Whilst management have made progress by identifying the key areas requiring development in the historic process, and created controls to mitigate the associated risks, the process has yet to be formalised and fully implemented. Scottish Enterprise continues to operate with 12 different entitlement registers although these are now centrally controlled following the reorganisation.

Recommendation five

FRS 17 *Retirement benefits*

Scottish Enterprise operates one pension scheme, the Scottish Enterprise Pension & Life Assurance Scheme. In addition, some members of staff are members of the Local Government Pension Scheme, namely the Strathclyde Pension Fund.

As part of the voluntary severance arrangements, £11.2 million of additional pension contributions were due to the Scottish Enterprise Pension & Life Assurance Scheme as at 31 March 2008. However, while the actuaries had taken past service costs into account in arriving at a value of the scheme's assets and liabilities, these additional accrued contributions were not considered. Through the audit process management requested and obtained a revised actuarial report that showed a pension scheme asset of £46.4 million (2006-07: £4.3 million asset). The scheme's actuaries have confirmed in their report that the recognition of this asset is appropriate as it represents the opportunity for future reductions in contributions. At 31 March 2008 the Strathclyde Pension Fund had a deficit of £2.9 million (2006-07: £12.7 million deficit).

An amendment to FRS 17 was issued in December 2006 to align UK accounting requirements with international accounting standards. The amendment is not mandatory for Scottish Enterprise until the year ending 31 March 2009, but there is an option to early adopt. The amendment requires quoted securities held by pension schemes to be measured using bid prices as opposed to mid-market prices. The scheme's actuaries valued the quoted securities held in the Scottish Enterprise Pension and Life Assurance Scheme at bid price in line with the required amendment to FRS 17, but were unable to provide the information for the Strathclyde Pension Fund. Despite initial intentions, Scottish Enterprise decided not to early adopt, as the accounts would have to be updated for additional disclosures (such as, separate opening to closing reconciliations for scheme assets and liabilities and disclosing the mortality assumptions used) and a revised actuarial report would be required to provide this. We have recorded an unadjusted audit difference of £1 million being the difference between the value of the assets valued in the scheme at bid price compared to mid market price as disclosed in the actuaries' report.

Corporate governance

- The corporate governance framework has been designed and implemented appropriately. The design and implementation of supporting, organisation-wide controls is effective. In relation to IT controls specifically, while management has increased focus on business continuity and disaster recovery arrangements in mitigation of potential organisational loss, they have made limited progress in other areas.
- In relation to 2007-08, internal audit concluded that there is a "satisfactory level of assurance in the areas reviewed, subject to implementation of the agreed actions for weaknesses identified".
- Various internal reviews found that procurement and contract tendering arrangements during the period to 31 March 2007 had not always been conducted in accordance with internal procedures or European Union regulations. The executive board introduced revised procurement and contract tendering arrangements from 1 April 2007.
- Management reported net expenditure for the year of £535.4 million, which is £2.2 million (0.4%) below the resource budget allocation. The 'non-cash' outturn was £8.9 million (25%) below the budget allocation. Management noted that measurement against the key performance indicators in 2007-08 demonstrate that Scottish Enterprise has had a very successful year.
- In March 2008 (revised June 2008) the board agreed a balanced budget and reflected this in the business plan, showing a resource outturn of £339 million. In order to inform resource allocation for 2009-10 and 2010-11 management has commenced a zero based budgeting review.

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 corporate governance arrangements as they relate to:

- reviews of systems of internal control, including reporting arrangements;
- the prevention and detection of fraud and irregularity;
- standards of conduct and arrangements for the prevention and detection of corruption; and
- 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 these arrangements, supported by formalised structures that distinguish between strategy and oversight and operations. There is a range of policies and procedures that set the context and the framework within which Scottish Enterprise operates consistent with requirements of the Management Statement set out by the Scottish Ministers.

Corporate governance framework

Scottish Ministers appoint board members who, with the exception of the chief executive, do not hold contracts with Scottish Enterprise. Subject to financial limits, a memorandum of delegated authority gives the chief executive authority for all functions. Where the board has delegated responsibility or decision-making power to the chief executive or a sub-committee, this is included in a memorandum of delegated authority or the terms of reference for the relevant sub-committee. There are six sub-committees: audit, operations, investment, performance, nominations and remuneration. The board consists of 12 members, including the chief executive. At an operational level, senior management – known as the executive board – supports the board.

The Ethical Standards in Public Life etc. (Scotland) Act 2000 requires Scottish Enterprise to implement a code of conduct for board members, outlining their responsibilities. In line with the model code, the Scottish Enterprise code contains rules of conduct on:

- general conduct;
- registering of interests;
- declaration of interests; and
- lobbying and access to members of public bodies.

We considered the corporate governance arrangements, and combined with the work of internal audit, have concluded that the framework has been designed and implemented appropriately.

Statement on internal control ("SIC")

The SIC for 2007-08 provides details of the internal control environment and risk management and control framework. Management highlight that the system of internal control is based on an ongoing process designed to identify the principal risks to the achievement of the organisation's policies, aims and objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively and economically. The SIC identifies that a number of processes have been established to allow the accountable officer to review the effectiveness of the systems of internal control. These include corporate risk arrangements, internal audit and an internal control assessment framework.

The internal controls assessment framework, complementing risk management and internal audit arrangements, 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 that provides the context for the business unit leader to sign off the local assurance certificate. Internal audit coordinated this process and the results were formally reported to the audit committee at the time of consideration of the annual accounts.

All statements of assurance received gave positive confirmation that the internal controls within individual business areas have been, and are, working well and there are no significant matters that require to be raised.

Detailed control checklists identified some issues, but these are not viewed as having a significant impact on the overall assurance given. The main issues (previously reported to the audit committee) were in relation to the procurement of consultants / contractors and European funding.

The SIC does not disclose any significant weaknesses in the systems of internal control. The content of the statement is consistent with our understanding.

Risk management

A formal risk management strategy is in place, approved by the board and in accordance with the relevant guidance issued by Scottish Ministers. During 2007-08 Scottish Enterprise refreshed its risk management arrangements. The organisation has an approved risk management policy that outlines the attitude to risk and approach to its management. The risk management policy and procedure is available to staff on the intranet.

At a corporate level, a risk register collates the identified risks and considers those risks that may influence the achievement of strategic goals and objectives. In addition, each business unit is responsible for maintaining a system of risk management that is consistent with the corporate risk arrangements. Management has confirmed that for 2007-08 local risk registers were in place at business unit level. Risks are also identified at a project level and there is a process to manage and mitigate identified risks and to escalate these where they are deemed critical. Risks are prioritised according to impact and likelihood, and allocated to specific directorates, including internal audit, for monitoring and control.

To support the organisational restructuring a number of work streams were identified to ensure that the process was managed as efficiently and effectively as possible. These included structure review, governance, advisory groups and stakeholder engagement, staffing models and financial overview amongst others. This was overseen in considerable detail by the executive board as individual work stream sponsors and collectively. The objectives of each work stream were communicated to staff along with details of the individuals responsible for them. The allocation of specific tasks to responsible individuals ensured that there was sufficient accountability for the delivery of project goals.

For each of the individual work streams, a risk register supported the detailed project plan. Significant risks were escalated to the head of business planning and reported to the executive board, along with mitigating actions to address them. To support overall project management an escalation procedure was established with effect from 5 December 2007. The purpose of the escalation procedure ensured that non-achievement of deliverables were highlighted and escalated quickly enough to an appropriate level to support resolution. Effective risk management procedures ensured that action was taken in a timely manner to mitigate the risks identified and subsequent action was taken when non-achievement of deliverables was identified.

The audit committee is responsible for reviewing the organisation's approach to risk management and receives reports on a six-monthly basis. The executive board and Scottish Enterprise board receive updates on risk management on a regular basis.

Internal audit

Our planned audit approach seeks, wherever possible, to place reliance on the work completed by internal audit to minimise duplication of effort and ensure maximum benefit from the combined audit resource. We revised our understanding of Scottish Enterprise's internal audit arrangements, assessing organisational and operational areas against recognised professional criteria. This included consideration of the scope of internal audit work, the independence of the internal audit function, arrangements to secure due professional care and quality of work performed and reporting mechanisms. Positive conclusions were again reached in all areas evaluated.

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 internal audit's work. We placed reliance on the following specific areas:

- priority industries;
- change management;
- efficient government;
- investments;
- treasury management;
- network finance centre;
- governance arrangements;
- key project controls;
- priority projects;
- procurement;
- national training programmes;
- European state aid and funding;
- ITI Scotland
- procurement of CRM contractors; and
- procurement of contractors.

We also took into account the findings from the other work completed by internal audit to inform our approach to the audit.

The 2007-08 internal audit plan was completed, with 2,102 days delivered compared to the planned level of 2,250. As part of their planned input internal audit also completed a number of 'real time' audits to support the organisation's transition process. In addition, internal audit also completed two special investigation assignments.

The main areas internal audit identified requiring attention was in relation to the procurement of contractors, European funding, priority projects, business continuity and disaster recovery and data handling. These areas are consequently identified as areas for continued focus in the 2008-09 plan. In relation to 2007-08, internal audit have concluded that there is a "satisfactory level of assurance in the areas reviewed, subject to implementation of the agreed actions for weaknesses identified."

Internal controls

Drawing on the work of internal audit, we carried out detailed testing in relation to both organisation-wide 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 and review of the IT control environment. This included a review of management's progress in implementing IT related recommendations from prior years.

We concluded that, overall, the design and implementation of organisation-wide controls was effective, and that key financial controls, with the exception of some minor observations, were operating effectively. We made some recommendations to enhance the efficiency and effectiveness of the control framework.

Work over IT general controls found that the controls operating over access to programs and data appeared generally appropriate, although we identified some areas for improvement. While there has been an increased focus on business continuity and disaster recovery arrangements in mitigation of potential organisational loss, limited progress has been made on the other issues identified in the previous year. Recent changes from the re-structuring in the information services department will have an impact on current business continuity and disaster recovery planning. In addition, Scottish Enterprise's intention to relocate IT infrastructure to an alternate site during 2008-09 increases the risk of incident and hence the requirement for disaster recovery provision to mitigate the risk. Internal audit's review of disaster recovery and business continuity arrangements also made a number of recommendations in this area. Management has considered the impact of the changing nature of the IT landscape across the organisation and the key risk areas identified. The IS team maintains an IT risk register from which key IT risks are fed into the corporate risk register.

Scottish Enterprise holds considerable client sensitive information and is at risk of significant reputational damage should a breach of system security occur. While significant steps to address the issue of information security have been taken, laptops / PDAs and other such devices remain unencrypted. A consistent approach to data classification has yet to be identified such that in the event of loss of IT assets the data lost can be fully identified.

Prevention and detection of fraud and irregularity

Fraud policy

A fraud and irregularities response plan is in place. This sets out what to do if fraud or any other irregularity is suspected. The plan forms part of Scottish Enterprise's procedures for handling suspicions, allegations or evidence of fraud or other irregularities in the network.

There is a formal whistle-blowing policy governing procedures in the event of a fraud, or suspected fraud. Where management becomes aware of a suspected fraud, an 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. There were no material instances of fraud reported during 2007-08.

Regularity

In accordance with our responsibilities within the *Code*, we provide an opinion on Scottish Enterprise's accounts and, as required by relevant authorities, the regularity of transactions. Our work programme in this connection included:

- Review of the design, implementation and operating effectiveness of the controls over:
    - project initiation, appraisal and approval process for Local Enterprise Companies, ITI Scotland and Scottish Enterprise projects; and
    - European Union funded expenditure;
- Consideration of the outcomes from the Network Compliance Services work programme over national training and Business Gateway expenditure, including sample testing to ensure that the monitoring control provided by the Network Compliance Service was appropriately designed, implemented and operating effectively;

- Consideration of the findings from internal audit's procurement of consultant and contractors, including extension of our planned regularity testing to include additional testing at transaction level;
- Consideration of the adequacy of the process for embedding the provisions within the Management Statement between the Scottish Government Enterprise, Transport and Lifelong Learning Department and Scottish Enterprise;
- Consideration of the results and implication of each of the major project reviews completed by internal audit in each ITI Scotland operating division.

Robust procurement arrangements are an important element in Scottish Enterprise's responsibilities for ensuring compliance with all relevant guidance over financial transactions, including compliance with European Union obligations. Prior to 2007-08, Scottish Enterprise had a devolved procurement structure with responsibility for procurement lying with the project managers across the network. Significant changes were implemented from 1 April 2007 when responsibility for procurement, with the exception of 'competitive place' contracts, transferred to the procurement shared service. The introduction of the procurement shared service coincided with revised procurement procedures being implemented across the network, including a requirement to ensure that appropriate consideration of European Union procurement rules and a requirement for all contracts greater than £10,000 be subject to tender through the procurement shared service.

Following the matters identified by internal audit in relation to the procurement of CRM consultants and contractors (dealt with later in this report), the executive board requested a comprehensive review of consultant and contractor spend by the organisation. The review considered 80 high value contracts from a listing of spend by supplier from April 2005 to assess whether relevant procurement guidance had been complied with regarding commissioning consultants and contractors. The review highlighted that for 67% of the cases reviewed relevant procurement procedures were appropriately applied. For the remainder, there was non-compliance with internal requirements to some degree, including an absence of 'exemption from tender' documentation or where documentation did not demonstrate compliance with permitted exemptions.

Ten contracts were identified where procurement had not followed applicable European Union procedures or where there was insufficient evidence to demonstrate that the rules relating to 'negotiation without a call for competition' had been satisfied. The business unit in which the highest number of non-compliant tenders was information services, although non-compliant contracts were also identified in finance and human resources.

Following assessment of these results, internal audit and the new procurement team reviewed all consultant and contractor spend for 2006-07 and 2007-08 (to period 10) over £10,000 (i.e. the value above which Scottish Enterprise procedures require formal tendering to be undertaken). This larger review confirmed the position from earlier review of larger contracts in terms of non-compliance with internal procedures. No new non-compliances with European Union requirements were identified.

Non-compliance with procedures was attributed to:

- exceptions to tender documentation not always subject to challenge / review prior to authorisation;
- ongoing organisational change;
- continuation of service from contractors with previous experience; and
- a requirement to meet tight deadlines, often in the absence of inadequate forward planning.

In response to the findings from internal audit's work we extended our planned regularity testing to include additional testing at transaction level. The results of this work identified one transaction (that was part of a contract for overseas tax advice previously identified in internal audit's review) as cumulatively over the European Union services threshold. Our findings therefore concurred with those of internal audit.

The level of expenditure incurred in 2007-08 that has been assessed as non-compliant with European Union requirements is £1.8 million. This includes expenditure where the contract had been awarded appropriately, but had been extended beyond the original period without further tendering. As this is below our materiality threshold it was not necessary for us to modify our opinion on the regularity of transactions reflected in the accounts.

The work of internal audit confirms the value to Scottish Enterprise of the revised, centralised procurement arrangements. Their work demonstrates that there has been an improvement in the level of compliance with internal procedures between 2006-07 and 2007-08.

Financial position

The final resource outturn budget for 2007-08 amounted to £569 million, comprising a 'cash' budget of £534 million and 'non-cash' budget of £35 million. Scottish Enterprise has achieved its main financial objective for the year by ensuring that the cash financial outturn showed a modest underspend against the cash resource budget allocated by the Scottish Ministers.

An analysis of the 2007-08 resource budget against the original operating plan is summarised below:

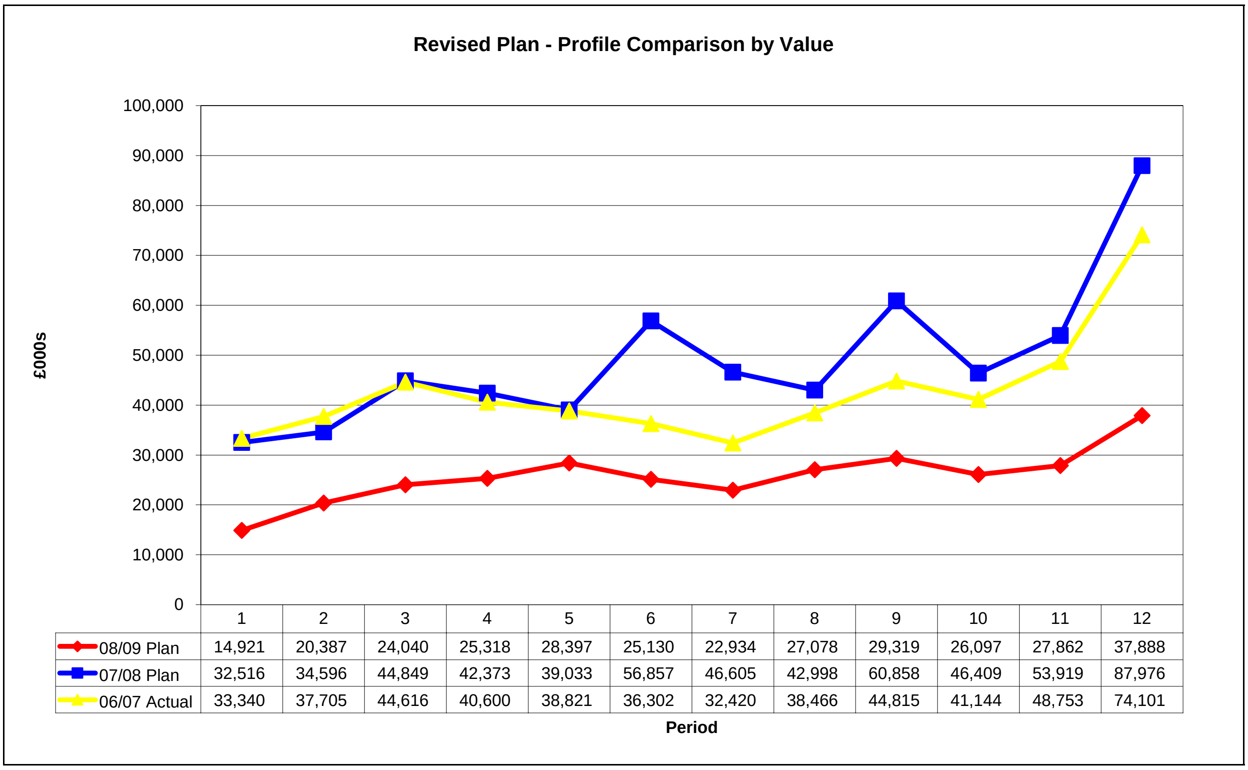
	Actual 2007-08 £'000	**Operating plan 2007-08 £'000**
Cash budget		
Grant-in-aid	524,139	509,000
Utilisation of cash reserves	10,000	10,000
Net utilisation of Scottish Co Investment Funds	3,500	-
	537,640	519,000
'Non-cash' budget	26,100	35,000
Resource budget 2007-08	**563,740**	**554,000**

Source: Scottish Enterprise

Management has reported net expenditure for the year of £535.4 million, which is £2.2 million (0.4%) below the resource budget allocation. The 'non-cash' outturn was £8.9 million (25%) below the budget allocation. At 31 March Scottish Enterprise had a cash balance of £159 million (2006-07: £96 million), of which £58 million related to the activities of the Scottish Co-Investment Fund.

At 28 February Scottish Enterprise had available spend remaining of £164 million from total available funds of £598 million, which included additional funding of £12.5 million from the Scottish Government that was confirmed as available in early March 2008. All business units were subsequently requested to confirm their forecast for the final month and several large projects were monitored throughout the month. Once the expenditure on these projects was finalised and business unit outturn identified, the board agreed to transfer £40 million into the Scottish Co-investment Fund as top-up funding. £36 million was transferred during 2007-08, with £4 million to be transferred during 2008-09. The final outturn for "cash" is in line with the revised outturn forecast.

Management has acknowledged continuing to seek improvements in the profiling of expenditure, subject to the demand-led nature of the expenditure and the impact of external factors, over the financial year, rather than showing increased expenditure towards the end of the financial year.



	1	2	3	4	5	6	7	8	9	10	11	12
08/09 Plan	14,921	20,387	24,040	25,318	28,397	25,130	22,934	27,078	29,319	26,097	27,862	37,888
07/08 Plan	32,516	34,596	44,849	42,373	39,033	56,857	46,605	42,998	60,858	46,409	53,919	87,976
06/07 Actual	33,340	37,705	44,616	40,600	38,821	36,302	32,420	38,466	44,815	41,144	48,753	74,101

Source: Scottish Enterprise

Key performance indicators

Scottish Enterprise uses a number of key performance indicators, some of which are set annually by the Scottish Ministers, to support their appraisal of the overall economic impact and their objective to stimulate more, better and faster investment than would otherwise take place. Management have noted that measurement against the key performance indicators in 2007-08 has demonstrated that Scottish Enterprise has had a very successful year.

Financial plan 2008-09

In March 2008 the board agreed a balanced budget and this was reflected in the business plan. In preparing the 2008-09 financial plan significant work was completed by management to develop detailed project budgets for 2008-09 in support of the new operational priorities and against a backdrop of the organisational restructuring. The subsequent local regeneration settlement with COSLA reduced funding by £12.5 million. Management intend to manage its planned expenditure on infrastructure projects by increasing property sales by approximately £12 million. Summarised below is Scottish Enterprise's (revised) planned expenditure across its three themes.

	Revised business plan 2008-09
	£'000
Enterprise	63,000
Innovation	89,000
Investment	82,000
Customer facing staff	40,000
Total delivery	274,000
Research and development	6,000
Premises, information services and support costs	29,000
Total (cash basis)	**309,000**
Non-cash	30,000
Total resource basis (excluding £12 million notional overhead for the provision of shared services)	**339,000**

Source: Scottish Enterprise

Expenditure to May 2008 is £35 million, amounting to 11% of the planned cash spend for 2008-09. All budgets have been re-based with effect from May 2008, following detailed scrutiny. Management intend to use these revised budgets to provide comprehensive variance reporting from period three. In respect of investments, 38% of the annual budget has already been utilised to May 2008 and management are estimating that certain elements of the budget may be fully utilised by quarter three. Management is continuing to monitor this position.

In order to inform resource allocation for 2009-10 and 2010-11 the executive board has approved the adoption of a zero based budgeting review. This will establish a framework for the future prioritisation of projects and programmes. Each area of the business is required to prepare submissions summarising their planned expenditure profiles, together with the economic development / financial outcome that will result from such expenditure. A 'challenge panel' comprising senior representation from regional operations, industries and policy and research will review submissions. Initial recommendations will then be made on future resource allocations. Management's intention is to complete this review during the first half of 2008-09, with a report to the board by October 2008.

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Performance management

- All areas of the business have now introduced a standard project progress report as part of the quarterly performance review framework. Of the 59 major projects that remained 'live' at April 2008, 51 of these projects were on track, subject to revised timescales.
- Overall, we have concluded that, subject to the matters identified by internal audit and us, that the management of the (internal) organisational change process appears to have been robust with risk management, project management and communication to both the executive board and other stakeholders embedded in the process.
- Organisational restructuring resulted in significant changes to the staffing structure during 2007-08. In total, 257 members of staff applied and were accepted for voluntary severance at a cost of £26 million. The governance arrangements for the scheme were appropriate.
- Review of the policies and procedures over dealing with complaints and allegations confirmed that, with the exception of a formal procedure for the investigation of serious complaints, managing anonymous complaints and trend analysis of data, arrangements are designed, implemented and operating effectively.
- The Best Value self-assessment questionnaire shows that Scottish Enterprise is now 'well developed' in seven of the nine areas and 'under development' in the remaining two (sustainable development, and equal opportunities).
- 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). For the remaining targets, a line-by-line review of expenditure and a review of information services aimed to save a further £2.6 million and £3.5 million, respectively. For 2007-08, management reported total savings of £7.2 million against the combined target of £5.1 million.

Major project reviews

All areas of the business have now introduced a standard project progress report completed as part of the quarterly performance review framework. Each project is provided with a 'red', 'amber', or 'green' status, taking into account the achievement of key milestones, budget status and the issues and risks associated with the project. In April 2008 the operations committee submitted a progress update on the major projects approved since 2002. Of the 59 major projects that remained 'live' at that time, management reported that 51 of these projects were on track, subject to revised timescales. The remaining eight projects were all identified as 'amber', compared to four 'red' and four 'amber' in the previous period.

Organisation restructuring

During 2007-08 Scottish Enterprise embarked upon a significant restructuring programme geared towards re-energising it as Scotland's enterprise, investment and innovation agency, while reducing bureaucracy and streamlining delivery. The nature of the change was complex and had several dimensions. We reported as part of our interim report that effective change management processes were vital to ensuring a smooth transition and to minimise disruption to operations. To manage the transition, a number of work streams were identified and task teams created to ensure delivery of each of the key objectives. Progress was monitored against an action plan and weekly progress reports were presented to the executive board focusing on areas where decisions / leadership were required.

We considered the work undertaken by management to ensure the successful implementation of the restructuring. Internal audit also completed a number of 'real time' reviews to support the transition process. This included reviewing management's approach to developing the new organisation's governance arrangements. Internal audit made two recommendations that we supported and which were addressed by management.

In May 2008 the project transition team presented closure reports to the executive board. These marked the conclusion of the transition project and the transfer of responsibilities for the delivery of the ongoing work back to the business. The reports summarised the changes and concluded that there was now a firm foundation for the ongoing development of Scottish Enterprise. The reports identified achievement of a number of key milestones including:

- development of a streamlined three-year business plan closely aligned to the Scottish Government's economic strategy;
- Skills Development Scotland established from 1 April 2008, with Careers Scotland and the majority of Scottish Enterprise's skills and development functions transferred;
- agreement of a new innovation and commercialisation strategy;
- redesign and streamlining of the organisation's account management strategy;
- arrangements for the transfer of the Business Gateway contracts to local authorities;
- review of business infrastructure, including the preparation for the transfer of local regeneration projects to local government;
- closure of the Local Enterprise Company network, with arrangements established for their wind-down in 2008-09 and the creation of a new regional structure within the single organisation;
- implementation of a new operating model, reflecting the new business plan and industry led approach;
- agreement and implementation of the strategy and approach to the industry and regional advisory boards;
- revised governance arrangements (and scheme of delegation) to reflect the new organisation, including a revised scheme of delegation;
- operation of a new staffing model; and
- implementation of the accommodation strategy aimed at achieving better use and value for money of the estate.

The report identified that there remained four outstanding issues for completion during 2008-09:

- transfer of local regeneration functions and Business Gateway activities to local authorities;
- transfer of innovation grants and supporting staff resources;
- development of shared services in consultation with the Scottish Government and partner organisations; and
- further refinement and embedding of the operating and staffing model.

Overall, we have concluded that, subject to the matters identified by internal audit and us, that the management of the organisational change process appears to have been robust with risk management, project management and communication to both the executive board and other stakeholders embedded in the process. However, some limitations were identified over governance arrangements and project controls transition.

Project controls transition

As part of the 2008-09 internal audit plan a 'real time' review of project control transition was completed, with an interim report highlighting significant issues identified at that time. This arrangement reflected that the organisational change process increased the risk to the control of projects. This arose mainly from project managers either leaving or transferring to new roles within the organisation. In the majority of cases (81%), there was no change in the project manager, but at Scottish Enterprise Glasgow and Scottish Enterprise Fife a higher proportion of project managers changed. The results of the audit work found that for projects:

- between £20,000 and £100,000, the majority had been satisfactorily transferred to new project managers; and
- in excess of £100,000, with the exception of Scottish Enterprise Glasgow and Scottish Enterprise Fife, a satisfactory handover had taken place.

In respect of Scottish Enterprise Fife there were issues with projects managed by one project manager where unsatisfactory handover arrangements were identified that had exposed Scottish Enterprise to increased financial and reputational risk. This was compounded by poor quality in project files. Separately, our year-end substantive audit work was impacted by delays in receipt of adequate audit evidence.

A potential conflict of interest was identified for one project manager who left under the voluntary severance arrangements and is now working for one of the companies with which he was leading Scottish Enterprise's contract discussions. Consideration was given to the possibility of pursuing legal redress for contravention of Scottish Enterprise's employee handbook, but it was concluded there is unlikely to be a successful basis for challenge on the matter.

For Scottish Enterprise Glasgow, a detailed review has commenced over 10 'construction and skills action plan' projects following the identification of recent non-compliances with one element. The short notice period associated with the four members of staff of the tourism team with responsibility for four projects resulted in an unsatisfactory handover.

It is possible that there will be some financial impact following the breakdown in controls in respect of the management of projects, particularly at SE Fife. Management has confirmed, however, that they have been unable to quantify these with sufficient certainty and, in any event, do not believe that they will be material to the financial position as at 31 March 2008.

Voluntary severance scheme

Significant changes were made to the staffing structure during 2007-08 as part of the organisational restructuring. An approved voluntary severance programme was implemented which was open to all senior managers across the network. In total, 257 members of staff applied and were accepted for voluntary severance. 174 members of staff left in 2007-08, with the remaining 83 leaving during the current financial year. The total cost of this severance programme was £26 million.

During an earlier severance programme we identified a weakness in the level of documentation retained by management to support the process in terms of evidence of approval and the determination of the cap to settlements. For the 2007-08 severance programme we again reviewed the governance arrangements in respect of the scheme and found these to be appropriate. We also performed sample testing on the awards made to confirm that liabilities are complete and accurate. Based on the sample of postholders reviewed, the calculation and recognition of liabilities associated with the approved voluntary severance scheme appear to be complete and in accordance with the organisation's approved policy.

Customer relationship management

In July 2007 we reported on findings from a review of Scottish Enterprise's implementation of a single customer relationship management ("CRM") system between November 2003 and February 2005, replacing some 50 different systems that had existed across the Network. The CRM system came in around budget and has delivered a range of benefits to the organisation. However, several internal reviews raised a number of serious concerns in relation to the procurement and implementation of the project and the quantification of benefits.

The review confirmed a number of previously identified issues in respect of the cost and procurement arrangements and benefit realisation, in part stemming from insufficient business requirements being agreed prior to implementation of the project commencing and the high risk and ill advised decision to proceed without an implementation partner given the lack of experience of such large scale IT projects within Scottish Enterprise. In the absence of competitive tendering for the majority of the spend on the CRM project it was not possible for Scottish Enterprise to demonstrate that it obtained value for money.

Ten recommendations were agreed with management as a result of the review and implementation is ongoing.

Complaints and allegations policies and procedures

As part of our appointment as external auditors of Scottish Enterprise, we review the controls over financial and non-financial systems. This includes not only systems that may be considered material in relation to the opinions on the accounts, but also those that require to be considered as part of the wider dimension of public sector audit. The scope of this element of work for 2007-08 included a review of the policies and procedures over dealing with complaints and allegations. Our review confirmed that, with the exception of a formal procedure for the investigation of serious complaints, managing anonymous complaints and trend analysis of data, arrangements are designed, implemented and operating effectively.

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.

In January 2008 internal audit presented a report to the executive board that provided an update on the embedding of Best Value. Management determined that, in the absence of any specific direction from the Scottish Government, Best Value should be incorporated into business activity, with internal audit monitoring progress through the internal audit process. The report also identified that the organisational restructuring could have a significant impact and the importance of ensuring that the principles of Best Value are continually highlighted going forward. Following the completion of the restructuring, there was no change to the composition of the steering group.

The self-assessment questionnaire issued by the Scottish Government for use by public sector organisations has been updated throughout 2007-08. At the year-end the self-assessment questionnaire showed that Scottish Enterprise is now 'well developed' in seven of the nine areas and 'under development' in the remaining two (sustainable development, and equal opportunities). In order to continue embedding Best Value in the organisation, internal audit have included the two areas that remain 'under development' in their 2008-09 audit plan.

2008-09 onwards

Audit Scotland has been committed to extending the Best Value audit regime across the whole public sector for some time now, with significant amounts of development work having taken place during the last year. Using the Scottish Executive's nine best value principles as the basis for audit activity, Audit Scotland has selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). Audit Scotland is currently developing a series of toolkits that auditors will be required to use from 2008-09. Completion of these toolkits will require a detailed examination of arrangements in specific areas. The focus of this work in 2008-09 will be on the use of resources, including efficiency, information management, procurement, asset management, performance management and people management. It is anticipated that national reports may be prepared by Audit Scotland.

Efficient government

The efficient Government plan was published in November 2004 and outlines the Scottish Government's strategy for improving the efficiency of the Scottish public sector. It contains measures to deliver at least £745 million of annually recurring cash-releasing efficiency gains and at least £300 million of recurring time-releasing efficiency gains.

Scottish Enterprise sought to make savings of £18.5 million by the end of 2007-08 by reviewing seven key areas within the organisation. 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). For the remaining targets, a line-by-line review of expenditure and a review of information services aimed to save a further £2.6 million and £3.5 million, respectively. For 2007-08, management reported total savings of £7.2 million against the combined target of £5.1 million. A formal return has yet to be made to the Scottish Government.

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Appendix – action plan

Priority rating for performance improvement observations raised		
Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the Board or systems under consideration. The weakness may therefore give rise to loss or error.	**Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items that may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.	**Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations that would assist us as auditors. The weakness does not appear to affect the availability of the controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.

No.	Issue and performance improvement observation	Management response	Officer and due date
1	In view of current conditions in the property market, management should keep the carrying value of its investment property portfolio under review, reflecting the impact in management accounts. *(Grade two)*	Agreed.	Financial Controller Ongoing
2	During 2006-07 management complied, for the first time, a fixed asset register to support the value of non-property fixed assets reflected in the accounts. Management should ensure that in the context of the recent reorganisation and the potential ongoing impact on Scottish Enterprise's fixed asset base, 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. *(Grade two)*	Agreed. Responsibility is already assigned to the Financial Controller and a clear framework will be implemented as part of our post LEC rationalisation.	Financial Controller 31 March 2009

No.	Issue and performance improvement observation	Management response	Officer and due date
3	In response to external audit observations as part of the 2006-07 audit process, management confirmed that the system for monitoring investments would be updated to allow a detailed review of each investment. While due for completion in December 2007, the implementation of the new system remains ongoing. Management should continue to progress the implementation of the investment monitoring system. *(Grade two)*	Agreed. The system was implemented in January 2008 and we anticipate full functionality and integration with the financial accounting system by March 2009.	Director of Investment 31 March 2009
4	Approval is required from the Scottish Government for all investments that result in Scottish Enterprise holding in excess of 30% of the company. Our audit testing highlighted that one investment exceeded this threshold, with no evidence of Scottish Government approval. Management should ensure that appropriate approval is sought and obtained in accordance with requirements prior to investments being made. *(Grade two)*	Agreed. In this case, a follow through investment was made in the company to avoid dilution of our interest due to the other investors not taking up their rights; Scottish Enterprise involuntarily increased its total investment to 30.6% of the company, breaching the approval limit by 0.6% - a cash value of £2,862. Approval will now be sought from the Scottish Government.	Director of Investment 31 August 2008
5	During 2007-08, management initiated a project to enhance the corporate approach to reporting entitlements to ensure a more consistent approach across the network. Whilst management have made progress by identifying the key areas requiring development in the historic process, and created controls to mitigate the associated risks, the process has yet to be formalised and fully implemented. Scottish Enterprise continues to operate with 12 different entitlement registers although these are now centrally controlled following the reorganisation. 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)*	The rationalisation is already underway as a matter of routine following the removal of the LECs.	Financial Controller 31 December 2008

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