



INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Scottish Enterprise

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

Year ended 31 March 2010

25 June 2010

AUDIT

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About this report

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

This report is for the benefit of 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.

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

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

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In common with other public sector organisations, Scottish Enterprise faces potentially significant funding pressures in 2010-11 and future years. Management recently held internal discussions with senior staff; outlining plans to clarify the strategic focus of Scottish Enterprise and to highlight the ways in which change is required to optimise service delivery and maintain service quality. This will require changes to the organisational structure, including a decrease in the number of directors agreed in May 2010.

Scottish Enterprise met its financial targets – cash target and non-cash target – for 2009-10. Management considered different scenarios before issuing a draft business plan to the board in February 2010 and continued scenario planning will take place during 2010-11. The 2010-11 financial plan forecasts that Scottish Enterprise will spend £295.1 million in delivering sustainable economic growth in Scotland. Future financial projections are based on a number of underlying assumptions, which may be subject to change as a result of the potential cut-backs in funding following the change of United Kingdom government.

Management reported efficiency savings of £13 million in 2009-10, primarily as a result of the 2008-09 restructuring programme (2008-09: £8.9 million). Future efficiency savings are also likely to reflect previous and ongoing restructure plans.

Scottish Enterprise maintains an integrated governance framework to provide an appropriate structure for maintaining decision-making, accountability, control and behaviour. Risk management arrangements continue to be routinely considered at the highest levels, with the strategic risk register reviewed by the executive board every quarter. A consistent approach to documenting risks for both project and business units has been defined. During the year, management undertook two Best Value toolkit self-assessments, carried out reviews into customer service and was subject to review by the central government centre of procurement expertise (“CGCoPE”), which identified a number of areas of good practice together with some areas for development.

Improving service delivery through expansion of partnership working, primarily in partnership with other members of the strategic forum, continues to feature on the executive board agenda. One example of this is the new joint information technology service delivery model between Skills Development Scotland and Scottish Enterprise, which became operational on 1 April 2010. Provided by Atos Origin, this should lead to improvements in service delivery. Similarly, there continues to be a commitment to performance management, with a clear framework of performance targets regularly reported to the board. Measuring the impact Scottish Enterprise has on the Scottish economy will be an increasingly important element of performance management arrangements. For example, in 2010-11, management has estimated that for every £1 invested, an additional £8.80 will be generated for Scotland’s economy by 2020.

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

Audit framework

This year was the fourth of our five-year appointment by the Auditor General for Scotland as external auditors of Scottish Enterprise. This report to Scottish Enterprise and Auditor General provides our opinion and conclusions and highlights significant issues arising from our work. We outlined the framework under which we operate, under appointment by Audit Scotland, in the audit plan overview discussed with the audit committee earlier in the year.

The purpose of this report is to report our findings as they relate to:

- the **accounts** and our audit opinions on net operating costs and the regularity of transactions;
- **use of resources**, including financial outturn for the year ended 31 March 2010 and financial plans for 2010-11 and beyond;
- arrangements around **governance and accountability**, including risk management, systems of internal control, partnership working and our consideration of the work of internal audit; and
- **performance management** and Scottish Enterprise's arrangements to achieve efficiency savings.

Best Value

Audit Scotland and the Scottish Government have 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 selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). There was no mandatory requirement for toolkits to be applied in central government bodies in 2009-10. Management performed self-assessments of arrangements around asset management and sustainability during 2009-10.

International financial reporting standards

The 2007 Budget announced that central government and health bodies would report under International Financial Reporting Standards ("IFRS"), as adapted by HM Treasury through the financial reporting manual ("FRoM"). The accounts for the year ended 31 March 2010, including comparative figures for 2008-09, were prepared on the basis of the FRoM.

Responsibilities of Scottish Enterprise and its auditors

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 record our appreciation of the continued co-operation and assistance extended to us by Scottish Enterprise staff during our work.

Business planning

As detailed in the business plan for 2010-13, Scottish Enterprise has a broad commitment to internationalisation and commercialisation. This commitment underpins all planning and resource alignment. Future plans are subject to a number of external factors; most notably the funding that will be received from the Scottish Government. As a result, the corporate planning and performance team considered various scenarios, including recurring annual funding cuts of £10 million or more from 2011-12, before drafting a budget for 2010-13. Management has indicated that further scenario planning work will be completed during 2010-11, the results of which will be vital for ongoing strategic planning, as and when future funding is confirmed. Effective scenario planning will allow management to act in a timely and considered manner should budget cuts be significant.

One of the key elements of the 2010-11 business plan is the establishment of the Scottish Investment Bank and its trading arm, the Scottish Loan Fund. This will involve Scottish Enterprise investing £50 million into a debt fund, which will be used to fund growth businesses. The intention of the fund, in the light of the recent banking crisis, is to show banks that there is sufficient, viable demand for this type of debt product and that commercial returns can be made. Scottish Enterprise placed £30 million into a separate Scottish investment fund bank account during 2009-10. It is anticipated that the additional £20 million will come from European funding.

Management recently held internal discussions with senior staff outlining plans to clarify the strategic focus of Scottish Enterprise and to highlight the ways in which a change process is required to optimise service delivery. As part of this change process, management recognised the need to rationalise layers of management and simplify internal decision making processes. As a result, there are plans to reduce the 92 'director' posts to less than 60 positions and to streamline the formal approval process before business decisions are taken. It is intended that this streamlining process will enhance the organisation and its focus on economic development by simplifying decision-making. Management anticipates that the appointment of all senior posts will be complete by the end of June 2010, with the re-alignment of reporting responsibilities completed for all staff by the end of July. As around 20 staff members will not be offered their current role or an equivalent, this will mean that there will be a further voluntary severance scheme for which Scottish Government approval has been obtained.

As part of future planning, management recognises the need to work alongside public sector partners to look for opportunities that will help to grow Scotland's economy. With resources available to the public sector expected to decline in the coming years, effective partnership working arrangements will need to be strengthened. The 2010-13 business plan outlines a number of areas where Scottish Enterprise can work closely with key partners on the strategic forum, such as Highlands and Islands Enterprise and Skills Development Scotland. Successful implementation of these partnership working arrangements will be key to Scottish Enterprise delivering future plans and it will be important that management can demonstrate delivery of tangible benefits through joint working. In addition, Scottish Enterprise also engages in close collaborative working with local authorities and the Scottish Government to deliver national regeneration projects.

Measuring Scottish Enterprise's impact on the Scottish economy will be central to performance management in the coming years. For example, in 2010-11, management has estimated that for every £1 invested, an additional £8.80 will be generated for Scotland's economy by 2020. In the short-term, the 11 key performance indicators centre around Scottish Enterprise's commitment to enterprise, innovation and investment. All performance targets have clear forecast range targets and the results from 2009-10 indicate that management has achieved at least the bottom end of the target range in all performance targets, with, in several instances, results above the forecast target range.

Future plans are clearly linked to customer focus, which is built around delivering services that will help support globally competitive companies, sectors and business environments. Management undertook a customer service excellence review during 2009-10 which focused on developing an understanding of the characteristics of current and potential customer groups, understanding how staff can demonstrate a commitment to customers, how information can be made available to customers and potential customers and how high standards of delivery can be maintained. A number of areas of good practice were identified, but maintaining these standards will present additional challenges during difficult economic times and potential funding cuts.

Scottish Enterprise published its business plan for 2010-13 on its external website for public access. This provides a clear forum for performance reporting and future plans. Members of the public are also able to obtain copies of the annual review, annual report and accounts from the website. Board meeting minutes are available from the website, but papers which were discussed during the meeting are not accessible by the public. Performance reporting would be improved if these papers are also made available alongside the meeting minutes, so that the public can obtain a better understanding of the issues discussed at board meetings.

Sustainability

Scottish Enterprise has a key role to play in Scottish Government sustainability goals, with projects in the renewable energy sector, for example, contributing to delivering a low carbon economy in Scotland. In April 2010 the board considered a paper on the importance of low carbon economic development, what a transition to low carbon economy would entail and Scottish Enterprise's current priorities in this area. The key implications for policy and delivery will be taken forward in future strategic plans.

Using an Audit Scotland toolkit, management self-assessed arrangements to achieve Best Value through sustainability. In all cases Scottish Enterprise rated its practice as being either 'better' or 'basic', but no arrangements were considered to be 'advanced'. This review highlighted clear sustainability priorities in services delivered to external customers and internal environmental management systems and procedures. Importantly, the review also highlighted that carbon reduction is considered in relation to budgeting and project appraisal and approval processes.

Management identified scope for increased promotion of environmental activities and that more needed to be done to ensure that sustainability is built into all activities. However, there are a number of areas where sustainability is actively considered and in the past five years Scottish Enterprise has been successful in reducing its energy use. Management should ensure that the findings of the review are progressed to ensure that 'advanced' practice is achieved, where appropriate.

Procurement

Internal reviews of procurement arrangements during 2009-10 found them to be operating effectively and revised procurement arrangements continue to be an important element in Scottish Enterprise's responsibilities for ensuring robust compliance with all relevant guidance over financial transactions, including compliance with European Union obligations. All contracts greater than £50,000 are subject to tender through Scottish Enterprise's procurement service. In addition, membership of national procurement groups include representatives of Scottish Enterprise.

Management had discussed the potential to monitor the performance of suppliers centrally, rather than by individual contract teams, and this should be formally considered going forward to maximise efficiency and minimise costs.

The central government centre of procurement expertise (“CGCoPE”) performed a procurement capability assessment at Scottish Enterprise, scoring the organisation highly in a number of areas, most notably in relation to procurement leadership and governance, procurement strategy and objectives and performance measurement. In four out of eight areas, Scottish Enterprise was considered to have ‘superior performance’ and in the remaining four areas, they were rated as ‘improved performance’. Overall, procurement status for the organisation was ‘improved performance’. Some areas for improvement were noted, mainly in contract and supplier management and sourcing strategies and collaborative procurement. The findings in the procurement capability assessment are consistent with our understanding of procurement arrangements.

Risk management

Risk management arrangements continue to feature in management’s top priorities, particularly given the impact a decrease in funding may have on Scottish Enterprise. The risk register is updated for executive board review on a quarterly basis. The risk management policy was last reviewed in March 2010. This policy is a comprehensive document, detailing, for example, roles and responsibilities in relation to risk and classifications of risk. A consistent approach to documenting risks for both project and business units has been defined and master templates have been created to assist staff. We reviewed, for example, the project risk register for the Edinburgh BioQuarter project, which considered a number of risks, scoring them and identifying mitigating actions where necessary.

Information management

Management recognises that risks around information management continue to be an important area for consideration and steps have been taken to embed awareness of these risks across the staff-base through internal training, which has been completed by the majority of employees. The new information technology service delivery model for Skills Development Scotland and Scottish Enterprise, ‘Enterprise IS’, became operational on 1 April 2010, followed by the transfer of hardware in early 2010-11. Provided by Atos Origin, the scope of the managed service includes: the information services service desk, all Scottish Enterprise and Skills Development Scotland data centres and infrastructure, desk side support and all application support, along with some strategy and business service components. A strategy paper has been developed for both Scottish Enterprise and Skills Development Scotland outlining the key plans for the service.

Asset management

The asset management Best Value toolkit was completed by members of the corporate service team during the year, but the results of the self-assessment were not complete at the time of this report.

People management and equalities

Scottish Enterprise places great emphasis on a culture of reward based on individual and organisational performance, robust management practices and continuous development. As an *Investor in People*, management ensures all staff are clear on their roles and their part in business delivery. Performance and reward strategies aim to ensure that Scottish Enterprise motivates its people based on their contribution and these strategies are reviewed and refreshed within the context of Scottish Government guidelines. Clear performance targets for individuals contribute to a culture of challenge and improvement. Management has taken steps to address unauthorised absences through the annual people manager course and there are plans to build reporting functionalities into the human resources system in relation to absence management over the next year.

Equalities has also been subject to management consideration. Equality reports continue to be issued to the executive board on a six-monthly basis. There have been revisions in the past year to diversity and harassment policies and equality impact assessments are being carried out on relevant projects. Scottish Enterprise recently commissioned research to provide baseline equality and diversity information that will help identify the main equality issues for each of the Scottish Government's key sectors.

Our interim report provided an overview of how Scottish Enterprise is addressing issues raised by the Audit Scotland *priorities and risks framework*. We identified some areas that we considered to be particular risk areas that management would need to address going forward. We summarise these below and note recent steps taken to mitigate these risks.

| Key area | Risk | Developments |
|---------------------------------|--------------------------------------|--|
| People management | Unauthorised absences | <p>The human resources team continues to promote best practice in managing through regular verbal and electronic communications. The annual two-day people manager course includes an absence management module. As well as processing individual absence returns, the human resources team also receive absence updates from business units on a weekly basis.</p> <p>The recently launched self-service human resources system will be developed during 2010-11 to include sickness absence, which will make it easier to monitor any reporting gaps and take remedial action.</p> |
| Partnership working | Ineffective partnership working | <p>The 2010-13 business plan outlines a number of areas where Scottish Enterprise can work closely with key partners on the strategic forum, such as Highlands and Islands Enterprise and Skills Development Scotland. Successful implementation of these partnership working plans will be key to Scottish Enterprise delivering future plans. In partnership with Skills Development Scotland, the new information technology service delivery model 'Enterprise IS' went live on 1 April 2010.</p> |
| Planning and resource alignment | Uncertainty over future budgets | <p>The revised financial forecasts estimate that Scottish Enterprise's overall expenditure will be £295.1 million in 2010-11. Management highlighted that various scenarios were considered during the planning process and before the budget was included in the 2010-11 business plan.</p> <p>Given the potential financial pressures, it would be beneficial if management outlined the various scenarios to the board. This would allow board members to understand fully the implications if expenditure needs to be lower than initially budgeted, or indeed if it could be higher than planned, and how this would impact individual areas of the business.</p> |
| Monitoring of contracts | Inconsistent monitoring of contracts | <p>Management had discussed the potential to monitor the performance of suppliers centrally, rather than by individual contract teams, and this should be formally considered going forward to maximise efficiency and minimise costs.</p> |

We have issued unqualified opinions on the accounts and the regularity of transactions reflected in those accounts.

We have assessed all key risk areas, as documented in our audit plan overview, and did not identify any significant issues that would impact our audit opinion. We did not identify any further key risk areas during our audit of the accounts.

Key issues arising from our audit of the accounts were:

- Implementation of IFRS – management made a number of key judgements in respect of investment properties, assets held for resale, leases, valuation of investments and consolidation and these are reflected in the accounts, including changes to the comparatives disclosed for the year ended 31 March 2009.
- Retirement benefits – management continues to account for assets and liabilities relating to retirement benefit obligations for 400 employees who transferred from Scottish Enterprise to Skills Development Scotland on 1 April 2008 and continued to participate in the Scottish Enterprise Pension and Life Assurance Scheme.

Reporting arrangements and timetable

The draft 'parent' accounts were received on 14 May 2010 and a copy of the group accounts on 3 June 2010, but commentary on the financial outturn was not available until 9 June 2010. This represented an improvement on previous years. Further changes to draft accounts were required to fully reflect the transition to International Financial Reporting Standards ("IFRS"). The audit was completed in a timely manner and the board considered and approved the accounts at the board meeting as planned. Achieving these timescales was greatly helped by subsidiary consolidation packs being received at an earlier date and by the quality of 'prepared by client' documentation.

Audit opinion

Following board approval we issued an audit report expressing unqualified opinions on the accounts for the year ended 31 March 2010 and on the regularity of transactions reflected in those accounts.

Key issues arising during our audit of the accounts

Our audit plan overview and interim management report narrated potential key risk areas. We have concluded our work in each area. In respect of the accounts, the two key areas of judgement related to the change in accounting framework, from UK GAAP to IFRS, and the on-going impact on accounting for retirement benefits following the transfer of employees to Skills Development Scotland on 1 April 2008.

Application of International Financial Reporting Standards as interpreted by the Financial Reporting Manual ("FReM")

The Scottish Government announced on 25 April 2008 that all Scottish Government departments, executive agencies, non-departmental public bodies and health boards would report under IFRS from 2009-10, necessitating the restatement of comparative information under new accounting policies. We reported in 2008-09 that management did not submit a restated opening balance sheet by the 28 November 2008 as required by the Scottish Government and Audit Scotland. The second target of submitting restated 2008-09 accounts by 30 November 2009 was achieved.

The transition to reporting under IFRS has resulted in key changes in the accounts for 2009-10, including comparative figures for 2008-09. Management were required to make several judgements, including:

- Changes in the definition of 'investment properties' resulted in reclassification within categories of property, plant and equipment and depreciation being charged to the net expenditure account.
- Introduction of a new category of current assets for assets held for resale rather than for operational use. Management considered each asset against strict criteria and, at 31 March 2010, £18.9 million of land and property is disclosed as 'held for resale'.
- Accounting for leases is not significantly different to UK GAAP, but application of the range of criteria is more balanced and less dependent on the outcome of numerical calculations. One lease is now recognised as a finance lease, i.e. included within property, plant and equipment and financial liabilities.
- Reporting all investments, including investments in start-up companies and unquoted companies, at fair value required significant effort and management resource and resulted in a net increase in the total value of investments at 31 March 2010.
- Changes in the requirements for consolidation did not change the group structure, but disclosures have been enhanced in respect of urban regeneration companies, which are not consolidated in the group accounts because their financial position would not have a material impact on the group.

Retirement benefits

As part of the reorganisation of responsibilities from 1 April 2008 around 400 employees transferred from Scottish Enterprise to the Skills Development Scotland Co. Limited ("SDS"), but remained in the Scottish Enterprise Pension and Life Assurance Scheme ("the Scottish Enterprise scheme") in respect of accrued service benefits to that date.

During the year ended 31 March 2010, SDS discussed with Scottish Enterprise and the trustees of the Scottish Enterprise scheme the various options it was considering in relation to future retirement benefit arrangements. Scottish Enterprise understands that as at 31 March 2010 SDS had not concluded alternative arrangements to its full satisfaction and, as the arrangements surrounding SDS's participation in the Scottish Enterprise scheme did not address how assets and liabilities attributable to accrued service obligations to 31 March 2008 should be determined and accounted for, Scottish Enterprise has continued to account for these at 31 March 2010.

Regularity of transactions

We updated our understanding of the framework under which Scottish Enterprise operates and reviewed the design, implementation and operating effectiveness of the controls over project initiation, appraisal and approval of Scottish Enterprise projects, and controls over European Union funded expenditure. Our testing identified no weaknesses in the design, implementation and operating effectiveness of these controls.

We understand that, after an initial query by the chair of the audit committee and following a review by internal audit, there has been a breach of the approved level of the Scottish Enterprise portfolio follow-fund. The fund was approved in January 2007 to respond to the requirements of existing investment portfolio companies, with an approved spend of £1 million each year between 2007-08 and 2009-10. Over the course of that period, £5.5 million was used from the fund against a total approved limit of £3 million. In 2008-09, following a significant increase in demand, actual spend totalled £2.9 million. We understand that overall internal investment allocation has not been exceeded and that, by the end of the 2009-10 financial year, retrospective approval had been given by the board. Internal audit will review investments in the second quarter of 2010-11 to assess controls around the approval of expenditure, particularly in relation to the portfolio follow-up fund.

The corporate department receives and distributes all circulars and guidance from the Scottish Government and other regulatory bodies. Electronic records detail all guidance received and record actions taken in response to each paper issued.

We have considered the specific requirements of a number of financial circulars and did not identify any instances of non-compliance.

Scottish Enterprise met its cash and non-cash targets following careful management of cash resources during the last quarter of the financial year. Management continues to report significant efficiency savings. These relate primarily to the results of organisational restructuring in earlier years.

The 2010-13 business plan forecasts that Scottish Enterprise will deliver a £277 million programme of economic development, focusing on increasing Scotland's sustainable economic growth. Key risks to achievement of financial plans in 2010-11 and future years arise from economic uncertainty around funding allocations from the Scottish Government.

Financial outturn

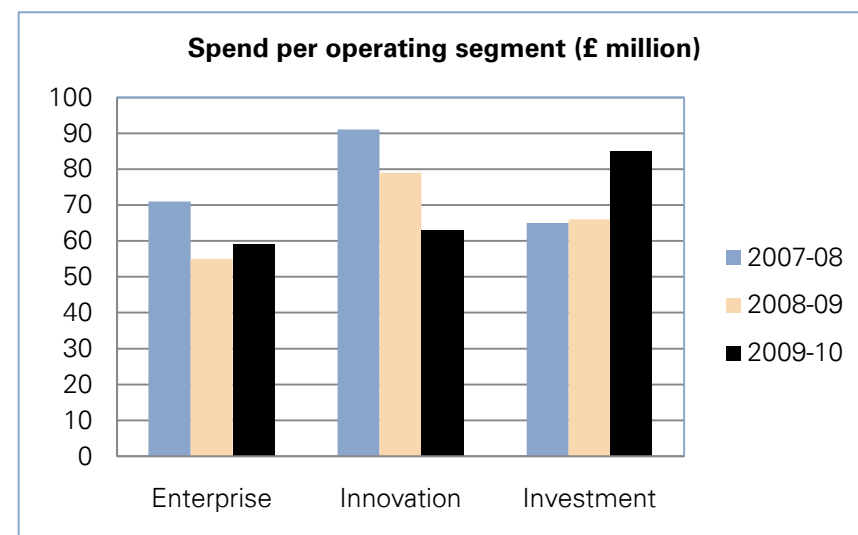
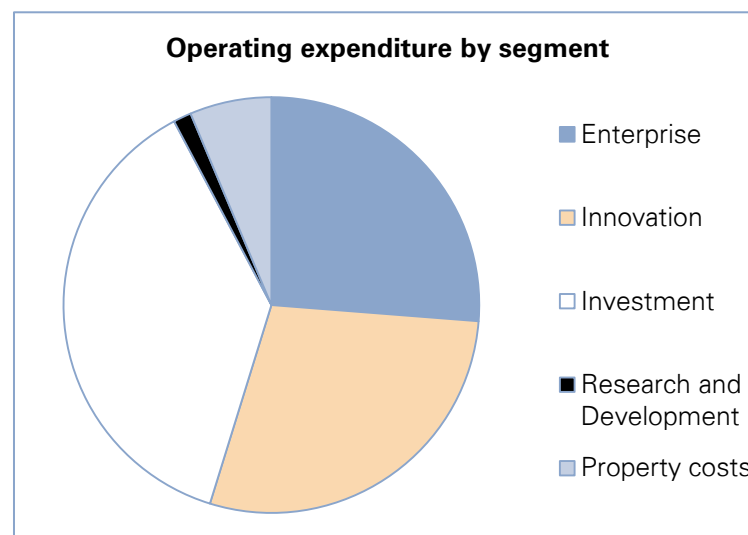
The analysis below summarises Scottish Enterprise's outturn and achievement of cash and non-cash targets in 2009-10.

| £ millions | Cash | Non-cash | Total |
|--|------------|-----------|------------|
| 2009-10 Grant-in-aid funding per the business plan | 250 | 33 | 283 |
| Add: revision of grant-in-aid funding during the year | 32 | - | 32 |
| Add: transfer of allocation from Highland and Islands Enterprise | - | 4 | 4 |
| Less: release of retained reserves from previous years | 7 | (7) | - |
| Adjusted expectation of spend to 31 March 2010 | 289 | 30 | 319 |
| Net expenditure per accounts | 282 | - | 282 |
| Less: non-cash | (32) | 32 | - |
| Add: non-cash adjustment for prior year balances | - | 3 | 3 |
| Less: Scottish co-investment fund provision | - | (7) | (7) |
| Add: capital expenditure | 9 | - | 9 |
| Add: investment in the Scottish investment bank | 30 | - | 30 |
| Expenditure for the purposes of the outturn | 289 | 28 | 317 |
| Underspend | - | 2 | 2 |

The Scottish Government allocated initial budgets of £250 million (cash) and £33 million (non-cash) in respect of 2009-10. A further £32 million of cash funding was approved during the year, bringing the total allocation to £315 million. The Scottish Government granted an additional £4 million (2008-09: £6 million) to Scottish Enterprise's non-cash allocation following Highland and Islands Enterprise's decision to surrender the same amount to the Scottish Government. In common with previous years, Scottish Enterprise released £7 million of cash reserves retained in previous years. In addition, £30 million was placed into a separate Scottish investment bank account, which will be used to support growth business from 2010-11. This was charged as expenditure in 2009-10 and 'scored' against the cash target.

The provisional financial outturn for the year ended 31 March 2010 was presented to the April 2010 board meeting. Management reported to the board that the provisional cash underspend of £4.6 million would be adjusted to reflect cash spend by subsidiaries consolidated in the group accounts and the results of adjustments as part of the financial statements preparation process. At that time management forecast a breakeven position against the cash target and around £1 million surplus against the non-cash target.

During the year, management spent £222 million pursuing three strategic objectives. The chart (below left) summarises this operating expenditure by segment. The most significant portion related to £83 million spent on investment, mainly in respect of intellectual property generation and business infrastructure. Management reviewed the financial position across these three areas of the business on a monthly basis during the year. These segments are consistent with new disclosures required in 2009-10 accounts under IFRS 8 *Segmental reporting*. We have also considered how spending on these segments compares to prior years (below right). This also highlights the considerable levels of investment made in 2009-10.



Careful management of cash resources was required in the last quarter of the financial year. The most significant reduction in expenditure against budget related to the Edinburgh BioQuarter extension purchase (£18.2 million) and management offset this by delaying some property sales and bringing forward expenditure totalling £9.5 million from 2010-11. Good practice in financial management included adequate forecasting of non-cash requirements and adopting a zero-based budgeting approach. The latter allowed management to:

- build a proposal for resource allocation;
- identify drivers for making resource decisions; and
- develop a framework for prioritisation.

Financial management (continued)

Efficient government programme

The Scottish Government issued the *efficient government programme for 2008-09 – 2010-11*, which provides details on the background, its application in various sectors, the types of savings and the method of reporting efficiencies. In 2008-09 Scottish Enterprise reported achievement of £8 million efficiency savings. In 2009-10, savings have reportedly been achieved in the following areas:

| Activity | 2009-10 (£ millions) |
|--|-------------------------|
| Payroll - restructuring to streamline the structure: increasing the number and proportion of staff in customer facing roles, and reducing senior, support and administration staff levels. | 11.1 |
| Facilities - including improved use of space and renegotiation of contracts with suppliers | 1.9 |
| Total | 13.0 |

Management anticipates generating a cumulative saving of around £37 million over the period 2008-11. However, continued consideration should be given by management to demonstrate that cost reductions are genuine efficiency savings and not simply a decrease in cost because a service has been either reduced or ceased to be delivered by Scottish Enterprise. Efficiency arrangements could be enhanced to:

- demonstrate how and where freed-up resources are used elsewhere to implement new initiatives; and
- increase focus and develop a formal and consistent mechanism to demonstrate how quality is maintained when meeting quantitative targets.

During 2008-09 Scottish Enterprise made the decision to 'buy out' employees' benefits in relation to its car scheme. Under accounting standards, the charge of £3.6 million was reflected in the 2008-09 accounts, but the cash payments to employees were not made until 2009-10. In addition to the savings listed above, management has indicated that this will have generated savings of around £1 million in 2009-10, but this was not included in the draft efficient government return submitted to the Scottish Government.

While the three year payback period generates annual savings of £1 million, there were no clawback provisions in the agreements with staff. Six staff members who received a total of £64,000 under the scheme have since left the organisation. Under the previous scheme, these members of staff would not have been allowed to keep their car when they left Scottish Enterprise.

We discussed with management efficient government plans for 2010-11, and, while we understand that the target is still to be finalised, savings of around £16 million are expected to be required. Similar to 2009-10 and previous years, management intends to meet these targets through previous and ongoing organisational restructuring.

Financial management (continued)

Financial planning

The 2010-13 business plan estimates Scottish Enterprise's cash budget to be £295.1 million in 2010-11, which compares to £289 million in 2009-10. The table below summarises planned expenditure in 2010-11:

| Area | 2010-11 business plan (£ million) |
|--|--------------------------------------|
| Supporting globally competitive business | 98.7 |
| Supporting globally competitive sectors | 28.7 |
| Globally competitive business environment | 116.0 |
| Running the business | 43.0 |
| Marketing, research and stakeholder engagement | 8.7 |
| Total | 295.1 |

Management updated the strategic themes for the year, as outlined above, moving from reporting by enterprise, innovation and investment to themes that place greater emphasis on internationalisation and commercialisation. Financial planning and reporting has changed to reflect this increased focus on understanding the global economic environment within which Scottish Enterprise operates. Management's initial forecast for 2010-11 was expenditure of £277 million, but this increased to reflect expenditure relating to the expansion of the Edinburgh BioQuarter (£18.8 million), which was initially expected in 2009-10, but was delayed into 2010-11.

Management reported that various scenarios were considered during the planning process before the budget was included in the 2010-11 business plan. Management also indicated that there will be a temporary suspension of re-allocating monthly forecast savings to new projects in 2009-10, except for business critical cases. This decision was taken in preparation for the first budget to be drawn-up by the United Kingdom coalition government and the consequential impact on Scottish Government budgets for 2010-11, which may impact Scottish Enterprise's grant settlement for 2010-11, albeit late in the financial year.

We have not been provided with the scenarios considered by management in planning for 2010-11 and beyond. Given the potential financial pressures, it would be beneficial if management outlined the scenarios to the board. This would allow board members to understand fully the implications if expenditure needs to be lower than initially budgeted, or indeed if it could be higher than planned, and how this would impact individual areas of the business.

Management has also prepared indicative resources allocation for 2011-12 and 2012-13. For both years, total cash investment has been forecast at £285 million, but these forecasts are subject to change when further details are confirmed in respect of grant settlements.

Key risks

There is some risk attached to achievement of the future financial plans, as they are dependent on several significant factors. The table below summarises some of the key risks identified by management.

Key risks identified by management

- The budgets for 2011-12 and 2012-13 are provisional and dependent on the outcome of the Scottish Government's spending review. Future financial projections are based on a number of underlying assumptions which may be subject to change as a result of potential cut backs in funding allocations following the change of government in the United Kingdom.
- Other income streams may decline, particularly grant contributions from UK business and skills and EU funding.
- Reducing running costs may prove challenging, for example there are plans to significantly reduce corporate services by about £5 million comparing the 2010-11 budget with the 2009-10 rebased budget. Such significant savings may not materialise.
- Given the adverse economic environment, Scottish Enterprise may be seen as marginalised and not taking appropriate action at the time of this economic downturn. This could lead to Scottish Enterprise's reputation being damaged, particularly if it is associated with failed rescue bids. The long-term effect of this reputational damage may be a decrease in funding from various sources. Management considers this to be a low risk.

The corporate risk register considers the potential impact of financial constraints and includes mitigating and controls and actions. However, management should seek to quantify the potential impact of these risks and also consider how quickly they can change future plans, given that a large element of income received is fixed funding from the Scottish Government and expenditure commitments can be made over a year in advance of cash payments.

The statement on internal control does not disclose any significant weaknesses, complies with Scottish Government guidance and is consistent with our understanding of Scottish Enterprise. Internal audit has completed its agreed plan for the year and concluded that the work carried out provides a “*good level of assurance*” in the areas reviewed.

The majority of key financial controls are designed appropriately and operating effectively. Scottish Enterprise has a fraud and irregularities response plan. 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 group. Management has informal procedures to consider individual Audit Scotland national reports.

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:

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

Governance framework

The 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, investment, economic policy, nominations/governance, urgent approvals and remuneration. The economic policy committee replaced the performance committee during 2009-10.

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

Remuneration report disclosures

Appointment of the new chief executive during the notice period of the former chief executive resulted in a payment of £115,000 in respect of pay in lieu of notice to the outgoing chief executive, who had served five months of the 12 months’ notice period required in his employment contract. This payment was approved by the chairman.

Internal audit

Internal audit completed their plan for the year. We relied on a number of reports, including:

- performance management;
- key industry sector reviews;
- key project controls;
- state aid;
- account management;
- commercialisation;
- business infrastructure review;
- entitlements; and
- business continuity.

Internal audit issued their annual report in June 2010, which stated that *"the overall conclusion of internal audit work carried out identifies a good level of assurance in the areas reviewed"*.

Internal controls

Since our appointment as the Scottish Enterprise's external auditors in 2006 we have reported minor areas where controls could improve. Management has generally been responsive to recommendations, for example, we have previously recommended amendments to the expenses policy. The expenses policy, revised in February 2010, reflects suggested changes to the hotel spend and foreign travel policies.

As part of their plan for the year, internal audit reviewed arrangements around entitlements. This concluded that there are adequate processes to identify and manage new entitlements as they arise, particularly in relation to higher value projects. However, at the time of the internal audit fieldwork in quarter three, four local enterprise companies registers had not been fully transferred to the central entitlements register. We understand that an action plan has been agreed to take these outstanding matters forward.

Our testing, combined with that of internal audit, of the design and operation of controls over significant risk points confirms that, with the exception of some weaknesses noted, controls are designed appropriately and operating effectively.

The statement on internal control provides details of the purpose of the system of internal control, the risk and control framework and the effectiveness of this framework. The statement complies with the Scottish Government's guidance.

Prevention and detection of fraud and irregularity

A fraud and irregularities response plan 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.

There is a formal whistle-blowing policy governing the procedures to be followed in the event of a fraud or suspected fraud. Where management is 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.

Information on any significant frauds is routinely reported to the audit committee on a quarterly basis.

There were no material instances of fraud reported during 2009-10. Two investigations were completed by internal audit in respect of claims of suspected fraudulent activity at two companies to which Scottish Enterprise had provided funding. In one case, there was no basis for the claim and, in the other, the funds were recovered in full by Scottish Enterprise.

Audit Scotland national reports

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

Management has established procedures to consider individual reports. Internal audit monitors all Audit Scotland reports on an ongoing basis and ensures that management, as necessary, are aware of recommendations which may impact Scottish Enterprise. Management is responsible for ensuring that appropriate action is undertaken in relation to the recommendations.

In 2009-10 we have reported action taken by management in response to a number of reports, which are summarised below.

| Report topic (issue date) | Discussed by a committee | Noted by a committee | Self-assessment performed | Local action plan prepared | Plans to feed back to a committee | Frequency of feedback |
|--|-----------------------------|-------------------------|------------------------------|-------------------------------|--------------------------------------|--------------------------|
| Improving public sector purchasing (July 2009) | x | x | x | 2 | 1 | 1 |
| Improving civil contingencies planning (August 2009) | x | x | ✓ | ✓ | 1 | 1 |
| Scotland's public finances: preparing for the future (November 2009) | ✓ | ✓ | x | x | 1 | 1 |

1. Feedback is only provided to a committee on an exceptions basis
2. Management considered this report from Audit Scotland in the light of existing arrangements, noting relevant actions where necessary.

In August 2010 we will be required to report to Audit Scotland on management's consideration of the following reports:

- Protecting and improving Scotland's environment; and
- Efficient government programme 2008-11.