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Scottish Enterprise

Annual audit report to Scottish Enterprise

and the Auditor General for Scotland

Year ended 31 March 2011

1 July 2011

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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.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

Headlines

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.

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

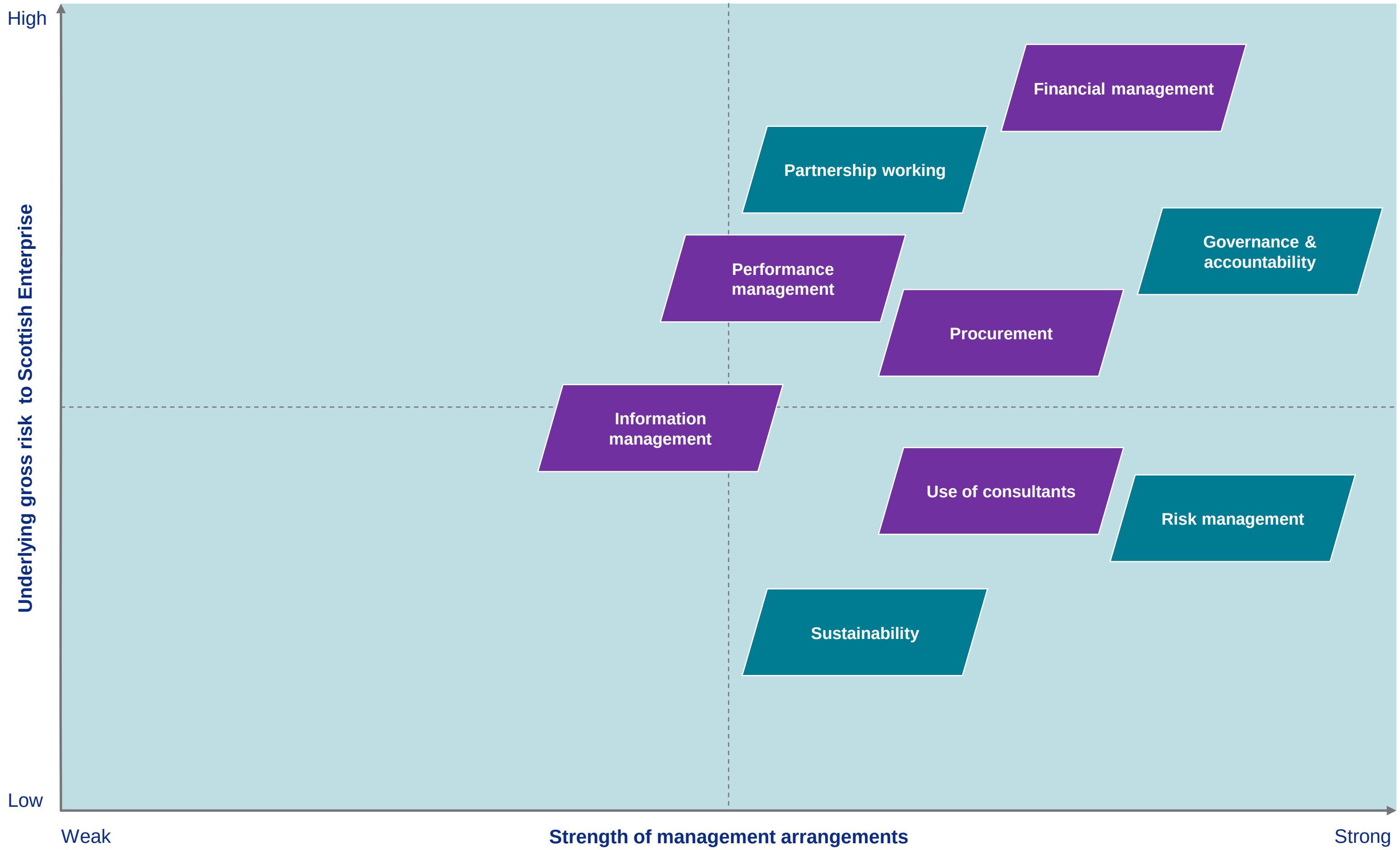
We wish to record our appreciation of the continued co-operation and assistance extended to us by Scottish Enterprise staff during the course of our work.

Service sustainability	
The financial and operating environment in which Scottish Enterprise operates continues to change, with developing priorities in renewable energy and the establishment of the Scottish Loans Fund. Financial and operational governance and management arrangements are robust and continue to develop to support continued achievement of performance targets and strategic aims and objectives. Changes in information management arrangements presented a number of challenges during the year, but matters have been monitored and reported on an ongoing basis.	Page 4
Accounts	
We have issued unqualified audit opinions on the 2010-11 accounts and the regularity of transactions reflected in those accounts.	-
A number of technical accounting matters were considered during the audit process and adjustments were required to account for the Aberdeen Science and Technology Park as a joint venture. Management provided good quality analysis, but opportunities for enhancements were identified in underlying processes.	Page 6
Use of resources	
Scottish Enterprise met its performance and financial targets; this involved in-year management of income and expenditure.	Page 9
Governance	
There have been no significant changes and the statement on internal control continues to confirm the existence of a comprehensive framework of internal control.	Page 11
Internal audit completed their plan and reported four 'significant' recommendations, all of which have been actioned during the year.	Page 11
We assessed management's response to Audit Scotland's national reports for reports issued during the year, including targeted follow-up of reports on procurement and consultancy.	Page 11
Arrangements to prevent and detect fraud are embedded in internal controls, including processes to comply with requirements in respect of the National Fraud Initiative.	Page 11

Summary of arrangements

Competing risks and pressures continue to present new and recurring challenges.

The diagram summarises the potential underlying risks to achievement of strategic objectives, compared to the strength of management arrangements to mitigate these risks. The following pages summarise service developments at Scottish Enterprise and key risks.



Assessment of risks

The financial and operating environment in which Scottish Enterprise operates continues to change, with developing priorities in renewable energy and the Scottish Loans Fund.

Economic stimulus is Scottish Enterprise's key aim, particularly in the current economic climate. Continually meeting increasing demand is challenging in light of pressure on public sector finances.

The three year business plan sets out the short and medium-term strategy, focussing on five priority areas – aligned with Scottish Government priorities – where Scottish Enterprise investment can maximise returns for the Scottish economy.

The Scottish Loans Fund (“the Fund”) has been established with a commitment of £55 million funding from the public sector, of which £30 million was provided by the Scottish Government and £25 million from European funding allocated to Scottish Enterprise. An additional £39 million of funding is committed by a number of private sector investors. Companies can apply for loans of between £250,000 and £5 million to support their growth. An independent fund manager has been appointed to administer the Fund which will begin making investments during 2011-12.

Scottish Enterprise, in partnership with Highlands and Islands Enterprise, has established the national renewables infrastructure fund (“NRIF”). This Fund aims to support investment in the infrastructure required to grow the renewables energy sector.

Scottish Enterprise has committed £70 million to NRIF over the next three years, but management acknowledges uncertainty around the level of demand in 2011-12.

Management identified a need to provide support for the prototyping phase of development of renewables technology. Through a number of other schemes, Scottish Enterprise is already able to fund research and implementation phases; to meet its renewables priority management intends to set up a specific prototyping fund. This proposal has been approved by the executive leadership team and now requires board approval. If successful, this will be funded from existing resources, although Scottish Enterprise may receive additional funding from the Scottish Government.

Administration of Scottish support grants, such as regional selective assistance (“RSA”), transferred from the Scottish Government to Scottish Enterprise in 2009; Scottish Enterprise will be responsible for this budget in 2011-12.

The Scottish Government has set a challenging target for growth in exports. While management is seeking clarity on the target baseline, the board has committed additional funding to internationalisation programmes, primarily through the work of Scottish Development International.

<table>
<tr><td rowspan="2">Performance management</td><td>The business plan sets out a number of performance measures that link to the Scottish Government’s national outcomes. In 2010-11 Scottish Enterprise achieved all of the performance measures set out in its business plan.</td><td>During the year management has been developing Scottish Enterprise’s performance measurement framework. This involves:
■ defining outcomes and success rather than focusing on outputs;
■ establishing clear milestones for longer term projects; and
■ achieving consistency in measures over time.</td></tr>
<tr><td colspan="2">■ In our view significant risks exist, but actions have been identified which are likely to mitigate these.</td></tr>
</table>

Assessment of risks (continued)

The outsourcing of IT services continues to represent a risk to the operational efficiency of Scottish Enterprise.

Scottish Enterprise has considered the conclusions in Audit Scotland reports on procurement and consultancy. Improved internal reporting would enhance procurement arrangements; arrangements to manage and report consultancy spend are strong.

Information management	Effective from 1 April 2010, Scottish Enterprise, through a contract led by Skills Development Scotland, outsourced its IT provision to a third party provider. This has included the transfer of staff from both organisations to the new service provider.	Internal audit reviewed the new governance arrangements, information security and benefits realisation. The approved business case for the process identified savings of £1.8 million per annum based on a fixed contract over five years for Scottish Enterprise. However, internal audit concluded that there "*have been issues with service performance, project delivery and user satisfaction*"; this may have an impact on the realisation of anticipated benefits. Internal audit has made a number of recommendations, agreed by management, that respond to the issues identified.
	■ In our view risks exist, but actions have been identified to address these risks.	
Procurement	Audit Scotland required specific follow-up work in respect of the joint Accounts Commission / Auditor General for Scotland report, *Improving Public Sector Purchasing* (July 2009). The aim of this work is to assess actions taken by public bodies to ensure that they can demonstrate value for money when purchasing goods and services.	The Scottish Government's Procurement Capability Assessment ("PCA") consistently grades Scottish Enterprise's arrangements as 'improved performance', the second of four ratings. The director of procurement produces a procurement performance update for the executive leadership team on an annual basis. The audit committee did not receive positive assurance following completion of the PCA process and the board has not received formal reports in respect of the PCA process. We have recommended that management formally report on the PCA process to the audit committee and board.
	■ In our view significant risks exist, but actions have been identified which are likely to address these risks.	
Use of consultants	Audit Scotland also requested a more targeted follow-up in respect of Scottish Enterprise's actions following publication of the Auditor General for Scotland report *Use of Consultancy Services* (January 2009).	Scottish Enterprise has a system of delegation and memorandum of delegated authority; these frameworks include a clear process for the procurement and authorisation of all expenditure, including expenditure on consultants. In response to work completed by internal audit, management will report every six months to the executive leadership team on the use of consultants.
	■ In our view significant risks exist, but actions have been identified to address these risks.	

Accounts preparation and audit process

Management anticipated risks around property, plant and equipment and retirement obligations; no audit adjustments were required and matters were generally concluded in a timely manner.

Areas of HIGH audit risk

Area	Value (£'000) 2010	Value (£'000) 2011	KPMG comment
Property, plant and equipment	183,618	193,255	Management obtained in-year and year end valuations of all land and properties. With the assistance of KPMG's internal valuation experts, we considered the valuation process and significant or unusual movements in the valuation of specific assets. No adjustment to the accounts was necessary.
Investments	68,423	59,363	Management considered the carrying value of its investments throughout the year. In conjunction with analysis from KPMG's internal sources, we discussed the valuation of investments with investment managers and are satisfied that these have been fairly stated.
Retirement benefit asset / (liability)	(44,526)	35,679	Management identified and considered a number of retirement benefit matters during the year, including: ■ management, actuary and external audit agreement of the actuarial assumptions in advance of 31 March 2011; ■ agreement of the accounting treatment of the impact of changing pension inflation from RPI to CPI in advance of 31 March 2011; ■ accounting for the movement in the defined benefit asset and obligation as a result of the transfer of staff to Skills Development Scotland on 1 April 2008, concluding matters after three years of discussion; and ■ accounting for the net retirement benefits asset (£36.5 million) at 31 March 2011 was considered during the audit process. No adjustments to the accounts were necessary.
Urban regeneration companies	-	-	As in 2009-10, management elected not to consolidate the financial results of four urban regeneration companies on the basis that neither net expenditure or net assets are material to the group accounts.

Systems and controls

- Draft accounts and supporting documentation were provided on 13 May 2011, in line with the agreed timetable.
- Finance staff responded to our questions quickly and provided high quality information to support the accounts, but we experienced delays in obtaining information from the investments and legal teams.
- Overall, management adopts an efficient approach to preparing the accounts.

Accounts preparation and audit process (continued)

Matters arising during our audit of property, investments and consolidation did not identify any material errors, but these present ongoing business matters to be monitored and resolved.

We identified three areas that, despite the lack of material error, should be considered by management in 2011-12:

- Valuation of land – to facilitate the sale of elements of the BioQuarter, Edinburgh site to an interested purchaser in accordance with its approved strategy for the site, Scottish Enterprise incurred costs of £6.5 million in ‘buying out’ title restrictions attached to various land holdings. During consideration of the accounting for these buy out costs, management became aware that Scottish Enterprise’s independent valuer had not previously been informed of these restrictions and consequently had not reflected the impact of the restrictions in its site valuation as at 31 March 2010. We requested that management obtain confirmation from the valuer of the site as at 31 March 2010 on the basis of the restricted title. This identified that the reported value would have been £300,000 lower at 31 March 2010. This difference is not considered a material error and remains unadjusted in the accounts. However, the underlying process gap – that the valuers were unaware of title restrictions – requires to be addressed by management to ensure there are no other similar circumstances.
- Investments – Scottish Enterprise entered into a limited partnership agreement with a property management company for the Aberdeen Science and Technology Park; Scottish Enterprise disposed of £3.2 million of assets for a 80% share of the profits and assets of this partnership. Management aimed to structure this arrangement such that the risk and rewards would rest with the property management company and Scottish Enterprise’s share would be accounted for as an investment. Considerable time and resources were incurred in respect of internal and external legal advice on the possible structures of the arrangement, which concluded that a limited partnership agreement would achieve the specific aim.

However, our review of the partnership agreement during the audit process identified a number of inconsistencies, as outlined in the table below.

Extract from the partnership agreement	Indicates joint control
Scottish Enterprise must consent to any changes in membership of the partnership	✓
The property management company has full power and authority to bind the partnership in areas such as borrowing, employment, litigation and bank accounts	✗
The consent of both partners is required prior to giving any guarantee, security or indemnity over the partnership’s assets	✓
Scottish Enterprise will not take any part in managing the partnership and cannot vote or sign on behalf of the partnership	✗
There shall be no recourse to Scottish Enterprise in respect of any debt of liabilities of the partnership	✗
Partnership meetings are only quorate if representatives of both Scottish Enterprise and the property management company are present	✓
Any resolution of the partnership is passed if approved by both partners	✓
Scottish Enterprise is required to approve the annual business plan	✓

Accounts preparation and audit process (continued)

As a result of these inconsistencies, we concluded that Scottish Enterprise has 'joint control', as defined in accounting standards, over the partnership. While the £3.2 million adjustment to the accounts did not have a material impact on net assets or net expenditure, there are weaknesses in the underlying process undertaken by Scottish Enterprise.

- Urban regeneration companies – Scottish Enterprise has the ability to exercise some control over these companies, but this power is not exercised. This reflects the policy change to reduce Scottish Enterprise's role in urban regeneration at the time of significant Scottish Enterprise restructuring two years ago. While the accounting impact of Scottish Enterprise's interest in four urban regeneration companies continues to be immaterial, and they are therefore excluded from the group accounts, there are wider business issues that require consideration and resolution. The level of funding provided by Scottish Enterprise in 2011-12 has been subject to discussion with, and eventual influence from, the Scottish Government; Scottish Enterprise was required to increase funding above that originally allocated in the 2011-12 business plan.

Financial position

Scottish Enterprise continues to achieve its financial targets, albeit in the context of significant movement during the year.

Efficiency savings continued to be required and challenges remain in securing future savings.

Financial outturn

Scottish Enterprise achieved its cash outturn target for the year as budgeted in the business plan. However, there were a number of significant movements to achieve this balanced outturn, including use of £1.7 million of cash reserves brought forward from previous years. The non-cash outturn was £6.6 million under the allocation, allowing Scottish Enterprise to access these reserves.

During the year management continually monitors and adjusts income and expenditure to meet this target. In 2010-11 there was slippage on a number of commercialisation projects and additional income was received from capital proceeds that were not included in the initial budget. In response, management brought forward grant contributions (£14.4 million) to a number of projects. The nature of the contracts agreed by Scottish Enterprise permits early cash contributions, to the extent that the total grant does not increase, which facilitates greater flexibility in future years when budgets are likely to be constrained.

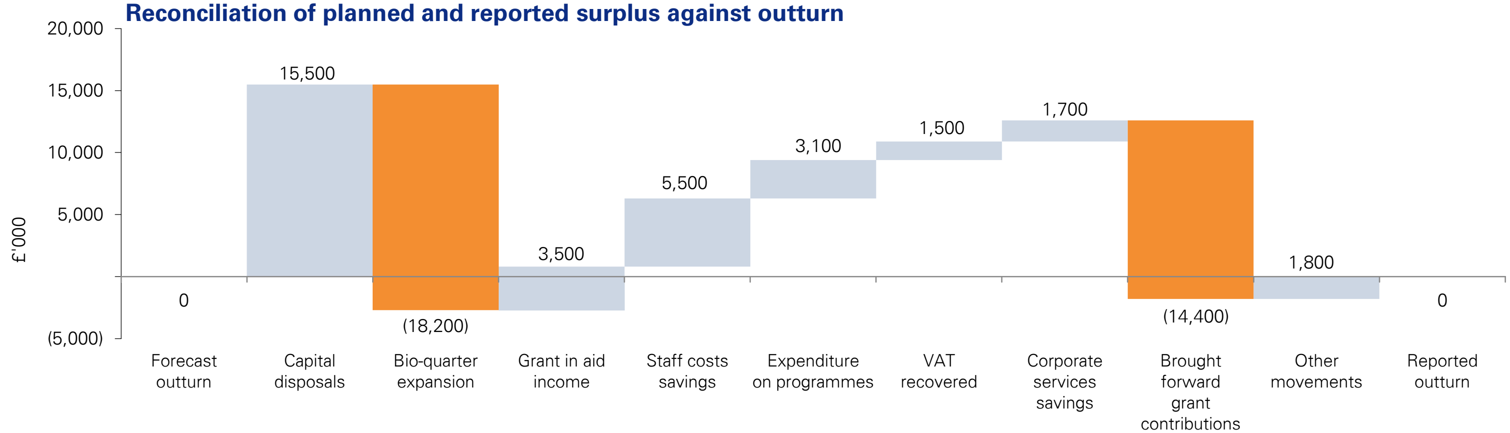
Efficient government savings

Management exceeded its 2% efficiency savings for 2010-11 through:

- restructuring savings generated from staff who left under voluntary severance programmes (£13 million);
- reductions in property costs through better space utilisation, rationalisation of suppliers contracts and reducing printing costs (£2 million); and
- grant contribution to the Edinburgh Bio-quarter (£12 million) from the UK Department for Business, Innovation and Skills; management has agreed with the Scottish Government that this can be recognised as a non-recurring 'efficiency saving'.

The Scottish Government has set the 2011-12 efficient government savings target at 3% for all public sector bodies. Achievement of this increasing target will be challenging. Management is discussing efficiency savings plans with departments, and how these will be measured and reported. It is important that plans are finalised and implemented as soon as possible in the second quarter of the financial year.

Reconciliation of planned and reported surplus against outturn



Financial position (continued)

Financial planning arrangements are robust and mechanisms exist to plan and monitor financial position and forecast outturn.

Best Value

In central government bodies all accountable officers are responsible for the delivery of Best Value. Audit Scotland's approach to auditing Best Value in the sector involves the production of a variety of specific performance reports and thematic reports on wider issues. Audit Scotland has also published a series of self-assessment toolkits for bodies to use.

Internal audit have considered these toolkits during their work, where appropriate toolkits were available. Scottish Enterprise's director of audit has provided the available toolkits to appropriate staff to consider. Completion of toolkits on a rolling basis across a number of years may be useful and could provide additional evidence to the Accountable Officer in respect of her statutory duty to demonstrate consideration of Best Value.

Financial planning

In February 2011 the board approved a balanced budget of £332 million for 2011-12 (2010-11: £295 million).

Business plan heading	2010-11 (£ million)	2011-12 (£ million)
Supporting globally competitive business (excluding RSA / SMART Scotland)	98.7	95.6
RSA / SMART: Scotland	-	45.2
Supporting globally competitive sectors	28.7	22.8
Globally competitive business environment	116.0	115.9
Marketing, research and stakeholder engagement	8.7	6.7
Running the business	43.0	45.6
Total	**295.1**	**331.8**

The business plan sets out Scottish Enterprise's five priorities for the next three years. Increasing focus and spend on areas such as renewables and energy are offset by decreases in intellectual property and commercialisation programmes. The 2011-14 business plan incorporates the 2011-12 budget and reflects £43 million of funding transferred from the Scottish Government in respect of regional selective assistance ("RSA") and other grant funding.

The business plan includes priority milestones and measures to monitor and report progress. Each measure will be reported to the board on a monthly or quarterly basis. Scenario planning reported to the board reflects known and estimated commitments and includes a cautious 'worst case' scenario.

These plans have also been provided to budget managers to illustrate the potential funding reductions in their budgets. This assumes that management will prioritise funding on key priorities and, as a result, reductions in funding would not be evenly distributed.

Scotland's Public Finances: responding to the challenge

Audit Scotland published *Scotland's public finances: preparing for the future* in November 2009 and intends to publish a follow-up review, *Scotland's public finances: responding to the challenge* in August 2011. At Audit Scotland's request, we submitted two returns on Scottish Enterprise's arrangements, concluding that:

- Scottish Enterprise has a clear picture of its strategic goals and the resources and savings that will be required to meet the goals;
- financial plans include three scenarios based on different percentages of potential budget reductions; in our view the range of percentages used was appropriate and realistic;
- management did not exclude any areas of expenditure from budget reductions and efficiency savings; and
- operating and support budgets were considered individually and set percentage savings were not applied 'across the board'.

Corporate governance framework and supporting arrangements

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

Corporate governance framework	The 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 sub-committee terms of reference.
Audit Scotland reports	Procedures exist to consider individual reports and, where appropriate, management self-assesses local arrangements against national recommendations and implement local action plans as required. We considered a number of reports published during 2010-11 and submitted a short return to Audit Scotland on management's response to each report.
Statement on internal control	The statement on internal control provides details of the purpose of the framework of internal control, along with an analysis of its effectiveness. This statement complies with guidance issued by the Scottish Government and does not indicate any areas requiring to be addressed. This is consistent with our understanding.
Internal controls	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls are designed appropriately and operating effectively.
Internal audit	Internal audit has completed all of their planned reports for the year. We considered the reports issued by internal audit during the year and have placed specific reliance on a number of reports, including those in respect of: ▪ key project controls; ▪ salaries and benefits; ▪ treasury management; ▪ consultants and contractors; and ▪ finance centre. These reports resulted in four 'significant' recommendations, which have all been actioned during the year. Internal audit's 2010-11 annual report indicates that the work programme "*identifies a good level of assurance in the areas reviewed*".
Fraud and irregularity	The fraud and irregularities response plan sets out expected action in 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. Information on any significant frauds is routinely reported to the audit committee on a quarterly basis. Scottish Enterprise participated in the National Fraud Initiative for the first time during this year. This process identified a total of 11 matches, all of which have been investigated by internal audit. This work has been completed and no instances of fraud have been identified. There were no material instances of fraud reported during 2010-11.

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