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The Skills Development Scotland Co. Limited

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

Year ended 31 March 2012

23 July 2012

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1. Audit Scotland code of audit practice – responsibilities of SDS	

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

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

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

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

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.

We also draw your attention to the following:

- management of Skills Development Scotland is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems;
- weaknesses or risks identified by us are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist; and
- communication by us of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve Skills Development Scotland management from its responsibility to address the issues raised and to maintain an adequate system of control.

Executive summary

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

2011-12 was the fourth full year of operations against a backdrop of a economic uncertainty, with a requirement to achieve £21 million of efficiencies at the same time as meeting increasing targets for apprenticeships.

As in prior years, SDS is deemed to have met its efficiency savings target for the year by ensuring spend was within its grant-in-aid allocation. An underlying surplus of £10.6 million was achieved, excluding adjustments for pension transactions, which increased the reported surplus to £12.7 million.

This underlying surplus primarily reflects spend on national training programmes being £8.7 million less than planned. Income (and expenditure) for the year includes £18.3 million of European grant funding, an increase of £6.3 million on the previous year.

The Scottish Government's target for modern apprenticeship starts increased from 20,000 in 2010-11 to 25,000 in 2011-12. Within this target, for the first time, 5,000 were for trainees aged over 20 years with up to three months' employment. SDS exceeded the overall target and reported 26,427 starts.

In February 2012, management identified that there was a risk that national training programme expenditure would be significantly less than planned; this risk materialised and the variance was £8.7 million. There are complex reasons behind this, including weaknesses in communication and the accuracy of activity forecasting. These weaknesses existed primarily between the operations team and third party contractors responsible for providing modern apprentices.

Management has taken a number of steps to mitigate future risk and improve monitoring arrangements internally and with third party contractors.

Harmonisation of employee arrangements through consolidation of retirement benefits arrangements is now complete. SDS made a payment of £1.4 million to wind-up the Skills Development Scotland Co Limited Retirement Benefit Scheme ("SDSRBS"). The cost is the shortfall between scheme assets at the date of wind-up and the total cost of annuities purchased, which has been appropriately reflected in the financial statements.

A balanced budget has been set for 2012-13. There are ongoing discussions with the Scottish Government regarding the letter of guidance, which includes the 2012-13 grant offer. The total resource budget is £176.4 million; SDS is also expecting to receive up to a further £22.9 million ring fenced funding, although the specific purposes for this are still to be agreed. Management is forecasting lower levels of European funding in 2012-13, with expected income of £12 million. There will be challenges in 2012-13 in respect of national training programme expenditure, which requires to be closely monitored to mitigate continuing risks around the level of expenditure, which is dependent on the timing of starts in 2012-13.

We completed follow up work on the Audit Scotland's *Role of Boards* study. Overall we found that the board is effective in seeking to continuously improve its performance and ways of operating and has effective systems in place to ensure that it has the necessary skills and expertise to perform its functions.

We have completed our audit for 2011-12 and have issued unqualified audit opinions on the financial statements and the regularity of transactions included within these financial statements.

Headlines

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

We reported, in our audit strategy, our responsibilities in respect of the audit. SDS's responsibilities are set out in appendix one.

This report summarises our work for the year ended 31 March 2012.

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

Financial statements	
Draft financial statements were provided on 9 May 2012, in line with the agreed timetable. These were primarily complete and of a high standard. Supporting information was received on the same date; the standard of requested analyses was very high and there was evidence of accountability and ownership of working papers across the finance department. We have issued unqualified audit opinions on the 2011-12 financial statements and the regularity of transactions reflected in those financial statements.	-
A number of technical accounting matters were considered during the audit process, including accounting for retirement benefits, income recognition and changes in HM Treasury's financial reporting manual.	-
Use of resources	
SDS met its financial targets through effective financial planning and management throughout the year. A surplus of £12.7 million was recognised, against a breakeven budget, which is mainly due to national training programme expenditure being £8.7 million less than planned and net pension credits of £2.2 million.	Pages 4 to 6
The 2012-13 budget indicates a forecast of breakeven position, although there are ongoing discussions with the Scottish Government about the detail of the letter of guidance (which includes the grant offer), which has yet to be finalised.	Page 7
Performance management	
We have completed our work on the follow up of Audit Scotland's *Role of Boards* report. Overall, we found that the Board is effective in seeking to continuously improve its performance and ways of operating, and has effective systems in place to ensure that it has the necessary skills and expertise to perform its functions.	Page 8
Governance	
Beyond a continuing strengthening of policies and procedures, there have been no significant changes in SDS's arrangements. The governance statement confirms the existence of a comprehensive framework.	Page 10
Internal audit completed their plan and concluded that "*Skills Development Scotland has in place a framework of governance, risk management and control, including operational, financial and ICT controls, that provides reasonable assurance regarding the effective and efficient achievement of the organisation's objectives.*".	Page 10
Arrangements to prevent and detect fraud are embedded in internal controls, in particular this includes the work of the compliance team in reviewing national training programmes.	Page 10

Financial position

Income and expenditure increased compared to 2010-11. The surplus reduced, primarily due to net pension creditors in 2010-11 not recurring in 2011-12 and increased European income in 2011-12.

Financial targets

SDS met its financial target for the year: to achieve financial balance. The result for the year was a surplus of £12.7 million within its resource budget of £197 million. To provide context for our commentary and views on the outturn for 2011-12, we summarise below significant changes compared to 2010-11.

	2010-11 £'000	2011-12 £'000	Variance £'000
Grant-in-aid	198,638	196,971	(1,667)
European income	11,945	18,274	6,329
IT services	7,078	8,396	1,318
Careers guidance	1,628	1,107	(521)
Miscellaneous	1,336	337	(999)
Total income	**220,625**	**225,085**	**4,460**
Operating expenditure	(168,014)	(180,705)	(12,691)
Cost of sales	(10,913)	(9,691)	1,222
Administrative expenses	(19,350)	(24,238)	(4,888)
Total expenditure	**(198,277)**	**(214,634)**	**(16,357)**
Finance costs	-	-	-
Finance income	752	2,265	1,513
Income tax	(16)	(25)	(9)
Surplus/(deficit)	**23,084**	**12,691**	**(10,393)**

The surplus for the year is lower than that achieved in the prior year due to a number of factors.

Grant-in-aid income continued to decrease from the prior year due to the current economic climate and continued Scottish Government funding reductions.

European income increased as a result of a new grant award from European social funds to provide local training opportunities for priority areas. A total grant of £14 million was offered, and £4.9 million was recognised in 2011-12.

IT services income increased during the year following Highlands and Islands Enterprise's decision to join the IT services framework managed by SDS. There was a similar increase in IT services expenditure (recognised as part of administrative expenses), and therefore there is no impact on the result for the year.

Increased operating expenditure on national training programme expenditure was supported by additional funding to increase modern apprenticeships starts to a target of 25,000; an additional £3.5 million expenditure was incurred, compared to the previous year, for modern apprentices.

Staff costs, included in operating and administrative expenditure, increased due to continuing voluntary severance costs and the £16.9 million one-off pension credit recognised in 2010-11.

These increases were offset by decreases in expenditure in relation to the *supporting business through recovery* and *skillseekers* national training programmes (£1.7 million and £3 million, respectively) and business enhancement projects (£5.3 million). Smaller decreases were observed across a number of other national training programmes.

Financial position (continued)

SDS reported a net surplus of £12.7 million, primarily as a result of national training programme expenditure being £8.7 million less than planned.

Performance against budget 2011-12

A breakeven budget was set for 2011-12; the management accounts at 31 March 2012 reported a surplus of £10 million, which increased to £12.7 million during the financial statement preparation process. The first section in the table below reconciles the original budget to the management accounts at 31 March 2012.

Surplus movements in 2011-12	Budget £'000	Q3 budget revision £'000	Management accounts £'000	Annual movement £'000
Total income	**212,865**	223,195	**224,096**	11,231
National training programmes	**135,213**	129,213	**126,547**	8,666
Business enhancement projects	**6,000**	7,616	**7,486**	(1,486)
Staff costs and salaries	**44,177**	54,400	**52,961**	(8,784)
Infrastructure, management and administration	**10,250**	11,400	**11,088**	(838)
Information technology and systems	**15,086**	14,466	**13,918**	1,168
Individual learning accounts Scotland	**624**	1,500	**1,218**	(594)
Other invoicing	**1,515**	1,910	**845**	670
Total planned expenditure	**212,865**	220,505	**214,063**	(1,198)
Surplus	**-**	**2,690**	**10,033**	**10,033**

Movements during financial statement preparation process	
IAS 19 net pension credit	2,161
My world of work website capitalisation	1,001
Tangible fixed asset depreciation	(658)
Increase in accrued IT income	751
Increase in accruals	(602)
Surplus in financial statements	**12,691**

The subsequent £2.7 million increase included a number of routine adjustments as part of the financial statements preparation process. These are shown opposite. The draft outturn (£10 million) was such that the £2.7 million additional adjustments did not have a significant impact on the financial position.

However, we believe that management should be able to minimise post year end adjustments in areas such as capital expenditure and depreciation, where these are known during the year, to mitigate the risk of changes in the outturn.

The main reasons for the initial £10 million surplus is the £8.7 million variance on national training programmes. Other individually significant movements – that did not impact on the outturn – include:

- The majority of the income increase is the additional funding to cover redundancy costs, as outlined below.
- Higher than budgeted staff costs and salaries (£8.8 million) are primarily due to the voluntary severance programme which cost £7.4 million for 144 member of staff. This was not included , not unreasonably, in the original budget because approval for the redundancy programme was not received from the Scottish Government until November 2011. On approval, the Scottish Government awarded additional funding to cover these costs.

Financial position (continued)

In-year expenditure on national training programmes was £8.7 million below the £135 million budget; this was due primarily to timing differences.

National training programmes

In February 2012 management identified that national training programme expenditure would be £8.7 million (6.4% of actual spend, £135 million) less than the original budget. Management has investigated the reasons for both the variance itself and why it was not identified earlier in the year. Modern apprenticeship starts is a high profile target and accounts for 46% of national training programme expenditure; management focused on this target in their consideration of the outturn. The 2011-12 target for modern apprenticeship starts was 25,000 (2010-11: 20,000); this includes a new target of 5,000 for trainees aged 20+ with up to three months' employment.

Annual expenditure includes payments in respect of these starts, as well as payments for those completing apprenticeships started in the previous year. Expenditure in respect of these ongoing apprenticeships was in line with budget, which is consistent with our expectations because the number of ongoing apprenticeships at 1 April is known and provides a robust basis on which to forecast spend. In respect of starts, a complex process of contracting and forecasting is undertaken by the SDS operations team. Third party providers – employers or training bodies working with apprenticeship starts – forecast expenditure of £80 million in 2011-12. This initial annual forecast was reduced to £77 million by the operations team, reflecting their experience and trend analysis and recognising the risk that providers may be optimistic in claiming all expenditure within the financial year.

The contracting and forecasting process is usually completed in April, at the start of the financial year. The increased number of starts, together with the new target, meant that the contracting inevitably took longer in 2011. The contracting timetable means that start figures typically peak in November/December each year. The operations team's quarterly financial forecasts are extensively based on information provided by contractors and it was assumed that this peak would increase relative to the increased activity.

The table below shows that these forecasts – which are submitted to the finance team to inform financial reporting and forecasting – did not start reducing until those submitted in January 2012.

Management agrees that, going forward, it is important that the operations team challenges robustly the information provided by third party contractors.

£ million forecast spend	Sept	Oct	Nov	Jan	Feb
Modern apprentices	77.6	77.6	77.5	77.6	73.7

Other reasons, identified by management, for the significant differences between budget and outturn include:

- Training programmes is a supply driven market and may be experiencing the cumulative effect of continually increasing targets.
- The economic climate and recession reduces employment and limits opportunities for business to allocate reducing levels of work to allow trainees to meet milestones.
- Expenditure is incurred when milestones are achieved, and although the number of starts target was achieved, due to a significant proportion of these starts being achieved towards the end of the year, this did not allow enough time for milestones to be achieved and payments to be made.

Following the large number of starts towards the end of 2011-12, there is a risk of an overspend in 2012-13 due to the volume of milestone payments due in respect of apprenticeships ongoing at 1 April 2012.

Management established a national training programme board to combine financial, operational and activity monitoring during the year, and improve contract management in respect of third parties. This is further supported by staff training, reintroduction of monetary values in the provider contracts and separation of continuing apprenticeships and starts within the contracts.

Financial position (continued)

The 2012-13 plan forecasts a breakeven position, achievement of which will be dependent on close monitoring of national training programme expenditure.

Financial plans 2012-13

Management has budgeted a breakeven position for 2012-13, based on anticipated grant-in-aid of £189.3 million, European income of £12 million and other income of £11.5 million from other sources. However the current budget being used is an interim and provisional budget and has been subject to change since receiving outline approval from the board. This is primarily due to late receipt of the Scottish Government letter of guidance, which includes the grant offer. Management is seeking clarification from the Scottish Government on the breakdown of individual targets within headline targets for key initiatives, such as modern apprenticeship starts.

The 2012-13 budget is summarised opposite. Overall, income is consistent with that budgeted and received in 2011-12. However, the Scottish Government is increasingly ring-fencing elements of grant-in-aid for specific programmes and initiatives.

Complying with these terms and conditions, within the financial year, decreases flexibility and can impact on management's ability to manage the budget as a whole and achieve the financial plan within any one year.

Expenditure	2011-12 management accounts outturn £'000	2012-13 budget £'000
National training programmes	126,547	132,560
Business enhancement projects	7,486	10,885
Staff costs and salaries	52,961	43,000
Infrastructure, management and administration	11,088	11,987
Information technology and systems	13,918	14,346
Other invoicing	845	-
Total planned spend	**212,845**	**212,778**

Audit Scotland national reports

During 2011-12 we have performed follow-up work in relation to the Audit Scotland national report: *Role of Boards* as well as preparing returns on national studies.

Our work has found that SDS's arrangements are generally strong.

Audit area	Overview	Findings
Role of Boards	As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified the *Role of Boards* report for follow-up in 2011-12. The aim of the follow-up work is to assess the progress that public bodies have made in seeking to improve the performance and operation of their boards.	We have completed our work on the follow up of the *Role of Boards* study, which involved considering the internal audit review and meeting with the management and the chief executive. Our detailed findings are reported in our report to those charged with governance. Overall we found that the Board is effective in seeking to continuously improve its performance and ways of operating, and has effective systems in place to ensure that it has the necessary skills and expertise to perform its functions.
Learning the lessons of public sector mergers	Audit Scotland is undertaking a performance audit of recent mergers and re-organisations. This will consider how well recent mergers and re-organisations of public bodies were planned and assess to what extent they have delivered the expected savings and other benefits. SDS is included as one of the detailed case studies. While Audit Scotland is carrying out this review, we will liaise with them, where relevant, to provide any information obtained through our role as external auditors. It is anticipated that the final report will be published in summer 2012.	Audit Scotland conducted their assessment of all bodies and we met with Audit Scotland to provide information on SDS's merger process. The report was published on 14 June 2012.

Best Value

Audit area	Overview	Findings
Best Value	Audit Scotland has been committed to extending the Best Value audit regime across the whole public sector for some time now. A series of toolkits covering financial, performance and governance processes are available for public sector organisations and auditors to use although there is no mandatory requirement for toolkits to be applied in central government bodies in 2011-12. However, these are available to be used by management to self assess arrangements where considered relevant.	As part of internal audit's planning for 2012-13 an exercise is being carried out to map internal audit work to the Best Value development areas and toolkits. Management is introducing a benefits tracking and realisation process to define savings and how to quantify them. Staff will be responsible for reporting savings realised which will be formally reported on a quarterly basis to the senior management team and finance and operational performance committee. Management should continue to evolve its benefits tracking and performance systems in order to link financial and non-financial benefits and performance indicators that focus on outcomes rather than outputs.
Priorities and risks framework	We use Audit Scotland's *priorities and risk framework* to extend the scope of our audit to consider non-financial management arrangements, identifying best practice and areas for continuous development. SDS continues to develop risk management arrangements. The update provided by management to the September 2011 audit and risk committee summarised progress to date and acknowledges the important next steps, which centre on embedding a culture of risk management and integrate arrangements with strategic and operational planning.	As part of the audit planning process, we met with management to update our understanding of non-financial management arrangements utilising the priorities and risk framework. There have been significant positive changes to the risk management process. All directorates have risk registers which are actively monitored and reported on internally, which feed into the corporate risk register. During the year the risk management policy was updated and guidance issued on how to assess and respond to risk. Quarterly risk assurance statements are also being completed which will provide comfort to the board that risk management is embedded throughout the organisation.

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 and internal control arrangements **Standards of conduct and prevention and detection of corruption**	SDS maintains an integrated governance framework to provide an appropriate structure for maintaining decision-marking, accountability, control and behaviour. There has been no change in the overall governance framework during the year. Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls are designed appropriately and operating effectively. However, we note that a minor weakness existed over payroll administration, where recommendations have already been agreed with management and reported in our interim management report. We evaluated the design and implementation of IT controls, and where appropriate tested the operating effectiveness. We have concluded that controls are designed appropriately and operating effectively.
Governance statement	The governance statement provides detail on the governance framework, the system of internal control, internal audit, internal financial controls and risk management arrangements, and analyses the effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. We have reviewed the governance statement and have confirmed that it is in line with new guidance and reflects our understanding of SDS.
Internal audit	As set out in our audit plan and strategy, we evaluated the work of internal audit and concluded that we can rely, where appropriate, on their work. The content of the internal audit plan is, in our view, comprehensive. We placed reliance on a number of reports, including those in respect of ESF income and NTP expenditure. Internal audit has completed their agreed plan and their annual report concludes that "*Skills Development Scotland has in place a framework of governance, risk management and control, including operational, financial and ICT controls, that provides reasonable assurance regarding the effective and efficient achievement of the organisation's objectives.*".
Prevention and detection of fraud	Procedures and controls related to fraud are designed and implemented effectively. The compliance team is responsible for reviewing a sample of national training providers and its work did not identify any fraud or systematic issues. In 2011-12 a sample of £20 million (2010-11: £16.5 million) of expenditure was tested and £100,000 (2010-11: £97,000) was recovered; an average recovery rate of 0.5% (2010-11: 0.6%). In management's view, the errors were due to weaknesses in data recording, rather than intentional fraud. Extrapolation of this recovery suggests that up to £0.6 million (2010-11: £0.7 million) may have been paid in error. These payments are not recoverable and therefore the potential error does not impact on the reported surplus for the year. No other significant fraud or irregularity has been identified during the year.

Appendix

Audit Scotland code of audit practice – responsibilities of SDS

Financial statements

Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources. Audited bodies are responsible for:

- ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the relevant financial reporting framework (eg, the Financial Reporting Manual or an Accounting Code of Practice);
- preparing and publishing with their financial statements an annual governance statement, statement on internal control or statement on internal financial control and a remuneration report; and
- preparing consolidation packs and, in larger bodies, preparing a Whole of Government Accounts return.

Systems of internal control

Audited bodies are responsible for developing and implementing systems of internal control, including risk management, financial, operational and compliance controls. They are required to conduct annual reviews of the effectiveness of their governance, systems of internal control, or internal financial control, and report publicly that they have done so. Such reviews should take account of the work of internal audit and be carried out by those charged with governance, usually through bodies' audit committees.

Prevention and detection of fraud and irregularities

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. This includes:

- developing, promoting and monitoring compliance with standing orders and financial instructions;
- developing and implementing strategies to prevent and detect fraud and other irregularity;
- receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity; and
- participating, when required, in data matching exercises carried out by Audit Scotland.

Standards of conduct and arrangements for the prevention and detection of bribery and corruption

Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and should put proper arrangements in place for:

- implementing and monitoring compliance with appropriate guidance on standards of conduct and codes of conduct for members and officers;
- promoting appropriate values and standards; and
- developing, promoting and monitoring compliance with standing orders and financial instructions.

Financial position

Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:

- such financial monitoring and reporting arrangements as may be specified;
- compliance with any statutory financial requirements and achievement of financial targets;
- balances and reserves, including strategies about levels and future use; and
- the impact of planned future policies and foreseeable developments on their financial position.

Best Value

Achievement of Best Value or value for money depends on the existence of sound management arrangements for services, including procedures for planning, appraisal, authorisation and control, accountability and evaluation of the use of resources. Audited bodies are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily.

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