cutting through complexity

The Skills Development Scotland Co. Limited

Audit highlights memorandum

Audit: year ended 31 March 2013

10 December 2013

Contents

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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 The Skills Development Scotland Co. Limited ("SDS") 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

This annual audit work summarises our findings in relation to the audit for the year ended 31 March 2013. Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("the Code"). This specifies a number of objectives for the audit, with our conclusions against those objectives set out in the report.

This report also sets out those matters specified by ISA (UK and Ireland) 260: *Communication with those charged with governance* in relation to the financial statements for the year ended 31 March 2013.

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

Area	Summary observations	Analysis
Service overview		
Business issues and update	The Skills Development Scotland Co. Limited ("SDS") met key government targets for 2012-13, against the backdrop of a challenging economic environment. Management have made enhancements to national training programme monitoring, reporting and forecasting, resulting in improved visibility in the performance and expenditure. Achievement of the new college learner programme target will be determined in July 2013, at the end of the measurement period. Our audit was focused on the key areas of: ■ national training programmes ("NTPs"); ■ valuation and presentation of the VAT assessment balances; and ■ recognition of the college learner programme balances.	Page 4
Financial position	SDS met its financial targets, through effective financial planning and management through the year. A surplus of £3.2 million was recognised, against a breakeven budget. During the year a VAT recovery of £5.1 million was recognised, contributing significantly to the surplus. Management has performed a three year modelling exercise to provide indicative budgets for 2013-14 to 2015-16. These indicate continued efficiency savings are required.	Page 6
Performance management		
Performance management	Best Value and performance management arrangements have continued to be enhanced. We completed our work on the follow up of Audit Scotland's *Scotland's public finances: Addressing the challenges* report. Overall, we found that there is a rigorous budget setting and review process, with a commitment to embedding efficiency savings throughout SDS.	Page 9

Headlines (continued)

Governance and narrative reporting		
Financial statements and accounting		
Accounting policies	There have been no changes to accounting policies in 2012-13. The impact of adopted IAS 19 (revised), effective for 2013-14, has been disclosed in the financial statements and the impact is not material. No other newly effective accounting standards are expected to have a material impact on next year's financial statements.	Page 16
Control observations	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively. The new Agresso system was implemented on 1 April 2013 and management expect this to improve controls and visibility.	Page 18
Audit conclusions and year-end process	The draft financial statements, directors' report, governance statement and remuneration report were received by the agreed date and were well supported by high quality working papers. We have issued unqualified audit opinions on the 2012-13 financial statements, following approval of the financial statements by the board on 4 July 2013.	Page 17
Governance	Over-arching and supporting corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision-making.	Page 12

Service overview

Our perspective on key business issues and
the financial position of the Company

Key business issues

The financial and operating environment in which SDS operates continues to change, with developing Ministerial priorities and development of supporting governance and performance arrangements.

SDS has achieved the government targets for NTP starts in 2012-13. Management have made enhancements to national training programme monitoring, reporting and forecasting.

Service overview and national training programmes ("NTPs")

With a challenging economic climate and labour market remaining challenging, the government's post-16 reform programme underpins the objectives of SDS. It is vital for SDS to understand the environment in which it operates to best support economic growth by helping people and businesses develop and make better use of skills. To this end, management considered labour market intelligence to inform the operating context in the 2013-14 planning process.

The Scottish Government set SDS the following targets for NTP starts:

	Target	2012-13 Actual
Modern apprentices ("MA")	25,000	25,691
Get ready for work ("GRFW")	9,500	9,583
Training for work ("TFW")	5,000	5,522
New college learner programme	5,656*	4,550*

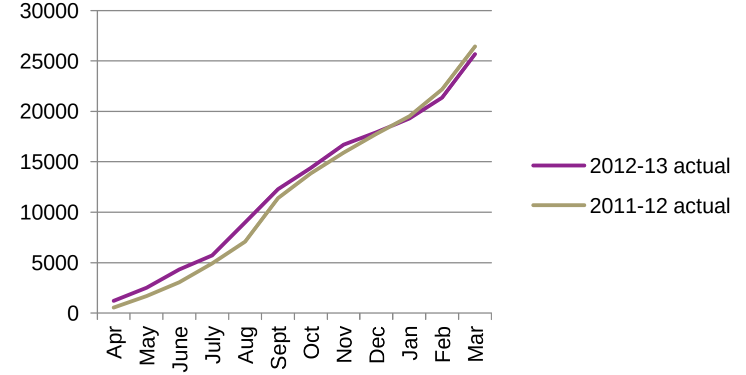
KPMG analysis of SDS performance dashboard to 31 March 2013

* The new college learner programme target is to be delivered over two financial years, all starts to be delivered by 31 July 2013. Management consider that the target will be achieved.

Establishment of a NTP programme board has assisted management in enhancing monitoring, reporting and forecasting to overcome some of the operational difficulties which arose last year. The board incorporates staff from the finance and operational teams and senior involvement from the board. Further training sessions will be provided to support improvements to forecasting.

In respect of NTPs, the initial budgeted spend for 2012-13 was £133 million. In quarter three this was reforecast to £123 million. The overall reduction is partly due to capacity constraints and partly from budget efficiencies. Full year spend on NTPs was £121.2 million, in line with quarter three forecasts.

The graph below illustrates the start profile of new MAs throughout the year, in comparison to prior year actual.



Analysis of this profile identifies that a similar profile is observed in comparing the two financial years. Quarter two (July to September) is the key period of growth for modern apprenticeships, when there is a sharp increase in starts. This aligns with the start of a new academic year. A further increase is observed in quarter four (January to March).

From 2013-14, SDS will continue to manage public contributions to modern apprenticeships. The employability fund will amalgamate some smaller employability programmes. Targets for 2013-14 include 25,000 new modern apprentice starts and 17,150 starts in the employability fund. This includes at least 2,650 college starts.

The 2013-14 operating plan was approved by the board on 11 April 2013. The plan incorporates an operating context, reviewing the economy and labour market, government policy, socio-demographic factors and the impact of technology. The combination of these factors provides a further challenging environment for 2013-14. Within the plan detailed actions, outputs, milestones and targets are identified against each strategic objective. This ensures alignment of operational processes with SDS's strategy.

Financial position

Income and expenditure decreased compared to 2011-12. The surplus reduced, primarily due to decreased grant-in-aid and European income, netted with decreased operating expenditure in 2012-13.

Financial position

The result for the year was a surplus of £3.2 million, within its resource budget of £178.8 million. A £16 million efficiency saving through reduction in grant-in-aid was allocated to SDS in 2012-13 (2011-12: £21 million). The £3.2 million surplus is supported by a £5.1 million VAT recovery recognised as a credit within cost of sales.

To provide context for our commentary and consideration of the outturn for 2012-13, we summarise below significant changes compared to 2011-12.

	2012-13 £000	2011-12 £000	Movement £000
Grant-in-aid	178,144	196,971	(18,827)
European income	9,366	18,274	(8,908)
IT services	8,984	8,396	588
Careers guidance	719	1,107	(388)
Miscellaneous	3,129	337	2,792
Total income	**200,342**	**225,085**	**(24,743)**
Operating expenditure	(167,111)	(180,705)	13,594
Cost of sales	(4,693)	(9,691)	4,998
Administrative expenses	(26,026)	(24,238)	(1,788)
Total expenditure	**(197,830)**	**(214,634)**	**16,804**
Finance costs	-	-	-
Finance income	658	2,265	(1,607)
Income tax	(18)	(25)	7
Surplus/(deficit)	**3,152**	**12,691**	**(9,539)**

Source: KPMG analysis of SDS financial statements

Grant-in-aid income decreased from the prior year, due to the current economic climate and Scottish Government funding reductions. In May 2013, the SDS budget allocation was amended with the agreement of both parties, reducing the grant-in-aid allocation for 2012-13 by £10 million. As a consequence, £10 million of grant-in-aid will be made available to SDS in 2013-14 subject to the requirement of activity levels.

European income decreased as a result of the conclusion of the *supporting business through recovery* programme. £2.1 million was recognised for this programme in 2012-13, in comparison to £11.2 million in 2012-13.

Miscellaneous income recognised in 2012-13 increased from the prior year, due to the recognition of £3.1 million DWP income in respect of training for work programmes. Management considered this income in 2011-12 and appropriately concluded that it is recognised in 2012-13.

Decreased operating expenditure on national training programme expenditure is due to decreases in specific programmes. Parts of the *supporting business through recovery* programme (£15.1 million) concluded in 2011-12, and less expenditure was incurred in 2012-13. Also, *employer recruitment incentive* programmes varied resulting in reduced expenditure. These decreases were offset by increases in relation to modern apprentices (£13.2 million), new college learner programme (£7.9 million) and the challenge fund (£2.7 million).

Staff costs, included within operating and administrative expenditure, decreased due to lower staff numbers and savings realised from the voluntary severance scheme in 2011-12. Significant pension settlement costs incurred in 2011-12 were not payable in 2012-13.

Cost of sales expenditure decreased in 2012-13, due to the recognition of the VAT recovery of £5.1 million in relation to the IT service contract. Underlying cost of sales expenditure did not significantly change from 2011-12.

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 2013-14

2013-14 will continue to be challenging for SDS. The Scottish Government has set SDS targets of 25,000 modern apprenticeship starts and 17,150 starts from the employability fund. SDS can draw down the £10 million not utilised in 2012-13 and also expect receipt of the net £4.7 million VAT claim in 2013-14. This will lead to challenges in ensuring this cash is expended appropriately and discussion is ongoing with Scottish Government.

Management has budgeted a breakeven position for 2013-14, based on anticipated grant-in-aid of £199.6 million, including £6 million college engagement funding and £6.2 million employability fund specific funding. Other budgeted income streams of £12.5 million relate to European income of £2 million, shared service recharge of £7.9 million and other income of £2.6 million. Grant-in-aid is to increase to cover the shortfall created by the cessation of the European Social Fund.

The 2013-14 expenditure budget is summarised opposite. This is the first year of the employability fund, with budgeted expenditure of £44.4 million.

Other invoicing includes individual learning accounts funding in 2013-14 which is expected to be re-directed to the Student Awards Agency for Scotland during the autumn and spring budget reviews

The financial statements total expenditure includes £5.1 million credit against cost of sales in respect of VAT, and other adjustments in relation to pension adjustments and depreciation, in comparison to the management accounts outturn.

Expenditure	2013-14 budget £'000	2012-13 management accounts outturn £'000
National training programmes	125,403	122,410
Development programmes and projects	10,000	8,639
Staff costs and salaries	45,500	42,924
Infrastructure, management and administration	13,823	12,281
Information technology and systems	11,838	15,038
Other invoicing	9,586	1,121
Total spend	**216,150**	**202,413**

Source: KPMG analysis of SDS management accounts

Medium term financial plans

Management is performing a three year modelling exercise which will provide indicative budgets for 2013-14 to 2015-16. The draft exercise identifies reduced grant-in-aid and European income. Further grant-in-aid continues to be received to cover the shortfall created by the cessation of the previous European Social Fund cycle over the three year period.

Performance management

Our perspective on the performance management arrangements, including follow up work on Audit Scotland reports

Performance management

Our work has identified that SDS's Best Value and performance management arrangements are maturing. Management are considering ways to embed and demonstrate benefits tracking and realisation.

Management are preparing a response the Director General, Governance and Communities letter on corporate expectations.

Best Value and performance management	In April 2002 the Scottish Ministers introduced a non-statutory duty on accountable officers to ensure there are arrangements designed to secure Best Value. Audit Scotland is committed to extending the Best Value audit regime across the whole public sector. Using the Scottish Executive's nine Best Value principles as a basis for audit activity, Audit Scotland previously selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). A new performance management framework was implemented in 2012-13, which was designed to strengthen SDS' s organisational accountability through relevant and meaningful performance management to support achievement of Best Value. We reported on this framework in the interim management report and noted that this will help to drive continuous improvement and support the achievement of Best Value. Management is considering ways in which to embed and demonstrate benefits tracking and realisation as a core discipline to the business. Management has stated that SDS's ethos is driven by finance and audit, to ensure they are leveraging resources in the best possible way and doing more within decreasing resource settlements through solid financial management and innovative ways of working, embracing technology and service redesign. Internal audit will complete a review of performance management arrangements in 2013-14, assessing the extent to which performance measures are linked to the delivery of corporate objectives and how these are linked to operational monitoring processes. A £16 million efficiency saving through reduction in grant-in-aid was allocated to SDS in 2012-13 (2011-12: £21 million). SDS has indicated it will contribute £1.5 million extra to meet an efficiency target of 3% in 2013-14 and management are in discussions on SDS's possible involvement in strategic forum savings. A commitment to continuous improvement to procurement and financial management enable SDS to contain and reduce costs. The strategic internal audit plan 2013 -16 aims to provide assurance of Best Value through reviews covering corporate, finance, human resources, communications and operations. These reviews will be linked to the Audit Scotland Best Value toolkits.
Corporate expectations	The Scottish Government's Director General, Governance and Communities wrote to public bodies on corporate expectations in July 2012 asking for a preliminary assessment of progress towards these expectations. Management's draft response identifies how SDS's operating plan 2013-14 and related work plans align to each expectation. The director of corporate services has responsibility for strategy, policy, planning and performance and corporate governance and government liaison. Relevant senior managers will be required to jointly coordinate reporting to the Scottish Government on corporate expectations. Work is still required to identify an overall assessment of performance and challenges and opportunities.

Performance management

During 2012-13 we have performed follow-up work in relation to the Audit Scotland national report: *Scotland's public finances: Addressing the challenges* as well as preparing returns on national studies.

Scotland's public finances: addressing the challenges	As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified the *Scotland's public finances: Addressing the challenges* for follow-up by local auditors in 2012-13. The aim of the follow-up work is to assess how public bodies are responding to the challenges of public sector budget constraints and their efforts to achieve financial stability. Our conclusions are that SDS has sound budget setting and review processes. Quarterly forecasts are performed by management. Variances and delivery against budget are closely monitored and discussed by the board and relevant sub-committees. Funding reductions are implicit within the approved budget for 2013-14 and no risks to service delivery have been identified as service delivery is aligned to the government letter of guidance and the budget set accordingly. Efficiency savings had previously been focused on budget reductions and balancing budgets, and specific targeted in-year challenges managed through the budget process. No individual service reviews have yet performed, except an organisation-wide voluntary severance and early retirement review in 2011-12. This had clear business plans and demonstrable payback periods. Management intend to commence a lower level, detailed efficiency programme. Finance is discussed at each board and relevant sub-committee meeting, ensuring a prominent role in the consideration of budget plans and potential risks to service delivery. Senior officials and non-executive directors contribute effectively to ensuring a sufficient focus on strategy and challenging longer-term financial plans. Management are updating their longer term budget for a three year period and completing scenario testing with regards service reviews, possible further budget challenges and changing income streams. Detailed findings are given in appendix three.
Local response to national studies	SDS's finance and audit team review Audit Scotland national reports on a quarterly basis, seeking assurances from directors that plans are in place to address relevant recommendations. An overview paper is presented to the audit and risk committee on the key findings and implications of such reports, including current controls and any planned actions to address recommendations from the reports. An initial sample based review in February 2013 identified SDS is following recommended good practice in many areas. Management has identified 40 actions to further improve performance against national report recommendations and is progressing implementation. Audit Scotland will be performing a review of modern apprenticeships in 2013, although SDS is only responsible for managing the public contribution and not the overall programme. Management have completed extensive preparation ahead of this work.

Governance and narrative reporting

Update on your governance arrangements

Our overall perspective on your narrative reporting, including the remuneration report and annual governance statement

Corporate governance arrangements

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

Annual governance statement and governance arrangements	The statement for 2012-13 outlines the corporate governance and risk management arrangements in operation in the financial year. It 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. The statement made by the Accounting Officer considers the effectiveness of the system of internal control based on information provided by the audit and risk committee, internal audit, directors' statements of assurance and feedback from the business. The statement identifies that there have been no significant risk-related matters and no significant lapses of data security. We have reviewed the governance statement and have confirmed that it is in line with guidance and reflects our understanding of SDS. SDS maintains an integrated governance framework to provide an appropriate structure for maintaining decision-making, accountability, control and behaviour. During the year, the board's composition changed; two board members resigned and three new directors were appointed by the Scottish Ministers. An additional new director was appointed post year end. The board continues to be supported by four sub-committees; the audit and risk committee, the finance and operational performance committee, the remuneration committee and the service development committee. SDS continues to build on last year's governance report actions through management actions and internal audit reviews. Management report that good progress is being made to implement risk management arrangements at corporate, directorate and team level. The corporate risk register, which represents the strategic risks facing SDS, is reviewed monthly by the senior management team. Directors complete quarterly risk assurance checklists providing the audit and risk committee with assurance that the risk management policy and guidance is being followed, internal controls are being followed and action is being taken to address Audit Scotland report recommendations. Internal audit performed a follow up review on risk management and identified all recommendations had been implemented. We have updated our understanding of the governance framework and documented this through our overall assessment of SDS's risk and control environment. This work has formed part of our assessment of SDS's annual governance statement. We consider the governance framework and annual governance statement to be appropriate for SDS.

Corporate governance arrangements (continued)

Annual report, including the management commentary	The financial statements form part of the annual report of SDS for the year ended 31 March 2013. We are required to consider the Directors' Report and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the directors' report is consistent with the financial statements. Changes to the UK Corporate Governance Code, which will be applicable for year ending 31 March 2014, will require that the 'front end' narrative reporting is 'fair, balanced and understandable.' Audit committees will be expected to consider this as part of their consideration of the annual report and financial statements. In our view, the annual report already complies well with this requirement, although we recommend early consideration by management of the requirements of the revised Code against SDS's reporting format.
Remuneration report	The remuneration report was provided in advance of the commencement of the audit, and supported by good quality information in terms of the disclosures provided. The remuneration committee met on 30 April 2013 to approve the report.
Internal audit	As set out in our audit plan and strategy, we evaluated the work of internal audit and concluded that we can rely on their work, where relevant. The content of the internal audit plan is, in our view, comprehensive. We reviewed a number of reports, including those in respect of procurement and NTP's. Internal audit have 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. Proper arrangements are in place, in the areas reviewed, to promote value for money, deliver best value and secure regularity and propriety in the administration and operation of the organisation"*.
Prevention and detection of fraud	Procedures and controls related to fraud appear appropriate for the size and complexity of the organisation. 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 2012-13 a sample of £7.5 million (2011-12: £20 million) of expenditure was tested and £73,000 (2011-12: £100,000) was recovered; an average recovery rate of 0.9% (2011-12: 0.5%). In management's view, the errors were due to weaknesses in data recording, rather than intentional fraud. Extrapolation of this recovery would suggest that, in a worst-case scenario, up to £1.0 million (2011-12: £0.6 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 material fraud or irregularity has been identified during the year.

Corporate governance arrangements (continued)

National Fraud Initiative (“NFI”)	The National Fraud Initiative (“NFI”) is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use for uploading data and monitoring matches. 2012-13 is the first year that SDS have participated in the NFI. The financial accounting manager submitted required data by 31 January 2013. SDS has received its matches and management intend to develop arrangements to review these matches after completion of the audit. We are required to complete an NFI questionnaire to Audit Scotland by 31 January 2014, assessing SDS’s engagement with the 2012-13 NFI exercise. We will complete this in liaison with management when matches have been reviewed.

Financial statements and accounting

Our perspective on the preparation of the financial statements and key accounting judgements made by management

Accounting policies

There have been no substantive changes to the financial reporting framework as set out in the Goevrnment's *Financial Reporting Manual* ("FReM").

There have been no changes to accounting policies in 2012-13. All accounting policies have been applied consistently.

Disclosure has been included in respect of the impact of revisions to IAS 19 *Employee benefits.*

The financial statements have been prepared on a going concern basis. The directors have appropriately disclosed the net liabilities position of the Company, and their reasons for considering that the going concern assumption remains appropriate.

Accounting framework and application of accounting policies	
Area	**KPMG comment**
Financial reporting framework	■ SDS prepares the financial statements in accordance with the Companies Act 2006 and follows the principles of the Government's Financial Reporting Manual 2012-13 ("FReM") as appropriate. Management provides the additional disclosures required by the FReM where these go beyond the requirements of the Companies Act 2006. ■ During the year there have been no substantive changes in financial reporting requirements, and consequently there are no material changes to SDS's accounting policies. ■ We are satisfied that the accounting policies adopted remain appropriate to the business.
Grant-in-aid	■ The treatment of grant-in-aid is consistent with that agreed in previous years, with confirmation obtained in 2011-12 that the Scottish Government is in agreement that, as a company, grant-in-aid (including capital grant-in-aid received) should be recognised as income reflecting the services provided in exchange by SDS.
Impact of revised accounting standards	■ Disclosure has been included in the financial statements highlighting that the impact of revisions to IAS 19 `*Employee benefits*' if the standard had been adopted early in 2012-13 would not have been material, with the estimated change to finance costs being of order £1.4 million. ■ No other newly effective accounting standards are considered to have a material impact on SDS's financial statements.
Going concern	■ The directors have considered the funding available to SDS, which is approved for 2013-14, combined with a longer term commitment to SDS. The group has net assets at the balance sheet date, although reduced by £4.0 million in the year, due primarily to the movement in the net pension deficit. ■ The directors consider it appropriate to adopt a going concern basis for the preparation of these financial statements, and disclosed these circumstances within the financial statements. We are satisfied that this disclosure remains appropriate, noting that the pension deficit does not become due in the next 12 months.

Audit conclusions

We have issued an unqualified audit opinion on the financial statements and the regularity of transactions reflected in those financial statements.

The financial statements and draft governance statement were made available on a timely basis and were accompanied by high quality working papers.

Audit conclusions

Following approval of the financial statements by the board, we have issued an unqualified opinion on the truth and fairness of the state of SDS's affairs as at 31 March 2013, and of SDS's surplus for the year then ended. We also provide our unqualified opinion on the regularity of transactions within the year. There are no matters identified on which we are required to report by exception.

In gathering the evidence for our opinion we have:

- performed a mixture of substantive and controls testing to ensure an efficient approach that covers all the key risks;
- liaised with internal audit and reviewed their reports to ensure all key risk areas having a potential financial statements impact have been considered;
- reviewed assumptions and judgements made by management and considered these for appropriateness;
- considered if the financial statements may be affected by fraud through discussions with senior management and internal audit to gain a better understanding of their work in relation to prevention and detection of fraud with the potential to impact on the financial statements; and
- attended the audit committee to communicate our findings to those charged with governance, but also to update our understanding of the key governance processes and obtain key stakeholder insights.

Financial statements preparation

- High quality working papers and full draft financial statements were provided at the start of the audit fieldwork on 13 May 2013. This included the directors' report, remuneration report and governance statement.
- In advance of our audit fieldwork, we issued a 'prepared by client' request setting out a list of required analyses and supporting documentation. The standard of documentation was very good and there was evidence of accountability and ownership of working papers across the finance department.
- Throughout the course of the year we have had regular correspondence with SDS's finance team to ensure that disclosure within the financial statements was consistent with the requirements of the Companies Act 2006 and the FReM. We provided feedback to management on the content of the financial statements, annual report and governance statement, and we are pleased to report that these were consequently prepared appropriately.
- There are no significant matters in respect of (i) audit differences; (ii) auditor independence and non-audit fees; and (iii) management representation letter content, as reported in appendix one.

Internal controls

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 relating to financial systems and procedures are designed appropriately and operating effectively.

In our interim management report, we made two `medium' grade recommendation in respect of journal entries and the compliance team. Management have implemented a new finance system from 1 April 2013, which has controls in place to mitigate the journal entry risks identified. Testing of general IT controls was ongoing at the date of our interim report. The table below summarises our findings.

Audit area	Key controls considered	Findings
General IT controls	■ Starters ■ Leavers ■ Passwords	■ The IT service provider could not provide a helpdesk ticket which matched the username and date for one of the five new users selected for testing. The NTP team leader advised the account was de-activated following a regular monthly check of all users as it was not assigned to a specific user, but then reactivated as it was being used by a skills investment advisor. The user was agreed to an establishment listing of staff members and access was appropriate for the job role. From our understanding this issue was a one off and not representative of the population. There is a risk that ghost users are added to the system or systems access is provided to unapproved users. ■ In 2012-13, there was one leaver with access to Exchequer. Access for this leaver had not been removed at the date of testing, four months after their leaving date. There is a risk that leavers could obtain access and make changes to SDS systems, or that other staff members could use the leaver's account to make changes which are unaccountable. ■ Although passwords are in place, CTS uses a legacy Microsoft Site Server which does not have any enforced password complexity rules, such as expiry dates. Furthermore, Exchequer passwords do not have a minimum number of characters. There is a risk that passwords could be 'solved'. Stronger password rules should be enforced on all systems to ensure they are protected from unauthorised access. ***Recommendation one*** ■ Further substantive testing was performed to ensure no further errors in starters and leavers access controls, and no adverse effects had occurred. No further weakness or adverse effects were identified.

Overview assessment

Overall, in respect of the key judgements made in the preparation of the financial statements, we are satisfied that management's judgements are generally balanced, and do not represent either an overly optimistic, or overly cautious, position.

Assessment of subjective areas

Asset/liability class	Current year	Prior year	Balance (£m)	KPMG comment
Pensions IAS 19 pension deficit	3	3	(24.7)	We have reviewed the assumptions used by the actuary in calculating the pension deficit. The assumptions are with in the acceptable range of the guideline assumptions that KPMG actuaries have calculated. Overall, the assumptions are considered to represent a balanced approach to valuation of the net pension deficit.
VAT accounting treatment	3	n/a	4.7	We have considered the accounting treatment for the VAT recovery. We consider it appropriate for a debtor to be recognised and management's calculations appear appropriate, being in line with the agreement with HM Revenue and Customs. We concur with the treatment of the VAT and the resultant debtor as at 31 March 2013.
New college learner programme	3	n/a		We have reviewed management's analysis of the new college learner programme and the programme rules. Overall, the income and expenditure recognised and related prepayment is appropriate.

Level of prudence

0 1 2 3 4 5 6

Audit difference | Cautious | Balanced | Optimistic | Audit difference

Acceptable range

Cautious means a smaller asset or bigger liability; Optimistic is the reverse

Employee benefits

Each of the assumptions used to value the Company's net pension deficit are within an acceptable range of KPMG's expectations.

We are of the view that this therefore represents a reasonable and balanced approach, in accordance with the requirements of IAS 19.

Defined benefit pension liability

Value (£000s)		
2013	**2012**	**KPMG comment**
(24,668)	(17,198)	In line with our established practice and in advance of the audit fieldwork, our actuarial specialists reviewed the approach and methodology of the actuarial assumptions used in the IAS19 pension report. Details of key actuarial assumptions are included in the table, along with our commentary.

Assumption	SDS	KPMG central	Comment
Discount rate	4.5%	4.25%	Acceptable - SDS's rate is weaker (lower liability) than KPMG's central rate and is at the top end of the range we consider acceptable
RPI inflation	3.6%	3.6%	Acceptable
CPI inflation	2.8% RPI - 0.8%	2.6% RPI – 1%	Acceptable – SDS's assumption is more prudent (higher liability) than KPMG's central rate, and is within the acceptable range.
Salary growth (long term)	5.1% 1.5% above RPI	1-2% above RPI/CPI inflation	Acceptable – SDS's assumption reflects the extension of the public sector pay freeze to 2016, followed by a long term assumption of RPI plus 1.5%.

The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of around 17 years.

The closing deficit increased by £7.5 million from 2011-12, primarily due to the application of an updated discount rate. A reconciliation from opening to closing deficit is included on the next page.

Employee benefits (continued)

The table opposite shows the reconciliation of the movement in the balance sheet.

The main elements of volatility are in respect of the discount rate, which drives the valuation of the liabilities.

	£000	Deficit / loss	Surplus / gain	Impact	Volatility	Commentary
	Opening surplus/(deficit)			**(17,198)**	-	The opening IAS19 deficit for the Scheme at 31 March 2012 was £17.198 million, in line with the Hymans Robertson's IAS19 Actuarial Valuation Report.
I & E	Service cost			(7,359)	●	The scheme is open to accrual. The service cost represents the value of new benefits built up over the year.
I & E	Curtailments			(58)	●	-
I & E	Net finance charge			554	●	This is the difference between the expected return on assets of £8.894 million and the interest on the Defined Benefit Obligation of £8.34 million.
I & E	Settlements			(143)	●	The final settlement payment for the rationalisation of the pension funds was incurred in 2012-13.
Cash	Contributions			6,718	●	The Company made cash contributions of £6.718 million.
OCI	Change in assumptions gain/(loss)			(7,182)	●	This represents an actuarial loss due to changes in assumptions, primarily due to the reduction in the discount rate.
	Closing surplus/(deficit)			**(24,668)**	-	

Key: ● Low ● Medium ● High

Source: KPMG analysis of scheme valuation movements. Volatility assessment based on KPMG's market experience.

I&E – impacts on surplus /(deficit) within statement of comprehensive income

Cash – cash-flow impact

OCI – charged through other comprehensive income

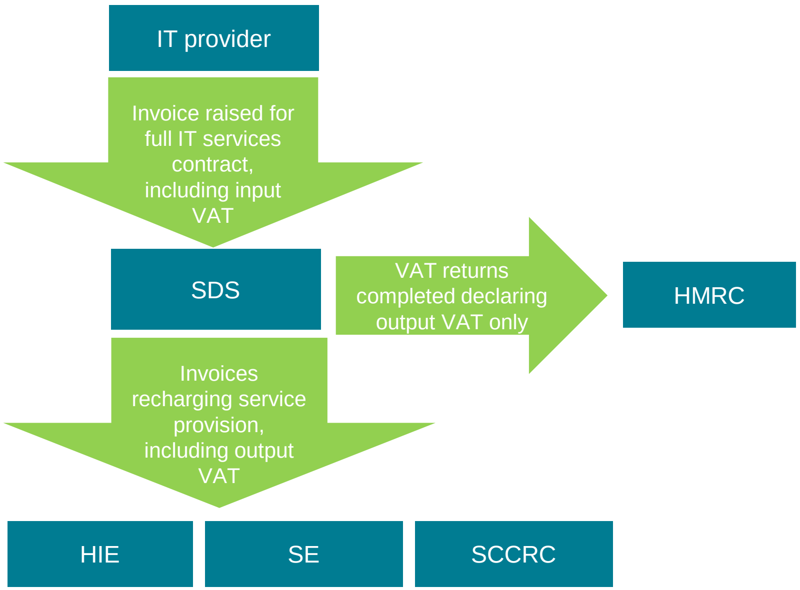
Key business issues

We have considered key business issues, in relation to VAT accounting treatment and the new college learner programme.

We concur with management's judgements.

VAT accounting treatment

A net £4.7m debtor has been recognised in respect of a VAT recovery in relation to the years 2008-09 to 2012-13. This is predominately the result of the IT service arrangement; SDS receive invoices from an external provider for IT services. The invoices have VAT included. SDS recharge Scottish Enterprise, Highlands and Islands Enterprise and Scottish Criminal Cases Review Commission for their element of the IT services, including VAT. Output VAT had been declared to HMRC in respect of the invoices to SE, HIE and SCCRC, although SDS has previously not claimed recovery of input VAT from the IT service provider's invoices. This is illustrated in the diagram below.



In 2012-13 management agreed with HMRC that the input VAT could be recovered and a business/non-business calculation method confirmed. Calculations of the VAT recovery balance were shared with HM Revenue and Customs on 15 April 2013 and a net £4.7 million VAT debtor was recognised with a £5.1 million credit to cost of sales. Management are discussing how the cash, to be received in 2013-14, will be used. There is currently no budget allocated by the Scottish Government, against which the cash can be utilised.

Having reviewed the correspondence with HM Revenue and Customs, consulted with our VAT specialists and considered management's calculations, we concur with the treatment of VAT and resultant debtor as at 31 March 2013. At the date of this report, HM Revenue and Customs has not confirmed agreement with management's calculations or refunded the input VAT.

New college learner programme

This new government initiative, launched in 2012-13, helps to deliver the government's commitment to protect student places. It prioritises young people and aims to support learners to move into jobs or more advanced learning. SDS received £13.1 million to manage the programme and colleges were invited to bid to deliver vocational and work experience places in the 2012-13 academic year.

In February 2013, the programme rules in relation to payments were amended, now requiring SDS to make advance payments to colleges. Claw back clauses are included for payments made to colleges which do not subsequently achieve eligibility criteria. Management have recognised the £13.1 million as grant-in-aid revenue and a deferred expenditure prepayment of £3.5 million in relation to payments made prior to 31 March 2013 which could be clawed back.

We reviewed management's analysis of this programme and agree with the decision to recognise the income and deferred expenditure, based on the revised programme rules.

Appendices

Mandatory communications

There were no changes to the core financial statement and there are no unadjusted audit differences

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft financial statements which impacted on the net assets or the surplus and deficit for the year. A small number of minor numerical and presentational adjustments were required to some of the financial statements notes.	-
Unadjusted audit differences	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences.	-
Confirmation of Independence Letter issued by KPMG to the Audit Committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of our Audit Director and audit staff. We have concluded that non-audit fees for the year (£2,000, corporation tax compliance) do not compromise our independence.	Appendix 2
Draft management representation letter Proposed draft of letter to be issued by the Company to KPMG prior to audit sign-off	There are no changes to the representations required for our audit from last year.	-

Auditor independence and non-audit fees

Auditing standards require us to consider and confirm formally our independence and related matters in our dealings with SDS

We have appropriate procedures and safeguards in place to enable us to make the formal confirmation in our letter included opposite.

Auditor independence

Professional ethical standards require us to provide to you at the conclusion of an audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed. This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence.

We have considered the fees paid to us by the Company and its related entities for professional services provided by us during the reporting period. We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Directors and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Regular communications
- Internal accountability
- Risk management
- Independent reviews

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the Board of Directors.

Confirmation of audit independence

We confirm that as of 4 July 2013, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This report is intended solely for the information of the Audit Committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

Scotland's public finances: addressing the challenges follow up

As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified Scotland's public finances: Addressing the challenges for follow-up in 2012-13.

We carried out follow-up work to consider the Company's response to the report.

1. Do public bodies have sustainable financial plans which reflect a strategic approach to cost reduction?	
Does the organisation have a balanced financial plan for 2012-13 which sets out: ▪ Assumptions about sources of income and cost pressures? ▪ What cost reductions and other efficiency savings will need to be made, and how they are to be delivered? ▪ Risks to service delivery as a consequence of the need to reduce costs and deliver identified efficiency savings?	We have considered the process for 2013-14 as this has now been approved by the Board. SDS has an operating plan and a budget in 2013-14 which have been approved by the senior management team ("SMT"), finance & operational performance ("FOP") committee, and the Board. Assumptions are set out and discussed by each of these groups. A baseline reduction of £16 million is implicit in the budget, and SDS has agreed with the Scottish Government to contribute £1.5 million through year end flexibility from 2012-13. The 2013-14 budget includes a target for efficiency gains of 3%. The FOP has considered a strategy for a more general efficiency approach. No risks to service delivery have been identified, as service delivery is aligned to the government letter of guidance and the budget set accordingly.
Does the organisation have a clear budget-setting process which: ▪ Demonstrates a clear understanding of its costs and how costs vary with activity? ▪ Takes into account previous years' service delivery performance and where improvements need to be made? ▪ Takes into account the body's track record on delivering against budgets and analysis of the reasons for previous years' under/over spends? ▪ Allocates resources according to a clear understanding of its priorities, including which services or activities are expected to contribute most and least to the achievement of the organisation's outcomes?	SDS has a rigorous budget setting and review process. All expenditure is requested through budget cases submitted to finance and the detail approved by FOP, SMT and the Board during January – April 2013. Following initial forecasts, there is a quarterly review of forecasts in addition to the autumn budget review and spring budget review revisions. The budget setting process takes into account previous years' service delivery and improvements to be made are agreed with the Scottish Government. Variances and delivery against budget are closely monitored and discussed at FOP, SMT and Board meetings. These are taken into account when setting the annual budget. The FOP committee robustly scrutinise expenditure plans to provide assurance on value for money and appropriate alignment against strategic priorities. The annual operating plan sets out the organisation's outcomes, and the budget is aligned with this. Two internal audits have been completed on budget management, providing assurances that there is a clear budget-setting process.

Scotland's public finances: addressing the challenges follow up(continued)

Is there a clear evidence base to cost reduction plans? If yes: ■ Does the organisation undertake a programme of service reviews designed to identify the scope to reduce costs? ■ Do cost reduction plans provide adequate detail on how savings are to be made and over what timeframe? ■ Do cost reduction plans state who within the organisation is accountable for their delivery? ■ Do cost reduction plans give adequate consideration to the impact of reduced expenditure/ changes to service delivery arrangements on service performance and outcomes? ■ Are clear baselines established against which efficiency savings can be measured?	No individual service reviews have taken place so far in terms of a cost reduction programme, outwith the voluntary severance and early retirement ("VSER") review in 2011-12. The approach has been to balance the budget and allocate resources to the main priorities based on the allocation granted by the Scottish Government, priority targets and aims set out in the annual letter of guidance and operating plan. VSER and technology plans considered how services have changed and was considered by both SMT and the service delivery committee ("SDC") in the last two years to ensure no impact on service. For VSER, each programme has had clear business plans and demonstrable payback periods. There have been discussions about making more granular cost reduction plans going forward. So far cost reductions and efficiency plans have been implemented at a high level only.
Does the organisation regularly use benchmarking to compare its costs and performance with other organisations, including public bodies in other sectors and other non-public sector bodies? Can the organisation demonstrate real and measurable benefits from its benchmarking activities in terms of cost and/or quality improvements?	In 2011-12 SDS took part in the Scottish Government Corporate Services benchmarking exercise. This allows organisations to compare their costs and performance to other public sector bodies. The 2011-12 report has not yet been published.
Does the organisation have a longer term financial strategy which: ■ Takes into account planned changes to service delivery arrangements and anticipated changes in demand for services? ■ Sets out how financial resources will be matched to strategic goals? ■ Demonstrates that current cost reductions and efficiency savings are in line with longer term strategic objectives?	The corporate strategy covers the period from 2012 to 2015. SDS is updating its longer term budget for a three year period and completing scenario testing with regards service reviews, possible further budget challenges and changing income streams. These forecasted outlooks are based on strategic priorities. The corporate strategy sets out objectives and is in line with the annual operational plan, which is aligned with the current year budget.

Scotland's public finances: addressing the challenges follow up(continued)

2. Do senior officials, elected members and non-executive directors demonstrate ownership of financial plans and are they subject to sufficient scrutiny before approval?	
Do senior officials, elected members and non-executive directors demonstrate ownership of financial plans: ■ Are high level financial targets and the overall financial position of the organisation discussed regularly at board level meetings? ■ In setting financial plans, do members adequately consider the impact of budget reductions on service quality and outcomes?	Finance is discussed at every Board, SMT and business management team meeting. It is also discussed at FOP, and for certain elements the audit and risk committee. Meeting minutes evidence this discussion. Members consider any budget reductions and seek assurance from the executive team that the service can be delivered within the set budget, and challenge different aspects of the assumptions.
Do senior officials, elected members and non-executive directors provide: ■ Sufficient focus on strategy and performance? ■ Adequate challenge on longer-term financial plans? ■ Regular consideration of financial risks? ■ Adequate monitoring of the achievement of efficiency targets?	FOP contributes effectively to the first three elements. SDS intends to embark on a lower level more detailed efficiency programme. These were discussed at FOP and BMT meetings in May 2013. Previously it had been centred on budget reductions and balancing budgets, and specific targeted in year challenges managed through the budget process.
Is there appropriate transparency and accountability of decisions about cost reduction measures and future organisational plans: ■ Is there appropriate consultation with the public and other stakeholders over cost reduction plans which identify various options and their impact on service delivery and outcomes? ■ Do financial and corporate plans adequately spell out the consequences of reduced budgets on the organisation's ability to deliver services and outcomes?	There is a clear governance structure in place at SDS and all meetings are minuted, including decisions taken which ensures transparency and accountability of decisions about cost reductions and future plans. There has not been significant stakeholder consultation over cost reduction plans as there have been no cuts to front line services and redundancy schemes have been voluntary. The 2012-15 strategic plan clearly sets out the need to make spending reductions and put efficiencies into practice as a result of the Scottish Government's spending review.

Scotland's public finances: addressing the challenges follow up(continued)

Do finance/resource committees and other scrutiny committees play a suitably prominent role in the consideration of budget plans and risks to service delivery: ■ Are finance/resource and other scrutiny committees sufficiently involved in the consideration of budget plans, including: ■ the impact of budget reductions on service delivery ■ the organisation's track record of delivering against budgets? ■ reasons for previous years' under/over spends against budget? ■ Do finance/resource and other scrutiny committees undertake a regular programme of reviews of business areas to examine issues such as the achievement of value for money and service delivery? ■ Do finance/resource and other scrutiny committees regularly assess areas such as financial risks and efficiency savings? Are reports from finance/resource and other scrutiny committees on budget plans and risks to service delivery given proper consideration by officials, with recommendations being promptly acted upon? ■ Do finance/resource and other scrutiny committees receive reports on the extent to which cost reductions and efficiency savings have impacted on service delivery?	The FOP committee, ARC, SMT and Board all consider budget plans and risks to service delivery. This includes impact of budget reductions, delivery against budgets and explanations of variances in previous years. This is evidenced through minutes. FOP, ARC and the Board regularly undertake reviews of value for money and service delivery, financial risks, cost reductions and service delivery. Efficiency savings are a key part of the 2013-14 annual operating plan and there are targets in place which will be monitored. Audit Scotland are performing a separate review on whether the modern apprenticeship programme provides value for money and SDS will participate along with other relevant, external parties. This is due to be published in March 2014.

Action plan

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses.

Priority rating for recommendations

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

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
1 General IT controls - leavers		**Grade two**
In 2012-13, there was one leaver with access to Exchequer. Access for this leaver had not been removed at the date of testing, four months after their leaving date. There is a risk that leavers could obtain access and make changes to SDS systems, or that other staff members could use the leaver's account to make changes which are unaccountable. Although passwords are in place, CTS uses a legacy Microsoft Site Server which does not have any enforced password complexity rules such as expiry dates. Furthermore, Exchequer passwords do not have a minimum number of characters. There is a risk that passwords could be 'solved'.	It is recommended that line managers are reminded of the need to notify ATOS in a timely manner to remove access. Furthermore, there should be a regular check of users on Exchequer to ensure access is appropriate. Stronger password rules should be enforced on all systems to ensure they are protected from unauthorised access.	Agreed **Responsible officer:** Director of corporate services **Implementation date:** 1 October 2013

cutting through complexity