cutting through complexity

The Skills Development Scotland Co. Limited

Annual audit report to the Board of Directors of Skills Development Scotland Co. Limited and the Auditor General for Scotland

Audit: year ended 31 March 2014

30 July 2014

Contents

The contacts at KPMG in connection with this report are:

Andy Shaw
Director, KPMG LLP

Tel: 0131 527 6673
Fax: 0131 527 6666
andrew.shaw@kpmg.co.uk

Sarah Burden
Engagement Manager, KPMG LLP

Tel: 0131 527 6611
Fax: 0131 527 6666
sarah.burden@kpmg.co.uk

Beth Grieve
Audit in-charge, KPMG LLP

Tel: 0131 527 6729
Fax: 0131 527 6666
bethany.grieve@kpmg.co.uk

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 and the Auditor General for 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 circumstances set out in the executive summary: scope and objectives.

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

Headlines

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

In accordance with ISA (UK and Ireland) 260: *Communication with those charged with governance,* this report summarises our work in relation to the financial statements for the year ended 31 March 2014.

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

Area	Summary observations	Analysis
Service overview		
Business issues and update	2013-14 is the second year of The Skills Development Scotland Co. Limited's ("SDS") three year corporate strategy, and progress has been made in achieving corporate objectives. SDS achieved the Government target of 25,000 modern apprenticeship starts in the year, having met this target in all three years since it was introduced. The Scottish Government has stated its intention to increase targets year-on-year to 30,000 by 2020.	Page 6
Financial position	SDS met its financial targets through effective management of resources in the year. Comprehensive net expenditure for the year was £10 million compared to a breakeven budget. This was driven by £18 million of grant-in-aid funding which was not drawn-down. SDS agreed the treatment with the sponsor department at the Scottish Government, to offset the large cash holding at 31 March 2014.	Pages 7 to 9
Financial statements and accounting		
Audit conclusions	We have issued unqualified audit opinions on the 2013-14 financial statements, following their approval by the Board in July 2014. The financial statements, strategic report, directors' report, governance statement and remuneration report were received by the start of audit fieldwork and were supported by high quality working papers.	Page 11
Significant risks and audit focus areas	We have considered inherent significant risks that the ISAs would require us to raise with you: ▪ revenue recognition; and ▪ management override of controls. In addition to these, the areas highlighted below are matters we consider to be of interest to the audit committee: ▪ cash balances at 31 March 2014; ▪ the effects of the changes to IAS19: Employee benefits; ▪ ATOS, IT shared services and system changes; and ▪ training provider control and management issues.	Pages 12 to 16

Headlines (continued)

Area	Summary observations	Analysis
Financial statements and accounting		
Significant risks and other matters (continued)	The areas of audit focus were agreed with the finance department as part of our planning procedures and audit work has been completed to satisfy the requirements of ISA 330 'The auditor's procedures in response to assessed risks', including tests of key financial controls. In respect of each matter, we are content with management's judgements and accounting treatment.	Pages 12 to 16
Control observations	Our testing 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.	Page 17
Accounting policies	SDS applied IAS 19 (revised) in the financial statements and we agreed with management's decision not to restate prior year comparatives due to the immaterial nature of the adjustment. There would be no impact on the prior year net assets position if SDS had restated the prior year comparatives. No newly effective accounting standards are expected to have a material impact on next year's financial statements. The financial statements have been appropriately prepared on a going concern basis.	Pages 18 to 19
Governance and narrative reporting		
Governance	Over-arching and supporting corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision-making.	Pages 21 to 23
Performance Management		
Performance management	SDS demonstrate generally robust Best Value and performance management arrangements. We have reviewed the work of internal audit and confirmed that they have used the Audit Scotland toolkits to assess SDS' compliance to Best Value guidance and principles.	Pages 25 to 26

Scope and responsibilities

Purpose of this report

The Auditor General for Scotland ("the Auditor General") has appointed KPMG LLP as auditor of The Skills Development Scotland Co. Limited ("SDS") under the Public Finance and Accountability (Scotland) Act 2000 ("the Act"). The period of appointment is 2011-12 to 2015-16, inclusive.

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at SDS and the Auditor General for Scotland. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit and risk committee at the outset of our audit.

Responsibilities

Audit Scotland's *Code of Audit Practice* ("the Code") sets out SDS's responsibilities in respect:

- preparation of financial statements;
- systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- financial position; and
- Best Value.

This report reflects our overall responsibility to carry out an audit in accordance our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the Code.

The Code sets out the wider dimensions of public sector audit which involves not only the audit of the financial statements but also consideration of areas such as financial performance and corporate governance.

An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. Weaknesses or risks identified 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. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260 *Communication with those charged with governance*, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity.

This annual audit report to members and our presentation to the audit and risk committee, together with previous reports to the scrutiny committee throughout the year, discharges the requirements of ISA 260.

Service overview

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

Key business issues

The financial and operating environment in which SDS operates continues to change, with the Scottish Government recently announcing year-on-year increases to modern apprenticeship targets from 25,000 in 2013-14 to 30,000 by 2020.

SDS has achieved targets set by the Scottish Government.

Service overview and national training programmes

SDS operates to targets set by the Scottish Government in respect of national training programmes ("NTPs"). In managing the challenges posed by post-16 education reforms and further education mergers, SDS has continued to achieve the targets.

The targets and actual numbers achieved by SDS are illustrated in the table below. The Scottish Government recently announced that targets will increase year-on-year to 30,000 MA new starts by 2020. This will create further challenges for SDS, notwithstanding the improving economic and employment conditions in Scotland.

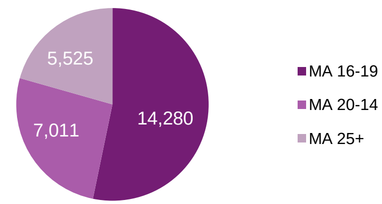
	2013-14 target	2013-14 actual
Modern apprenticeships ("MAs")	25,000	25,284
Employability fund ("EF")	17,150	17,370

KPMG analysis of period 12 NTP dashboard

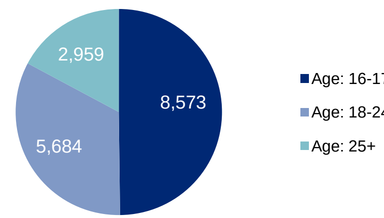
SDS continue to monitor progress against targets on a monthly basis at Board level. During 2013-14 Audit Scotland published their report in respect of the Modern Apprenticeship programme. This provided external assurance over the management and objectives of modern apprenticeships, and was generally positive in terms of SDS's achievements.

From 1 April 2013, a number of NTP schemes, including Get Ready for Work ("GRfW"), Training for Work ("TfW") and Lifeskills, were amalgamated into a single Employability Fund. The aim of the Employability Fund is to provide focused responses to employment to meet local needs. Future development of the fund will ensure that its aims remain aligned to those of individuals and employers.

In March 2014 the Board approved the proposed starts for 2014-15 in relation to core NTPs, as summarised below:



Proposed 2014-15 Modern Apprenticeship starts by age



Proposed 2014-15 Employability Fund starts by age

The proposed figures reflect the Scottish Government's commitment to ensure that young people between the ages of 16 and 19 have an opportunity to enter employment, training or education. SDS track attainment of school leavers through the annual School Leaver Destination Return ("SLDR") and published results for 2012-13 academic year state that the proportion moving into training, education or employment had increased to 91.4%, with a 0.8% decrease in the number going to University. The trends support continued diversification in post-16 education pathways and provide assurance that SDS is progressing towards further target attainment.

Financial position

Both income and expenditure increased compared to 2012-13. A deficit of £10 million was reported in 2013-14, in comparison to a surplus of £3.2 million in 2012-13.

This reflects greater staff costs, lower income in respect of European funded programmes and a prior year VAT debtor recognised in 2012-13 as a credit against other expenditure.

Financial position

A deficit of £10 million is reported for 2013-14 compared to a £3.2 million surplus in 2012-13, which included a £5.2 million credit in respect of a one-off VAT recovery.

Due in part to the prior year surplus, SDS started the first part of 2013-14 with a significant cash balance. Through discussion with the sponsor department, SDS agreed not to draw down £18 million of the initial grant-in-aid allocation (which included £10 million not utilised in 2012-13); electing to operate a deficit budget. Expenditure increased compared to the prior year, since delivery was maintained.

The nature of grant funding and the inherent differences between accruals accounting and resource accounting under the FReM can lead to cash balances being misrepresentative of the financial position of organisations, since funding is often received ahead of expenditure. Management are aware of the need to manage current cash and future capacity, and are in regular dialogue with the Scottish Government to ensure appropriate resources are provided.

Consolidated statement of comprehensive income

The key movements in income and expenditure compared to the prior year:

- Increased staff costs and pension costs, following the 1% pay rise and pay progressions as due, and changes from the IAS19 Employee benefits (revised).
- Other expenditure increased by £7.8 million largely due to the prior year exceptional item in respect of the VAT recovery.
- A small decrease in national training programme expenses, driven by the cyclical nature of this expenditure and the payment pathways utilised in defining milestones and outcomes.
- Greater grant-in-aid from the Scottish Government, being £12 million higher representing ring-fenced funding of £6 million for college engagement and £6.2 million for the Employability Fund.
- Lower European income due to the majority of EU funded programmes being completed by 31 March 2013. A similar decrease in European accrued income is recognised on the statement of financial position.
- Other income decreased due to non-recurrence of £3.1 million funding received from DWP in 2012-13 in respect of training for work programmes.

Consolidated statement of comprehensive income	2013-14 £'000	2012-13 £'000	Variance £'000
Grant-in-aid	190,112	178,144	11,968
European income	1,393	9,366	(7,973)
Other income	9,864	12,832	(2,968)
Total income	**201,369**	**200,342**	**1,027**
National training programmes	(120,480)	(121,170)	690
Staff costs	(49,203)	(43,830)	(5,373)
Other expenditure	(40,585)	(32,830)	(7,755)
Total expenditure	**(210,268)**	**(197,830)**	**(12,438)**
Net expenditure	**(8,899)**	**2,512**	**(11,411)**
Finance cost	(1,162)	-	(1,162)
Finance income	137	658	(521)
Income tax	(27)	(18)	(9)
(Deficit)/surplus	**(9,951)**	**3,152**	**(13,103)**

Source: KPMG analysis of SDS financial statements 2013-14

Financial position (continued)

The group has net liabilities £15 million as at 31 March 2014 (2012-13: net assets of £1.3 million). The movement reflects the £10 million operating deficit and £6.4 million actuarial losses in respect of the pension scheme.

Consolidated statement of financial position

The group has net liabilities at 31 March 2014 date of £15 million (2012-13: net assets of £1.3 million). The key elements of the movement from net assets to net liabilities is set out below.

Trade and other receivables

The significant decrease in other receivables is due to the £4.3 million VAT recovery debtor recognised as at 31 March 2013, the cash being received during 2013-14. Accrued income also decreased by £5.4 million in line with the reduction in European income, following the completion in 2012-13 of EU funded programmes.

Prepayments were £5.4 million lower as a result of reductions in the ATOS and college learner programme balances; the ATOS service contract income is now paid monthly in advance instead of quarterly in advance as in previous years. As noted in the prior year annual audit report, as at 31 March 2013 there was a prepayment balance in respect of the first year of the college learner fund, prior to students achieving outcomes / milestones in 2013-14.

Cash and cash equivalents

The increase in cash, despite the £10 million operating deficit, is primarily due to receipts related to 2012-13 debtors for the European accrued income and VAT recovery.

To manage the cash balance, SDS agreed not to draw down £18 million of the original grant-in-aid allocation; the cash balance will be retained to supplement working capital going forward. This treatment has been agreed with Scottish Government, in part to minimise timing differences in the accounts between income accrued in one period and received in the next as noted on the previous page. Furthermore, £2 million has been granted to its subsidiary, Careers Trust Scotland Limited, albeit disclosed in the consolidated statement of financial position shown opposite.

Consolidated statement of financial position	2014 £'000	2013 £'000
Non current assets	444	974
Trade and other receivables	13,012	27,057
Cash and cash equivalents	16,627	5,963
Total assets	**30,083**	**33,994**
Retirement benefit obligations	34,541	24,668
Trade and other payables	9,563	6,976
Other current liabilities	955	1,009
Total liabilities	**45,059**	**32,653**
Net liabilities / assets	**(14,976)**	**1,341**

Source: Draft financial statements

Retirement benefit obligations

The pension liability increased by £9.9 million compared to the prior year, due to a small decrease in the discount rate and expected return on plan assets assumptions. Consideration of the pension assumptions and key judgements is provided on pages 12 – 13.

Financial position (continued)

The 2014-15 budget forecasts a breakeven position, although final confirmation of grant-in-aid funding is yet to be agreed with the Scottish Government.

Financial plans 2014-15

The 2014-15 budget is awaiting approval by the Board, alongside ongoing discussions with the Scottish Government over indicative budget transfers in the Autumn and Spring Budget Revisions. The draft budget submitted to the Board in March 2014, as shown opposite, forecast a break-even position. The outcome of discussions with the Scottish Government may give rise to adjustments in grant-in-aid, with resultant effects on planned expenditure.

Notwithstanding the status of overall funding agreement, ring-fenced grant-in-aid has been provisionally agreed for college engagement and the Employability Fund. ESF income has been assumed as £nil, due to the winding down of projects from 31 March 2013. This decrease has been offset by increased income from other initiatives:

- digital skills;
- low carbon;
- targeted young people
- Scotland's Best;
- Commonwealth Games; and
- youth employment promotion.

Staff costs are budgeted to increase due to the effects of incremental rises and a 1% pay award to salary bands in October 2014. Other expenditure is set to increase by £9.0 million in respect of transition arrangements for the Enterprise Information System, although an element of these costs will be recharged to other partners under the ATOS shared service agreement. The expenditure relates to the procurement of the new IT support service, following the conclusion of the ATOS shared service arrangement in late 2014.

	2014-15 budget £'000	2013-14 Q3 revised budget £'000
Core income		
Grant-in-aid ("GIA")[1]	196,200	190,112
ESF income	-	1,387
ATOS shared service cost recovery	11,440	8,796
Bank interest receivable	90	112
Other income[2]	8,539	352
Total income	***216,269***	***200,759***
Core expenditure		
NTP expenditure	(112,369)	(118,813)
Staff costs	(50,800)	(46,521)
SAAS and contact centre	(7,379)	(1,062)
IT and systems[3]	(12,796)	(14,614)
Programmes and projects	(20,493)	(14,650)
Infrastructure management and admin	(12,432)	(14,090)
Total expenditure	***(216,269)***	***(209,750)***
Surplus / (deficit)	**-**	**(8,991)**

Source: SDS draft budget 2014-15.

[1] Grant-in-aid for 2014-15 includes £6m for College engagement and £6.2m for employability fund specific funding.

[2] Other income includes GIA funding for other initiatives in respect of digital skills and sustainability measures. This is awaiting confirmation from the Scottish Government.

Financial statements and accounting

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

Audit conclusions

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

The financial statements, including the governance statement and strategic report, were made available on a timely basis and were accompanied by high quality working papers.

Audit conclusions

Our audit work is complete following receipt of management's representations and update of subsequent events. 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 2014, and of SDS's deficit for the year then ended. We also have issued an 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 controls testing and substantive procedures to ensure that key risks to the financial statements have been covered;
- communicated with internal audit and reviewed their reports as issued to audit and risk committee to ensure all key risk areas which may be viewed to have an impact on the financial statements have been considered;
- reviewed estimates and accounting judgements made by management and considered these for appropriateness;
- considered the potential effect of fraud on the financial statements through discussions with senior management and internal audit to gain a better understanding of the work performed in relation to prevention and detection of fraud; and
- attended audit and risk committee to communicate our findings to those charged with governance, and to update our understanding of the key governance processes.

Financial statements preparation

- High quality working papers and draft financial statements were provided at the start of the audit fieldwork on 12 May 2014. This included the strategic report, 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 communication and discussion with SDS's finance team to ensure that disclosure within the financial statements was consistent with the requirements of 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.
- We consider that management has maintained a robust control environment, in a year with some challenges; given the implementation of Agresso at the start of the year, relocation of key operating departments, the investigations in respect of training provider control and management issues and ongoing delivery against operating targets.

Significant risks and audit focus areas

The main audit focus areas are discussed the following pages.

These focus areas are significant risks in respect of:

- **management override of controls; and**
- **revenue recognition fraud risk;**

and other focus areas of:

- **employee benefits;**
- **cash balances;**
- **ATOS, IT shared services and system changes; and**
- **training provider control and management issues.**

Significant risks that ISAs require us to raise in all cases

Professional standards require us to consider two specific risks for all organisations:

- management override of controls; and
- fraudulent revenue recognition.

Our audit approach to address these was set out in our audit plan and strategy. We do not consider fraudulent revenue recognition to be a significant risk for SDS as there are limited incentives and opportunities to manipulate the way income is recognised given the nature of grant funding. We therefore rebut this risk and do not incorporate specific work into our audit plan in this area over and above our standard fraud procedures. Although we do not consider the presumed risk of fraud from revenue recognition to be applicable, we remained alert to indications of fraud during the course of the audit.

As part of our work to address the significant risk of management override of controls we performed the following tests:

- testing of journals at the year end, and during the year;
- review of unusual transactions in the year;
- enquiries with employees outside the finance department;
- a test of unpredictability; and
- controls testing, including higher level controls.

We do not have any findings to bring to your attention in relation to these matters. No control overrides were identified.

Other areas of audit focus

Our audit strategy and plan included the following other areas of audit focus:

- the assumptions and accounting in respect of IAS19; Employee benefits.
- cash balances as at 31 March 2014;
- ATOS, IT shared services and system changes; and
- training provider control and management issues.

Significant risks and audit focus areas (continued)

In respect of employee benefits, each of the assumptions used to value SDS'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.

We set out below the assumptions in respect of employee benefits.

Defined benefit pension liability

2014 £'000	2013 £'000	KPMG comment
(34,541)	(24,668)	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 scheme valuation. Details of key actuarial assumptions are included in the table, along with our commentary.

Assumption	SDS	KPMG central	Comment
Discount rate (duration dependent)	4.30%	4.30%	Acceptable. The actuarial assumption has been calculated using a different approach from the prior year. It is KPMG's view that this represents an enhancement in methodology.
CPI inflation	RPI - 0.8%	RPI – 1%	Acceptable – SDS's assumption is more prudent (higher liability) than KPMG's central rate, but is within the acceptable range.
Net discount rate (discount rate – CPI)	1.40% - 1.50%	1.65% - 1.75%	Acceptable – SDS's assumption is more prudent (higher liability) than KPMG's central rate, but is within the acceptable range.
Salary growth	1% pa until 31 March 2015. 1.5% above RPI	0% - 1.5% above RPI/CPI inflation	Acceptable – SDS's assumption reflects 1% salary increases until 31 March 2016.

The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of between 17 and 23 years. The closing deficit increased by £9.9 million compared to 2012-13, primarily due to the application of an updated discount rate. A reconciliation from opening to closing deficit is included on the next page.

SDS have appropriately applied IAS 19 *(revised)* in the financial statements. If the standard had been adopted early in 2012-13, the estimated change to finance costs would be £1.4 million. We do not consider this to be a material amount and therefore agree with management's decision not to restate the prior year comparatives. There would be no impact on the prior year net assets position if SDS had restated the prior year comparatives.

Significant risks and audit focus areas (continued)

The table opposite shows the reconciliation of the movement in the statement of financial position.

Increases to the pension scheme deficit in the year have been driven by changes to the financial assumptions, particularly in respect of the discount rate.

	£'000	Deficit / loss	Surplus / gain	Impact	Commentary
	Opening pension scheme deficit			**(24,668)**	The opening IAS 19 deficit for the Scheme at 1 April 2013 was £24.7 million, consisting of assets of £182million and defined benefit obligation of £206.7 million.
I & E	**Service cost**			(9,550)	The scheme remains open to accrual. The employees' share of the cost of benefits accruing over the year is £9.6 million.
I & E	**Past service cost**			(90)	A past service cost of £0.1 million has been recognised, relating to early retirement over the year.
I & E	**Net interest**			(1,162)	This is the interest on the opening deficit of £24.7 million adjusted for contributions paid during the period.
Cash	**Contributions**			7,295	SDS has made contributions of £7.3 million, broadly in line with contributions made last year, allowing for salary increases.
OCI	**Actuarial gain/(loss) – demographic assumptions**			-	There has been no change to the demographic assumptions since 31 March 2014, and so there is no gain or loss.
OCI	**Actuarial loss – financial assumptions**			(10,535)	There has been an actuarial loss of £10.5 million, driven by a 0.2% decrease in the discount rate assumption. This is in line with the size and duration of the scheme.
OCI	**Return on assets**			4,169	The actual return on assets is lower than the interest on assets of £8.3 million.
	Closing pension scheme deficit			**(34,541)**	The closing IAS19 deficit on the scheme at 31 March 2014 is £34.5 million (consisting of assets of £200.3 million and defined benefit obligation of £234.8 million).

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

Cash – cash-flow impact

OCI – charged through other comprehensive income

Significant risks and audit focus areas (continued)

We have considered the cash balances as at 31 March 2014 and the ATOS and IT shared services contract.

Cash balances as at 31 March 2014

Due in part to the prior year surplus SDS started the first part of 2013-14 with a significant cash balance. Management has proactively considered the cash balance at the Executive Management Team and through discussion with the Scottish Government. This is summarised on page six.

During 2013-14 SDS granted Careers Trust Scotland Limited ("CTSL"), a 100% owned subsidiary, £2 million in order to enable it to support a number of identified initiatives in 2014-15 and beyond, in line with the charitable objectives of CTSL.

CTSL objectives relate to:

- the promotion of careers within the fields of science, technology, engineering and mathematics ('STEM') amongst young people; and
- supporting innovative approaches to delivery of career guidance.

Funding will be utilised during 2014-15 and 2015-16 to achieve these objectives and it is hoped that successful achievement will promote cohesive Innovation in Vocational Education and Training ('IVET') activity across Scotland.

As at 31 March 2014, CTSL held £5.5 million of cash, with a low level of transactions, in relation to the recognition of bank interest and the audit fee cost. The £2 million grant should allow the trustees to revitalise strategic objectives of the charity.

We concur with the accounting treatment of the grant to CTSL and note the consequent need to increase the activities of CTSL.

ATOS and IT shared services; system changes

SDS currently utilise a tower-basis shared service arrangement to deliver day-to-day maintenance and project IT support. The costs are borne by SDS which recharges to the other partners:

- Scottish Enterprise;
- Highlands and Islands Enterprise; and
- Scottish Criminal Cases Review Commission.

The current IT provision from ATOS is due to terminate in December 2014 and SDS have tendered for a range of services.

SDS has implemented Agresso, a new financial ledger system, in the year. KPMG performed a post-implementation review of the system and this formed part of out interim audit report. Overall, we consider that the system is well-implemented and embedded controls are operating effectively. We identified some opportunities for improvements and provided recommendations to management, all of which were agreed.

Significant risks and audit focus areas (continued)

Although not material to the financial statements, we have considered the accounting treatment of NTP contract repayments, with which we concur.

Management are reviewing the control environment across NTP – Operations and Compliance services.

NTP contract repayments

Although the financial impact of the repayments is not material to the financial statements, we have considered the matter during the audit given the potential significance to the management of NTP contracts in the future. Procedures and controls within the team are undergoing review, following the identification of irregularities within training provider spend during 2013-14.

Having suspended payments as necessary, SDS and internal audit conducted investigations to ascertain the scale of the irregularities and related financial impact.

Investigations by SDS took the form of file reviews, telephone calls to trainees and interviews with in-training' apprentices. Management identified that expenditure had been incorrectly incurred in respect of:

- trainees who did not satisfy eligibility criteria for the programmes;
- unsatisfactory record-keeping and document retention; and
- 'ghost' trainees, who had not willingly entered the programme.

Ongoing discussions in the year concluded that £0.4 million, paid by SDS since 2009, had been illegitimately claimed in respect of maladministration or ghost trainees and as such was recoverable. Agreements to repay the costs (and any additional sums arising from the investigation) were reached prior to 31 March 2014 and a receivables balance has been included within the financial statements. KPMG have agreed the accounting treatment of this balance to documentation and post year-end bank statements.

Management have undertaken a significant programme of review across all NTP spend to provide further reasonable assurance over regularity within the population as a whole. Targeted sampling across the population commenced prior to our final audit procedures and was due to have concluded by the end of May 2014.

The irregularities have been the catalyst for introducing changes to the NTP – Operations and Compliance teams (who respectively oversee and monitor NTPs) pending conclusion of the review of team procedures and controls. These changes include, but are not limited to:

- the reinstatement of trainee interviews to be performed by skills investment advisors and the compliance team;
- new approach to the risk profiling of NTPs with payment assurance and payments made in arrears where possible;
- a suite of new compliance controls, including external verification of NTP – Operations and Compliance teams; and
- a refresh and change of emphasis of the role of the NTP – Operations and Compliance teams through workforce planning reviews.

Since the start of the new contract year, SDS have been receiving provider assurance statements. At the time of our audit work, 77 of 380 were outstanding, although all 'high-value' statements had been received.

Internal controls

Our testing of the design and operation of financial controls over significant risk points identified no issues.

We raised two recommendations in the interim audit report, in respect of journals and compliance team documentation.

Internal controls

SDS management are responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the financial statements. 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.

Testing of general IT controls was ongoing at the date of our interim report, and testing over NTP compliance controls was also concluded during our final audit. The table below summarises the findings.

Audit area	Key controls considered	Findings
General IT controls	■ Starters ■ Leavers ■ Passwords	■ In addition to the post-implementation Agresso review, we have considered general IT controls as part of our audit procedures. Our review of controls has focused on access controls. ■ Controls tested are designed appropriately, implemented and are operating effectively.
Regularity of transactions	■ Compliance team audits of national training providers	■ During our controls testing at the interim stage of our audit, we tested 14 compliance audits of national training programme providers. To ensure full-year coverage, we tested a further sample of 11 files during our year-end procedures. With the exception of the minor weaknesses reported in the interim management report, testing of other controls over the regularity of expenditure identified that these had been designed and implemented appropriately.

The findings of our controls testing relate only to those matters identified during our normal audit work, in accordance with the Code, and there may still be weaknesses or risks within the control environment which have not been identified through this work. KPMG's identification of weaknesses, where applicable, does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

As part of our interim audit report, we raised one moderate-graded recommendation over the authorisation of journals, and one low-graded recommendation over the documentation of the compliance team. These were due to be implemented in June 2014, following the conclusion of our on-site fieldwork and as such no follow-up has been performed. We will consider the implementation of recommendations as part of our 2014-15 audit.

Accounting policies

In line with changes to the financial reporting framework as set out in HM Treasury's *Financial Reporting Manual ("FReM"),* SDS have considered the impact to the financial statements arising from revisions to *IAS19: Employee Benefits*.

The financial statements have been appropriately prepared on a going concern basis, having due consideration of the outstanding agreement of Grant-in-Aid in respect of 2014-15.

Accounting framework and application of accounting policies	
Area	**KPMG comment**
Financial reporting framework	■ SDS prepares financial statements in accordance with the Companies Act 2006 and follows the principles of the Government's Financial Reporting Manual 2013-14 ("FReM") as appropriate. Management provides the additional disclosures required by the FReM where these go beyond the requirements of the Companies Act 2006. ■ SDS has applied the revisions to IAS 19 *Employee Benefits,* opting not to restate the prior year comparatives on ground of materiality. We concur with this approach as there were no changes to the statement of financial position as a result of the retrospective application of IAS19R, and the impact on the statement of consolidated income and expenditure are not material. Appropriate disclosure has been provided within the accounting policies note. ■ Changes to the FReM in 2013-14 require SDS to prepare a strategic report in line with section 414C of the Companies Act 2006 as interpreted by the FReM. The strategic report requirements include disclosures previously required within the directors report and new disclosures (if not previously included) on social, community and human rights issues, a description of the body's strategy and business model and a gender break down of directors, senior managers and employees. Appropriate disclosure has been included within the strategic report. ■ We are satisfied that the accounting policies adopted remain appropriate to SDS.
Going concern	■ Whilst Scottish Government funding for 2014-15 has not been formally agreed, the directors have considered indicative communications regarding available funding, combined with a longer term commitment to SDS. A budget is currently being agreed in consultation with the Scottish Government which indicates that the organisation will continue to operate. ■ The group has net liabilities at 31 March 2014 of £15 million (*2012-13: net assets of £1.3 million*) and the parent company has net liabilities at 31 March 2014 of £20.5 million *(2012-13: net liabilities of £2.2 million).* The movement from net assets to net liabilities is due to the reported deficit of £10 million combined with an increase in the pension liability as a result of a change to the discount rate and expected return on plan assets assumptions. ■ 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. ■ The draft 2014-15 budget for SDS shows a budgetary shortfall to achieve a break-even position as at 31 March 2015. The budget will be updated following the conclusion of funding discussions with the Scottish Government, but we are satisfied that they do not constitute a risk to going concern in light of new working capital arrangements agreed in the year.

Accounting policies

Accounting framework and application of accounting policies	
Area	**KPMG comment**
Income recognition	- 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	- There are no newly effective accounting standards that are considered to have a material impact on the SDS's financial statements in the current year. Appropriate disclosure to this effect is included within the accounting policies note to the financial statements.

Governance and narrative reporting

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

Update on controls findings from our audit

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 2013-14 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on SDS's governance framework, operated internal controls, the work of internal audit, internal financial controls and risk management arrangements and analyses the efficiency and effectiveness of these elements of the framework. The statement made by the Accountable 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. Although there have been no significant risk issues during the period, the governance statement notes the focussed management input to address and bring to conclusion the irregularities highlighted within training provider spend in the year. The statement concludes that reasonable assurance can be placed on the governance of SDS, its internal control and management of resources in the year to 31 March 2014. Governance of SDS continues to be overseen by the Board, supported by four committees to scrutinise audit arrangements, finance, remuneration and service development. The composition of the board changed in the year with four directors retiring and one director's term ending in May 2014; as a result there are six non-executive directors with five available positions on the Board. SDS is actively seeking new Board members which will help to ensure continued robust governance arrangements. A new adviser has been recruited to the Board following the appointment of the previous adviser to non-executive director in May 2013. Three depute directors were appointed to the Executive Leadership Group on 1 August 2013, following a reconsideration of governance arrangements; they are not registered as directors of the company under the requirements of the Companies Act 2006. This is in line with other directors comprising the Executive Leadership Group and it is our view that the appointments have been made to support and strengthen SDS's development. The new RIMS risk management system has been implemented in the year and continues to embed in the organisation and its risk management processes. This has been rolled out to key individuals in the organisation, and training has been provided to ensure that the system is used effectively. RIMS is used to monitor and manage risks in the organisation, and will also be used going forward to monitor the delivery of the internal audit plan. 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 the annual governance statement. We consider the governance framework and annual governance statement to be appropriate for SDS and that the governance statement is in accordance with guidance and reflects our understanding of the organisation.

Corporate governance arrangements (continued)

Our testing 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.

Annual report, including the strategic and directors' reports	The financial statements form part of the annual report of SDS for the year ended 31 March 2014. Following amendments to the Companies Act becoming effective for 2013-14, SDS is required to include both a strategic and a director's report as part of the annual report. The strategic report must contain a minimum level of information, through prescribed headings, the information largely presented within the directors' report in prior years. We have reviewed the contents of the strategic and directors' report against the revised disclosure requirements and are content with the proposed reports. We provided management with some relatively minor suggestions relating to how the reports could be enhanced and / or where additional information disclosures should be made. We are required to consider the strategic and directors' reports, and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the strategic and directors' report is consistent with the financial statements.
Remuneration report	The remuneration report was included within the draft financial statements and supported by good quality information and working papers. The 2013-14 FReM included an additional requirement for disclosure of total directors' remunerations as a single figure; this has been correctly included within the financial statements. SDS's appointment of depute directors in the year has been reflected in the remuneration report and their remuneration for the year ending 31 March 2014 correctly disclosed.
Prevention and detection of fraud	No material fraud or other irregularities were identified during the year, and we consider that SDS has appropriate arrangements to prevent and detect fraud. The arrangements include policies and codes of conduct for staff and board members, supported by a fraud prevention policy and response plan. A review of the NTP – Operations and Compliance team procedures and controls is underway, following the identification of irregularities within training provider spend. Having suspended payments to providers as necessary, SDS and internal audit conducted investigations to ascertain the scale of the irregularities and related financial impact. Further details are provided on page 23 of this report. It was clear that illegitimate claims had been made and settlement of £0.4 million was agreed following the investigations. Whilst claims were not appropriately made, legal advice received by SDS stated that there was no determinable fraud. The compliance team is responsible for reviewing a sample of national training providers. Out with the above instance of irregularity and/or maladministration, in 2013-14 a sample of £7.3 million (2012-13: £7.5 million) of expenditure was tested and £133,000 (2012-13: £73,000) was recovered; an average recovery rate of 1.8% (2012-13: 0.9%). In management's view, the errors were due to weaknesses in data recording, rather than intentional fraud. The review of the NTP – Operations and Compliance service procedures is intended to provide greater assurance over NTP expenditure and respond to the weaknesses highlighted from management's review of training providers.

Corporate governance arrangements (continued)

Our testing 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.

Arrangements for maintaining standards of conduct and the prevention and detection of corruption	We consider that SDS has appropriate arrangements to prevent and detect inappropriate conduct and corruption. The arrangements include policies and codes of conduct for staff and board members, supported by a whistleblowing policy. Board members are responsible for setting the 'tone at the top' and are responsible for abiding by the code of conduct and disclosing interests which may be of importance – material or otherwise – to their work at SDS.
Internal audit	As set out in our audit plan and strategy, we evaluated the work of internal audit and concluded that we can apply their work to inform our procedures, 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 national training programmes, payment processes for national training programmes, and performance management. Internal audit have completed their agreed plan for the year ended 31 March 2014, and the annual report states that "*the governance, risk management and internal control arrangements in place at Skills Development Scotland are adequate and effective".* The report also concludes that arrangements to secure value for money and regular administration of the organisation are in place.
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. Our review of SDS' NFI participation resulted in an amber grading and our findings were reported in our interim management report. Although the review did not identify areas for immediate improvement, some opportunities for improvement were identified reflecting that 2012-13 was the first year that SDS participated in the NFI.

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 generally robust.

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 (vision and leadership, effective partnerships, governance and accountability, use of resources, and performance management). 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 prior year and noted that this helps to drive continuous improvement and support the achievement of Best Value. Internal audit performed a review of performance management in the year and we reviewed the findings during our audit. The report contained one moderate recommendation in relation to inconsistencies of monitoring of performance, and all other controls were assessed as operating effectively. We reviewed SDS's performance management arrangements as part of our 2013-14 audit procedures and consider them to be appropriate. Documents relating to performance management are reviewed at executive level to facilitate the undertaking of mitigating actions where targets are at risk of not being achieved. SDS produce NTP and operational 'dashboards' on a monthly basis which show the organisation's progress to their aims in the year. In 2013-14, SDS reported the achievement £16.4 million of efficiency savings. Achievement was supported through the progression against the three-year People Strategy, which aims to promote efficient and effective use of SDS' human resources as well as commitment to improving procurement processes. Management remain committed to leveraging resources in the best possible way and doing more within decreasing resource settlements . This requires solid financial management and innovative ways of working, embracing technology and service redesign. The strategic internal audit plan 2013 -16 aimed 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.

Performance management (continued)

Local response to national studies	Audit Scotland periodically undertakes national studies on topics relevant to the performance of central government bodies. To ensure that added value is secured through the role of Audit Scotland and its appointed auditors, auditors will continue to ensure that audited bodies respond appropriately to reports from Audit Scotland's programme of national performance audits. 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 update on implications for SDS from the Audit Scotland national reports is provided at audit and risk committee meetings. This provides the audit and risk committee with assurances that sector and national issues are being identified and action is being taken by management to address any potential weaknesses in SDS' processes. In March 2014, Audit Scotland published an audit report on the modern apprenticeship programmes administered by SDS and representing the first evaluation of modern apprenticeships since SDS' formation in 2008. The objectives of the report were to identify the costs and activities of training providers within the programmes, to assess the extent to which modern apprenticeships are meeting targets, and to evaluate the management of modern apprenticeship programmes. The report stated that SDS achieved the annual target of 25,000 new starts since 2011-12, and that the annual number of starters has doubled since SDS' creation in 2008; demonstrating the demand for alternatives to traditional post-16 education pathways. The strong performance to targets supports the future growth in the annual target to 30,000 new starts by 2020. The report concluded that SDS is performing well against Scottish Government strategic priorities, however noted the need to monitor financial sustainability on an ongoing basis to ensure that they can continue to deliver objectives within budget limits. As part of its targeted approach to following-up a number of performance audit reports each year, Audit Scotland has identified the *Managing ICT contracts* for targeted follow-up by local auditors in 2013-14. The aim of the follow-up work is to establish to what extent central government bodies have applied the lessons learned highlighted by the report to their ICT contracts and arrangements. Our work will focus on the ATOS shared services arrangement. We will submit a report to Audit Scotland concluding on this work by 30 November 2014.

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 net operating cost for the year. A small number of minor numerical and presentational adjustments were required to some of the financial statement notes.	-
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	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 and Risk 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.	Appendix two
Schedule of Fees Fees charged by KPMG for audit and non-audit services	We have concluded that non-audit fees of £1,500 for the year in respect of corporation tax compliance do not compromise our independence.	Appendix two
Draft management representation letter Proposed draft of letter to be issued by SDS to KPMG prior to audit sign-off	There are no changes to the standard representations required for our audit from last year.	-

Auditor independence

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 SDS 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 30 July 2014, 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

cutting through complexity