

The Skills Development Scotland Co. Limited

2016/17 Annual Audit Report



 AUDIT SCOTLAND

Prepared for Skills Development Scotland and the Auditor General for Scotland

25 August 2017

Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.
- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.
- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public
- identifying risks, making clear and relevant recommendations.

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Key messages

Audit of the 2016/17 financial statements

- 1 The financial statements of The Skills Development Scotland Co. Limited (SDS) give a true and fair view of the financial position, and expenditure and income of the company and its group.
- 2 The expenditure and income in the financial statements were incurred or applied in accordance with applicable enactments and guidance.
- 3 The other information in the annual report and financial statements is consistent with the financial statements and prepared in accordance with legal requirements.

Financial management

- 4 SDS has effective arrangements in place for financial management. It managed its 2016/17 budget well and reported an expenditure underspend of around 1% of its budget for the year.
- 5 No significant internal control weaknesses were identified during the audit.
- 6 SDS is participating in the National Fraud Initiative and is engaging well by investigating the recommended matches.

Financial sustainability

- 7 SDS has good financial planning arrangements in place. Its five-year rolling financial model is comprehensive, based on reasonable assumptions and regularly updated for changing circumstances.
- 8 The financial model identifies a significant increase in apprenticeship expenditure as SDS works towards achieving the increased Scottish Government's targets for modern apprenticeships. In the absence of clear, longer term funding commitments, there is a risk that SDS will have a significant funding gap going forward.

Governance and transparency

- 9 SDS has appropriate arrangements in place to support good governance, accountability and scrutiny. The terms for six board members, including the chair, will come to an end between September 2017 and September 2018. Recruitment of new board members has been deferred pending the completion of the Enterprise and Skills review. SDS agreed the temporary co-option of four board members with the Scottish Government. SDS will need to work with the Scottish Government to ensure that board members' skills and expertise are maintained over this period of change.
- 10 The Memoranda of Understanding between SDS and its partners for the shared service ICT function require updating to reflect the change from a single supplier to multiple suppliers, as part of a new Service Integration and Management model. SDS has established components of an ICT

strategy based on its strategy to 2016, and is now developing a new, over-arching ICT and Digital Strategy that reflects the requirements and approaches of SDS and its partners. SDS needs to complete this work to support effective governance of its ICT services.

- 11** The SDS board meetings are not open to the public and SDS does not publish board and committee papers and committee meeting minutes on its website. SDS acknowledges that making papers publicly available would increase transparency but considers the associated costs would be too high. With increasing public expectations for more openness in the conduct of public business, SDS needs to keep this area under review and consider whether there is scope to enhance transparency.

Value for money

- 12** Value for money is a key element of our audit approach. In 2016/17, the first year of our audit appointment, we did not identify any significant value for money risks during our planning and therefore we did not undertake any specific value for money work this year. We will keep this area under review over the five-year audit appointment and will report as appropriate.

Introduction

1. This report is a summary of our findings arising from the 2016/17 audit of Skills Development Scotland (SDS).
2. The scope of our audit was set out in our Annual Audit Plan presented to the December 2016 meeting of the Audit and Risk Committee. This report comprises:
 - an audit of the annual report and financial statements
 - consideration of the wider dimensions set out in the [Code of Audit Practice 2016](#) as illustrated in [Exhibit 1](#).

Exhibit 1 Audit dimensions



Source: Code of Audit Practice 2016

3. The main elements of our audit work in 2016/17 have been:
 - an interim audit of the SDS main financial systems and governance arrangements with the findings reported to the Audit and Risk Committee on 30 March 2017
 - an audit of the SDS 2016/17 annual report and financial statements, including the issue of an independent auditor's report setting out our opinions

- wider dimension work on the SDS arrangements in place for financial management, financial sustainability and governance and transparency including a follow-up of the 'Role of Boards' national report, published in September 2010.

4. SDS is responsible for preparing financial statements that give a true and fair view, for the accuracy of the other information in the annual report and financial statements, and for establishing effective arrangements for governance, propriety and regularity that enable the board to successfully deliver its objectives.

5. Our responsibilities as independent auditor are established by the Public Finance and Accountability (Scotland) Act 2000 and the [Code of Audit Practice 2016](#), supplementary guidance and, guided by the auditing profession's ethical guidance.

6. These responsibilities include giving independent opinions on the financial statements, regularity, the remuneration report, the strategic and directors' reports and the governance statement. We also review and report on the arrangements within SDS to manage its performance, regularity and use of resources. In doing this, we aim to support improvement and accountability.

7. Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#) and supplementary guidance.

8. The weaknesses or risks identified in this report are only those that have come to our attention during our normal audit work, and may not be all that exist. Also, our annual audit report contains an action plan at [Appendix 1 \(page 22\)](#). It sets out specific recommendations, responsible officers and dates for implementation.

9. Communication in this report of matters arising from the audit of the annual report and financial statements or of risks or of weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

10. As part of the requirement to provide fair and full disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2016/17 audit fee for the audit was set out in our Annual Audit Plan and as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.

11. This report is addressed to both the board and the Auditor General for Scotland and in due course will be published on Audit Scotland's website www.audit-scotland.gov.uk.

12. We would like to thank management and staff who have been involved in our work for their co-operation and assistance during the audit.

Part 1

Audit of 2016/17 financial statements



Main judgements

The financial statements of SDS for 2016/17 give a true and fair view of the state of its financial affairs at 31 March 2017 and of its net expenditure for the year.

We gave an unqualified opinion on regularity of the SDS expenditure and income and on the remuneration report, strategic and directors' reports and governance statement.

Unqualified audit opinions

13. The annual report and financial statements for the year ended 31 March 2017 will be approved by the board on 24 August 2017. We reported, within our independent auditor's report:

- an unqualified opinion on the financial statements
- an unqualified opinion on regularity of expenditure and income and
- an unqualified audit opinion on the remuneration report, strategic and directors' reports and governance statement.

14. Additionally, we are satisfied that there are no matters which we are required by the Auditor General to report by exception.

Submission of annual report and financial statements for audit

15. We received the unaudited financial statements on 8 May 2017, in line with our agreed audit timetable.

16. The working papers provided with the unaudited financial statements were of a good standard and finance staff provided excellent support to the audit team which helped ensure the annual report and financial statements audit process ran smoothly.

Risk of material misstatement

17. [Appendix 2 \(page 25\)](#) provides a description of those assessed risks of material misstatement that were identified during the planning process which had the greatest effect on the overall audit strategy, the allocation of resources to the audit and directing the efforts of the audit team.

The annual report and financial statements are the principal means of accounting for the stewardship of resources and performance in the use of those resources.

Materiality

18. Materiality defines the maximum error that we are prepared to accept and still conclude that our audit objective has been achieved. The assessment of what is material is a matter of professional judgement. It involves considering both the amounts and nature of any misstatement.

19. Our initial assessment of materiality for the annual report and financial statements was undertaken during the planning phase of the audit and reviewed on receipt of the annual report and financial statements. The overall materiality and reporting threshold remained at 1% of gross expenditure and 1% of overall materiality, respectively. We revised the performance materiality from 60% to 40% of overall materiality as the National Training Programmes (NTP) expenditure is made up of a high volume of low value transactions. This ensured that we achieved adequate coverage during our testing. Materiality values are summarised in [Exhibit 2](#). Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

Exhibit 2

Materiality values on receipt of the annual report and financial statements

Materiality level	Amount
Overall materiality – This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at 1% of gross expenditure for the year ended 31 March 2017.	£2.0 million
Performance materiality – This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality, this would indicate that further audit procedures should be considered. Using our professional judgement we have calculated performance materiality at 40% of overall materiality.	£0.8 million
Reporting threshold – We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This has been calculated at 1% of overall materiality.	£ 20,000

Source: Audit Scotland

Evaluation of misstatements

20. There were no material adjustments to the unaudited financial statements arising from our audit. All individual misstatements which exceeded our reporting threshold have been amended in the audited financial statements.

Significant findings from the audit

21. International Standard on Auditing (UK and Ireland) 260 requires us to communicate significant findings from the audit to you. These are summarised in [Exhibit 3](#). Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in [Appendix 1 \(page 22\)](#) has been included.

Exhibit 3

Significant findings from the audit of the financial statements

Issue	Resolution
<p>1. Remuneration report disclosures</p> <p>SDS has disclosed the remuneration of six out of ten members of the Executive Leadership Group. We have been advised that this is because the remaining four directors do not have the authority or responsibility for directing or controlling the major activities of SDS. They are deemed to influence the decisions of individual SDS directorates only rather than the decisions of SDS as a whole.</p>	<p>Based on evidence to date, we are content that the remuneration report disclosures are in line with the requirements of the Companies Act.</p> <p>We will keep this under review during 2017/18 and consider further evidence as appropriate.</p>
<p>2. Recognised good practice in disclosures</p> <p>SDS has prepared its 2016/17 annual report and financial statements in line with the requirements of the Companies Act and the Scottish Public Finance Manual (SPFM) as appropriate. Some disclosures such as elements of the remuneration report go beyond that required by the Companies Act and therefore also comply with the Financial Reporting Manual (FReM). There are other areas where SDS could provide further information in line with good practice and transparency principles for public bodies, such as including a Statement of resource outturn. There are also some areas such as accounting for grant-in-aid funding where there is conflict between the Companies Act and the FReM and further clarification needs to be sought from the Scottish Government's sponsor department.</p>	<p>SDS will consider additional disclosures in compliance with the FReM for the 2017/18 annual report and financial statements.</p> <p>Action Plan (Appendix 1, point 1)</p>
<p>3. Accounting policy for intangible assets</p> <p>During 2016/17, SDS reduced the value of its intangible assets (software for 'My World of Work' or 'MyWoW' website) to £nil. While this was approved by senior officers as appropriate, it was not in line with the SDS accounting policy for intangible assets. The policy states that websites delivering services are written down over three years which is deemed to be the life of these assets. MyWoW website was included in the balance sheet during the 2015/16 and therefore its value should have been written down over the three years from 2015/16 to 2017/18. This means that its value should have been reduced to £nil in 2017/18 rather than in 2016/17.</p>	<p>SDS will consider updating its accounting policy for intangible assets during 2017/18. It is likely that the websites will no longer be included in the balance sheet as they become obsolete very quickly after they are released for use. Expenditure associated with websites will instead be treated as an expense.</p> <p>We will review the accounting policy for intangible assets during the audit of 2017/18 financial statements.</p>

Recommendation 1

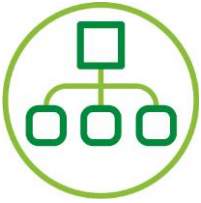
SDS should consider providing further disclosures for 2017/18 annual report and financial statements, in line with good practice and transparency principles for public bodies.

Other findings

22. Our audit identified a number of presentational and disclosure issues which were discussed with management. These were adjusted and reflected in the audited financial statements.

Part 2

Financial management



Main judgements

SDS has effective arrangements in place for financial management. It managed its 2016/17 budget well and reported an expenditure underspend of around 1% of its budget for the year.

No significant internal control weaknesses were identified during the audit. During 2017/18, SDS is planning to introduce significant changes to the controls over its expenditure on the National Training Programmes.

SDS is participating in the National Fraud Initiative and is engaging well by investigating the recommended matches.

Financial performance in 2016/17

23. The main financial objective for SDS is to ensure that the financial outturn for the year is within the budget allocated by Scottish Ministers.

24. SDS has reported total expenditure outturn of £213.6 million, remaining within its overall 2016/17 expenditure budget of £215 million, set in April 2016, with an underspend of £1.4 million.

25. The financial performance against Departmental Expenditure Limits (DEL) is shown in [Exhibit 4](#). Before the start of every financial year, the Scottish Government provides SDS with an initial allocation of grant-in-aid (GiA) funding and indicates further funding to be confirmed through the Autumn and Spring Budget Revisions (ABR and SBR). In 2016/17, SDS received an initial GiA allocation of £176.1 million and a further £25.5 million was expected to be confirmed through ABR and SBR. This meant that the SDS board approved the 2016/17 budget without certainty of receiving 13% of the total GiA funding. SDS subsequently received sufficient GiA funding of £199.6 million to deliver its core services and reported a DEL underspend of £2.9 million.

Financial management is about financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

Exhibit 4

Performance against DEL in 2016/17

Performance	Initial GiA budget	Final GiA budget*	GiA drawn down	Outturn against GiA drawn down	Underspend (operating surplus)
	£m	£m	£m	£m	£m
Resource DEL	176.1	201.6	199.6	196.7	(2.9)
Capital DEL	0	0	0	0	0
Total DEL	176.1	201.6	199.6	196.7	(2.9)

*Final GiA budget includes £0.5 million of ring-fenced (non-cash) DEL.

Sources: SDS 'Budget allocation and monitoring: 2016-17' letter from the Scottish Government, 14/03/2017; 'Management Accounting Finance Report as at 31st March 2017' to the SDS board, 27/04/2017

26. The £2.9 million operating surplus was a result of lower spending than planned in a number of business areas. SDS attributes this to:

- the Transition Training Fund, where spending was £0.8 million lower than planned because some applications had not progressed to the point where expenditure could be recognised in this financial year
- staff costs, which were £0.5 million lower than planned due to not filling vacancies within the planned timescales
- other lower than expected spending, totalling £1.6 million, including in industry support projects (£0.6 million), IT projects (£0.3 million) and delivery programmes such as the Employability Fund (£0.7 million).

27. SDS attributes the difference of £2 million between the final grant-in-aid budget and the cash drawn down to:

- £1.0 million less spending on the Scotland's Employer Recruitment Incentive (SERI), reflecting lower liability payments from the 2015/16 scheme, as agreed with the Scottish Government before the SBR
- £0.5 million less spending on the digital initiative for schools, now planned from 2017/18 as agreed with the Scottish Government
- £0.5 million ring-fenced (non-cash) DEL not drawn down due to lower amortisation charges than expected.

Internal controls

28. As part of our audit we identify and confirm the key internal controls in those accounting systems which we regard as significant for the production of the financial statements. Our objective is to gain assurance that SDS has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

29. Our findings were included in the interim audit report presented to the Audit and Risk Committee on 30 March 2017. No significant internal control weaknesses were identified during the audit which could affect the SDS ability to record,

process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements. We identified the need to gain further assurances in key areas involving the National Training Programmes (NTP) expenditure.

30. From a further consideration of controls over NTP expenditure, we found that SDS was planning to introduce significant changes to the process during 2017/18. This includes migration of NTP data to the new system introduced during 2016/17 and changes to the roles of various teams involved in NTP procurement, processing and monitoring. As this is a key area of expenditure, we plan to carry out further audit procedures during the 2017/18 audit.

Budgetary processes

31. We reviewed the SDS budgetary processes and budget monitoring arrangements. From our review of budget monitoring reports, review of committee papers and attendance at a board meeting we confirmed that senior management and members receive regular, timely and up to date information on the financial position. We observed board members providing effective scrutiny of finance reports and the draft annual budget.

32. We concluded that, overall, SDS has good budgetary monitoring and control arrangements that support effective scrutiny of its finances. Our interim report identified scope for SDS to enhance the financial information provided to the board. In particular, the finance reports to the board were prepared on a cash rather than accruals basis and did not make it clear how committed expenditure may impact on the year-end outturn. We are pleased to note that SDS has since improved the format of its finance reports with these now clearly showing year-to-date spending, committed expenditure and the expected year-end outturn as compared with the approved budget. This ensures that the board has a complete picture of the SDS financial position and thus supports effective scrutiny.

33. Internal audit reviewed the financial controls in place during 2016/17 and concluded that SDS had robust controls in place over budget setting and monitoring which supported the economic, efficient and effective use of public funds. Internal audit's report also noted a number of areas of good practice and identified opportunities for improvement. This included the need for SDS to establish clear thresholds for providing explanations against variances and for any actions agreed to address variances to be robustly followed up by finance business partners.

34. Last year's annual audit report noted value for money considerations arising from SDS' inability to use cash held in its subsidiary, Careers Trust Scotland Limited (renamed during 2016/17 to WBL Scotland) due to constraints on budgets. As WBL Scotland is a consolidated subsidiary of SDS, budget cover is required before this money can be applied. During 2016/17, management continued discussions with the Scottish Government on this matter. As at June 2017, this issue has not yet been resolved.

Prevention and detection of fraud and irregularity

35. We assessed SDS' arrangements for the prevention and detection of fraud. Our audit work covered a number of areas such as whistleblowing and a review of the counter-fraud strategy. We concluded that SDS had appropriate and adequate arrangements in place during 2016/17. The SDS response and approach to the investigation of suspected frauds is appropriate.

36. Internal Audit's review of counter-fraud controls identified improvements that could be made to strengthen the control framework. Management recognised that there is scope for further improvement in this area and is implementing actions to strengthen counter-fraud arrangements in general and in particular over training funds that are managed outwith mainstream computerised systems and processes.

National Fraud Initiative

37. The National Fraud Initiative (NFI) in Scotland is a counter-fraud exercise coordinated by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different financial systems, to identify 'matches' that might suggest the existence of fraud or error. The 2016/17 NFI is the third counter-fraud exercise for SDS. ([Exhibit 5](#)).

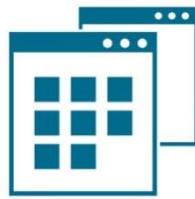
Exhibit 5

Total number of matches



27,930

Number recommended for investigation



121

Completed/closed investigations



121

Source: SDS

38. NFI identified 27,930 total matches for SDS in 2016/17. Of these, 121 were recommended for investigation. SDS has prioritised the recommended matches and, as at June 2017, it had reviewed all 121 the matches and did not identify any issues. As with the previous NFI exercise, management intends to inform the Audit and Risk Committee of the overall results in due course. Based on evidence to date, we concluded that SDS is proactive in investigating matches and reporting the outcomes of NFI activity.

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

39. We have reviewed the arrangements in place to maintain standards of conduct including the Staff Handbook and Civil Service and Members' Codes of Conduct. There are established procedures for preventing and detecting any breaches of these standards including any instances of corruption.

40. Based on our review of the evidence we concluded that SDS has appropriate arrangements in place for the prevention and detection of bribery and corruption. We are not aware of any specific issues that we need to bring to your attention.

Part 3

Financial sustainability



Main judgements

SDS has good financial planning arrangements in place based on its corporate plan. It used scenario planning to prepare its five-year rolling financial model and sensitivity analysis to maintain it and develop it further. The financial model is comprehensive, based on reasonable assumptions and regularly updated for any changes in circumstances.

The SDS financial model identifies a significant increase in apprenticeship expenditure as SDS works towards achieving the increased Scottish Government's targets for modern apprenticeships. In the absence of clear, longer term funding commitments, there is a risk that SDS will have a significant funding gap going forward. SDS has recognised this risk as part of its risk management process.

2016/17 financial position

41. The Statement of Financial Position summarises what is owned and owed by SDS. The financial statements show that SDS:

- has net liabilities of £90.8 million, an increase of £49.3 million on 2015/16, largely attributable to increased valuation of pension schemes' liabilities
- pension schemes remain in an overall deficit position with liabilities exceeding assets by £113.4 million (£61.2 million in 2015/16).

Financial planning

42. SDS set a balanced budget for 2017/18, showing income and expenditure of £222.8 million. This is a £9.2 million increase on the 2016/17 expenditure outturn, mainly reflecting the impact of increased targets for modern, graduate level and foundation apprenticeships. As at June 2017, SDS has identified a potential pressure of £0.2 million which it intends to absorb through effective budget management.

43. In April 2017, the Scottish Government provided SDS with an initial GiA funding allocation of £179.6 million. It also indicated that SDS would receive a further £17 million through the Autumn and Spring Budget Revisions. As a result, the Board approved its budget in anticipation of formal approval of around 9% of its total GiA. If the Scottish Parliament approves this additional funding then SDS will receive £196.6 million funding in total in 2017/18, £3 million (1.5%) less than it drew down in 2016/17.

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they are delivered.

Medium to long term financial planning

44. We reviewed SDS' financial planning systems and assessed how effective they are in identifying and addressing risks to financial sustainability across the medium and long term. SDS is mainly funded from the Scottish Government through grant-in-aid (94%), set on a year-on-year basis. It recognises the importance of preparing medium to long term financial plans based on sensitivity analysis and scenario planning for possible budget changes.

45. SDS maintains the five-year rolling financial model. We looked at the assumptions and forecasts built into the model, sensitivity analysis used and how the model is used for financial monitoring and reporting. Our findings were included in the interim report presented to the Audit and Risk Committee on 30 March 2017:

- We concluded that SDS is well advanced in financial planning. Its financial model is comprehensive, based on reasonable assumptions and regularly updated for any changes in circumstances. SDS used scenario planning to prepare the financial model and sensitivity analysis to subsequently consider options for service delivery under different possible funding levels. SDS recognises that it now needs to perform further scenario planning to identify risks to financial planning and possible resulting actions.
- The financial model identifies a significant increase in apprenticeship family expenditure as SDS works towards achieving the targets set by the Scottish Government. In the absence of clear, longer term funding commitments, there is a risk that SDS will have a significant funding gap going forward. There is uncertainty over the SDS funding beyond one year but the SDS National Training Programmes are based on multi-year commitments and the Scottish Government's targets on modern apprenticeships have increased. This creates a risk to the SDS financial sustainability. SDS recognised this risk as part of its risk management process.
- The financial model is used to inform the Executive Leadership Group's budget review. While elements of the model are shared with the board and the Scottish Government's sponsor department, presenting the full picture would help promote a shared understanding of the SDS financial position and the challenges in achieving financial sustainability.

Recommendation 2

While SDS shares elements of the five-year rolling financial model with the board and the Scottish Government's sponsor department, presenting the full picture would help promote a shared understanding of the SDS financial position and the challenges in achieving financial sustainability.

Part 4

Governance and transparency



Main judgements

SDS has appropriate arrangements in place to support good governance, accountability and scrutiny. The terms for six board members, including the chair, will come to an end between September 2017 and September 2018. Recruitment of new board members has been deferred pending the completion of the Enterprise and Skills review. SDS agreed the temporary co-option of four board members with the Scottish Government. There is a risk that, going forward, the board may have gaps in skills and expertise and there may be lack of scrutiny as a result. SDS will need to work with the Scottish Government to ensure that board members' skills and expertise are maintained over this period of change.

The Memoranda of Understanding between SDS and its partners for the shared service ICT function require updating to reflect the change from a single supplier to multiple suppliers, as part of a new Service Integration and Management model. SDS has established components of an ICT strategy based on its strategy to 2016, and is now developing a new, over-arching ICT and Digital Strategy to support effective governance of its ICT services.

The SDS board meetings are not open to the public. Board minutes are published on the SDS website but board and committee papers and committee meeting minutes are not publicly available. SDS acknowledges that making these publicly available would increase transparency but considers the associated costs would be too high. With increasing public expectations for more openness in the conduct of public business, SDS needs to keep this area under review and consider whether there is scope to enhance transparency.

Governance arrangements

46. As part of the wider review of governance arrangements across the public sector, we completed a follow-up of our 'Role of Boards' national report, published in September 2010. This involved review of documentation, discussions with key officers and attendance at the board and Audit and Risk Committee meetings. We concluded that, overall, SDS has appropriate arrangements in place that support good governance, accountability and scrutiny. As reported in our interim report presented to the Audit and Risk Committee on 30 March 2017, we found:

- The SDS board is well established, with members demonstrating a strong level of commitment to their roles and responsibilities. There is clear evidence that the board effectively scrutinises policy decisions and performance. The Corporate Office is also well established in its role of supporting and developing the board. The board, with the support of the

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making and transparent reporting of financial and performance information.

Corporate Office, demonstrates a commitment to continuous improvement and personal development. The arrangements in place also support effective working relationships between the board and the SDS Executive Leadership Group.

- As at June 2017, the board was made up of seven Scottish Government appointees and three co-opted members. The terms of two board members that were due to come to an end at the end of February 2017, were extended until March 2018. The board chair's term was also due to come to an end at the end of September 2017 but this has been extended until September 2018. The terms for a further three board members will expire at the end of September 2017. Recruitment of new board members has been deferred pending the completion of the Enterprise and Skills review. SDS agreed the temporary co-option of four board members with the Scottish Government. There is a risk that, going forward, the board may have gaps in skills and expertise and there may be lack of scrutiny as a result. SDS will therefore need to work with the Scottish Government to ensure that board members' skills and expertise are maintained in this period of change.

Recommendation 3

With the terms of six board members coming to an end between September 2017 and September 2018 and recruitment of new board members deferred pending the completion of the Enterprise and Skills review, SDS should work with the Scottish Government to ensure that board members' skills and expertise are maintained in this period of change. This will enable effective scrutiny to continue.

47. Internal audit reviewed the SDS governance arrangements in place during 2016/17. Internal audit's report concluded that governance arrangements at SDS were robust and in line with best practice. It also identified two areas for improvement, including the need to monitor identified training sessions for the board and committees until completion, and to record and monitor actions identified through the board and committee self-assessments.

48. SDS obtained board approval to pay a discretionary allowance in lieu of pension benefits to a director. The Management Statement and Financial Memorandum (March 2008) requires SDS to obtain approval from its Scottish Government sponsor department for pensions arrangements. While SDS informed us that Scottish Government officials are aware of the allowance, it was unable to evidence formal approval from the sponsor department. We concluded that this is a technical oversight but in our view SDS should fully document the position and approvals, and ensure it obtains appropriate approvals for any future arrangements of this nature. We will continue to request and review such approvals as required during the course of our routine audit testing.

The governance statement

49. Under the Companies Act, SDS must prepare an annual governance statement within the annual report and financial statements. Guidance is set out within the Scottish Public Finance Manual (SPFM) for the content of the statement and provides assurances around the achievement of the organisation's strategic objectives.

50. The SPFM does not prescribe a format for the annual governance statement, but sets out minimum requirements for central government bodies. The process undertaken by management included conducting an assurance mapping exercise that assessed the evidence underpinning the preparation of the governance statement.

51. We concluded that the 2016/17 annual governance statement complies with the guidance issued by the Scottish Ministers and based on our knowledge and work performed presents a comprehensive picture and assessment of governance arrangements and associated matters.

Internal audit

52. Internal audit provides SDS and the Accountable Officer with independent assurance on the SDS overall risk management, internal control and corporate governance processes.

53. The internal audit function is carried out by Scott Moncrieff. We carried out a review of the adequacy of the internal audit function and concluded that it operates accordance with the Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

54. To avoid duplication of effort, we place reliance on the work of internal audit wherever possible. In 2016/17, we planned formal reliance on internal audit's work in financial controls self-assessment and IT application review. In the event, the internal audit's IT application review was postponed and therefore we were unable to place reliance on this work. During our review of controls in place in the key financial systems, we took into account the results of the internal audit's review of the SDS controls self-assessment. As part of our wider dimension work, we considered internal audit's reviews of budget monitoring and governance. Internal audit's review of organisational culture was still on-going at the time of writing this report.

ICT risks

55. The SDS ICT function is provided by Enterprise Information Systems (EIS), with the EIS Chief Information Officer reporting directly to the SDS Chief Executive. EIS is a shared service partnership that provides IT services to SDS, Scottish Enterprise and Highlands and Islands Enterprise. We carried out a high level review of the arrangements in place for providing IT and digital services and the results of this review will be reported to each of the three organisations separately.

56. We found that the Memoranda of Understanding between SDS and its partners for the shared service ICT function require updating, to reflect the change from a single supplier to a Service Integration and Management model. We understand that SDS is in discussion with its partners on revised MoUs. EIS' technical information system strategy is dependent on well-defined digital strategies in all three partners. We found that SDS has established components of an ICT strategy based on its strategy to 2016, and is now developing a new, over-arching ICT and Digital Strategy that reflects the requirements and approaches of SDS and its partners.

Recommendation 4

SDS should conclude updating the Memoranda of Understanding with its partners for the shared service ICT function. It should also complete its new, over-arching ICT and Digital Strategy to support effective governance of its ICT services.

57. Audit Scotland provides a survey called Your Business @ Risk which gauges the awareness staff have of information security issues. Particularly with the current increase in threat levels from cyber attacks, user awareness about good practice helps mitigate the risk exposure. The survey results would help management target particular areas of concern, for example use of passwords and screen locks, or mobile devices. SDS management is keen to take part in the survey and has indicated that the best time for this would be towards the end of this calendar year. This is because SDS is in the process of conducting a number

of other staff surveys in this area and its programme of review and internal audit are currently on-going.

Risk management

58. We reviewed the SDS risk management arrangements including its risk management policy and guidance, corporate risk register and Audit and Risk Committee papers on risk management. We concluded that the SDS risk management arrangements are effective and reporting arrangements appropriate.

Transparency

59. Transparency means that stakeholders, including the public, have access to understandable, relevant and timely information about how the board is taking decisions and how it is using public resources. The SDS board meetings are not open to the public. Detailed board minutes are published on the SDS website but board and committee papers and committee meeting minutes are not available publicly.

60. As reported in our interim report, presented to the Audit and Risk Committee on 30 March 2017, SDS acknowledges that making the papers publicly available would increase transparency but considers the associated cost and resources would be too high. The SDS Corporate Office recognises the need to keep this policy under review.

Recommendation 5

With increasing public expectations for more openness in the conduct of public business, SDS should consider whether there is scope to enhance transparency and keep this area under review. This could include, for example, reviewing the availability of board and committee papers and committee minutes.

National performance audit reports

61. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2016/17, we published a number of reports which are of direct interest to the board. These are outlined in [Appendix 3 \(page 28\)](#). The SDS risk manager reviews all Audit Scotland's reports and circulates any of interest to management and members of the board.

Appendix 1

Action plan 2016/17

2016/17 recommendations for improvement



Page no.	Issue/risk	Recommendation	Agreed management action/timing
11	<p>1. Recognised good practice in disclosures</p> <p>SDS has prepared its 2016/17 annual report and financial statements in line with the requirements of the Companies Act and the Scottish Public Finance Manual (SPFM) as appropriate. While some disclosures go beyond that required by the Companies Act and therefore also comply with the Financial Reporting Manual (FReM), there are some areas where SDS could provide further disclosures in line with good practice and transparency principles for public bodies.</p> <p>Risk</p> <p>The SDS annual report and financial statements may not be in line with good practice and transparency principles for public bodies.</p>	<p>SDS should consider providing further disclosures for 2017/18 annual report and financial statements, in line with good practice and transparency principles for public bodies.</p>	<p>SDS will continue to monitor best practice and reporting obligations, and will commit to reviewing disclosures and altering reporting formats where appropriate.</p> <p>Responsible Officer – Director Finance & Audit</p> <p>Agreed Date – 31 March 2018 and ongoing</p>
17	<p>2. Five-year financial model</p> <p>The financial model is used to inform the Executive Leadership Group's budget review. Elements of the model are shared with the board and the Scottish Government's sponsor department but not the model in full.</p> <p>Risk</p> <p>The board and the Scottish Government's sponsor department may not be aware of all challenges SDS faces in</p>	<p>Presenting the financial model in full to the board and the Scottish Government's sponsor department would help promote a shared understanding of the SDS financial position and the challenges in achieving financial sustainability.</p>	<p>Financial sustainability and the multi-year model are discussed frequently at ELG, Board, its Committees, and in formal fora with SG officials. During 2017/18, in the context of the Comprehensive Spending Review and aspirations for the apprenticeship family, particularly, the SDS executive will be presenting more information to these groups.</p> <p>Responsible Officer – Director</p>



Page
no.

Issue/risk

Recommendation

Agreed management
action/timing

achieving financial
sustainability.

Finance & Audit

Agreed Date – 31 July 2017
and ongoing

19

3. Board succession planning

As at June 2017, the board was made up of seven Scottish Government appointees and three co-opted members. The terms for six board members, including the chair, will come to an end between September 2017 and September 2018. Recruitment of new board members has been deferred pending the completion of the Enterprise and Skills review. SDS agreed the temporary co-option of four board members with the Scottish Government.

Risk

Going forward, the board may have gaps in skills and expertise and there may be lack of scrutiny as a result.

SDS should work with the Scottish Government to ensure that board members' skills and expertise are maintained in this period of change. This will enable effective scrutiny to continue.

SDS has no direct influence on the timing of the recruitment of Ministerially-appointed Board members, but will remain in dialogue with Scottish Government officials. SDS is able to influence the inclusion of co-opted members and is progressing this from June 2017.

Responsible Officer – Acting
Director Corporate Affairs

Agreed Date – 30 June 2017
and ongoing

20

4. ICT governance arrangements

The Memoranda of Understanding between SDS and its partners for the shared service ICT function require updating to reflect the change from a single supplier to multiple suppliers as part of a new Service Integration and Management model. SDS has established components of an ICT strategy based on its strategy to 2016, and is now developing a new, over-arching ICT and Digital Strategy.

Risk

The SDS' governance arrangements do not support effective delivery of ICT services.

SDS should conclude updating the Memoranda of Understanding and complete its new, over-arching ICT and Digital Strategy to support effective governance of its ICT services.

Both EIS partner bodies have indicated that they would prefer to operate under the existing MoU, or the protocols it has established, in order that key staff remain focused on delivery. SDS has sought legal advice on this and has prepared a draft to be discussed with partners, with the aim of affording better clarity and protection for all partners.

Responsible Officer – Director
Finance & Audit

Agreed Date – 30 June 2017



**Page
no.**

Issue/risk

Recommendation

**Agreed management
action/timing**

21

5. Transparency

The SDS board meetings are not open to the public and SDS does not publish board and committee papers and committee meeting minutes on its website. SDS acknowledges that making these publicly available would increase transparency but considers the associated costs would be too high.

Risk

The board's commitment to transparency may not be in line with good practice principles.

With increasing public expectations for more openness in the conduct of public business, SDS should keep this area under review and consider whether there is scope to enhance transparency. This could include, for example, reviewing the availability of board and committee papers and committee minutes.

SDS will continue to monitor best practice and reporting obligations, and will commit to reviewing this issue from the mid-point of the financial year.

Responsible Officer – Acting
Director Corporate Affairs

Agreed Date – 30 September
2017 and ongoing

Appendix 2

Significant audit risks identified during planning

The table below sets out the audit risks we identified during our planning of the audit and how we addressed each risk in arriving at our conclusion. The risks are categorised between those where there is a risk of material misstatement in the annual report and financial statements and those relating our wider responsibility under the [Code of Audit Practice 2016](#).

Audit Risk	Assurance procedure	Results and conclusions
Risks of material misstatement in the financial statements		
<p>1 Risk of management override of controls</p> <p>ISA 240 requires that audit work includes consideration of the risk of fraud, which is presumed to be a significant risk in any audit. This includes the risk of management override of controls to change the position disclosed in the financial statements.</p>	<p>Detailed testing of journal entries.</p> <p>Review of significant management estimates and evaluation of the impact of any variability in key assumptions.</p> <p>Focused testing of accruals and prepayments.</p> <p>Substantive testing of transactions after the year end to confirm expenditure and income has been accounted for in the correct financial year.</p> <p>Evaluation of any significant transactions that are outside the normal course of business.</p>	<p>No issues identified.</p>
<p>2 Pensions accounting</p> <p>SDS accounts for its participation in the Strathclyde Pension Fund and Highland Council Pension Fund in accordance with IAS 19 Retirement benefits, using a valuation report prepared by the appointed SDS actuaries. There is an inherent risk with the determination of pension charges due to the extent of assumptions actuaries use in calculations and the impact they can have on the financial statements.</p>	<p>Completion of 'review of the work of an expert' for the actuary.</p> <p>Focused substantive testing of key areas including data SDS provides to its actuaries.</p>	<p>No issues identified.</p>
<p>3 Risk of fraud over income</p> <p>ISA240 requires auditors to presume a risk of fraud where income streams in addition to Scottish Government funding are significant. SDS receives approximately 6% of income</p>	<p>Analytical procedures on income streams.</p> <p>Detailed testing of income transactions focusing on the areas of greatest risk.</p> <p>Detailed cut-off testing of</p>	<p>No issues identified.</p>





















Audit Risk	Assurance procedure	Results and conclusions
<p>from sources other than Scottish Government funding. The extent and nature of income means that, in accordance with ISA240, there is an inherent risk of fraud that requires an audit response.</p> <p>The Code of Audit Practice expands the ISA240 assumption on fraud over income to aspects of expenditure. Most of SDS operating expenditure (£114 million, 65%) is on multi-year national training programmes. While these are contracted annually, SDS has a commitment to support them over several years.</p>	<p>income streams.</p> <p>Detailed analysis of EU income</p> <p>Walk-through of controls over national training programmes.</p> <p>Detailed substantive testing of expenditure transactions with a focus on cut-off testing.</p> <p>Review of compliance team's checks of national training programmes contracts.</p>	
<p>4 System upgrade</p> <p>Agresso Business World is the SDS' main financial system. A major upgrade is planned to a 'cloud based' system. There is a risk that the upgrade impacts the financial information produced by the system. As this information feeds into the financial statements, there is a financial statement risk as a result.</p>	<p>Review of the implementation of the upgrade, including business continuity arrangements.</p> <p>Consideration of internal audit's IT application review.</p> <p>Focused substantive testing of material areas.</p>	<p>No issues identified.</p>
<p>Risks identified from the auditor's wider responsibility under the Code of Audit Practice</p>		
<p>4 Financial sustainability</p> <p>The SDS national training programmes are based on multi-year commitments and its targets on modern apprenticeships have increased but there is uncertainty over the SDS funding beyond one year. This creates a risk over the financial sustainability of SDS. SDS has recognised this risk as part of its risk management process.</p>	<p>Review and assessment of the adequacy and robustness of medium to long-term financial plans.</p> <p>Focused review of any forecasting or scenario planning feeding into financial plans.</p>	<p>Our conclusions from our review of the SDS five-year rolling financial plan are outlined in paragraph 45 and included in the action plan (Appendix 1, point 2).</p>
<p>5 Financial management – year-end outturn</p> <p>The approved budget for 2016/17 shows income and expenditure of £215 million. Income includes £176 million of core Grant-in-aid from the Scottish Government and £23 million expected to be confirmed through the Autumn</p>	<p>Monitoring of the financial position throughout the year by reviewing budget monitoring reports.</p> <p>Review SDS's achievement of outturn at year end</p>	<p>SDS managed its 2016/17 budget well. It received sufficient funding to deliver its core services and reported an expenditure underspend of £1.4 million and DEL underspend of £2.9 million.</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>and Spring Budget Revisions. As at November 2016, SDS is yet to receive £13 million (6%) from the Scottish Government through the Spring Budget Revision. There is a risk that SDS will not receive sufficient funding to deliver its core services and break-even in 2016/17.</p>		
<p>6 Financial management - budget monitoring</p> <p>Finance reports, provided to the SDS board, are presented on a cash rather than accruals basis. There is a risk that the board is not aware of all income and expenditure that could have an impact on the outturn and SDS financial position.</p>	<p>Consideration of internal audit's budget monitoring work.</p> <p>Regular review of budget monitoring reports.</p> <p>Attendance at some Board meetings to observe the scrutiny of finance report.</p>	<p>Our conclusions from our review of the SDS budget monitoring are outlined in paragraphs 31 and 32.</p>
<p>7 Governance and transparency - scrutiny and challenge by SDS board</p> <p>Due to the on-going skills and enterprise review, SDS board's long-term future is uncertain. Terms for a number of board members are also coming to an end within the next nine months. SDS co-opted four board members but there is a risk that the board may have gaps in skills and expertise, and there may be a lack of scrutiny and challenge as a result.</p>	<p>Follow-up work on the 'Role of Board' performance audit, published in September 2010.</p> <p>Consideration of internal audit's work on governance and organisational culture.</p>	<p>Our conclusions from the review of the SDS governance arrangements are outlined in paragraph 46, and included in the action plan (Appendix 1, point 3).</p>

Appendix 3

Summary of national performance reports 2016/17



Apr			
May		Common Agricultural Policy Futures programme: an update	
Jun		South Ayrshire Council: Best Value audit report	 The National Fraud Initiative in Scotland
Jul		Audit of higher education in Scottish universities	 Supporting Scotland's economic growth
Aug		Maintaining Scotland's roads: a follow-up report	 Superfast broadband for Scotland: a progress update
			 Scotland's colleges 2016
Sept		Social work in Scotland	 Scotland's new financial powers
Oct		Angus Council: Best Value audit report	 NHS in Scotland 2016
Nov		How councils work – Roles and working relationships in councils	 Local government in Scotland: Financial overview 2015/16
Dec		Falkirk Council: Best Value audit report	 East Dunbartonshire Council: Best Value audit report
Jan			
Feb		Scotland's NHS workforce	
Mar		Local government in Scotland: Performance and challenges 2017	 i6: a review
			 Managing new financial powers: an update

Central Government reports which may be of particular interest to SDS:

[The National Fraud Initiative in Scotland](#) – June 2016

[Audit of higher education in Scottish universities](#) – July 2016

[Supporting Scotland's economic growth](#) – July 2016

[Scotland's colleges 2016](#) – August 2016

[Scotland's new financial powers](#) – September 2016

[Managing new financial powers: an update](#) – March 2017

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