INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Scottish Enterprise

Annual audit report to Scottish Enterprise and the Auditor General for Scotland

Year ended 31 March 2009

7 July 2009

AUDIT

AUDIT ▪ TAX ▪ ADVISORY

Contents

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

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

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

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

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Executive summary

Following completion of a programme of significant organisational change in early 2008-09, management has focussed on changing internal planning and reporting processes to ensure that these meet the needs of the organisation. The 2008-11 business plan is aligned to a new set of priorities: enterprise, innovation and investment. Projects, monthly reporting and the accounts have been similarly re-aligned. Scottish Enterprise's review of ITI Scotland resulted in integration of Scottish Enterprise's activities with ITI Scotland and a transition plan is now in place.

In line with best practice in the public and private sector, management commenced a two-phased introduction of zero-based budgeting during 2008-09. This approach increases challenge at senior management level and aims to realise efficiencies for reinvestment.

Scottish Enterprise met its financial targets – cash target, non-cash target and capital allocation – for 2008-09. Investment in property was £15 million and contributions to companies through financial investment was over £33 million. The 2009-10 financial plan forecasts that Scottish Enterprise will spend £319 million and aims to maximise impact on increasing Scotland's sustainable economic growth.

Robust procurement arrangements are now an important element in Scottish Enterprise's responsibilities and all contracts greater than £50,000 are subject to tender.

Management achieved efficiency savings of £8 million, primarily as a result of the restructuring programme, compared to the target of £7.7 million. Scottish Enterprise will continue to be subject to achieving recurring efficiency savings of 2% in future years. £1 million of savings will be achieved in 2009-10 and future years following the buy out of the employee car scheme in 2008-09.

Management continues to assess progress against the Best Value action plan, but chose not to participate in Audit Scotland's voluntary programme of studies on efficiencies and information management during the year.

Scope

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

Audit framework

This year was the third of our five-year appointment by the Auditor General for Scotland as external auditors of Scottish Enterprise. This report to Scottish Enterprise and the Auditor General provides our opinion and conclusions and highlights significant issues arising from our work.

We outlined the framework under which we operate, under appointment by Audit Scotland, in the audit plan overview discussed with the audit committee on 17 December 2008.

The purpose of this report is to report our findings as they relate to:

- the **accounts** and our audit opinions on net operating costs and the regularity of transactions;
- **use of resources**, including financial outturn for the year ended 31 March 2009 and financial plans for 2009-10 and beyond;
- arrangements around **governance and accountability**, including risk management, systems of internal control, partnership working and our consideration of the work of internal audit; and
- **performance management** and Scottish Enterprise's arrangements to achieve efficiency savings.

Best Value

Audit Scotland and the Scottish Government have been committed to extending the Best Value audit regime across the whole public sector for some time now, with significant amounts of development work having taken place during the last year. Using the Scottish Executive's nine Best Value principles as the basis for audit activity, Audit Scotland selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). Audit Scotland is developing a series of toolkits that auditors are using from 2008-09. Management declined to participate in reviews of information management and efficiencies during 2008-09, primarily due to the timescales involved.

Responsibilities of Scottish Enterprise and its auditors

External auditors do not act as a substitute for Scottish Enterprise's own responsibilities for putting in place proper arrangements to account for the stewardship of resources made available to it and its financial performance in the use of those resources, to ensure the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the effectiveness of those arrangements and, through the accountable officer, to make arrangements to secure Best Value.

Action plan

This report includes an action plan containing areas for development or improvement identified during our accounts audit fieldwork. We have not repeated recommendations raised in reports issued during our earlier work in respect of our 2008-09 audit. Responsibility for taking action and monitoring progress in response to all our recommendations lies with management.

Acknowledgement

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

Background – overview of activities

Overview of activities

During the year ended 31 March 2008 Scottish Enterprise implemented a programme of significant organisational change. Some regional activities, including Business Gateway, were transferred to local authorities and skills, learning and Careers Scotland activities were transferred to Skills Development Scotland on 1 April 2008, along with 1,328 staff. The 12 local enterprise companies were abolished in operational terms and subsumed within a central structure, with five newly created regions in operation during 2008-09. The changes to the corporate structure also included a voluntary severance scheme in which 257 members of staff left the organisation.

During 2008-09 management focussed on changing internal planning and reporting processes to ensure that these met the needs of the organisation in its revised state. Scottish Enterprise realigned its business plan from the Metropolitan Scotland approach to align with the Government economic strategy. Management produced a business plan for 2008-11 aligned to a new set of priorities: enterprise, innovation and investment. Projects have been re-aligned under these three themes and their associated sub-themes. The accounts for 2008-09 present the organisation's expenditure under these new categories. The business plan for 2009-12 is also structured around these three key areas.

As a result of extensive changes in the organisational structure, the executive board approved adoption of a zero-based budgeting approach to the development of the 2009-11 business plan. Implementation of this approach is on a phased basis. Phase one was completed in the autumn of 2008 and required submission of draft budgets to a challenge panel established by senior management. The second phase, during 2009, will focus on delivery models and the introduction of a consistent framework for consideration and approval of appropriate models. Management reports that good progress was made during 2008-09. Identification of drivers for decision-making had been considered in the past, but the reasons for each driver are now considered to be clearer. Further work is required to develop a prioritisation framework and this will be progressed during 2009. Application of a zero-based budgeting approach is consistent with best practice across the public and private sectors.

ITI Scotland, a subsidiary of Scottish Enterprise, was established in 2003. Scottish Enterprise completed a review of ITI Scotland during 2008-09. The review considered, among other areas, ITI Scotland's strategic and operational objectives, cost effectiveness and efficiencies and the impact of the monitoring and evaluation framework on capturing the benefits of intellectual property commercialisation. Consideration of the findings of this review resulted in a view that greater integration of Scottish Enterprise's activities with ITI Scotland was the preferred solution for future activity. An integration project was presented to the executive board in January 2009 and management subsequently established an ITI Scotland integration team, consisting of staff from both organisations, to develop a transitional plan for greater integration of ITI Scotland's activities.

Accounts

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

Key issues arising from our audit of the accounts were:

- Atlantic Quay, Glasgow – despite Scottish Enterprise's much reduced presence in the building, the rent payable on the Atlantic Quay lease up until 31 May 2009 was not initially recognised as an onerous obligation to be charged in 2008-09. This was subsequently amended. Fixtures and fittings left in Atlantic Quay were written off with a net charge of £0.9 million.
- FRS 17 *Retirement Benefits* – Scottish Enterprise continues to account for pension assets and liabilities as at 1 April 2008 associated with staff who transferred to Skills Development Scotland on 1 April 2008 because the transfer documentation does not clarify how these assets and liabilities should be determined and accounted for.
- Valuation of property portfolio – Scottish Enterprise obtained a third party valuation of its commercial and industrial property interests as at 31 March 2009 and has reflected these in the accounts.
- Valuation of investments – the carrying value of Scottish Enterprise's interests in a variety of companies are reflected in the accounts on the basis of management's processes and monitoring arrangements.

Recommendations

The action plan includes recommendations to improve the following areas.

Area for development	Action plan reference
Agreement of how pension assets and liabilities should be allocated and accounted for by Scottish Enterprise and Skills Development Scotland following the staff transfer at 1 April 2008.	One
Significant progress is required to fully restate the 2008-09 accounts in line with the IFReM.	Two

Audit opinions and key issues

Reporting arrangements and timetable

We received a draft of Scottish Enterprise 'parent' accounts on 19 May 2009, one week later than the agreed date of 11 May 2009, and a number of notes and disclosures were incomplete. We received a first draft of group accounts on 9 June 2009. This was also later than the planned timetable and they were incomplete. Management provided the remuneration report and management commentary on 4 and 11 June 2009, respectively, but commentary on the financial outturn was not available until 19 June 2009.

Management made a number of late adjustments to the accounts during week commencing 8 June 2009. The net impact was to reduce net operating costs by £2.7 million.

Audit opinion

Following approval we issued an audit report expressing unqualified opinions on the accounts for the year ended 31 March 2009 and on the regularity of transactions reflected in those accounts.

Key issues arising during our audit of the accounts

Our audit plan overview and interim management report identified four key risk areas, which are summarised below.

Key risk area	Conclusions
Property portfolio	Scottish Enterprise's accounting policy for investment properties and land is to reflect these in its accounts at market valuation, as advised by external valuers. Management was pro-active in responding to the affects of the economic downturn and continued previous practice in obtaining early valuations to quantify the impact of falling property values on the financial position. During 2008-09 management obtained a valuation of all investment properties at 31 October 2008. A second valuation of high risk properties was completed in January 2009 and medium / low risk properties in February 2009. These valuations were subsequently updated to arrive at the year-end position. This approach ensured that delays and changes to the accounts were minimised, with only five properties being adjusted after the draft valuations. This exercise assisted management in financial planning, particularly in relation to the impact of impairment charges on the non-cash target. The position at 31 March 2009 was a cumulative downward revaluation of investment properties of £60 million. Management adopted a consistent and thorough approach to monitoring and reporting progress to the executive board during the year.
Entitlements	In meeting its strategic objectives Scottish Enterprise regularly enters into agreements with third parties. These contractual arrangements may result in future revenue streams or future liabilities to Scottish Enterprise. Following the abolition of the local enterprise companies, management merged the individual entitlements registers into a single register. Project managers made finance staff aware of any new entitlements arising as a result of investment activity in 2008-09. Progress has been made to identify and record new entitlements. Responsibility for collection of entitlements should be assigned to members of staff to ensure action is taken when they fall due. Our testing did not identify any significant entitlements that had not been captured in the accounts.

Audit opinions and key issues (continued)

Key risk area	Conclusions
European funding	During 2007-08, and previous years, management undertook an assessment of funding that had been claimed by the group from the European Union that may not comply with funding rules. The Scottish Government (as managing agent), in agreement with Scottish Enterprise, included a provision for the maximum potential repayment to the European Union within its 2007-08 accounts and provided confirmation that it would settle any claims directly with the European Union, with no re-charge to Scottish Enterprise. Management continues to await the report from the European Court audit of the 1994-99 programme. There is an ongoing issue related to Scottish Enterprise historically not maintaining the required evidence of payments made to companies receiving project funding. Management received correspondence from the Scottish Government indicating that they will underwrite any losses incurred by Scottish Enterprise as a result of this issue. The position at the date of report is that confirmed clawback is £480,000 and potential clawback is £7.6 million.
Financial instruments	Under the requirements of the Government financial reporting manual, the financial reporting standards relating to financial instruments – FRS 25 *Financial instruments: presentation* and FRS 26 *Financial instruments: recognition and measurement* – are applicable to Scottish Enterprise for the year ended 31 March 2009. The objectives of these standards are to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities and to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Scottish Enterprise's financial reporting framework permits central government bodies to apply an exemption to restate comparative information for these accounting standards. The accounts have been updated to include disclosure and measurement of the three risks to which Scottish Enterprise is exposed from the use of financial instruments. These are liquidity risk, credit risk and market risk. The disclosure explains how these risks are managed by Scottish Enterprise. This information was not initially reflected in the draft accounts, but was updated during the audit process.

Audit opinions and key issues (continued)

We identified a further three risk areas during our audit of the accounts:

Investments

In pursuit of economic growth targets, Scottish Enterprise makes investments in a variety of companies, in part using funds provided by the European Union through the Scottish Co-Investment Fund. Investments by way of ordinary shareholdings and loans during 2008-09 totalled £33.7 million. Management monitors the performance of all investments and regularly adjusts the carrying value to recognise, where appropriate, provisions for diminutions in value. During 2008-09 additional provisions against new and existing investments of £10.6 million were required as a result of current economic conditions. Audit testing confirmed the efficacy of management's processes to monitor investment performance and to recognise adjustments to carrying value, where required.

Atlantic Quay

Scottish Enterprise moved from its headquarters at Atlantic Quay to Atrium Court, Glasgow during the year. The move was completed in stages, beginning in September 2008, with the last exit from the building being at the end of April 2009. The lease was initially due to be taken on by the Scottish Government on 31 March 2009, but this was delayed. Consequently, Scottish Enterprise was liable for rent on Atlantic Quay until 31 May 2009. We alerted management in March 2009 to the requirement to consider whether the rent obligations would constitute an onerous contract, which is defined in accounting standards "as a contract in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received". In our view the criteria are met by Scottish Enterprise's obligation because the majority of the floor space to which the rent relates was not occupied by Scottish Enterprise during the period from 1 April 2009. The accounts did not initially recognise this obligation, but the charge of £372,000 was subsequently reflected during the finalisation of the accounts.

Another aspect of the move from Atlantic Quay relates to the fixtures and fittings previously recognised as tangible fixed assets, partially matched by deferred income relating to an incentive received in previous years. The fixtures and fittings were written off at 31 March 2009 to reflect discontinued use following the staff move and subsequent refurbishment by new tenants. The deferred income was also released, but the net impact on net operating costs was a charge of £0.9 million.

FRS17 *Retirement benefits*

As part of the reorganisation of responsibilities from 1 April 2008 a number of employees transferred to Skills Development Scotland, but remained in the Scottish Enterprise Pension and Life Assurance Scheme ("the Scheme"). The Trustees of the Scheme, Scottish Enterprise and Skills Development Scotland, entered into an agreement effective from 1 April 2008 whereby these employees of Skills Development Scotland will continue to participate in the Scheme. This is in accordance with the Deed of Agreement and Trust and other governing documentation of the Scheme.

The Deed of Participation, admitting Skills Development Scotland as a participating employer to the Scheme, does not address how the assets and liabilities of the Scheme relating to Skills Development Scotland's employees former participation in the Scheme, as employees of Scottish Enterprise, should be determined and accounted for. The Trustees of the Scheme have not yet determined a basis for apportionment of assets and liabilities between Scottish Enterprise and Skills Development Scotland. As a result, for the purposes of FRS 17, Scottish Enterprise continues to account for all assets and liabilities of the Scheme prior to 1 April 2008. We agree with management's view that the future apportionment of the assets and liabilities of the Scheme is unlikely to have a material impact on the net assets of Scottish Enterprise.

It is important that management work with Skills Development Scotland and the Trustees of the Scheme to clarify the basis of Skills Development Scotland's participation in the Scheme without further delay.

Recommendation one

Regularity

Regularity of transactions

We updated our understanding of the framework under which Scottish Enterprise operates and reviewed the design, implementation and operating effectiveness of the controls over project initiation, appraisal and approval of Scottish Enterprise projects, and controls over European Union funded expenditure. Our testing identified no weaknesses in the design, implementation and operating effectiveness of these controls.

To gain assurance over the regularity of expenditure we used statistical sampling methods, in accordance with International Standard on Auditing 530 *Audit sampling and other selective testing procedures*, to test a sample of purchases to ensure that expenditure is in accordance within Scottish Enterprise's three themes. Testing of delegated authority limits identified some controls weaknesses during the period from April to December 2008, but we did not identify any instances of irregular expenditure as a result of these control weaknesses.

We considered the adequacy of processes for embedding provisions in the Management Statement between the Scottish Government Enterprise, Transport and Lifelong Learning Department and Scottish Enterprise. Internal audit tested all consultant and contractor spend greater than the tendering threshold of £50,000. This testing identified non-compliance with Scottish Enterprise's tending procedures totalling £122,000 and no instances of non-compliance with European Union tendering rules. The non-compliance represents 2% of the sample tested. This is an improvement on the 5% identified in the prior year, and is not considered to be material.

One instance of non-compliance with the terms of the management framework between Scottish Enterprise and ITI Scotland was identified by management in relation to the appointment of a senior employee.

The corporate department receives and distributes all circulars and guidance from the Scottish Government and other regulatory bodies. Electronic records detail all guidance received and record actions taken in response to each paper issued. In 2007-08 we recommended that a control was established to identify any circulars that have not be received. Management sought advice from the Scottish Government, who noted that circulars deemed not relevant to Scottish Enterprise will not be sent. As such, management has decided to accept the minor risk that guidance will not be received.

We have considered the specific requirements of a number of financial circulars, particularly those in relation to remuneration and procurement, and did not identify any instances of non-compliance.

Implementation of International Financial Reporting Standards

The 2007 Budget had announced that central government and health bodies would report under international financial reporting standards ("IFRS"), as adapted by HM Treasury through the financial reporting manual ("IFReM"), from 2008-09. Following consultation with Government departments and the Financial Reporting Advisory Board on the technical work needed to implement this change, the Government now intends to move to IFRS from 2009-10 as announced in the 2008 budget.

Central government bodies will be required to prepare their accounts on the basis of the IFReM from 2009-10. Shadow IFReM financial statements, including an opening balance sheet, will be required for 2008-09. The shadow IFReM financial statements are subject to a 'dry run' audit in accordance with timescales prescribed by the Scottish Government. The timescales are set out in the table below.

	Presented for audit	Completion of dry-run audit
Opening 2008 IFRS based balance sheet	28 November 2008	28 February 2009
2008-09 shadow IFRS based financial statements	30 November 2009	28 February 2010

Management did not submit a restated opening balance sheet by the 28 November 2008 deadline and this has not been received at the time of this report. Our work, to be completed by 28 February 2010, is required to consider complete primary statements and full disclosure notes, including accounting policies, which are supported by a level of documentation similar to an audit. While management has made some progress in considering tangible fixed assets, leases, and investments, significant progress is still required during the period to 30 November 2009.

Recommendation two

Use of resources

Scottish Enterprise met its financial targets – cash target, non-cash target and capital allocation. The 2009-10 financial plan forecasts that Scottish Enterprise will deliver a £319 million programme of economic development, which focuses on maximising Scottish Enterprise's impact on increasing Scotland's sustainable economic growth.

Scottish Enterprise invested £15 million in investment properties during 2008-09 and £33 million in companies.

Scottish Enterprise places a great emphasis on a culture of reward based on individual and organisational performance, robust management practices and continuous development. As an *Investor in People* management ensures all staff are clear on their roles and how they play their part in business delivery.

Robust procurement arrangements are now an important element in Scottish Enterprise's responsibilities for ensuring compliance with all relevant guidance over financial transactions, including compliance with European Union obligations. All contracts greater than £50,000 are subject to tender.

The corporate services department receives all guidance and forwards all Audit Scotland national studies to the head of internal audit, who is responsible for evaluating relevance to Scottish Enterprise. Where deemed appropriate, the report will be discussed with relevant personnel and a action plan developed to put in place the study's recommendations.

Recommendations

We did not identify any significant recommendations for development of Scottish Enterprise's arrangements to manage the use of resources.

Financial management

Financial position

The business plan is set at a high level and monitored throughout the year in order to manage any significant under / over spends. Management identified that they required an additional £8 million of non-cash resource and requested an additional allocation from the Scottish Government. The Scottish Government granted an additional £6 million to Scottish Enterprise as a result of the Highland and Islands Enterprise's decision to surrender the same amount to the Scottish Government.

The analysis below shows that Scottish Enterprise met its cash and non-cash targets. The business plan has to be adjusted for the Scottish Co-Investment Funding which is included in the plan but not in the Government's targets. In addition, the business plan did not include costs incurred in the accounts in relation to local regeneration expenditure or Skills Development Scotland notional shared services costs. The transfer of Scottish Enterprise's interest in Edinburgh Waterfront Limited prior to the year end under "machinery of government" rules avoided the need to account for that organisation's loss.

Operating income is below planned levels as a result of reduced property disposals. Actual grant-in-aid received was higher than management had originally planned due to a deduction in relation to local regeneration funding being less than anticipated.

£'000	Cash	Non-cash	Total
2008-09 business plan	297	30	327
Less: Scottish Co-Investment funding	(16)	-	(16)
Add: Local re-generation expenditure	8	-	8
Add: Skills Development Scotland notional shared services costs	12	-	12
Add: Transfer of allocation from Highland and Islands Enterprise	-	6	6
Management forecast	**301**	**36**	**337**
Expenditure per accounts	317	-	317
Less: Non-cash	(35)	35	-
Capital expenditure	19	-	19
Expenditure for the purposes of the outturn	**301**	**35**	**336**
Underspend	**-**	**1**	**1**

Financial management (continued)

Financial management and budgetary control

The corporate performance team is responsible for the budget setting process. Details of the 2008-09 budget setting process were not available to all staff. Budgets are allocated against the headings of enterprise, innovation and investment to ensure the operations are aligned with the strategy, which has changed due to significant structural and organisational change. This was not formalised until 27 June 2008, during which time management operated to draft funding arrangements agreed with the executive board.

Adequate forecasting of the impact of the economic downturn was achieved through timely consideration of the market value of investment properties. Throughout the year management was forecasting non-cash costs of £11 million in relation to the revaluation. The actual impact was a charge of £13 million.

There are a variety of ways in which information is monitored and reported to management, including *ad hoc* reporting, quarterly balance sheet reporting and mid-year reviews.

From 2009-10 onwards, Scottish Enterprise is adopting full zero-based budgeting. The aims of this are to:

- build a proposal for resource allocation;
- identify drivers for making resource decisions; and
- develop a framework for prioritisation.

Adoption of this approach is consistent with best practice across the public and private sectors and should ensure that:

- Scottish Enterprise's business plan reflects its new operating structure;
- efficiency savings are identified; and
- limited resources are used to maximise agreed outcomes.

Efficiency savings

The Scottish Government issued the *efficient government programme for 2008-09 – 2010-11*, which provides details on the background, its application in various sectors, the types of savings and the method of reporting efficiencies.

Scottish Enterprise had a target to deliver efficiency savings of £7.7 million in 2008-09. These savings were achieved through the restructuring programme initiated in 2007-08. Management reduced costs by £8 million in 2008-09, out-performing the Efficient Government target of 2%. Further reductions of at least 2% per annum will be required in the next two years; generating a cumulative saving of £37 million over the period 2008-11. These savings will arise primarily from a reduction in staff costs. Further savings of £4 million per year will be generated from a rationalisation of operational properties.

During 2008-09 Scottish Enterprise bought out employees' benefits in relation to its car scheme at a cost £3.6 million, which is included in the 2008-09 accounts. Management anticipates savings of around £1 million per year as a result.

Financial management (continued)

Financial planning

In March 2009 the executive board approved the 2009-12 business plan, which includes a balanced budget for 2009-10. Significant work was undertaken to develop detailed project budgets for 2009-10 in support of the business plan focus. The 2009-10 business plan anticipates a cash allocation of £319 million.

Achievement of the business plan in 2009-10 will be challenging due to the economic uncertainty facing Scottish Enterprise's customers in the year ahead. The business plan includes a 14 point action plan in response to the economic downturn.

Summarised below is Scottish Enterprise's planned expenditure across its three themes in 2009-10, including a comparison to 2008-09.

£'000	2009-10 business plan	2008-09 business plan
Enterprise	54,600	63,000
Innovation	74,000	89,000
Investment	113,400	82,000
Customer facing staff	43,800	40,000
Total delivery	285,800	274,000
Research and development	2,400	6,000
Premises, information services and support costs	30,800	29,000
Total planned cash spend	**319,000**	309,000

Expenditure to 31 May 2009 totalled £34.2 million, amounting to 10.7% of the planned cash spend for 2009-10, which is in line with the spend profile in previous years. An increasing proportion of spend is demand led and can be subject to the vagaries of external factors. Management has greater transparency of spend behaviours than in previous years and this should allow them to continue to improve the overall management of resources.

Management arrangements

Workforce management

Scottish Enterprise places a great emphasis on a culture of reward based on individual and organisational performance, robust management practices and continuous development. As an *Investor in People* management ensures all staff are clear on their roles and how they play their part in business delivery. Performance and reward strategies aim to ensure that Scottish Enterprise motivates its people based on their contribution and these strategies are reviewed and refreshed within the context of Government guidelines.

Management believes that effective employee communications and engagement enhances productivity, reduces absence and improves customer relationships. Scottish Enterprise is committed to open, timely and effective employee communications through regular cascade briefings, staff emails, intranet updates and leadership question and answer sessions.

Scottish Enterprise's human resource team manages all employee and industrial relations and has an employee relations framework, which comprises a joint consultation and negotiation committee supported by sub-groups on terms and conditions, pay and pensions. These provide an opportunity for recognised trade unions to negotiate and consult with human resources and management representatives on a range of topics and issues, including consultation on and negotiation of change programmes and job reductions. The human resource team manages all employee relations issues, both formal and informal, and designs and supports all major change programmes.

Significant changes were made to the staffing structure during 2007-08 as part of the organisational restructuring. An approved voluntary severance programme was implemented and was open to all staff. In total, 257 members of staff applied and were accepted for voluntary severance. Of these, 174 members of staff left in 2008-09, with the remaining 83 leaving during 2009-10. Combined with previous programmes, Scottish Enterprise recognised costs of £8 million in the year ended 31 March 2007, £26 million in 2008 and £2 million in the current year.

In January 2009 a restriction on recruitment was implemented, with only business critical posts being filled once approved by the executive board. This restriction on recruitment was implemented for two reasons. Firstly, due to the ongoing restructuring exercise and, secondly, the ongoing need to reduce salary costs in line with the three year business plan.

The car benefit scheme involved employees being paid a set amount, dependant on their grade, towards a car lease. Scottish Enterprise was liable for the road tax, insurance and maintenance costs of the cars. In January 2009 it was communicated to employees that Scottish Enterprise would buy out this taxable, contributory benefit, the cost of which was based on three years net payment. A charge of £3.4 million is reflected in the 2008-09 accounts in line with the requirement in accounting standards to recognise an obligation at the time a formal decision is made. Reasons supporting the change include consideration of Scottish Enterprise's environmental strategy. Management estimates that the annual cost of providing the car benefit was £1 million and the payback period is just over three years.

A further voluntary severance programme was launched in March 2009 with the intention of achieving savings over the current spending review period. Scottish Government approval has been received for costs up to £10 million. Management's current estimate is around £5 million.

Management arrangements (continued)

Procurement

Robust procurement arrangements are now an important element in Scottish Enterprise's responsibilities for ensuring compliance with all relevant guidance over financial transactions, including compliance with European Union obligations. All contracts greater than £50,000 are subject to tender through Scottish Enterprise's procurement shared service. Sample testing by us and internal audit during the year did not identify any significant deficiencies.

Partnership working

The Scottish Government actively encourages public sector bodies to work closely together to ensure that there is an integrated approach to meeting the objectives of its economic strategy. The chief executive has a specific responsibility to ensure that arrangements have been established to secure Best Value. Joint working is one of nine key characteristics of Best Value. The majority of Scottish Enterprise's plans are delivered jointly with business customers, academia, industry and other parts of the public sector. Following the restructuring of and ongoing constraints on Scottish Enterprise's budget, the proportion of projects with partners where Scottish Enterprise does not take the lead has increased from prior years. Management believes this potentially increases Scottish Enterprise's risk profile and internal audit will consider this as part of their review of priority projects and key project controls in 2009-10.

Management has reported that significant partnerships include the following:

- close collaboration with partners on the Strategic Forum, including Scottish Government, Highlands and Islands Enterprise, VisitScotland, Skills Development Scotland and the Scottish Funding Council, in order to provide clear ministerial leadership and promote greater integration and collaboration;
- engaging actively in community planning with local authorities in the development and delivery of single outcome agreements;
- continuing to work closely with lead local authorities on the development of Business Gateway to ensure a seamless service for companies wishing to access the range of business support available across the public sector;
- supporting Skills Development Scotland's lead role in delivering *Partnership Action for Continuing Employment*, the Scottish employer service and industry skills gateways for employers, which aims to identify ways in which companies facing financial difficulties can minimise job losses and, where this is unavoidable, to provide support to employees when organisations announce redundancies;
- complementing VisitScotland's work on maximising the economic value of the Scottish brand, providing information for visitors and quality assurance to the visitor and to the industry;
- working closely with the Scottish Funding Council on stimulating the relationship between Scottish business, universities and colleges;
- pooling resources and expertise with the Scottish Environment Protection Agency in two key areas to stimulate sustainable economic growth in Scotland. Firstly, improving advice on environmental legislation to boost business competitiveness and, secondly, using new technologies to generate power, reduce power consumption and recycle waste, and offer technology companies new opportunities in growth markets; and
- close working relationship with Highlands and Islands Enterprise and development of shared approaches to support for high growth companies, the development of key sectors under the guidance of the industry advisory groups and the work of Scottish Development International in securing greater international trade and investment opportunities for Scotland.

Governance and accountability

The statement on internal control does not disclose any significant weaknesses. The content of the statement is consistent with our understanding of Scottish Enterprise.

Internal audit has completed its agreed plan for the year and concluded that the work carried out identifies a satisfactory level of assurance in the areas reviewed.

The majority of key financial controls are designed appropriately and operating effectively.

Scottish Enterprise has a fraud and irregularities response plan in place. This sets out what to do if fraud or any other irregularity is suspected. The plan forms part of Scottish Enterprise's procedures for handling suspicions, allegations or evidence of fraud or other irregularities in the group. There was no material instances of fraud reported during 2008-09.

Management have established informal procedures to consider individual Audit Scotland national reports.

Recommendations

We did not identify any significant recommendations for development in governance and accountability arrangements.

Corporate governance arrangements

Introduction

Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all bodies.

Through its chief executive, Scottish Enterprise is responsible for establishing arrangements for ensuring the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. The *Code* requires auditors to review and report on corporate governance arrangements as they relate to:

- Scottish Enterprise's reviews of its systems of internal control, including its reporting arrangements;
- the prevention and detection of fraud and irregularity; and
- standards of conduct and arrangements for the prevention and detection of corruption.

Governance framework

The Scottish Ministers appoint executive board members who, with the exception of the chief executive, do not hold contracts with Scottish Enterprise. Subject to financial limits, a memorandum of delegated authority gives the chief executive authority for all functions. Where the executive board has delegated responsibility or decision-making power to the chief executive or a sub-committee, this is included in a memorandum of delegated authority or the terms of reference for the relevant sub-committee. There are six sub-committees: audit, operations, investment, performance, nominations and remuneration.

We considered the corporate governance arrangements, which, combined with the work of internal audit, have concluded that the corporate governance framework has been designed and implemented appropriately.

Statement on internal control

The statement for 2008-09 provides details of the internal control environment and risk management and control framework. Management highlights that the system of internal control is based on an ongoing process designed to identify the principal risks to the achievement of the organisation's policies, aims and objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively and economically. The statement identifies that a number of processes have been established to allow the accountable officer to review the effectiveness of the systems of internal control. These include corporate risk arrangements, internal audit and an internal control assessment framework.

The internal controls assessment framework complements risk management and internal audit arrangements and requires each significant business unit to submit signed statements of assurance to the chief executive. Significant business units include all internal business units and significant subsidiaries. The basis of this review is a detailed internal control checklist that provides the context for the business unit leader to sign the local assurance certificate. Internal audit coordinated this process and the results were formally reported to the audit committee at the time of consideration of the accounts.

Corporate governance arrangements (continued)

Expenses

Scottish Enterprise has a comprehensive expenses policy, which is supported by internal validation procedures. The policy does not specify maximum hotel rates outside the UK, but management considers the general requirements to exercise good judgement and prudence with regard to business expenses to be sufficient in this area. Testing of the policy's operation on a sample basis identified a small number of instances where claims had been paid for UK hotel accommodation in excess of pre-defined thresholds and where travel had been booked outwith Scottish Enterprise's appointed travel organisers. We suggest that these matters are considered in a future review of the policy.

Internal audit

Our planned audit approach seeks, wherever possible, to place reliance on the work completed by internal audit to minimise duplication of effort and ensure maximum benefit from the combined audit resource. In accordance with our audit plan overview we placed reliance on the following areas of work audited internally:

- governance arrangements;
- key project controls;
- European funding;
- ITI Scotland;
- contractors / consultants;
- ICT reviews;
- risk management;
- conflicts of interest;
- budgetary control and reporting;
- payroll;
- shared services; and
- follow-up of prior year actions.

Internal controls

Our testing, combined with that of internal audit, of the design and operation of controls over significant risk points confirms that, with the exception of some minor weaknesses over fixed assets, purchasing, income and payroll, controls are designed appropriately and operating effectively.

The statement on internal control provides details of the purpose of the system of internal control, the risk and control framework and the effectiveness of this framework. The statement complies with the Scottish Government's guidance.

Corporate governance arrangements (continued)

Equality and diversity

As a public body Scottish Enterprise is legally required to be proactive in pursuit of equality in relation to race, disability and gender. In anticipation of future requirements, Scottish Enterprise published a single equality scheme in November 2008. This scheme outlines the process for completing equality impact assessments on past and future projects. Progress in completing these assessments will be reported to the executive board on a six-monthly basis.

Prevention and detection of fraud and irregularity

A fraud and irregularities response plan sets out what to do if fraud or any other irregularity is suspected. The plan forms part of Scottish Enterprise's procedures for handling suspicions, allegations or evidence of fraud or other irregularities.

There is a formal whistle-blowing policy governing the procedures to be followed in the event of a fraud or suspected fraud. Where management is made aware of a suspected fraud, the internal fraud response group is convened to co-ordinate an investigation. Attendance at the fraud response group depends on the nature of the alleged fraud, but will usually include senior management from finance, human resources and internal audit.

Significant frauds are reported to the audit committee on a quarterly basis.

There were no material instances of fraud reported during 2008-09.

Audit Scotland national reports

Audit Scotland periodically undertakes national studies on topics relevant to the performance of central government bodies. While the recommendations from some of the studies may have a national application, elements of the recommendations are also capable of implementation at local level, as appropriate.

Management has established procedures to consider individual reports. Internal audit monitors all Audit Scotland reports on an ongoing basis and ensures that management, as necessary, are aware of recommendations which may impact Scottish Enterprise. This involves performing a self assessment and developing a local action plan for the areas requiring attention. Following internal audit's reporting, management is responsible for ensuring that appropriate action is undertaken in relation to the recommendations. The applicable recommendations will be independently assessed as part of the ongoing internal audit process.

We submitted short returns to Audit Scotland in February and July 2009 on Scottish Enterprise's responses and have summarised these below.

Report topic (issue date)	**Discussed by a committee**	**Noted by a committee**	**Self-assessment performed**	**Local action plan prepared**	**Plans to feed back to a committee**	**Frequency of feedback**
Review of major capital projects in Scotland (June 2008)	✓	✗	✓	✓	1	1
Improving energy efficiency (December 2008)	✓	✓	✓	✓	1	1
Central government's use of consultancy services (January 2009)	✗	✗	✓	✓	1	1

1. Feedback is only provided to a committee on an exceptions basis

Performance

Management achieved efficiency savings of £8 million, primarily as a result of the restructuring programme initiated in 2007-08. In addition, annual recurring savings of £0.5 million were achieved through lower property, maintenance and print costs. Management monitors progress against efficiency targets and communicates performance to the Scottish Government.

Scottish Enterprise will continue to be subject to achieving continued recurring efficiency savings of 2% in future years.

During 2008-09 Scottish Enterprise bought out employees' benefits in relation to the car scheme. This amounted to a cost in the 2008-09 accounts of £3.6 million, however Scottish Enterprise believe this will result in savings of around £1 million per annum.

Management is continuing to assess progress against the Best Value action plan implemented in 2007-08.

Recommendations

We did not identify any significant recommendations for development in performance management arrangements.

Performance management

Performance management arrangements

Scottish Enterprise's corporate performance team reports directly to the director of finance and performance. The director of finance and performance produces corporate reports which are presented to the executive board on a monthly basis.

Performance against targets in 2008-09

The business plan for 2009-12, approved by the executive board in March 2009, outlined the key performance measures against which the plan would be monitored. The table below shows the actual performance for 2008-09 against the published target ranges.

Measure	2008-09 Actual	Target range	Within or exceeded range
Outcomes			
Growth businesses supported	1,908	1,900 - 2,100	✓
Additional turnover growth in businesses supported	£930m	£400m - £600m	✓
Growth businesses increasing their turnover by £1 million or more in the previous three years	577	800 - 1,000	✗
Planned jobs through inward investment of a high value nature	1,807	1,800 - 2,400	✓
Outputs			
Major high growth start-ups (including spin outs) with potential to reach a value of £5 million in three years	17	18 - 23	✗
Investment in research and development by supported businesses	£103m	£50m - £60m	✓
Activities			
Private sector leverage invested per deal through Scottish Enterprise investment	1:2.55	1:2 to 1:3	✓

Scottish Enterprise attributes the cause of not achieving all targets to the current economic conditions. Scottish Enterprise invested more in research and development businesses as management believes that increasing levels of innovation will help support businesses through the current economic challenges. Finally management note that the major high growth start-ups target was not achieved due to the slowing and withdrawal of private investment as a result of current economic conditions.

Performance management (continued)

Public performance reporting

Scottish Enterprise published its business plan for 2009-12 on their external website for public access. Members of the public are also able to obtain copies of the annual review, annual report and accounts from the website. Executive board meeting minutes are available from the website, but from our review of executive board meeting minutes, the majority of these refer to papers which were discussed during the meeting and these papers are not accessible by the public. It is recommended that these papers are also made available alongside the meeting minutes for the public to obtain a better understanding of the issues discussed at executive board meetings.

Best Value

In 2007-08 management updated the self-assessment questionnaire issued by the Scottish Government for use by public sector organisations. The self-assessment questionnaire showed that Scottish Enterprise is now ‘well developed’ in seven of the nine areas and ‘under development’ in the remaining two (sustainable development and equal opportunities). In order to continue embedding Best Value in the organisation, internal audit considered the two areas previously reported as ‘under development’ in their 2008-09 audit plan. Reports issued as a result of this work highlighted that:

- Equal opportunities – Scottish Enterprise has made progress is implementing appropriate arrangements, including developing an equal opportunities toolkit, which is available to all staff, and incorporating equality duties into the project life cycle approval process, but some areas still require management attention. In particular, the one ‘grade A’ recommendation suggests that impact assessments should be carried out and published for all new policies and functions relating to equal opportunities. There are also six ‘grade B’ recommendations. Overall, the review is graded ‘three’ on the scale of one to five.
- Sustainable development – Management has significantly developed this area in recent years, visible both externally, through embedding sustainable development in projects and programmes, and internally, through corporate waste management initiatives and implementation of a new print management contract. There are no ‘grade A’ recommendations, but the report includes five ‘grade B’ and eight ‘grade C’ recommendations. Overall, this review is also graded ‘three’.

Audit Scotland is currently scoping the remit for a review of enterprise funding streams. This will involve Scottish Enterprise and Highlands and Islands Enterprise. The study is likely to focus on the outcomes achieved as a result of several different funding streams and how the enterprise agencies use evidence – particularly evaluations – to decide which new streams to fund.

Appendix one – action plan

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

No.	Issue and recommendation	Management response	Officer and due date
1	The Deed of Participation admitting Skills Development Scotland as a participating employer to the Scottish Enterprise Pension and Life Assurance Scheme does not address how to determine and account for the assets and liabilities of the Scheme relating to Skills Development Scotland's employees former participation in the Scheme, as employees of Scottish Enterprise. It is important that management work with Skills Development Scotland and the Trustees of the Scheme to clarify the basis of Skills Development Scotland's participation in the Scheme without further delay. (*Grade one*)	Agreed.	Human resources director 31 December 2009
2	Management did not submit a restated opening balance sheet by the 28 November 2008 deadline and this has not been received at the time of this report. While management has made some progress in considering tangible fixed assets, leases, and investments, significant progress is still required during the period to 30 November 2009. (*Grade two*)	Agreed.	Director of finance and information systems 30 September 2009