



INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

The Skills Development Scotland Co. Limited

Annual audit report to Skills Development Scotland
and the Auditor General for Scotland

Year ended 31 March 2010

9 December 2010

AUDIT

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

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

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

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

The timescales within which the organisation was established resulted in a number of challenges for management during the first year of operations, particularly in relation to governance and risk management arrangements, workforce management and financial reporting. In Skills Development Scotland's second full year of operations, management progressed harmonisation of operating structures and arrangements, creating six distinct directorates, and related policies. A number of key governance policies were successfully implemented, but some critical policies remain outstanding.

A procurement policy was approved by the board during the year. Our testing identified that management authorised one non-competitive action during the year and one contract was granted without adhering to the procurement policy.

Management are committed to building successful partnership working arrangements and Skills Development Scotland managed the IT collaboration / outsourcing project on behalf of Scottish Enterprise and itself during the year. As of 1 April 2010 IT services have been provided to both organisations by ATOS Origin which should lead to service improvements. The memorandum of understanding setting out the terms of the collaboration with Scottish Enterprise has yet to be finalised.

The financial statements were produced in compliance with International Financial Reporting Standards for the first time for the year ended 31 March 2010. We completed work on the "shadow accounts" as part of the process and made a number of recommendations. All recommendations made in this work have been considered and appropriately concluded by management.

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 second of our three-year appointment by the Auditor General for Scotland as external auditors of The Skills Development Scotland Co. Limited. This report to Skills Development Scotland and Auditor General provides our opinion and conclusions and highlights 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 earlier in the year.

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

- the **financial statements** 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 2010 and financial plans for 2010-11 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 Skills Development Scotland'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). There was no mandatory requirement for toolkits to be applied or for external audit involvement in central government bodies in 2009-10.

International financial reporting standards

The 2007 Budget 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 ("FReM"). The financial statements for the year ended 31 March 2010, including comparative figures for 2008-09, were prepared on the basis of the FReM.

Responsibilities of Skills Development Scotland and its auditors

External auditors do not act as a substitute for Skills Development Scotland'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.

Acknowledgement

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

Governance and accountability

Management has continued to develop the processes and procedures, including those in relation to governance and accountability. However, some arrangements have not been updated and remain those inherited from the legacy organisations. Management is in the process of moulding the structure of the organisation to ensure suitable and appropriate for its function. During the year this included aligning operations into six individual directorates, each of which report directly to the strategic management team .

In October 2009 an independent review was undertaken on the effectiveness of the current board and related governance arrangements. The review focussed on five key areas:

- relationships,
- information flows;
- capabilities;
- risk management; and
- governance structures.

The resulting report raised recommendations in each of these areas. The major findings of the review were that there should be a greater skill set amongst the members of the board, and that management should consider implementation of a revised committee structure. A plan, including a timetable, has been put in place to act on each recommendation. Four new board members were appointed on 1 August 2010 to cover planned retirements and expand board capacity, reflecting a need for expertise and a greater breadth of skills. It is management's intention to review and seek board approval for changes to the committee structure.

The "*Corporate Plan 2010-12*" was submitted to the Scottish Government in January 2010 and has three main goals linked to the Skills Development Scotland mission statement. Terms of reference have been put in place for the heads of the six directorates and each will have the obligation to monitor performance against budget in the future. The director of finance and audit reports on financial performance to the board and the senior management team on a monthly basis. Accruals-based management accounts are produced on a monthly basis to monitor financial performance and, at the year end, further analysis is produced on a cash-basis to manage grant-in-aid draw-downs.

Risk management

The risk register was revised during the year, following a session led by Skills Development Scotland's internal auditors. Management intend to build a risk management framework around this that will be incorporated into the corporate and operating plans. Risk is now a standing item at each board meeting and that a performance management officer has been appointed to assess the risks to the organisation and the manner by and extent to which management has mitigated them.

Information management

As a result of legacy arrangements, management considers that it did not have full control over information management arrangements during the year. This was due to the existing shared service arrangements and a consequent reliance on partner organisations.

Following a business review and competitive tendering exercise, a new outsourced IT services contract with Atos Origin commenced on 1 April 2010. This arrangement has been established jointly with Scottish Enterprise and should allow management to manage risks in this area more effectively. In June 2010 internal audit performed an ICT health check review of the new arrangements. The review did not identify any major weaknesses in operational controls within the organisation as they relate to the Atos Origin contract and concluded that processes are maturing. Skills Development Scotland's legacy information strategy is considered ineffective and management has begun a project that will produce more effective arrangements.

People management and equality

There was no overall performance management system for staff in place at the beginning of the year. A temporary system for staff appraisals was introduced during the year, with a full system to be implemented in 2010-11. All human resources policies have been produced in accordance with Advisory Conciliation and Advisory Standards principles. Skills Development Scotland is committed to equality with an equality champion on the board and an equalities statement in place and available for reference on the organisation's intranet. There is also an equality reference group chaired by the director of human resources and ongoing cultural and disability awareness training.

Procurement

As with other public sector organisations, Skills Development Scotland has been required to embed efficiency since its formation in order to comply with efficient government initiatives. This is achieved through budgetary control and effective utilisation of the discretionary element of its budget. A procurement strategy has been established and a procurement policy was implemented during the year, the effectiveness of which will be reviewed by internal audit during 2010-11. Efficient government returns are submitted to the Scottish Government on a quarterly basis.

Skills Development Scotland is currently unable to demonstrate its contribution towards sustainability, although the corporate and operating plans include a goal for the organisation to be greener in the future.

Performance management

A number of key performance indicators were set at the beginning of the year, and progress towards them is reported to the board on a regular basis. Management has commenced work on a performance management framework, and a head of performance has been appointed, reporting on the progress of the framework to the board. Management are committed to challenge and improvement; this has been demonstrated in a number of ways, particularly in the restructuring of the organisation and the board effectiveness review.

Partnership working

The organisation has effective partnership working arrangements in place, the most notable of which are the shared service arrangements with Scottish Enterprise and day-to-day dealings with education and training providers. Senior management's overall ethos is continual improvement of the service provided to the organisation's customers which necessitates strong partnership working.

On 9 December 2010 we issued an unqualified opinion on the financial statements and the regularity of transactions reflected in those statements.

We have addressed all key risk areas as documented in our audit plan overview and did not identify any other significant issues that would impact our audit opinion.

Key issues arising from our audit of the financial statements were in relation to retirement benefits and the conversion to IFRS.

Our opinion on the regularity of transactions in the financial statements is unqualified.

Recommendations

The action plan includes recommendations to improve the following areas.

Area for development	Action plan reference
Harmonised employee performance arrangements should be formally implemented across the organisation.	One
All employees should be issued with Skills Development Scotland contracts of employment.	Two
A formal agreement should be put in place with Scottish Enterprise in relation to the arrangements for recharging costs attached to the IT collaboration.	Three
In accordance with the board effectiveness review, the committee structure of the organisation should be reviewed when the new board members are recruited.	Four

Reporting arrangements and timetable

We received a draft of Skills Development Scotland financial statements on 17 May 2010, as agreed in our audit timetable. The draft statements were generally well prepared. Management provided the remuneration report on the same date, and only minor adjustments were required to enhance reporting. The management commentary was not received until 20 July 2010.

Accounting adjustments were required to correct the financial statements, but we note the improvement on the 2008-09 audit. There was however no overall effect of these adjustments on the outturn for the year.

Audit opinion

On 9 December 2010 we issued an audit report expressing unqualified opinions on the financial statements for the year ended 31 March 2010 and on the regularity of transactions reflected in those financial statements.

Key issues arising during our audit of the accounts

Our audit plan overview and interim management report identified seven key risk areas, four of which were in relation to the financial statements, two in relation to IT and one in relation to governance and risk management. We have concluded our work in each of these areas. In respect of the financial statements, the three key areas of judgement related to the accounting for retirement benefit obligations, revenue recognition in relation to grant-in-aid and the change in accounting framework, from UK GAAP to IFRS. We also performed increased work around payroll costs and systems due to identified control deficiencies.

Retirement benefit obligations

Skills Development Scotland continues to account for employees' participation in a number of different pension schemes. The financial statements have been prepared consistently with those of the prior year and the actuarial assumptions used to calculate the obligations for each of the schemes are consistent.

As part of the harmonisation of employee benefits, terms and conditions, management intend to rationalise the pension schemes available to employees. The board of Skills Development Scotland appointed a project team in August 2009 to investigate the options available to the organisation for the harmonisation of pension arrangements. The project team appraised the relevant options available to the organisation, and it was decided to harmonise the existing pension schemes into two local government schemes – the Highlands Pension Fund and the Strathclyde Pension Fund – which are future service benefit funds.

Employees currently participating in one of the other existing arrangements will be given the option to transfer to the Strathclyde Pension Fund in 2010-11. Skills Development Scotland obtained agreement from the Scottish Government for additional funding of £6 million to cover the anticipated shortfall between the transfer values of the assets and the related liabilities in each of the various schemes when they are eventually transferred.

For employees who transferred from Scottish Enterprise to Skills Development Scotland on 1 April 2008, management continues to account for only the element of assets and liabilities in relation to service post 1 April 2008. At the year end, the assets and liabilities in relation to pre 1 April 2008 service of these employees remained with Scottish Enterprise.

Application of International Financial Reporting Standards

The Scottish Government announced on 25 April 2008 that all Scottish Government departments, executive agencies, non-departmental public bodies and health boards would report under IFRS from 2009-10, necessitating the restatement of comparative information under new accounting policies.

In our annual audit report for the year ended 31 March 2009, we recommended that management implement an action plan in order to prepare a local timetable to ensure that the timetable issued by the Scottish Government was met. Management submitted "shadow" 2008-09 accounts for review in line with the agreed timetable and on conclusion of our work we issued a report with a number of areas where further consideration was required. All such areas were fully considered and conclusions determined prior to commencing our final audit procedures.

The most significant change as a result of the change to IFRS has been the overall format and presentation of the financial statements. As a result of the adoption of revised accounting policies, an accrual for employee's untaken annual leave at each year end has been recognised.

Audit opinions and key issues; regularity (continued)

Organisational restructuring

The voluntary severance scheme commenced in the prior year was completed during 2009-10. During the year, 155 employees left the organisation at a total cost to the organisation of £12 million, equal to an average cost per employee of £78,000. The expected payback for the organisation in terms of ongoing cost savings is approximately 18 months; management expects to make cost savings amounting to around £6.4 million per annum.

Testing of the controls and arrangements surrounding the scheme during our interim audit fieldwork identified that the controls over approvals and payments had been implemented as expected and we reported no deficiencies in our interim management report. Following completion in the year, the scheme was closed on 31 March 2010 from the Scottish Government.

Regularity of transactions

We updated our understanding of the framework under which Skills Development Scotland operates and reviewed the design, implementation and operating effectiveness of the controls over project initiation, appraisal and approval of Skills Development Scotland projects, and of its contracting and consultant arrangements. Further detail on these are given under procurement later in this report.

We considered the controls around how Skills Development Scotland receives and distributes circulars and guidance from the Scottish Government and other regulatory bodies. Testing during interim audit fieldwork identified that there was no process in place for Scottish Government circulars. However, management have since implemented a process whereby any guidance received is documented by a staff member and placed on the organisation's intranet for reference.

Reliance was placed on the work and conclusions from Skills Development Scotland's compliance services team that expenditure incurred on the national training programmes and individual learning accounts has been incurred within the terms of related contractual arrangements. The compliance services team identified potential overpayments of up to £335,000. We do not believe this is material.

We satisfactorily applied statistical sampling methods in accordance with International Standard on Auditing 530 *Audit sampling and other selective testing procedures*, to test a sample of expenditure items to ensure that expenditure had been incurred properly.

Our testing around the controls in relation to financial circulars from the Scottish Government found that the controls have been designed and implemented appropriately, and that they have been operating effectively.

Skills Development Scotland recorded a surplus of £8.4 million for the year ended 31 March 2010. The organisation has been allocated a total budget of £209.5 million in grant-in-aid for the year ending 31 March 2011.

An operating plan for 2010-11 and a corporate plan covering the period from 2010 to 2012 were submitted to the Scottish Government in January 2010.

Skills Development Scotland achieved its efficiency savings target of £12 million for 2009-10. The efficiency target for 2010-11 has been increased to £19 million.

A procurement policy was implemented during the year, and the procurement and finance departments have conducted procurement and finance 'roadshows' in order to further educate employees about the issues around procurement and finance.

Management have implemented a process for receiving, processing and monitoring Scottish Government circulars during the year. Any relevant Audit Scotland reports are reviewed, but these are not yet considered formally at board level.

Skills Development Scotland has close working relationships with other public sector organisations, which has been highlighted by the organisation managing the IT collaboration project between Scottish Enterprise and itself.

Financial position

Total grant-in-aid drawdown has increased over the prior year primarily due to funding received for the voluntary severance scheme completed during the year, the additional budget allocation for modern apprenticeships and the timing of draw down requests in line with cash spend requirements.

The original budget for modern apprenticeships was £16 million, but only £12 million was drawn down as the organisation exceeded target levels comfortably within budgeted costs. Accrued income has decreased as amounts accrued in 2008-09 were received in the year.

Operating expenditure has increased due to the voluntary severance programme and costs for the additional modern apprenticeships.

Cost of sales has increased due to the setup costs for the IT project incurred in the year. Administrative expenses have increased primarily due to the additional expense in moving the head office location to Atlantic Quay, Glasgow. Finance income has reduced due to lower interest rates. Finance costs have increased from the increase in the pension interest costs due to the increase in the pension liability.

Preparation of the financial statements in accordance with IFRS, the FReM and the Companies Act 2006 has resulted in a surplus being reflected for the year. In line with other NDPB's, grant-in-aid is recognised as it is physically drawn-down, other than specific elements awarded to a specific year which will not be required in cash terms until a future date. This includes specific income in relation to retirement benefit obligations. Unincorporated NDPB's recognise this income as a movement in equity (as specified in the FReM). However, as an incorporated entity, Skills Development Scotland must follow the Companies Act and accordingly reflects grant-in-aid as turnover in the statement of income. This can result in the creation of a surplus (in 2009-10) or a deficit (as in 2008-09) as expenditure is accounted for in the period to which it relates rather than the period in which it is settled.

Financial management and budgetary control

The finance team and senior management were responsible for setting the 2009-10 budget. The process was based on meetings with the then recently appointed directorate heads and consideration of financial performance in 2008-09, projected salary increases, and operational expenditure plans based on projections submitted by national training programme project managers. A programme of regular meetings between finance management and directorate heads was established to consider performance against the budget.

Statement of income	2009-10 £'000	2008-09 £'000	Variance £'000
Grant in aid received	203.0	176.9	26.1
Add: accrued income	-	1.6	(1.6)
Careers Scotland invoicing	3.1	3.9	(0.8)
Other income	4.2	1.3	2.9
Total income	210.3	183.7	26.6
Operating expenditure	(172.3)	(161.8)	(10.5)
Cost of sales	(7.4)	(4.3)	(3.1)
Administrative expenses	(20.9)	(20.2)	(0.7)
Total expenditure	(200.6)	(186.3)	(14.3)
Finance income	0.1	0.8	(0.7)
Finance costs	(1.4)	(0.6)	(0.8)
Income tax expense	-	(0.2)	0.2
Surplus	8.4	(2.5)	10.9

Source: Audit working papers

Financial management and budgetary control (continued)

The main movements against the 2009-10 budget were as follows:

- decreased income drawn-down which was not required in year in relation to modern apprenticeships, offset to an extent by increased income from recharges to Scottish Enterprise for IT collaboration; and
- Increased expenditure on national training programmes and business enhancement projects as a result of activity levels.

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. The efficiency saving target for the organisation for 2009-10 amounted to £12 million (roughly 6% of income). The efficiency target was incorporated into the annual budget and the target effectively reflected the savings required from the legacy organisations which made up the organisation against a 'base-line' budget from costs in those organisations. As the savings were incorporated into the budget, the targets would be met, were the organisation to meet or exceed its budget.

The organisation submits quarterly efficient government reports to its sponsor department at the Scottish Government. The sponsor department has confirmed that the reports have been allocated a 'green' status, which essentially means that the organisation has achieved its efficiency savings target.

The efficiency target set for 2010-11 is £19 million (9%), and has again been incorporated into the annual budget for the year. Any income not included in the base-line budgets, eg modern apprenticeships, aids in meeting these targets as they result in the relatively fixed staff costs being spread over a greater level of operations, ie. the element allocated to legacy business is reduced.

Financial planning*

Management has budgeted a break even position for 2010-11. Zero based budgeting has not been adopted due to the nature of the business model operated by Skills Development Scotland. A large proportion of the costs, such as national training programmes and staff costs, are semi-fixed, hence there is an immediate requirement for resource. The budget has been prepared largely on a cash accounting basis; the variation from an accruals basis is however not significant.

In January 2010 the board approved the *2010-12 Corporate plan* and an *Annual Operating Plan*, which includes a budget 2010-11. Significant work was undertaken by management in holding meetings with the heads of the six directorates within the organisation in order to produce this. The 2010-11 business plan anticipates a total cash allocation of £209.5 million. The processes involved in setting the budget have been highlighted previously.

The achievement of the 2010-11 business plan will be challenging for the organisation due to a number of factors. These include the anticipated cost saving exercise being undertaken by the UK Government, achievement of the £19 million efficiency savings allocated to the organisation and the continuing high levels of unemployment in the country which is expected to lead to an increase in demand for Skills Development Scotland's services.

* Note: references in this report to financial planning and budgets refer to the budget that was in place and approved at 25 August 2010.

Financial management (continued)

Financial planning (continued)

The table shows the budgeted expenditure profile for 2010-11.

Expenditure to 31 May 2010 totalled £24.09 million, amounting to 11.5% of the planned expenditure for 2010-11, and £60,000 lower than originally budgeted. Staff costs have been £520,000 lower than budget due to vacant positions not being filled and infrastructure and management costs have been £384,000 lower than budgeted due to a number of rent and rates invoices not being received by the organisation due to timing differences. This is offset by expenditure on national training programmes exceeding budget by £1.429 million, predominately due to an increase in modern apprenticeship enrolment.

Budgets	2010-11 £'000	2009-10 £'000
National training programmes	113,000	117,750
Business enhancement projects	17,000	10,588
Staff costs and salaries	48,870	49,622
Infrastructure, management and administration	13,000	10,957
Information technology and systems	5,200	4,047
Individual learning accounts Scotland	12,000	11,000
Other invoicing	430	-
Total planned cash spend	209,500	203,964

Source: Skills Development Scotland

Management considers that it is not currently possible to budget for the impact of any future cuts in funding levels due to uncertainties as to how they may be allocated. However, management is undertaking high-level financial scenario planning to consider possible actions to that could be undertaken to reduce costs and the related impact of these. This is likely to result in a number of options being identified that could be implemented if required. It is noted that any significant reductions in funding would inevitably result in reductions in the services delivered.

Workforce management

All human resource matters are dealt with by the organisation's dedicated human resources department. All human resource policies in place, for example the harassment and grievance policies, have been implemented in full accordance with Advisory Conciliation and Arbitration Standard principles and have been implemented with due input from the trade unions.

During the year there was no formal employee appraisal arrangements; the delay in implementing a formal policy has been caused by the complexities around the legacy contracts, as all employees must be on the same contract before an effective performance management policy can be implemented. However, interim staff review arrangements were conducted during the year, and the human resources department are currently investigating the most effective appraisal policy to be introduced within the organisation for 2010-11.

Our testing identified that employees are still contracted under the terms of their old, legacy arrangements. Management believe that any potential legal issues in relation to this, for example any future equal pay claims, have been mitigated by the equal pay exercise completed in 2008-09, the harmonisation of pension arrangements during 2010-11 and the introduction of job grading evaluations.

Our annual audit report for the prior year highlighted a restriction on recruiting that had been introduced during that year. The restriction has generally remained in place, but some recruitment has been permitted on a case by case basis where the head of the directorate recruiting could demonstrate to the strategic management team that the appointment was business critical.

Procurement

Management implemented a procurement policy in January 2010 and the procurement team, in conjunction with finance, has conducted 'roadshows' for employees, stressing the need to comply with the approved procurement policy at all times. In addition, brief desktop guides have been produced and distributed to relevant employees within the organisation. We believe the processes and systems in place around procurement have been strengthened in comparison to the prior year, although testing identified some weaknesses in the operating effectiveness of these controls. In part, this was due to inherited arrangements.

During the year, an anonymous allegation was made to Audit Scotland, raising concerns over the award of contracts by Skills Development Scotland to a company during 2008-09 supporting its revised information management arrangements. A number of specific allegations were made stating that this company was awarded work without appropriate tendering processes being followed.

Having discussed the allegations with management and obtained documentary evidence over a somewhat protracted period of time, no evidence was found to support a number of the allegations. However, we concluded that proper tendering processes were not followed for an initial contract of £105,000 with the company; the company and a related entity were eventually paid over £1.5 million, albeit with no evidence that proper processes were not followed in respect of the larger 'follow on' contracts awarded to the company. In addition, Skills Development Scotland does not appear to have managed the potential for favourable treatment of the company in the tender process arising from the related company's previous involvement in Skills Development Scotland's information management arrangements and the knowledge advantage gained by the company as a result of that involvement. No recommendations were made following our investigation in the light of the changed procurement procedures and processes that had already been implemented by management.

Partnership working

The Scottish Government remains committed to encouraging public sector bodies to work closely together in order to ensure the objectives of its economic strategy are met. By doing so, the achievement of Best Value will be enhanced. Joint working is one of nine key characteristics of Best Value.

The objectives of the organisation are to improve the learning and skills within Scotland's population and enable those unable to find employment to retrain in order to increase their skills. These objectives are closely matched to the objectives of other public sector organisations, and during the year Skills Development Scotland has continued to work closely on:

- planning, co-ordinating and delivering services at a local level as part of the single outcome agreements with local authorities;
- working with the NHS and local health boards to deliver employability, health and wellbeing and promote social cohesion;
- working with *Jobcentre plus* in rolling out the integrated employment and skills services and other welfare reforms;
- working closely with the Scottish Funding Council in developing integrated approaches to skills utilisation and brokering deeper relationships with Scotland's colleges and universities – this includes jointly chairing the Scottish Skills Committee with the Scottish Funding Council ;
- working with the Scottish Qualifications Authority to develop the learning continuum and ensuring that qualifications match learner employer need; and
- working closely with Scottish Enterprise and Highlands and Islands Enterprise in assisting those employers who are important to sustainable economic growth in Scotland.

The organisation also managed the IT collaboration project with Scottish Enterprise which officially began on 1 April 2010. This project will allow both organisations to save significant amounts on an annual basis, and clearly demonstrates Scottish Government Best Value principles.

The statement of internal control details that improvements have been made in governance arrangements during the year. The statement also recognises that there remains weaknesses in the control framework that require to be addressed by management. The statement is consistent with the requirements of the Scottish Public Finance Manual and our understanding of Skills Development Scotland.

Management has not yet formally appointed the internal audit function for 2010-11 onwards; the incumbent internal auditors have been retained until the tender and selection process for the new supplier is finalised.

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

A fraud policy was implemented during the year, and the policy is available to employees on the Skills Development Scotland intranet.

Management have implemented a policy for the review of any relevant Audit Scotland national reports.

Recommendations

We have identified one recommendation in relation to Skills Development Scotland's use of resources. This is included in the action plan attached in Appendix one.

Area for development	Action plan reference
The internal audit function should be appointed by management as a matter of priority.	Five

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, Skills Development Scotland 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:

- Skills Development Scotland'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

All board members are appointed by the Scottish Ministers, and the chief executive is designated as Skills Development Scotland's accountable officer. The board has corporate responsibility to ensure that Skills Development Scotland fulfils the aims and objectives as set by the Scottish Ministers. There are two sub-committees to the board – audit and remuneration. We understand that the committee structure of the board will be reviewed following the appointment of additional board members, in line with the recommendations arising from the board effectiveness review.

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 of internal control for 2009-10 provides details of the internal control environment and risk management and control framework. Management have highlighted 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 statement of internal control assesses the control risk framework, and along with recommendations from the internal audit assignments carried out and from assurances to the chief executive from the directorate heads. The statement concludes that there are no internal control weaknesses within the organisation other than those highlighted in areas for development. The areas of development highlighted are the completion of unified policies and procedures inherited from the legacy organisations. This is consistent with our understanding of the organisation.

Governance and risk management

Our annual audit report for 2008-09 stated that there were a number of key policies outstanding within the organisation and made a number of recommendations for management to address. Our 2009-10 interim report to management updated our understanding on the various governance issues, commenting on the fact that management had implemented a number of key policies during the year, but also noting that there were key policies outstanding. The effectiveness review undertaken in the year is an example of good practice and appropriate action of the recommendations will improve the board's arrangements.

As previously noted, management has made positive progress in the year in relation to governance and risk management processes. A number of key policies have been implemented during the year, including a fraud policy, a procurement policy, an online expenses system and a number of human resources policies. We note, however, that employee terms and conditions of employment have yet to be officially harmonised. Management are aware of the need to harmonise employee contracts and employment terms but has prioritised harmonisation of the pension arrangements and the introduction of job evaluation as they believe these mitigate the potential legal risks of not having harmonised contracts, such as pay claims under the Equal Pay Act.

An internal audit assignment was undertaken in August 2009 in relation to operational planning processes in place; this was updated in December 2009. A number of areas were identified where control procedures in place were insufficient. The updated report noted that significant progress was made to December 2009, although further progress was required. Taking cognisance of these findings management has utilised internal audit on an *ad hoc* basis to provide assurance whilst the operational plan was developed.

The audit committee met four times during the year which is in line with proper practice and what we would expect of this size of organisation. We note however that the framework arrangements for these meetings are not agreed and communicated on a planned basis.

Internal audit

A professional internal audit service has been in place throughout the year, and work has been carried out in accordance with the internal audit plan submitted to the audit committee prior to the start of the year. During the year the plan was subject to ongoing review and revision to reflect changes in the organisation's risk profile and priorities. As noted above, one of the main changes to the plan was the ICT review which was moved from 2009-10 into 2010-11 and has now been completed. We have reviewed relevant internal audit reports, and reviewed the internal auditor's files at its business premises.

Management received internal audit's annual report in July 2010, which concluded that "*Skills Development Scotland has a framework of controls in place that provides reasonable assurance regarding the effective and efficient achievement of the organisation's objectives and the management of key risks*". We note that due to the continuing development of the organisation, controls in some key systems were still being implemented during the year and were therefore not in place for the whole year.

Management have yet to secure an internal audit function for 2010-11, and as such no internal audit plan has been presented to the audit committee. An internal audit service is a key element of a strong control environment and as such we recommend appointment of an internal audit function for 2010-11 be progressed as a matter of urgency. We note that the current internal audit providers have been requested to continue in place on an interim basis until the provider for 2010-11 has been put in place and are working to the three year plan approved when they were appointed.

Internal controls

A number of control deficiencies in the organisation's payroll systems were identified in our interim audit fieldwork and also by internal audit. These were mainly in relation to amendments to payroll information and retention of evidence to back up such changes.

Our audit approach involves a controls based approach to payroll costs and these deficiencies required us to perform further audit procedures to 'top-up' our audit evidence in this area. Our enhanced procedures included further substantive testing of a sample of employees payroll costs to job evaluation letters and contracts, where possible. Contracts for those employees who transferred employment from Highland and Islands Enterprise ("HIE") are still held by HIE and have not been released by the organisation due to data protection considerations. This presents risk to Skills Development Scotland as the terms of employment for these individuals cannot be evidenced should these be challenged. Accordingly, we have raised a recommendation in this area.

Whilst our additional testing did not identify any significant errors, there is a risk that there may be non-material errors in the payroll systems which have not been detected. As this is a significant cost to Skills Development Scotland, it is important that procedures are enhanced as a matter of priority.

Equality and diversity

As a public body Skills Development Scotland is legally required to be proactive in pursuit of equality in relation to race, disability and gender. Skills Development Scotland has implemented an Equality Reference Group. The Group is chaired by the director of human resources and meets on a regular basis, where any external guidance is considered and any applications to the organisation are discussed.

In addition, an equalities statement has been implemented, and the statement has been published on the organisations intranet.

Prevention and detection of fraud and irregularity

During the year, a fraud prevention and response policy was finalised and approved by the board. The policy is available on the organisations intranet. The policy clearly documents the procedures to be followed by employees in the event of, or suspicion of, any frauds.

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.

Management have confirmed that there were no material instances of fraud which occurred during 2009-10.

Information Technology ("IT")

During the year, Skills Development Scotland led the project to appoint a third party IT provider on behalf of Scottish Enterprise and itself. The purpose of the project was to appoint a prime managed service provider to develop and deliver an information systems capability aligned to the Skills Development Scotland strategy, to implement and manage a performance based service and supplier management model to govern delivery of the relevant services to both organisations and to review and examine the organisation's systems capability. The services to be provided by the managed service provider are the service desk, desk side administration, infrastructure and data centre, networks and security, applications and business services.

The service began on 1 April 2010, at which point the geographically dispersed legacy systems began to be phased out and seven of Skills Development Scotland's employees transferred to the managed service provider as part of the agreement. Management believes that the process will be completed in full by August 2010 at which point Skills Development Scotland will have a fully functional information system of which they have overall control. This will facilitate the implementation of any policies required in the future on an organisation-wide basis. The outsourced IT contract means that Skills Development Scotland will no longer have to rely on partner organisations for key IT processes. Management must consider, however, the assurance they obtain over the operation of the various controls in place at the provider.

The agreement has a contractual length of three years, although there is the option to extend this by one year at the end of each of the third and fourth years. Therefore, if the extensions are agreed, the contract length will be five years, and the total costs over that period are estimated to amount to around £40 million.

Although the service is shared between Skills Development Scotland and Scottish Enterprise, a formal agreement has not yet been put in place between both parties; a memorandum of understanding has yet to be finalised by Scottish Enterprise.

As previously noted, the internal audit health check review was rescheduled into 2010-11 to allow arrangements to “bed down”. This review was completed in June 2010 and reported to the audit committee on 23 July 2010. This considered six key areas. No key weaknesses were identified, although as may be expected at this stage in the arrangements, a number of areas with scope for improvement were identified.

In the prior year, there were three legacy financial systems in place at Skills Development Scotland, due to the way in which the organisation was created. On 1 April 2009, an exercise commenced to migrate the majority of financial systems onto the *Exchequer* system already in use within the finance function. Most of these systems were migrated by August 2009, with the migration of the expenses system completing the exercise in December 2009. The alignment onto one system has allowed management greater control in the finance function; in particular, less reliance is now required on other organisations’ systems. Our testing of the migration onto one system was completed during our interim audit fieldwork; no issues were identified.

Area for development	Action plan reference
In 2010-11 management should consider obtaining a SAS 70 report from its IT managed services provider to give assurance that controls have operated appropriately during the year. This will provide management with comfort over the operations of such controls and allow us to rely on this in our audit work for 2010-11.	Six

Public performance reporting

The corporate plan for 2010-12 and operating plan for 2010-11 has been published on the Skills Development Scotland website and can be easily found. The financial statements for the year ended 31 March 2009 were published on the organisation’s website during 2009-10. Management intend to publish the financial statements for the year ended 31 March 2010 on the website once finalised, and intend to produce an annual report which contains highlights from the financial statements. This will also be published on the website.

Board meeting minutes and related papers are not yet available on the website. It would enhance the transparency of the organisation if these were published when approved and therefore we recommend management consider this.

Best Value

Management did not utilise any of the Audit Scotland Best Value toolkits on use of resources during the year. A start has, however, been made to implement procedures to consider Best Value and a paper was produced post year end and discussed at the July 2010 audit committee meeting. The next steps are further investigation of the checklists and toolkits and a paper will be taken to a meeting of the senior management team in due course.

Although Best Value has not been explicitly considered, the head of procurement has drafted a Skills Development Scotland Value for Money policy. In drafting the document, the procurement department held 'value for money roadshows' in order to inform employees of the requirements of value for money under the current economic climate, and allow any questions to be answered. In addition, value for money pamphlets have been distributed to all employees.

The policy addresses those savings which could be made in transactions such as procurement, but also those savings available in services such as utilities and stationery.

The largest area of expenditure open to savings within the organisation has been identified as national training programme expenditure; the procurement department will undertake an exercise during 2010-11 to identify potential savings.

The head of procurement will report the quarterly value for money savings to the strategic management team which will give senior management visibility of savings being made and allow challenge, where appropriate.

Recommendations

We identified one recommendation in relation to the performance measures of Skills Development Scotland. This has been included in the action plan on appendix one.

Area for development	Action plan reference
Management should consider publishing all relevant information, such as board minutes and any papers applicable to the meeting, on the organisation's external website.	Seven

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.

Three reports during 2009-10 – *Scotland's finances: preparing for the future*, *Improving public sector efficiency* and *Improving public sector purchasing* – are of particular relevance to Skills Development Scotland. Management has implemented a register whereby any relevant reports are downloaded from Audit Scotland's website and placed on a shared drive by a designated employee. However, the reports are not yet formally considered at board or committee level. Given the potential benefits from the findings and recommendations in these reports, it is recommended that management should ensure the reports are appropriately considered and acted upon.

Area for development	Action plan reference
Management should put in place a process to ensure relevant national reports are appropriately considered at board / committee level and that action plans are produced , where appropriate.	Eight

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 their merit attention.

No.	Issue and recommendation	Management response	Officer and due date
1	<p>There was no formal employee appraisal in place at the organisation during the year. Although interim arrangements were put in place, matters such as employee disciplinary procedures may not be possible if there is no formal meetings and discussions between employees and line managers.</p> <p>We recommend the introduction of an organisation-wide employee appraisal policy.</p> <p><i>(Grade two)</i></p>	<p>Formal meeting and discussion to take place.</p> <p>Interim produced – April 2010.</p> <p>Final – October 2010.</p>	<p>Complete.</p>
2	<p>Our testing has identified that employees who transferred from the legacy organisations have still not been issued with Skills Development Scotland contracts of employment,</p> <p>Once employee pension arrangements have been harmonised, we recommend management issue Skills Development Scotland contracts of employment to minimise the risk to the organisation.</p> <p><i>(Grade two)</i></p>	<p>Accepted.</p>	<p>HR Director.</p> <p>October 2010.</p>
3	<p>During the year, Skills Development Scotland managed the IT collaboration project on behalf of Scottish Enterprise and itself. As part of the agreement with the service provider, Skills Development Scotland is invoiced for the costs, and the portion due from Scottish Enterprise is recharged to it.</p> <p>However, a formal agreement has yet to be finalised between the two parties. We recommend that a formal contract is signed between both parties as a matter of urgency,</p> <p><i>(Grade two)</i></p>	<p>Accepted.</p>	<p>Currently with Scottish Enterprise Legal, Finance Director.</p> <p>October 2010.</p>

Appendix one – action plan (continued)

No.	Issue and recommendation	Management response	Officer and due date
4	<p>The review of the board effectiveness has recommended that additional board members be appointed by the organisation, and a revised committee structure be introduced.</p> <p>We understand that the recruitment process has begun, and appreciate that this can be an extended process. However, we recommend that board members are recruited as soon as possible, and that the committee structure is reviewed in as short a timeframe as possible.</p> <p><i>(Grade two)</i></p>	<p>Four new board members appointed 1 August 2010. Further enhancement being considered.</p>	<p>Sponsor team and CEO. Ongoing.</p>
5	<p>Management have not yet appointed the external supplier of the internal audit function. We understand that a tender document is to be placed on the Scottish Portal in order to receive tenders for the services.</p> <p>Due to this, an internal audit plan for 2010-11 has yet to be presented to the audit committee.</p> <p>We recommend that the internal audit function be appointed by management as soon as possible, to allow approval of an appropriate internal audit plan by the audit committee.</p> <p><i>(Grade two)</i></p>	<p>Currently, three potential suppliers identified and awaiting audit committee date. Three pieces of work completed this year, including IT. Have plan which will be revised during the year.</p>	<p>Board. September 2010.</p>
6	<p>The outsourced IT contract means that Skills Development Scotland will no longer have to rely on partner organisations for key IT processes. Management must consider however, the assurance they obtain over the operation of the various controls in place at the provider, i.e. Atos Origin.</p> <p>In 2010-11 management should consider obtaining a SAS 70 report from Atos Origin to provide assurance that controls have operated appropriately during the year. This will provide management with comfort over the operations of such controls and allow us to rely on this in our audit work for 2010-11.</p> <p><i>(Grade three)</i></p>	<p>Accepted.</p>	<p>IT Director. October 2010.</p>

Appendix one – action plan (continued)

No.	Issue and recommendation	Management response	Officer and due date
7	In order to add to the transparency of the organisation, we recommend that board minutes and relevant board papers are published on the organisation's website. <i>(Grade three)</i>	Accepted.	Head of Corporate Office. October 2010.
8	A process is in place to identify and review any relevant national reports, although these are not yet considered at board / committee level. Management should put in place a process to ensure relevant national reports are appropriately considered at board / committee level and that action plans are produced where appropriate. <i>(Grade three)</i>	Accepted.	Head of Finance. December 2010.