ENTERPRISE AND CULTURE COMMITTEE

Tuesday 25 April 2006

Session 2

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ENTERPRISE AND CULTURE COMMITTEE
11th Meeting 2006, Session 2

CONVENER

*Alex Neil (Central Scotland) (SNP)

DEPUTY CONVENER

*Christine May (Central Fife) (Lab)

COMMITTEE MEMBERS

*Shiona Baird (North East Scotland) (Green)
*Richard Baker (North East Scotland) (Lab)
*Susan Deacon (Edinburgh East and Musselburgh) (Lab)
*Murdo Fraser (Mid Scotland and Fife) (Con)
*Karen Gillon (Clydesdale) (Lab)
*Michael Matheson (Central Scotland) (SNP)
Mr Jamie Stone (Caithness, Sutherland and Easter Ross) (LD)

COMMITTEE SUBSTITUTES

Mark Ballard (Lothians) (Green)
Donald Gorrie (Central Scotland) (LD)
Fiona Hyslop (Lothians) (SNP)
Margaret Jamieson (Kilmarnock and Loudoun) (Lab)
David McLetchie (Edinburgh Pentlands) (Con)

*attended

THE FOLLOWING ALSO ATTENDED:

Nicholas Grier (Adviser)
Jim Mather (Highlands and Islands) (SNP)

THE FOLLOWING GAVE EVIDENCE:

Mr John Campbell (Society of Messengers-at-Arms and Sheriff Officers)
Iain Carmichael (Scottish Enterprise)
Yvonne Gallacher (Money Advice Scotland)
Fred Hallsworth (Scottish Enterprise)
Susan McPhee (Citizens Advice Scotland)
Charlie Morrison (Scottish Enterprise)
Jack Perry (Scottish Enterprise)
Beccy Reilly (Citizens Advice Scotland)
Sir John Ward (Scottish Enterprise)
Hillary Wilson (Institute of Revenues, Rating and Valuation (Scottish Association))

CLERK TO THE COMMITTEE

Stephen Imrie

SENIOR ASSISTANT CLERK

Douglas Thornton

ASSISTANT CLERK

Seán Wixted

LOCATION

Committee Room 6

Scottish Parliament

Enterprise and Culture Committee

Tuesday 25 April 2006

[THE CONVENER *opened the meeting at 14:01*]

Scottish Enterprise

The Convener (Alex Neil): I welcome everybody to the 11th meeting in 2006 of the Enterprise and Culture Committee. We have a few housekeeping matters to address. I ask everybody to turn off their mobiles rather than just switching them to silent mode because they interfere with the broadcasting system. I have an apology from Jamie Stone. I welcome Jim Mather, who has asked to participate in agenda item 1. Scottish Enterprise and I have agreed to allow the BBC to use an additional camera today on the condition that it remains in a fixed position for the duration of agenda item 1. I hope that it does not annoy anybody too much.

This afternoon's session is the first of a possible four on Scottish Enterprise. Our first witnesses are Sir John Ward, Jack Perry and Iain Carmichael, who will be followed immediately by the chair and vice-chair of the audit committee of Scottish Enterprise. We have reserved the possibility of inviting back the Scottish Enterprise team next week, once the budgets are known. We are also due to see the Deputy First Minister and Minister for Enterprise and Lifelong Learning either next week or the following week.

Several papers have been circulated to committee members, including the KPMG report. A final version of the summary has been laid on people's desks—there were one or two minor changes to the version that was circulated previously. A copy of Jack Perry's letter is among the papers, as well as a copy of the internal Scottish Enterprise audit committee's report.

I welcome Sir John Ward, chairman, Jack Perry, chief executive and Iain Carmichael, finance director of Scottish Enterprise. I invite you to say a few words of introduction before I open the meeting to questions from the committee.

Sir John Ward (Scottish Enterprise): Thanks, Alex; I appreciate the time to speak to the committee. In addition, I introduce Charlie Morrison, chairman of our audit committee and Fred Hallsworth, the vice-chairman. You will see in your papers that their committee meetings are attended by Audit Scotland and the Scottish Executive. The internal audit function in Scottish Enterprise reports to the chairman and vice-chairman, not to the Scottish Enterprise executive.

The summary conclusions and their responses were reviewed by the Scottish Enterprise board at the board meeting that took place at the beginning of April. The final report, which is the one that the committee has received, was endorsed at a special board meeting last Thursday morning. I was anxious that we should go through the whole process so that the committee could receive the entire report. We appreciate the two-week slippage—I know that Alex Neil and Jack Perry had a discussion about that—because we felt that it was important that you had the audit report, which is the most comprehensive document that we have about what has happened in the past year.

We understand that there is some interest in the progression of events throughout the past year so I will talk about that and then pass over to Jack Perry before committee members ask questions.

A long-standing problem for Scottish Enterprise has been the shortage of really compelling investment projects, which in most years has resulted in the organisation underspending its budget, sometimes quite significantly, and a huge drive in the last five or six weeks of the financial year to spend approximately 25 per cent of it.

The Scottish Enterprise board feels that that is bad governance. After all, if we give money back, the economy loses investment potential. As a result, new measures were introduced in 2004 to strengthen the pipeline and improve the flow through each month of the year. That did not solve the problem and in 2004-05 we still had the same hockey-stick graph with a huge spending build-up in the last five weeks of the year. Moreover, although over the first six months of the year the flow through the pipeline tended to be £600 million to £650 million, the flow quickly eroded from about September onwards and we ended up with a substantial underspend.

Further measures were introduced in 2005 to focus the organisation on opportunity and to try to build a more sustainable pipeline. Over the first half of the year—up to about August—the pipeline followed the previous years' pattern with £600 million to £650 million flowing through it. However, unlike in previous years, the pipeline did not erode, but continued to build. At the October board meeting, the board asked the executive whether the pattern was normal or whether we had actually reached a different situation. Three questions were posed. First, we wondered whether the pipeline was real or whether, as in the past, it would erode at some point. Secondly, we asked whether this phenomenon was evidence that our strategy was working or whether other factors were at play. Thirdly, despite past accommodation in Treasury rules that precluded access to free cash reserves or offset for the £25 million non-cash budget shortfall, the Scottish Executive had indicated that that matter was still being discussed. The board said that things had to be netted out, because we needed to know exactly where we stood.

At the board meeting at the beginning of November, it was confirmed that the pipeline was—as best as could be judged—solid and that encouraging evidence was emerging that the strategy was working, with quite a number of significant projects of scale identified. Supporting that view was the fact that, for the first time in Scottish Enterprise's history, the monthly spend—in other words, the monthly profile if the budget is divided by 12—was spot on a twelfth of the budget. We no longer had the hockey-stick arrangement of running under budget during the year and then having to catch up at the end.

At that time, it was also confirmed that the cash operating plan, as opposed to the non-cash operating plan, would be achieved without any requirement to force spend in the last five or six weeks of the year.

However, it was finally confirmed that, because of resource accounting and budgeting, the Scottish Executive could not access the £45 million cash reserves that we have without a pound-for-pound reduction in grant in aid. Moreover, this year, the Executive could not cover the £25 million gap between the non-cash budget allowance and non-cash allocated cost. Although we are allocated £9 million, the actual cost of that allocation is £34 million. It was also confirmed to the board that, since resource accounting and budgeting was introduced, operating plans had not been based on the assumption that that gap had to be covered. Given those factors, the strength of the pipeline and the growing impact of top-sliced programmes such as the intermediary technology institutes, it was concluded that there was potential for the budget to be overspent.

Although, in November and December, the Scottish Enterprise executive implemented a cutback programme across business units and local enterprise, it did not have a significant effect. The limited response over this period was a key reason for the inability in January to March fully to cut back to budget. As a result, in January, we introduced an immediate cessation of non-committed spend. At the same time, the chairman of the internal audit committee, Charlie Morrison—I have already introduced him—initiated with the chief executive's support a full audit of the process that led to being over budget and agreed control measures for management and prioritisation of the robust and emerging project pipeline.

The internal audit and management responses also recommended a range of other improvements. Those include end-year flexibility and carry forward, called the central unallocated provision—CUP; access to cash reserves as a bridging factor; proper adequacy of non-cash budgets; accommodation of longer-term projects across years, particularly when we have no control of the spend; restoration of budget flexibility when top-slicing happens; and also an examination of the double counting that happens, because when we spend money in cash it is then counted in an investment, so we have to pay depreciation in cost to capital on it—under those rules, we could pay double for what is being invested.

We greatly value the support of the Minister for Enterprise and Lifelong Learning and the Enterprise, Transport and Lifelong Learning Department in the search for solutions when we judge that improvement is necessary, not only within Scottish Enterprise but externally, and in looking at the 2006-07 budget and the years beyond.

Convener, we would also appreciate the help and support of the Enterprise and Culture Committee as we try to find solutions to the problems. These are important matters for Scotland as we try to address the longer-term issues that affect the economy. We hope that in the committee's discussions it will find issues on which it can support us.

Thank you for the opportunity to make an introductory statement. I will hand over to Jack Perry.

Jack Perry (Scottish Enterprise): When I took this job, just over two years ago, I felt certain that Scotland faced a wealth of investment opportunities, which, if they were properly identified and harnessed, could help us to address the underperformance of the Scottish economy. I know that that is one of the principal objectives of the committee. It seemed curious that Scottish Enterprise had underspent its budget in each of the preceding five years by between 1.2 and 6.6 per cent. Consequently, its annual budget for each succeeding year had declined. That was curious when there seemed to be so many good opportunities. Therefore, as Sir John Ward outlined, our approach over the past two years has been to stimulate greater levels of activity and to create genuine competition for funding so that, within the limited resources that are available, projects that would give the best return on investment for Scotland would be funded.

The committee requested a detailed report on the circumstances of our budget overspend. We have now provided a full background on our transition from being an organisation that sought to spend a budget to being one that makes hard choices on investment opportunities. We have made clear where there have been weaknesses in our management of the transition and where there have been restrictions on our freedom to manoeuvre. The restrictions are well known and understood by us, but they are no less frustrating for that.

We understand that the committee will have a number of questions on our report and perhaps on other matters related to our role in stimulating more and better economic development. However, we now seek, and hope to enlist, the committee's support as we work with the Executive to reach solutions to the longer-term budgeting and funding issues illustrated in our report. Our strategy for the future appears to be well aligned to deliver against the conclusions of the committee's business growth inquiry. I believe that our restructuring plans will help to enable us to deliver our strategy, but we need certainty about our funding for the future and we look forward to the imminent resolution of our budget for the forthcoming year.

The projects that we are now pursuing, such as Stirling Medical, the Pacific Quay digital media park, Ravenscraig, the Scottish co-investment fund and the translational medicine research collaboration, are the right projects for Scotland. They will impact on every region in Scotland, they respond to the needs of our key industries and they demonstrate excellent private-sector leverage. We have filled our pipeline with those projects and we would like to do more.

We realise that many of the systems and management practices required for the management of a full portfolio of potentially competitive projects need to be more rigorous than those that served the organisation well when it struggled to spend its budget. I am confident that the changes described in detail in our report, which are already in place or will be implemented soon, will prevent a recurrence of this year's problems.

I will hand over to Iain Carmichael, who will discuss in more detail the steps that we are taking.

Iain Carmichael (Scottish Enterprise): Although the decisions that were made at specific times during the past year were all taken after due consideration, and in the light of both the best information that we had available at the time and past experience, it is clear that there are lessons to be learned. The events of the past year have been reviewed seriously by the executive team and independently, in some detail, by our own internal auditors, our audit committee and KPMG. Although there is no evidence of money being spent recklessly, irregularly or improperly, it is regrettable that there have been problems with the phasing of expenditure. We accept responsibility for that.

All the recommendations that have been made have been acted upon or are in the course of being implemented for 2006-07. The recommendations are set out in the submissions, but let me summarise some of the key points. As a temporary measure, devolved budgets on a resource accounting basis are being applied to all expenditure this year so that we can stabilise the position. Responsibility and accountability is being clearly assigned to named senior staff members. However, in implementing that control, it is important that we do not stifle the creation of a fuller pipeline of innovation and creativity such as was stimulated by the changes that we made last year. An effective prioritisation process for expenditure has been further developed and systems for regular reviews of priorities are being established. Responsibility for planning and financial control, which is currently split between two teams in Scottish Enterprise, will be organised under one executive board member. All the other recommendations in the submissions either have been acted upon or are in the course of being implemented.

In addition, we will work with the Scottish Executive and other development agencies to try to ensure that the unintended consequences of resource accounting and budgeting are recognised and do not result in an adverse impact on economic development activity. Finally, we will continue discussions with the Executive's sponsoring division, in what is a strong and supportive relationship, to attempt to resolve our resource cover issues, which currently restrict our access to available cash resources.

14:15

The Convener: Thank you very much indeed. Quite a number of policy and operational issues need to be addressed concerning what has happened and what that might imply for the future. Therefore, I will allow members a fairly free-wheeling approach because we have a lot to cover. Several members have questions, but we will start with Christine May.

Christine May (Central Fife) (Lab): Good afternoon, gentlemen, and thank you for the submissions and the opening statements that we have been given. Let me start by recognising that Scotland's economy is not a basket case but is doing well in key areas such as the clusters that were identified, which have been successful. However, in meetings that I have had with Scottish Enterprise, I have put on record my concerns about the balance between local expenditure—which is relatively small-scale stuff, but important in local terms—and strategic national expenditure. I will leave it to other members to ask how Scottish Enterprise's budget got into its current situation, but I have three questions.

First, I get complaints from constituents and businesses that Scottish Enterprise is breaking commitments because it has no money. How can that be explained in light of the claims that the organisation will honour existing commitments? For example, it has been reported that training expenditure will be reduced by 17 per cent.

Sir John Ward: Shall we respond to each question in sequence?

Christine May: Yes, I would like a response to that before I ask my other questions.

Jack Perry: I will respond, although I might ask Iain Carmichael to answer as well.

As members will know, we do not have a resolved budget for this year. We hope to hear about that from the Minister for Enterprise and Lifelong Learning on 2 May. As such, we have issued interim budgets to all business units based on a worst-case scenario. As a consequence, there has been speculation about cuts of possibly 50 to 70 per cent. Much of that speculation is wide of the mark and is made without people knowing what the budget for the coming year will be. Such speculation on what may or may not happen to the budget is both premature and potentially damaging to our relationships with customers.

I understand the complaints about breaking commitments. We are doing everything in our power to ensure that we honour our legal commitments to our customers, but it can be hard to define what constitutes a commitment. Often, a commitment will be an offer with certain conditions attached and, until the conditions are fulfilled, there is no commitment. We are trying wherever possible to honour every commitment to our customers. I am aware of certain cases in which, because of the continuing uncertainty, we cannot give the clarity to customers that we would like. We are acutely aware of the issue and we want to ensure that we honour all our legal commitments.

Perhaps Iain Carmichael can amplify the issue.

Iain Carmichael: Our commitments range from fixed legal commitments that may have very few conditions attached to, at the other end of the scale, discussions with a business on providing support for its plans. Such discussions involve no commitment, but may have raised an expectation that we will support the business's plans. When we get feedback that we have broken commitments, we need to find out where on the scale that commitment is positioned. If we have a fixed legal commitment, we will honour it. At the other end of the scale, we will perhaps have to disappoint people and say that in our prioritisation process their project is not going to rank ahead of others. Given the nature of prioritisation, we will have to disappoint some people. We have to see where we are on the scale with each business.

Christine May: That response concerns me and others. There are no formal, legal commitments on many of the projects. Nonetheless, given the experience of previous years, there is more than a vague expectation that they are on track. Projects that might have expected to get £X million will now expect to get £X million minus £Y million, because of prioritisation. I hope that you accept that that has implications for the budgeting of other local businesses and partners. The uncertainty arising from the delay in fixing the budget will have an impact. There might also be uncertainty for staff. Can you give us any reassurances about projects that are not absolutely signed, sealed and buttoned down?

Jack Perry: I am not aware of any five-year programme that we look like abandoning after four years. I would find that remarkable. If you have an example of that, I would certainly like to know about it. The reality is that, given past experience, our expectation is not necessarily that we will continue to do the same old things that we have always done.

As Iain Carmichael said, by necessity, if there is competition for funding, we will fund the programmes, projects or interventions that provide the best return for the Scottish economy. That means that although someone might have had an expectation of funding because we provided them with a certain kind of support in the past, we will not necessarily continue to provide the same kind of support in future. It is a question of expectation rather than commitment.

Christine May: You said that you have a full project pipeline for next year. Does that mean that anything that is not already in the pipeline is not going to happen and that you have closed your minds and books to any new projects?

Iain Carmichael: We are definitely still open to new ideas and projects. We have a full pipeline of projects, but our experience over the 15 years of Scottish Enterprise is that many of them will slip or not go ahead for a variety of reasons. We need to continue to fill the pipeline and prioritise against it.

Christine May: Forgive me, Iain, but the KPMG report said that that was the expectation last year, which is part of the reason why you got into this position. Are you saying that the information that you have for next year gives the lie to the practice in the past year?

Iain Carmichael: No. I do not think so. As I said in my introductory remarks, we will have a better prioritisation process for the coming year, but we still need to continue to fill the pipeline, because there will be slippage in projects.

Jack Perry: By necessity, in any one year we have to overplan. We gave you examples in the documents that we provided of major projects that slipped substantially during the year. Unless we overplan significantly, we will undershoot our budget. We have to keep filling the pipeline with new projects. That is different from committing to the spend.

Sir John Ward: The board would look to the executive team to build as robust and strong a pipeline as possible. There might be a constraint on money—that is a prioritisation issue—but it is simply not good enough that in the past we have had insufficient pipeline to fill the budget.

Christine May: I, and I am sure other committee members, appreciate that, but the issue is the process of getting from how things used to be done to how you would like them to be done.

The report identifies a number of areas to be addressed, not all of which are in your control. I suspect that the funding of the capital element, which has traditionally had to be met by a reduction in grant in aid, is not going to change for two years. How will you manage that?

Sir John Ward: We are working those things through with the Executive to see what flexibilities are in the system. There are longer-term issues that will have to wait for the next spending round. In my introductory remarks, I mentioned the fact that, because of the cost of money and depreciation, we can end up paying twice for capital projects. Clearly, there are practices that do not look sensible. The regional development agencies in England are exhibiting the same problems. One hopes that, in time, we will find ways through by taking up some of the points that I made about development at the end of my introductory remarks.

Murdo Fraser (Mid Scotland and Fife) (Con): Some of the things that Scottish Enterprise has tried to do over the past two years have been welcome. Projects such as the ITIs, the co-investment fund and the new business growth fund are new and exciting departures and will lead to greater economic growth in the future. Having said that, I think that the committee, the Parliament and members of the public expect that a body that deals with very large sums of money—Scottish Enterprise is Scotland's largest quango and has a bigger budget than any other—should have sufficiently robust financial controls in place to ensure that funds are properly spent and that we do not reach the year end with a large overspend on the books.

I was concerned to read some of the criticisms of accounting practices in Scottish Enterprise that are contained in the KPMG report. I want to ask you two questions arising from the report. For ease of reference, I refer you to the sixth bullet point in the executive summary on page 4, which states:

> "In November 2005 SEn became aware of a significant overspend but action taken at that time was not sufficiently robust. This was not helped by poor and slow financial reporting and unclear budget accountability. Only in January 2006 were clear budgetary caps put in place by which time it was too late fully to realign spend with budget".

Why did it take you two months from the date when the problem was drawn to your attention to put in place measures to try to deal with it?

Jack Perry: I am delighted to talk you through that. Let me go back to the beginning of the year. When we introduced the new system, one of our biggest concerns as an executive board was the risk of serious underspend. We genuinely did not know how the network would respond to the new freedoms that we had given to it and whether it would come up with the projects that would allow us to meet our budget. In the first half of the year, the pipeline and the forecast exhibited all the characteristics that they had exhibited in previous years. At the halfway stage, when we considered the matter at a board meeting, we began to realise that this year was quite different—that the pipeline was solid and the forecasts were more robust.

We had introduced new measures to make forecasting more robust and reckoned that we needed to take some action. However, we did not want to stifle the innovation and creativity that we had brought to the network by giving it freedom. If within six months we had said, "Sorry, guys, this is not working. Stop—you are back to capped budgets," we would have stifled a lot of the initiative that we were trying to stimulate and encourage in the network. Following a management conference with all our business unit leaders, we requested voluntary reductions in their forward forecasts. At the time, we gave them guidance that we were seeking reductions of about 15 per cent.

The failure came because our exhortation and the active management that we were trying to encourage did not yield the savings that we were seeking. Savings came in at approximately 5 per cent. As we have made quite clear in our report, we lost a crucial couple of months. By January, it had become apparent that the management processes that we had initiated to seek reductions were not yielding the kind of reductions that we needed, so we put budget caps in place. The problem was that, having lost two months, it was very difficult for us to put the brakes on certain projects that had already started. That led to the overrun, which amounted to 2 per cent of our cash budget. That is clear from the KPMG report. Of the budget overspend, £25 million relates to non-cash spending for which we are not seeking additional cash support.

Some of the actions that we took proved, in retrospect, to be less effective than we would have liked. The end result was a 2 per cent overspend in our cash budget, which is highly regrettable, but as that is in the context of a budget of £530 million, it is important that we keep the nature and scale of the problem in perspective.

14:30

Iain Carmichael: It is for Scottish Enterprise's audit committee and for Audit Scotland to comment on the financial controls in Scottish Enterprise, but it was the financial reporting that highlighted the situation in November.

Murdo Fraser: Other members may want to comment on that point, but I would like to ask a second question, which also arises from the KPMG report. The report states that the Scottish Executive made it clear to Scottish Enterprise at the outset of 2005-06—last May—and throughout the year that there could be no increase in the non-cash allocation of £9.6 million without a corresponding decrease in the grant in aid. If you were aware of that, why did you proceed as you did?

Iain Carmichael: There were two reasons, which are related but different. One was that, in previous years, our experience had been that, despite a resource shortfall of £25 million, that shortfall had been covered by the Scottish Executive from underspends in other departments, so we hoped—possibly we were too optimistic—that that might happen. However, we accept that it was made clear that that would not happen last year.

The other reason was that, after May 2005, we continued discussions with the Scottish Executive about getting access to our cash reserves. Right through until November, we continued to be optimistic that we might find a way to access cash reserves to underwrite that shortfall. Again, we have to put our hands up and admit that we were too optimistic in making that assumption.

Murdo Fraser: You just said that you were told that it would not happen, but you remained optimistic that it would happen.

Iain Carmichael: Yes.

Murdo Fraser: Is that not a contradictory statement?

Sir John Ward: Cash reserves and non-cash cover are two different things.

Iain Carmichael: We realised that the £9.6 million non-cash cover could not be increased until the next spending review. That was clear. We were not certain that we would not get additional resource cover, which would have enabled us to access our cash reserves. We had a series of discussions with the Scottish Executive about that, through to November. Behind our thinking on that was the fact that we were urged by Audit Scotland in its report on our accounts for 2005 to do whatever we could to reduce our cash balances, so we were in supportive discussions with the Scottish Executive, trying to find a way to access our cash balances last year to make good the £25 million that we could not get from the inadequate resource cover.

Jack Perry: It is also fair to say that, despite the letter in May saying that it was unlikely that we would get access to those balances or any relaxation or relief from the resource budget shortfall, discussions continued well after May to see whether there was any further likelihood of that shortfall being covered.

Murdo Fraser: So, notwithstanding what the Scottish Executive told you, you believed that the door was still open.

Jack Perry: We felt that it was still ajar.

Murdo Fraser: That is something that we can put to the minister when we see him.

What message do you think that it sends to the business community when the agency that is responsible for economic growth and for providing business support and advice faces such difficulty in balancing its own budget and has had such a critical report from a firm of auditors such as KPMG?

Sir John Ward: It is disappointing that we have the excess spend that we have, but I think that the business community must have been even more disappointed in previous years, when we could not spend the budget because we did not have any projects to support businesses. I would have thought that those in the business community would at least give us credit for trying to build a pipeline of support, which is what they want. As you have said, the big drivers that caused the cash increase—forget the non-cash issue that we have been discussing—were the ITIs, the co-investment fund and specific company support. That is what pushed the cash demand up. I would have thought that the business community would be pleased with that support.

Jack Perry: I should also point out that, under resource accounting rules, we probably have less flexibility than we had in the past. We understand the rules and know well that we have to work within them. However, in the preceding year, we underspent by £10 million and returned that to the Executive. We also had surplus receipts of £17 million, which instantly got locked into our reserves and to which we did not have access. So it could be said that, last year, we were out of balance by £27 million the wrong way—that is, underspend—which is the same kind of magnitude by which we are out of balance this year, although this year it is largely non-cash. It is not possible to land this jumbo jet on a postage stamp within the constraints of resource accounting.

Murdo Fraser: I am not an accountant, so I will let that pass for the time being. Clearly, it has been a difficult period for the agency and you face criticism from internal audit and KPMG. Have any of you offered your resignations as a result of that?

Jack Perry: No, we have not.

Karen Gillon (Clydesdale) (Lab): I will go back to basics to help me. Who at Scottish Enterprise headquarters was specifically responsible for taking an overview of the Scottish Enterprise LEC spending over the course of 2005-06?

Jack Perry: As I am accountable officer, that would be me, but the executive board has collective responsibility and, ultimately, the board signs off our operating plan and budget.

Karen Gillon: What process was in place to ensure that you, as accountable officer, were aware month by month of the spending?

Jack Perry: There is a very rigorous process that consists of our monthly management accounting and our quarterly reviews and management conferences. We have also provided you with the executive board and board papers as appendices to our report. Those papers clearly outline the new processes that we put in place to manage the new resource allocation and prioritisation process.

Karen Gillon: You said that it was a very rigorous process.

Jack Perry: Yes.

Karen Gillon: However, in July, October and November 2005, it failed to pick up—or it signed off—a projected cash overspend of £100 million.

Jack Perry: We have already described the nature of overplanning, in which we engage every year. It is essential by the nature of what we do. We have given you some graphic examples of the kind of project slippage that means that, were we not to overplan, we would almost certainly underspend our budget in each year. It would be wrong to characterise that as a lack of visibility or accounting information, because we had those. As we have said on the management decisions and actions that were taken as a consequence of that visibility, I think with hindsight that more active management at an earlier stage might have prevented the overspend that ultimately occurred.

Iain Carmichael: There is not much to add to that, other than to say that, at the dates that Karen Gillon mentioned, our financial reports indicated the numbers to which she referred. Those reports were not taken lightly. They were discussed in depth by the executive board and action was decided on.

At the time, we thought that that action was appropriate. In particular, after the six-month review in early November, the executive board considered the options for how to manage the budget down. Given the slippage that had occurred in previous years, we are concerned that the optimistic bias of some of our forecasts could result in an underspend if the action that we took was too rigorous, so we decided at that point not to reimpose budget caps but to try to work with our business units to manage the spend down. We held a management conference in the middle of November at which that was presented and discussed, but it was obvious just before Christmas that the action that had been taken during the few weeks between mid-November and Christmas had not been robust enough to manage down the spend. In very early January, when everybody returned after the Christmas break, we reimposed caps, which significantly reduced the spend to the £30 million overspend that we are now projecting.

Personally, I believe that if we had taken more robust action in the period from the middle of November up till Christmas—the reports show this—we could probably have reduced the spend down to a balanced budget. That is partly with the benefit of hindsight. At the time, we decided not to reimpose budget caps because we were genuinely concerned that we would end up with an underspend. It would also have sent the wrong signal, because we have had some benefits from the new process—as the chairman said, we have a fuller pipeline of projects and a flatter profile of spend—and we did not want to abandon those. With hindsight, I think that we probably should have taken slightly different action.

Karen Gillon: To take a slightly different tack, do you think that the budget that you have is adequate?

Jack Perry: That is a very good question. It is up to us to make a case for getting a different budget. We have provided you with a profile of what has happened to Scottish Enterprise's budget since its inception and over the past five years. To a large extent, Scottish Enterprise is to blame for the decline, because we kept underspending our budget and we did not have a compelling case for further investment. I would like to think that if we have a robust case, we will make that case, and it will be up to ministers and Parliament to decide.

Karen Gillon: Forgive me if I am reading this wrongly and if I am somehow being naive, but you say that the restrictions were well known and understood; that you need certainty of funding for the future; and that there is no evidence of reckless spending—I think that Iain Carmichael said that. The truth is that you knew from day one of the budget that, if you used the money, you had to balance off the non-cash with the cash. Am I right or wrong?

Jack Perry: It might be wrong to say from day one, but certainly from May.

Karen Gillon: Okay—from day two, then. You had to balance off that budget. I think that the total that is cited in the KPMG report is approximately four times what you are allocated, which is £9.6 million.

Jack Perry: That is correct: £9.6 million against £34 million.

Karen Gillon: So you knew that you had to allocate that off your budget. It would seem quite simple to me to take that off the total and spend what is left. It appears from my reading of the reports that you did not take that figure off the total and that you assumed that the Executive would come good in the end, so you thought that you could spend the money anyway and get the money off the Executive.

Jack Perry: There was an element, based on past custom and practice, of starting the year believing that, because the non-cash allocation was so inadequate, there would be some accommodation. Even after things were made clear, we felt that the door might still have been ajar. In retrospect, that was optimistic and we have said as much. The reality is that the allocation is completely inadequate.

So that members understand how that works, I should explain that we are given £9.6 million of non-cash resource. However, we are charged £34 million of non-cash expenses. The only way we can balance the books is to cut £25 million of cash expenditure. We would have to cut Scottish Enterprise's programmes and projects by £25 million of cash to meet what is a non-cash bill. Based on past custom and practice, we did not feel it unreasonable to expect some accommodation for an amount of resource cover that was inadequate. In retrospect, that was a mistake.

Karen Gillon: You have described a £25 million resource deficiency, but you had a £27 million underspend last year—essentially, you managed to do things last year with around £50 million less. You are saying that there is something fundamentally flawed somewhere in the process.

I would accept it if you told us that you had 10 projects that were so fantastic that they all had to go ahead for the good of the Scottish economy but you had the resources to fund only seven of them, so you were asking the Minister for Enterprise and Lifelong Learning and the Parliament to find the extra £30 million to help. However, I resent people holding a gun to my head at the end of a financial year and saying that, regardless of what they were being told over the previous 12 months, they have gone ahead and overspent their budget, so somebody somewhere needs to help them, otherwise somebody somewhere will suffer.

I know from my local enterprise company and a project that I learned about yesterday that the people who will suffer are not the Ravenscraigs or the Pacific Quays, but the people who deliver training programmes to some of the most vulnerable young people in Scotland. That aggravates me as a member of the Parliament. If you had said X, Y and Z, I would have respected that, but what you said was, "Really guys, it's your fault."

14:45

Jack Perry: It might be useful to speak about the nature of the discussions that we had throughout the year. It is wrong to say that we came to you right at the end of the year and said, "Bail us out here," because that is not the case. Regardless of the timing of events, we would have had to make the decisions about what to cut sooner or later.

Iain Carmichael: I do not want to sound as if I am trivialising matters and I said already that we did not take robust enough action in November and December, but if we had taken more robust action in that period, it is likely that the projects on which the £30 million was spent in 2005-06 would have been deferred until 2006-07 and the money for that year then spent on those projects. There would still have been pressures on this year's budget to prioritise what we are doing.

Karen Gillon asked whether we had enough money. The committee needs to understand that Scottish Enterprise does not control the timing of its expenditure. We make a commitment to support projects, often with conditions attached and usually dependent on other things happening. If we support a business project, the business has to do certain things before we release our money and we have no control over the timing of when the business satisfies our conditions. Similarly, if we make a commitment to a physical infrastructure project—the Finnieston bridge in Glasgow is a good example—if somebody puts in a late planning appeal that delays it for a couple of years, we are still committed to funding the project when it happens. In the case of the Finnieston bridge, it cost us about £7 million more when it eventually happened.

It is for the board to ask for more money, but more flexibility in our annualised budget would definitely help us to address some of the issues.

Sir John Ward: There was no attempt to put a gun to anybody's head. However, the board found it strange that we were sitting on a lot of free money—£27 million was mentioned—which had arisen largely because investments that we had made had earned money, but we were prevented from using it. As Iain Carmichael said, another example is delays in planning applications that moved expenditure from one year to the next. Those things are outwith our control. There has been no attempt to put pressure on the system for more money; that is a decision that the Parliament and the minister to whom we report have to take.

Our drive has been to build the pipeline and make it as robust as possible, but we accept and understand that that will cause prioritisation. We will agree with the Minister for Enterprise and Lifelong Learning, who sets our objectives, how that prioritisation will happen.

Karen Gillon: But surely you knew about the restriction at day two. You said in your opening statement that the restrictions on the budget process were well known and understood, yet you proceeded on the basis of the door being slightly ajar.

Sir John Ward: The door was slightly ajar—the dialogue with the Executive continued until November. I made the point in my introductory address that, at its October meeting, the board said, "You've got to sort out with the Executive what is and is not allowable with our cash reserves and whether we can address the £25 million, which is a crazy budget situation." Those situations were being and continue to be debated.

Karen Gillon: I look forward to speaking to the minister next week.

Michael Matheson (Central Scotland) (SNP): Following on from Karen Gillon's theme, I note that you failed to take any account of the non-cash cost that you would have to meet from your budget. Jack Perry mentioned that he thought that the door was still ajar with the Executive. How did you make that assessment?

Jack Perry: Again, I will bring in Iain Carmichael, who was more involved in the direct discussions on the matter. It is true that the Executive made it clear in writing that it was unlikely that there would be any accommodation in the Treasury rules. However, the custom and practice in previous years suggested that the Executive could find additional resource cover. After all, discussions were continuing on the matter. What would have been the point of continuing to discuss a completely dead issue?

I do not dispute that, in retrospect, we should have implemented contingency plans earlier. However, meaningful and substantive discussions on the matter continued right through to November.

Iain Carmichael: As Jack Perry has said, I was perhaps closer to the issue. In our discussions with the Executive from May onwards, the sponsoring division was always supportive and was sympathetic not only to the problem of inadequate resource cover but to our need to access the cash reserves as an addition to our budget, not as a replacement for our grant in aid.

In November, it became clear that we were not going to get any joy in that regard. We knew by then that that door was closed. Moreover, our financial reports were by then showing the forecast spend until the end of the year. We come back to the fact that the action that we took in November and December was inadequate. Although our overestimation of the possibility of accessing the £25 million was an issue in the first half of the year, we knew by November that it was no longer an issue and that we had to reduce our spend to take account of the situation.

Michael Matheson: So you started the financial year knowing that you had to find £25 million from your cash budget. Despite the letter from the Executive that you received in May advising you that it might not be able to provide the additional financial cover, you felt that that door was still ajar. You continued to discuss the issue with the Executive until November—

Iain Carmichael: I am sorry to interrupt, but we also discussed the issue of accessing our cash reserves.

Michael Matheson: Okay, but you continued to discuss the matter until November, when the penny dropped that you were not going to get the bail-out that you got in previous years. As a taxpayer, I—and, I am sure, other taxpayers—find that difficult to understand. Surely it is a big gamble to pin your hopes on the possibility that at some later point in the financial year the Executive will come up with the £25 million that you require. Is it not the case that after you received the letter in May you gambled on being able to access the other money?

Iain Carmichael: I would not describe it as a gamble—we made a balanced judgment on whether we would get access to the cash. You should bear in mind that we were asking the Executive not for additional cash but for resource cover to use cash locked up in our bank account.

Michael Matheson: I appreciate that, but to me—and to anyone outside looking in—it looks like a gamble.

In your discussions with the Executive on this matter, did it explicitly say that it was seeking ways of enabling you to access your cash reserves?

Iain Carmichael: The Executive was sympathetic to and trying to work with us on the issues that we were trying to address. I do not know what was happening in the Executive itself, but it certainly discussed with our finance department ways of unlocking some of the reserves that we were sitting on.

Michael Matheson: Your second quarterly review highlighted a projected £100 million cash overspend. According to the KPMG report, your first quarterly review highlighted the same projection and stated:

> "at this stage in the financial year, this is a manageable position and no immediate action is proposed".

Why did you take that view?

Iain Carmichael: We took it based on past experience. We decided that the projected overspend at that point in the final year would probably come back, because there would be slippage in projects. We agreed at that point that the critical time to have a review and take action would be after the half-year report.

Michael Matheson: Given that the financial arrangements were changed at the beginning of the financial year, do you think that it would have been appropriate to consider earlier whether the problem was much more deep rooted and to begin to tackle it, rather than wait for the second quarterly financial report?

Iain Carmichael: At the end of the first quarter a detailed, almost line-by-line review was carried out with each business unit to consider the forecast. At that time, past experience suggested that pulling back the forecast would have put us in danger of having an underspend at the end of the year.

Michael Matheson: You used the phrase, "based on past experience." The KPMG report states:

> "Forecast outturn expenditure in 04/05 was consistently within forecast revenue for the first eight months of the year, whereas in the equivalent period in 05/06, forecast outturn expenditure was on average £100 million greater than forecast revenue."

Iain Carmichael: The KPMG report does not make it clear that different processes were in place in 2004-05. When we had business unit budgets, business units were forecasting up to the budget level, whereas in 2005-06 they were forecasting the pipeline. The report does not compare like with like.

Richard Baker (North East Scotland) (Lab): Do circumstances mean that resource accounting is more difficult for Scottish Enterprise than for other Executive departments and agencies, which seem to be able to manage the process?

Iain Carmichael: Resource accounting and budgeting hits particularly hard where an economic development agency creates assets through acquiring or developing land or investing in companies. If an agency delivers services with largely revenue budgets year on year, resource accounting does not have such an impact. When we create an asset we are charged with the cost of creating it, the cost of any depreciation in its value and the capital cost of holding it, so we are hit in three ways. A non-departmental public body that largely delivers a service would not be hit in that way.

Jack Perry: We do not believe that there is another organisation that has the same risk profile as Scottish Enterprise that is subject to resource accounting. It is interesting that some of the guidance on resource accounting that was issued to you says that it should broadly follow United Kingdom generally accepted accounting principles. I have to tell you that it does not.

Iain Carmichael: The nearest equivalent to Scottish Enterprise in terms of the adverse impact of resource accounting is the RDAs in England. We are having discussions with them and we are trying to work together on the issue.

Richard Baker: You have been looking for ways to change your accounting procedures.

Iain Carmichael: We do not know whether we can do that.

Richard Baker: I am particularly interested in how the current budget situation impacts on local services. Jack Perry said that some organisations expected to receive funds when they had not received a commitment to get them. I am aware that the get ready for work programme, which is a work programme for young people that is run in the Scottish Enterprise Grampian area, said that its programme had been agreed—you identified the need that it met. What can you do now to ensure that programmes such as that, which deliver services to meet needs and which have been agreed, can go on despite the current budget situation?

Jack Perry: A lot will depend on the final budget settlement, so it is difficult for me to speculate on what we might or might not end up being able to deliver in any area. It is up to individual business units to help set the priorities for each area.

We are doing our very best to honour our legal commitments. However, as increasing demands are made for our support and as we develop a fuller and more exciting pipeline, some tough decisions will have to be made. We will stop supporting programmes that we have supported in the past.

Richard Baker: I imagine that tough decisions lie ahead because of the level of demand. In relation to the creation of new businesses, such demand is welcome. There should be flexibility to respond to local needs and demands. We have heard from the Convention of Scottish Local Authorities that it is particularly concerned that the current situation will impact on local services. There are also concerns about the flexibility that local enterprise companies will have under a new structure. Can you reassure us today that LECs will still have enough flexibility in their budgets to respond to local circumstances and the distinctive economic needs in their areas?

15:00

Jack Perry: Sure. We are presently working on the detailed implementation plans for our restructuring and are taking cognisance of the instruction from our minister to try to retain as much local decision making as possible. That will be possible only to the extent that there is free discretionary budget within the system to enable each business unit to have meaningful decision-making powers.

We have an extremely full pipeline, an awful lot of which was developed locally by individual business units. Please do not forget that, regardless of what our budget settlement is, we are still talking about spending £500 million on Scottish economic development, much of which has been developed at the grass roots and locally. That will continue, but the question is how much free discretionary budget there will be for new projects and programmes in the coming year over and above what is already committed. We need to wait for the budget to come out to know that and then work on the detailed prioritisation.

Richard Baker: Your strategy has an important bearing on that. I know about the key industries in the metropolitan regional strategy and that you are centralising work in headquarters. The plans are exciting but, in large metro regions, some local enterprise companies will—rightly, in my view—argue that the economic needs of their areas are particular and divergent. Is it your intention and that of the Scottish Enterprise board to ensure that they still have flexibility in decision making in their areas to address those needs?

Jack Perry: We are taking particular care in our structure to ensure that in the governance of each of our metropolitan regions there is adequate representation from every area within the region. I realise that there are some perception issues, but our metropolitan regional strategy is not about pumping more moneys into the cities; it is about ensuring that regions act as proper metropolitan regions, which should mean that there are good opportunities for outlying areas as well.

Please do not forget that what drives the metropolitan strategy is the fact that the metropolitan regions exist to fulfil demand from our key industries, many of which—such as food and drink, tourism, textiles and forest industries—play right into and can be served well by many of our rural and outlying areas. Those are important industries, but it is up to local enterprise companies to keep coming up with compelling reasons why we should invest in their areas.

Sir John Ward: It is worth adding that the chairmen of the local enterprise companies are putting together the way in which the strategy will work. They are doing that in full recognition of the fact that we need a balance between the local need and the wider regional need, which is where the economy works. We are deeply involved with them and we have tried to give them their heads as far as possible. The strategy is not dreamed up in Atlantic Quay; it is dreamed up by the chairmen of the enterprise companies—the people who will implement it. They have a set of proposals on bringing partners into the organisation—which will vary in different parts of the country—to ensure that representation is as broad as possible. You do not need to be concerned, because we will try to ensure that there is flexibility.

Shiona Baird (North East Scotland) (Green): Has Scottish Enterprise ever been challenged about its underspend in previous years?

Jack Perry: I could not answer that, although we were certainly not challenged last year.

Iain Carmichael: We have not been challenged in any serious way, although I am not sure what you mean by challenged.

Shiona Baird: I came to the matter, like everybody else, thinking that it was dreadful of Scottish Enterprise to be going over budget, but then I started reading the papers. It seems to me that if you are trying to support and invest in the Scottish economy, and there was an underspend in previous years, we should be saying that you were not doing your job properly.

Jack Perry: I agree.

Shiona Baird: Instead of that, we are having a heated and lengthy debate on a fairly small overspend that, I hope, has been put to the benefit of the Scottish economy. The issue is perhaps one for us as taxpayers. What proportion of the money that is spent by Scottish Enterprise goes on supporting projects? To what extent is the money being spent on administration and management? I have a particular interest in the situation in Dundee, given the debacle over the leasing arrangement, which has been a huge embarrassment at Scottish Enterprise Tayside. Those are the issues that we need to draw out to establish whether we are having the right argument.

Jack Perry: You raise a number of interesting points. I hope that people keep the subject of our current discussion in some perspective, and I am grateful to you for retaining that perspective.

On the relative spend of our budget, I am certain that our agency stacks up well against any other NDPB or part of the public sector in terms of spend on management and administration. I do not know any other public sector organisation that has cut its staff by fully one quarter and realised substantial productivity improvements in the process, and that has recorded benefits of £170 million over a five-year period. Our management and administration costs compare very favourably indeed with other RDAs.

There is a limit to what I can say about the issues in Dundee, which are the subject of legal appeal. The dispute is a contractual one with a landlord. The figures that have been quoted relate to the entire rental exposure over 10 years with an assumption that there is to be no sublet during that period, which is a highly unlikely scenario. The matter is the subject of litigation so, although I might like to, I will not say any more on it at the moment.

Shiona Baird: Murdo Fraser raised the question of the messages that are being sent to the business community. Having read up on the background, I feel that many businesses will be blooming glad that they are not in your position. When a business underspends one year, the money is available to be spent in future years. If money is held in reserve, it is available to be drawn upon when the need arises. That is the nature of business. I am a small business owner myself, and that is how I work. You are in an unenviable position in many respects.

I am interested in your internal audit report, which discusses the need for greater flexibility. Having done all that investigating and carried out that in-depth review, have you learned enough lessons so that current events do not happen again, while ensuring that the projects that are in the pipeline will actually deliver for Scotland?

Jack Perry: That is our aim. Judging from all the evidence that we have discussed today, many of the projects meet those criteria. We are pleased with the new projects that we have brought online, which are getting substantial private sector leverage and which we are confident are going to achieve a good return on investment for the taxpayer. That is what we are about.

You might want to direct your question about the business perspective to the non-executive directors of Scottish Enterprise, who have a broad business perspective from what they have learned as a consequence of getting into our budgeting and accounting regime and the restrictions that bear upon us. You are right: I have had a lot of support from the business community on the nature of our predicament, although that is not an excuse for not doing some of the things that we should have done. I think that we have been pretty open and transparent about that.

The circumstances in which we manage a large, complex organisation that manages complex projects, many of which take place over several years and are subject to conditions and the actions of other parties, are themselves complex. It is up to us to learn from our experiences.

Sir John Ward: I endorse Jack Perry's point that the business programmes are yielding £3 of private money for every £1 of taxpayers' money, which suggests that the programmes are what the business community wants. That is money in the pocket in terms of support. The Wyeth project in Dundee is potentially one of the biggest breakthroughs that we have had and it could make Scotland a global hub in the life sciences arena.

We are frustrated that although we have about £100 million in the bank, half of which is free, we cannot access it. I am sure that our colleagues on our audit committee would agree that that is frustrating. It seems strange that as an organisation that invests in the economy we have no means of accessing that money and that there are accounting entries that prohibit us from doing so. We understand that the money comes from the public purse, but our inability to access it is a frustration.

To add to Iain Carmichael's point, we are getting a lot of support from the Scottish Executive to find ways around the problem. As we invest in companies through, for example, the Scottish co-investment fund and R and D plus, we will earn money for the taxpayer. If all we do is stick that money in the bank, one has to ask what we are up to. It is crazy.

Susan Deacon (Edinburgh East and Musselburgh) (Lab): I will pursue some wider issues about Scottish Enterprise's future structure and strategy, which are important aspects of our discussion today.

In the autumn of last year, if I recall correctly, you launched a significant review of Scottish Enterprise's structure and there were considerable discussions about it in the months that followed, including conversations with members of the committee and a range of other organisations throughout Scotland. In those discussions, the expectation was that, in future, Scottish Enterprise's structure would reflect the shift towards an emphasis on metropolitan regions and a greater strategic focus.

On 30 March, the Deputy First Minister, in a statement to Parliament, said that he too wanted that move towards a regional approach, an emphasis on metropolitan regions and a greater strategic focus, but that he also wanted to retain 12 local enterprise companies. In your opinion, what will be the impact of that decision by the minister, both on the efficiency and effectiveness of the organisation and on its decision-making processes? Not least, what will be the cost of that decision?

Jack Perry: There was no surprise whatsoever in relation to the minister's statement of 30 March. In fact, the committee will recall from our previous meeting that it was our intention to retain the local enterprise companies. That became apparent at a relatively early stage in our design and consultation process. What was under debate was whether the LECs should retain statutory limited company status, with all the corporate governance issues that that entails. The minister reinforced his desire for an appropriate level of local decision making to be retained within the LECs. We believe that that is manageable within the structure that we have.

The metropolitan regions are, in effect, planning entities. The planning of our services and our strategy will be based on the metropolitan regions and services will be delivered through the local enterprise companies. We will also rely on the LECs to help us develop projects and programmes for inclusion in the metropolitan plan. Although we could probably have streamlined some of the governance and we might have been able to speed up some of the decision making as a consequence, we believe that the structure that we are left with is manageable.

It looks as if I have not answered your question as fully as you would like.

Susan Deacon: I was merely pausing to see whether Sir John wanted to comment further.

15:15

Sir John Ward: I will add to what Jack Perry said: we cannot forget the local dimension—it exists, and it has three dimensions. The first is the local needs to which Christine May referred. We recognise that there are needs, and we have to try to find a way to allow local enterprise companies to respond to them. The second is that local enterprise companies have a role in identifying baseline projects to feed in to the system. The third dimension is that LECs are the delivery mechanism. Our executive teams deliver through them. It is a complex arrangement.

At the metropolitan level, the issue is how we ensure that there is a balance. If, say, we have a hub in the centre of this city, the centre of Glasgow or the centre of one of our other cities, the things that are happening there can benefit the wider community. Rather than compete with each other, LECs will join together so that we have fewer competing projects. That will mean that, as Jack Perry mentioned earlier, in the prioritisation process some LECs might be frustrated because, for example, it might make sense for only one port in the Forth to be invested in. A decision has to be made about that, and we look to the LECs to reduce the amount of duplication, of which there is a lot in the system.

Also at the metropolitan level, as I said in answer to Richard Baker's earlier question, there is an ability to draw in a wider opinion from the business community and, possibly, a council view as well. The question is then how we use that to arrive at the best plan that can be executed through the LECs. The LECs have a role to play, as Jack Perry said.

There were huge opinions on governance, to do with the requirement to register directors at Companies House. We all have our own opinions about whether that is right or wrong, but we concluded that we might as well leave it, because there was no clear opinion. Some LECs felt that we should get rid of that requirement and some felt that we should not get rid of it. It is not a huge issue in the scheme of what we are trying to do.

Susan Deacon: Thank you both for your responses. Let me pursue some of the matters further. Given some of the issues that you require to deal with to develop and improve the project funding arrangements, how are you going to ensure that the structure results in an effective decision-making process rather than being simply an extra layer of bureaucracy, which would be of concern to us all?

I am privileged to be a member not only of this committee but of the Audit Committee, so I look at Scottish Enterprise through a number of different prisms. The recent Audit Scotland report on performance management in Scottish Enterprise observed that the agency compared favourably with other enterprise agencies globally, in terms of its performance measurement and performance management systems. Indeed, the report commented favourably on the changes that you have made to the system of project funding. It also noted, however, that it is important to improve the way in which messages and the understanding of the system are cascaded down through the organisation. The report observed that the large and dispersed nature of the organisation militated against that. That concerns me, given the structural arrangements that there will be in the various layers of decision making and given the fact that, in the future, it will be more difficult rather than—as was thought when Audit Scotland produced its report—less difficult to ensure that the improvements in management practice within the organisation take place.

Sir John Ward: That is absolutely fair. The audit report was useful and our performance committee has taken it up with some enthusiasm. The report suggested some benchmarks that we might use in those areas—no one has a holy grail here.

One of the problems that we face is that, as we slice up our business programmes and LECs, we reach a point at which there is no economic outcome; we can only measure the level of activity. That is one of the things that we have to address in our business investment programmes. We mentioned the co-investment fund, but there is a range of business programmes, and the pipeline of all the programmes—the ITIs and everything else—delivers the outcome. Similarly, the metropolitan areas are, we hope, large enough to deliver economic outcomes.

One criticism of all regional and national development agencies is that they measure activities. We must try to get away from that, because there is no holy grail in it. If we join up work, we will have a better ability to do that.

The metropolitan areas are only one aspect. The business of key industry leadership is to consider whether we can join up our pipelines—if so much is put in at one end, what comes out at the other end? Through time, I hope that we will improve that.

Perhaps we have overfocused on the metropolitan approach, which is only one of several elements that we are trying to bring together to answer the question. We should be able to tell you what our impact on the economy is rather than say that we have met our targets, which we always do. Our targets are input activity targets, and there is nothing wrong with that, but we would like output targets, too.

Jack Perry: In the hierarchy of decision making, the risk is real. We are undertaking detailed implementation planning on the introduction of metropolitan regions, to ensure that decisions are made at the lowest possible level and that we do not end up with more bureaucracy as a consequence. The function of the metropolitan boards is largely to help to develop and approve metropolitan plans. Thereafter, most decision making should take place where it belongs—lower down or back with the SE board. I hope that what we are coming up with is manageable and will not slow the process. It should result in better and more coherent investment decisions for the Scottish economy and should cut the overlapping and duplication from which we sometimes suffer.

Susan Deacon: I concur strongly with Sir John's comment—I am sorry; I will paraphrase it—that the emphasis is often on input targets. Perhaps by necessity, much of the wider consideration of Scottish Enterprise concerns inputs and many relatively short-term, albeit important, issues. How can we in the committee, the Parliament or the country put our eye back on the ball of the big-ticket strategic issues on which we all need to focus and—I say this with the greatest respect—on which we need to hold you to account for your contribution to achieving?

Jack Perry: You referred to the Auditor General's report and I am glad that you highlighted the positive feedback in that. I looked in on the Auditor General giving evidence to the Audit Committee a couple of weeks ago.

We are going for more strategic projects and we are trying to harness genuine industrial demand. There is great evidence from some projects that I have mentioned, such as Stirling Medical Innovations and the translational medicine research collaboration. Those projects have great leverage in private sector investment and show good returns for the taxpayer. In the translational medicine collaboration, we are participating in the commercial venture, which will own some of the resulting royalties. However, we are also issuing loan notes, which carry a commercial rate of return.

That is a much more satisfying and worthwhile way of sharing risk with our customers and partners than is giving out grant funding, but it has an impact on our funding. As Iain Carmichael has described, we are almost hit twice for investing rather than just giving out grants. From a strategic point of view, we need to achieve clarity on longer-term budgeting, funding and accounting for Scottish Enterprise, so the matters are related. The strategy of harnessing better industrial demand and delivering it on a metropolitan basis or planning for it on a metropolitan basis with local delivery is right.

Sir John Ward: The annuality issue to which Jack Perry referred and which I have mentioned is important. I will return to Karen Gillon's question. Of last year's £27 million underspend, £17 million was a gain on an investment that we made. If that money cannot be spent in the year in which it is realised, it goes into the bank; it is locked away and we cannot get at it. That seems rather silly. If we can accumulate reserves, because we have earned them, they might be applied back through time rather than being lost on 31 March at the end of a financial year.

That is what happens currently and it comes back to the access to cash reserves, which arise because we made investments and accumulated cash. As Jack Perry said, if the translational medicine brings us a lot of income and we do not spend it in the year in which it is derived, it will go into the bank and be lost. It will just sit there earning interest. I would think that there would be a better way of handling the annuality. As I said in my introduction, that is one of the areas that we are discussing with the Executive. The question is whether we can find a way of having some sort of through-flow. The more big projects that we get involved in—we are trying to do that—the more the cash issue will arise.

Susan Deacon: On the point that there must be a better way of creating the wider public sector accounting framework within which an agency such as Scottish Enterprise operates, how confident are you that the current dialogue with the Executive will involve a wide-ranging discussion—and, I hope, a positive outcome—in that regard? Does the discussion need to be widened to cover what might be the appropriate public sector accounting regime for the longer term rather than the short term? Such a regime could ensure, on the one hand, high standards of public accountability for the expenditure of our national enterprise agency and, on the other hand, freedom for the agency to operate, take strategic decisions and develop the projects that we would all agree are necessary to grow the Scottish economy and meet our shared objectives for it.

Jack Perry: We recognise some of the restrictions under which the Executive operates. Many of the rules that we have described are Treasury rules that apply across the UK. It might be possible to get something further in terms of end-year flexibility that could be applied in Scotland and which would give us what we seek. We are exploring that with the Executive. At this stage, I admit that I do not know what flexibility the Executive has at its disposal; I am sure that it, too, needs to learn as we go along what may or may not be possible.

We seek the flexibility to earn surpluses and be able to recycle them. We were asked to create a three-year operating plan, which was introduced last year for the first time. However, the reality is that although we prepare a three-year operating plan that includes all our expenditure and projects, the budget remains strictly annualised. It would be nice if one could get an alignment of the operating plan with the budgeting regime.

Jim Mather (Highlands and Islands) (SNP): Good afternoon, gentlemen. I am keen to follow up on Shiona Baird's point about being on the right argument and considering effectiveness. You have painted a complex picture that includes a high degree of uncertainty and the restrictions to which you just referred. On top of that, it seems to me that there is no guarantee that the resultant wealth, or anything that is produced by Scottish Enterprise investments, will be wholly rooted in Scotland. That view is reinforced by the fact that we have no clear outcome measures, as opposed to inputs or outputs, other than the 30 years of low growth that we have had.

On performance, Jack Perry has told me in the past that we will see the results of the investment in 15 to 20 years. That seems to me to be too long a timeframe. John Ward has spoken about the critique of the size of the public sector in Scotland; today, Brian Wilson is seeking to burnish it to the bare metal. The International Institute for Management Development's world competitiveness index puts Scotland very much lower than the rest of the UK. There is no level playing field in the UK. In addition, we have the current difficulties. Given the current system, can the job be done? Will you be able to foster meaningful growth that will allow the taxpayers who fund Scottish Enterprise to see their living standards converge on what is happening elsewhere? Can that be done?

Sir John Ward: Before answering the question, I want to correct one point that you made. I have never criticised the size of the public sector. Any comment that I have made was about the proportion of the demand side of our economy, which is driven by Government spending.

Jim Mather: I accept that.

15:30

Sir John Ward: The public sector is as big as we can afford it to be. That is what we should aim for.

Convener, may I take a moment to respond to Jim Mather's point?

The Convener: Yes.

Sir John Ward: We used to be a manufacturing economy and the dynamic of a manufacturing economy is that the plants have to be near mass labour. We are now a 70 per cent service economy, in which the whole effort has to be close to the customer. As long as there is a global supply chain and cheap labour, plants can be put anywhere in the world, but we cannot do that with a service economy, so what matters is the size of the conurbation.

Jim Mather: Yes, but—

Sir John Ward: Let me finish. The one conurbation in Britain that fits on Loughborough University's world map is London. In Scotland, we must recognise that unless we begin to join up our country—as Copenhagen and Malmo did, or as Stuttgart has done, or as Manchester and Liverpool are trying to do—we cannot answer your question. We need your help to do that. If we join up the critical mass of Scotland, we have more intellectual property for our size than any other part of the UK, we have a more highly educated workforce than most other countries in the Organisation for Economic Co-operation and Development and we have a lot of talent locked into quite a small piece of geography.

Jim Mather: You have just said that you cannot answer the question. Are you telling me—

Sir John Ward: I did not say that. I said that unless we join up Scotland's critical mass, we cannot answer the question.

Through our key industries, which should be globally competitive, and our metropolitan regions, we are trying to find a way in which to answer your question. The specific answer is that if we fragment the country, we cannot answer that question.

Jack Perry: I am paraphrasing, but I think that the nub of your question is that although we keep achieving activity or input targets, you do not see any evidence that the economy is growing as well as you would like it to.

We are trying to find better output measures and, ideally, impact measures, although they are quite difficult, particularly on long-term projects; as the Auditor General said, no one around the world is doing that particularly well. Increasingly, on projects such as co-investment funding, we look at leverage, private sector investment and R and D plus. With R and D plus, we put in £15 million and get £120 million of new research and development expenditure in Scotland that would otherwise simply not have happened. We have invested £45 million since the co-investment fund and our other investment funds were set up. We have attracted approximately £150 million of private sector equity into new, early-stage Scottish businesses and £200 million of new equity investment that otherwise would not be happening in Scotland. If our performance is compared with that of the rest of the world, Scotland is still the major region of the UK, outwith the south-east of England, in terms of attracting new inward investment.

We want to look at the gross value added of the projects that we sponsor and in which we invest.

Jim Mather: I hear all that, but—

Jack Perry: All our project appraisals attempt to forecast the GVA that is created by our investment, but that is difficult. Let us consider something like the Clyde waterfront project. That is a seven-year plan for us to put in £126 million. Over a 15-year period, we will ultimately be looking for more than £2 billion of other public and private investment in that project.

What do I claim is the GVA that Scottish Enterprise contributed to that project, which we anticipate will be very substantial? Do I claim the whole lot? We initiated the project and we put together the partnerships. Other investment would not have happened without us, but the people who put in the £2 billion might have something to say about that. It is quite wrong to say that we cannot measure our contribution so we should give up. You need to understand that sometimes those measures are kind of tricky.

Jim Mather: I understand that, but other countries seem to manage it.

Jack Perry: Not according to the Auditor General.

Jim Mather: What was your reaction last week to what Ronald MacDonald, who is the holder of the Adam Smith chair of political economy at the University of Glasgow, said about the major flaw in our economy being that we have a bail-out set-up? I presume that you are being bailed out, and the Scottish Executive can be bailed out from time to time. Ronald MacDonald said that it is not possible to spend wisely or grow the economy in such a climate and that such a set-up creates a moral hazard in which mistakes can be made and effectiveness is liable to go out of the window.

Jack Perry: From the day that John Ward and I came into office, we have been transparent. The thrust of our investment ought to be to share risks with our customers rather than to deficit fund programmes, although that has proved to be unpopular in places. The reality is that we exist to work with companies that can make a disproportionate impact on the Scottish economy and that we do so by sharing investment risks in order to improve their productivity. Increasing that productivity means less deficit funding and more co-investment.

Jim Mather: You say that, but people of my generation have been in business here for 30 years and have watched smart people, capital, decision making and profits flowing out of Scotland and the consolidation of ownership elsewhere. What is your reaction to the words of the chief economist of the OECD, Jean-Philippe Cotis, who said that a failure to converge in economic terms is a failure to learn? Are there other things that we can learn to do in Scotland that we are not doing?

Jack Perry: I am certain that there are. However, some of the major projects on which we are embarking are in those convergent technologies. We think that Scotland has outstanding technology, for which there are long-term, sustainable global markets. That is the whole thrust behind our key industries policy, and that is what will drive the demand for future Scottish Enterprise intervention.

Jim Mather: I admire your optimism, but in the current climate—

Sir John Ward: I hope that we also have your support.

Jim Mather: You always get my support because you are all that we currently have. I want a lot more than you do and I want you to leave a better legacy. I will be honest. John Ward and I go back a long way. I say with total respect that I genuinely look forward to his retirement from his job, because he will then be free to say what really needs to be said.

The Convener: The discussion has continued for more than an hour and a half and I appreciate the patience that has been shown. However, there are questions that I would like to ask.

I agree with the witnesses on two matters. Some policy issues that have been addressed, such as the use of reserves and more flexibility, need to be considered. I hope that the committee will consider such issues in due course and address them with the minister. Secondly, I fully understand that there is a need for a stronger pipeline of good and worthwhile projects that will have a higher impact on the Scottish economy than there has been in years past, and I support what has been said. You have made a fair case on both matters; that said, the way in which finances have been managed in the past year brings to mind Walter Mitty a wee bit.

I want to pursue points that have been made by Karen Gillon, Michael Matheson, Murdo Fraser and others. I understand why you kept discussions going with the Scottish Executive on getting more flexibility with the use of reserves, but we must make a clear distinction between bids for projects and commitments to expenditure. It is clear that there is no fundamental problem with encouraging as much bidding for projects as there can be—in fact, you want to encourage that—because the best projects that would have the greatest impact on the Scottish economy could then be selected. However, I still do not understand why there was a failure to keep expenditure commitments within the agreed budget. Will you enlighten me on that?

Jack Perry: Sure. I will bring in Iain Carmichael in just a second.

The reality is that we will simply underspend if we do not have commitments that are in excess of budgets. When we make offers—which count as commitments—the conditions behind them are often not fulfilled or partners do not come up with a similar commitment. Frankly, we have to overcommit because we know that there will always be slippage. There was substantial slippage last year. In the end, we had to force some of it. It is easy to talk about the difference between bids, commitments and offers, but the reality is that there is a broad spectrum and, often, the lines are not clear. If we are to avoid underspending, we have to overcommit.

Iain Carmichael: At our executive board meeting this morning, we discussed a project with the project manager and he made the point that some of our business units believe that they have to overcommit by 100 per cent in order to spend their budget within year because so many of the commitments that we make do not materialise and crystallise into a payment within year.

I agree with Jack Perry. We still need to commit more than our budget in any one year to avoid an underspend. The error that we made last year was that we did not take sufficiently robust action to rephase our expenditure in November and December.

Jack Perry: I would love to have a system in which the money followed the commitment. Any sensible business would organise itself in that way. Money would be reserved for a commitment until such time as it was fulfilled or it lapsed. However, we cannot operate in that way. With an annualised system, that is not possible.

The Convener: However, many other organisations are in a similar position and operate under the same rules. Highlands and Islands Enterprise is the best example in Scotland, but it has managed its budget. Indeed, although Scottish Enterprise has underspent in the past, it managed its budget until last year. It is a question of what went wrong last year.

Jack Perry: Absolutely. We consistently underspent; I illustrated the extent of the underspend in my opening remarks. About four years ago, it ran to 6.6 per cent, which represents a serious loss of economic opportunity for Scotland. I do not think that that is necessarily indicative of better or worse management than what we have exercised or displayed this year.

Highlands and Islands Enterprise is a fine organisation. It has more than enough non-cash resource cover for all its needs.

The Convener: At First Minister's question time on 19 January, I asked about the emerging financial problems at Scottish Enterprise. The First Minister said:

> "We should ensure that Scottish Enterprise knows its budget and that it implements its decisions within that budget. That is what we expect Scottish Enterprise to do. That is its responsibility, and it is properly audited for that purpose. I expect Scottish Enterprise to meet its budget targets."—[*Official Report*, 19 January 2006; c 22555.]

When the First Minister made that statement, you were still projecting a £77 million overspend. Did anyone tell the First Minister about the projected overspend or did he not know about it?

Jack Perry: The discussions that we had were with the enterprise department. I could not tell you what was or was not relayed to the First Minister at that time. The figure that you mention is about right for that time, given the overplanning or overcommitment, but we knew that it would be managed down. In the end, we overshot by 2 per cent on cash and £25 million on non-cash resource cover. There was certainly never any intention to mislead ministers, who were given information based on the available facts at the time.

The Convener: Just to be absolutely clear, the enterprise department knew in January that internally you were still forecasting a £77 million overspend.

Jack Perry: The department would have been party to our forecast, but there was also an open discussion with the department on the nature of the risks that remained for the rest of the year.

The Convener: So the department had all the information that you had and it should have been absolutely clear that there was a projected overspend of £77 million.

15:45

Jack Perry: Please remember that, at that time, we were managing it down and we believed that we would get pretty close. It would be wrong to characterise what happened as disinformation on behalf of the enterprise department.

The Convener: I am not characterising it as anything; I am just asking the question. As far as you were concerned, the enterprise department knew at the time, in January, that you were still forecasting a £77 million overspend—although you were trying to manage it down further.

Jack Perry: I could not tell you, at that date, what the—

Iain Carmichael: I would want to check the specific dates.

Jack Perry: Yes, we would be happy to come back to you—

The Convener: I am going by page 10 of the KPMG report, which says, for January 2006:

> "Cash overspend projected at £77 million. November 'active financial planning' has not had sufficient effect. BUs given capped budgets for the remainder of the year".

Did the Scottish Executive Enterprise, Transport and Lifelong Learning Department know that at the time? It is a straightforward question.

Iain Carmichael: I would want to check the dates. I am not absolutely certain. You have to remember that at that time a lot of meetings were going on with the enterprise department.

The Convener: But I presume that you kept the enterprise department informed every time that you made a new forecast.

Iain Carmichael: Yes.

The Convener: Okay. So it should have known at the time.

Iain Carmichael: I suspect so, but I would like to confirm that.

The Convener: Right. Okay.

Jack Perry: At 13 January, our figure for the original forecast was £48 million. The revised figure would have included the £25 million non-cash element.

The Convener: But, to paraphrase very clearly, at that stage you knew that you were unlikely to come within your budget.

Jack Perry: At that stage, we were still trying to work the figure down and I do not think that we knew how close to the break-even point we would get.

The Convener: According to information that was published under the freedom of information regime at the weekend, Eddie Frizzell said in a letter to you in January that Scottish Enterprise broke assurances that it would work within its budget for 2005-06. The letter suggested that you misled the First Minister about the true state of Scottish Enterprise's finances. Is that nonsense?

Jack Perry: I cannot recall what previous conversations would have led to that remark in that letter. I am not certain what conversation he was referring to.

The Convener: In the January letter from Eddie Frizzell—who is the head of the enterprise department—he said that the overspend was

> "very unsatisfactory, and raises in my mind, as it will in others', questions as to whether there are failings in the approval arrangements for projects and in budget monitoring which have to be addressed."

What happened as a result of that letter?

Jack Perry: I wrote to him shortly afterwards and, as you know, we initiated the internal audit review at that time to ensure that we fully understood where all weaknesses may have occurred. That information, with full descriptions, is now in your hands.

The Convener: However, the Scottish Executive did not order its audit from KPMG until about two months later.

Jack Perry: The Scottish Executive was well aware, because of its attendance at our audit committee, of the actions that we were taking on the initiation of the internal audit.

The Convener: Who from the Scottish Executive sits on your audit committee?

Jack Perry: It varies, but it is generally Jane Morgan.

The Convener: The KPMG report says:

> "There was no reporting until January 2006 of the non-cash expenditure".

Why not?

Iain Carmichael: The reporting that is referred to is probably the reporting to the board on non-cash expenditure. That followed our discussions in November and December, when we agreed that we had to start accounting for resource accounting. In the early part of last year, our reports had not included the resource accounting element.

The Convener: Why not?

Iain Carmichael: I think because we underestimated the impact that it would have.

The Convener: Is that because you did not understand it, or because you did not realise the implications, or because you did not think that it was going to have any impact on your budget?

Iain Carmichael: I think that it was because we did not realise the serious implications that resource accounting would have, partly because we did not fully understand it.

The Convener: You did not understand resource accounting?

Iain Carmichael: We did not understand its implications.

The Convener: Resource accounting is two thirds of the reason for the deficit.

Iain Carmichael: I do not agree with that. As I said, I think that we have ended up with a deficit because although we knew in November that we had an issue with resource accounting and that overspend had been forecast, we did not take appropriate action in November and December to reduce the spend to the end of the year, taking all those factors into consideration.

The Convener: You are saying that when resource accounting was introduced, Scottish Enterprise made no detailed assessment of the implications of that for its budget.

Iain Carmichael: In previous years, the custom and practice had been that resource accounting issues were resolved. That was masked by the fact that we had underspends in those years. As we have already said, in the early part of 2005-06 we were optimistic—wrongly, as it turns out—that the resource accounting issues would be resolved with the enterprise department during the year. When we got to November and realised that they would not be resolved, we started to take account of them in our work to reduce our forecast spend.

The Convener: Would you describe that as very poor financial management?

Iain Carmichael: In retrospect, our behaviour was inappropriate; we should have taken account of the problems.

The Convener: I will let Karen Gillon in and then I will come back in.

Karen Gillon: I have a quick follow-up question. I do not understand how the Executive could provide extra resources for an organisation that had underspent. How had the shortfall been managed out in previous years in which you underspent? Why did you think that you would get extra money on the basis of what had happened in previous years? Were you working under different rules? Iain Carmichael appears to have contradicted what he said to me.

Jack Perry: Iain Carmichael will correct me if I am wrong, but I think that the underspends in previous years were probably less than the amount of resource shortfall and that the excess was found from elsewhere in the enterprise department. The non-cash resource shortfall was taken care of by a combination of underspends and surplus resource cover that was available from elsewhere in the enterprise department.

Karen Gillon: I am more confused than I was before. If you underspent by £27 million last year—

Jack Perry: We underspent by only £10 million and had surplus receipts of £17 million.

Karen Gillon: In 2004-05, as opposed to the most recent financial year, you underspent by £10 million. I take it that your non-cash asset was roughly the same—about £34 million. Was that removed from, or set off against, the budget?

Jack Perry: No. Let me give you some hypothetical figures to illustrate the situation. If there was a £25 million shortfall and an underspend of £10 million, £10 million would be set off against the £25 million and £15 million would still have to be found. We believe that the £15 million was found from elsewhere in the enterprise department.

The Convener: Basically, you gambled on the same thing happening in 2005-06.

Jack Perry: At the beginning of that year, we genuinely believed that the new process meant that there was a serious risk that we would underspend, so at that stage we were less concerned about our non-cash resource cover. As the year progressed, it became increasingly apparent that that would be a problem.

Michael Matheson: I want to clarify for how many financial years you have been operating under resource accounting.

Iain Carmichael: Since 2003-04. In 2003-04 and 2004-05, resource accounting was not an issue for us because there was a cash underspend, which was compensated for by the non-cash overspend. It became an issue in 2005-06 because our cash spend was high.

Michael Matheson: In previous years, did you always account for the non-cash element in your budgets?

Iain Carmichael: Not in detail. Although we took account of it at a central level, we did not do so in our allocation of budgets to business units because a different process was in place then.

Michael Matheson: I am aware that a different process would have been in place in previous years, but you were still meant to account for the non-cash element and you failed to do so.

Iain Carmichael: We accounted for it: we were aware of it, and we obviously had to capture it and report on it.

Michael Matheson: Did you budget for it in both those years?

Jack Perry: Individual business unit budgets did not include non-cash resources.

Michael Matheson: You did not budget for it in the two years in question.

Jack Perry: No.

Michael Matheson: You just carried forward the assumption into this financial year.

Jack Perry: Yes.

The Convener: But the situation could not all have been down to RAB. Page 8 of the KPMG report says:

> "The level of projected cash expenditure in the first nine months of 05/06 was significantly in excess of the projected cash resource".

In other words, you were spending way beyond your means.

Iain Carmichael: We were forecasting ahead of our means. We thought that we had taken appropriate action in November and December to manage that back, but it turned out that that action was not robust enough. We were aware in November and December that we were forecasting ahead of our resources and we started to take action on that then.

Jack Perry: Again, the KPMG report makes it clear that the final cash overspend was £10 million.

Karen Gillon: Where did the money come from? When did you get the extra money from the Scottish Executive?

Iain Carmichael: The £30 million?

Karen Gillon: No, the extra money that seemed to appear from somewhere to prevent you from having to do the present exercise last year—the extra £15 million.

Jack Perry: Using that hypothetical example, we believed that there was unused resource cover available within the department.

Karen Gillon: So the department just slipped it into your bank account.

Iain Carmichael: No. It is not cash.

Karen Gillon: All right—it is just about writing a different wee line in the budget.

Iain Carmichael: It does not come into our budget; it is balanced at department level.

Karen Gillon: This is why I am having severe difficulties in understanding how the budget that you followed for the past two years suddenly caused you such difficulties this year.

Iain Carmichael: The reason why it caused us difficulty this year is because we have a stronger pipeline and a greater demand on our resources. The balancing is done within the department; it is not done within Scottish Enterprise.

The Convener: I take the point about the greater pipeline and commitment, and I accept that you must always plan. However, when I worked in the computer industry, we had a budget and a plan for monthly shipments, but we always kept within our resource budget. Obviously, you went over your total cash-plus-RAB budget by an amount in the order of £34 million.

Of the new budget allocation system, KPMG says:

> "The new system created increased expenditure but the accountability and monitoring systems were not sufficiently robust to exercise the overall control of expenditure required to keep within budget".

Iain Carmichael: Yes.

The Convener: You accept that. Is that not poor financial management?

Jack Perry: We were clear about that in the internal audit report on the work that was done. The systems that we had in the organisation for the monitoring and tracking of commitments were quite adequate for an organisation that persistently underspent its budget, but they proved to be inadequate—we said that clearly—for an organisation that had significant competition for funding. Those inadequacies are being addressed.

The Convener: You would agree with the KPMG statement that action to deal with the looming overspend last year was "not sufficiently robust" and that there was

> "poor and slow financial reporting and unclear budget accountability."

Jack Perry: Again, we made it clear in our previous answers that there was a crucial two-month period when the measures that we took did not produce sufficient reduction in the forecast spend. At that stage, we had to introduce fixed and capped budgets for each business unit.

The Convener: Had you accepted, as a fact of life that was not going to change, the Scottish Executive's word that there was no way that you were going to get additional resources from the reserves, RAB or grant in aid—which appears to have been the case since May 2005—would you still have overspent by £34 million?

Jack Perry: Possibly not, but you are going into hypothetical circumstances now. The reality is that, because of inadequate resource cover, we would have had to cut £25 million of cash spend. We would have had to make that decision sooner or later, regardless.

16:00

The Convener: There was no plan B.

Jack Perry: At that stage, we had no alternative. We continued to have discussions.

The Convener: You will understand our concern—which is widely felt in the Parliament—about the implications. For example, on Friday, I visited a relatively new training company that employs five people who were extremely worried about the company's future because of the problems at Scottish Enterprise. We can probably multiply that example many times throughout our constituencies. It is not just a matter of getting the accounts right; the human impact on people outwith Scottish Enterprise is that they could lose their jobs. We will not know the scale of that impact until you know your new budget, which projects will proceed and have priority and which projects will be dumped. That is why we want to see you again next week or the week after that. We are all extremely concerned about the human story.

Jack Perry: We understand that well. Similarly, we have had much support from businesses that recognise the transition that we are making and support the changes that we are introducing.

It is interesting and important to note that quite a lot of discussion has taken place about the value that Scottish Enterprise delivers to the Scottish economy. It is evident from all the discussions that the committee has had and from much of the speculation about what might or might not be cut that people overwhelmingly find that what we deliver creates real value and is desperately important to their businesses, their training and some of the major projects that will make a transformational difference to Scotland. If members want evidence of the value that Scottish Enterprise delivers, it is amply available. Any discussions about the risk to Scottish Enterprise's funding and projects have caused anguish.

The Convener: That is why I said at the beginning of my comments that the policy changes find much favour with me.

Jack Perry: We agree.

Murdo Fraser: I would like clarification of an answer that you gave Alex Neil. I will return to the two months between November and January when insufficient action was taken. Paragraph 1.3.4 of the internal audit report "Review of Resource Allocation" says:

"An opportunity was missed following the quarterly review in November 2005 to achieve the required reductions within a controlled course of action. In conclusion a combination of the following factors contributed to this situation, as follows:

(i) Financial Management

The action taken during the year to reduce forecasted expenditure was insufficient. There was a lack of clear communication in setting specific targets for all business units. The first clear communication of a target for each business unit was in January 2006."

What happened in November?

Jack Perry: In November, we gathered together all the business unit leaders from the network. We highlighted the problem exactly and asked each business unit leader to come back to us with proposals for reductions in their budgets. We were not prescriptive; we did not say, "You will each cut your individual budget by X per cent." By late December, it was evident that the individual business units were not producing sufficient reductions in their forecast spend, so we introduced capped budgets.

We did not want to introduce capped budgets, for the reasons that I discussed. In retrospect we can say that, had we done so, we probably would have avoided the overspend. However, the decision was not made carelessly; it was deliberate. We did not want to shackle the business unduly when we felt that the situation was still manageable. However, in retrospect, it would have been better to do so.

Murdo Fraser: So you say with hindsight that that was a mistake.

Jack Perry: In hindsight, it was a mistake. Hindsight is a great thing.

The Convener: We gave that session just over two hours and I think that every member has had the opportunity to ask the questions that they wanted to ask. I thank Sir John Ward, Jack Perry and Iain Carmichael for giving us their time. We look forward to seeing them again, probably next week or the week after that, once we know what the budgets and their implications are. We will leave it to the clerks to negotiate the exact timing.

Jack Perry: The timing will be based on the outcome and timing of decisions. We will need to work through the implications for our operating plan and forecast for next year.

The Convener: When we complete this series of interviews, the committee will have time to consider its views and discuss whether to hold a fuller investigation into both the policy and the operational issues.

Before we move on to our next panel, we will have a five-minute break.

16:05

Meeting suspended.

16:16

On resuming—

The Convener: We move on to our second panel. I welcome Charlie Morrison and Fred Hallsworth, who are, respectively, the chair and vice-chair of the audit committee of Scottish Enterprise. We will follow the same pattern as before. I invite Charlie and Fred to say a few words—we have their report, for which I thank them—and I will then open up the discussion to questions from members.

Charlie Morrison (Scottish Enterprise): I am conscious that time is marching on, so I will keep my opening comments short.

You have all focused on the KPMG report, but there is also a comprehensive internal report. We planned to take it to the quarterly meeting of our audit committee in June, but we accelerated it. As soon as we knew that there was a serious potential overspend, we got the activity started. That was at the end of January. We took the time to explore every angle and we reviewed not only the internal processes but the overall budgeting factors, because both make a significant contribution, as you have seen.

The main focus of the audit committee and audit team is on deciding what the weaknesses were—Shiona Baird made that point earlier—and identifying and resolving all the issues so that the same problems are not repeated. Not everything is within our control, but we can examine the processes to make sure that there is no repeat. We will track the recommendations and pursue them to a conclusion. There is an internal commitment to resolve most of them within about seven or eight days from now.

I have two comments to make, but in the interests of time I will not make them now. I want to address a serious point that Karen Gillon made and one that Shiona Baird made, but I will come back to them.

Fred Hallsworth (Scottish Enterprise): Good afternoon. As you know, Charlie Morrison and I requested access to you today and we are delighted that you consented, particularly given the amount of business that you had set up for today and the length of the session with the previous panel.

We are here to answer any questions that you have about our audit committee's report, which Charlie Morrison and I were instrumental in compiling. We are keen to assist your understanding of how the forecast overspend for 2005-06 occurred, to explain the recommendations that the internal audit group made to minimise the risk of the overspend recurring and to discuss the part that we will play to try to ensure that that happens.

The Convener: Thank you for circulating the audit report, which is helpful.

Christine May: Paragraph 3.6 of the summary conclusions in the internal audit report states that Scottish Enterprise

"needs to work with the Scottish Executive and other economic development agencies to ensure that such unintended consequences do not result in an adverse impact on the Scottish economy."

Will the witnesses expand on that? Which other agencies are you referring to in that recommendation and why?

Charlie Morrison: The other economic development agencies could include Highlands and Islands Enterprise and the agencies down south that have similar issues. Jack Perry and Iain Carmichael spent quite a lot of time talking to and liaising with those agencies, which face many of the issues that we have heard about this afternoon.

The key point is that there could be a disincentive to go down the capital project route and that grants could simply be offered if, in effect, everything has to be paid for twice. We must keep working on that matter. RAB will have to be dealt with, but can there be more flexibility? Logically, that should come in time. That is the thrust of the matter.

Christine May: Okay. So you are considering a United Kingdom-wide approach as well as a Scottish approach, given that the issues also apply to the regional development agencies.

Fred Hallsworth: We consciously made that conclusion the last of the major conclusions because it is for the future.

Christine May: I would like to continue to focus on the future and unintended consequences. Will you highlight which of your recommendations are geared towards ensuring that the agency can continue to do both elements of its work, which Sir John Ward and others have mentioned? I am referring to the big, national stuff and local, ground-up or smaller training projects, which Alex Neil mentioned. Such projects could involve relatively few employees, but could provide an important service in the local community.

Charlie Morrison: Several recommendations have been made, which I would split into two groups. Things to do with internal processes and the management system need to be done. The information technology control and planning system needs to be overhauled in order to give a sharp and much more powerful focus on actual projected expenditure than there has been this year. That issue contributed to the problem. A way of tracking and controlling projects that are bouncing from one year to the next is needed, which, to be fair, is not a trivial task, as 5,000 projects are involved. If those things happen, they will give the management team sharp information on a real-time basis that will allow it to control its expenditure well and thus to allocate resources in a more controlled and balanced way among the big projects, training programmes and smaller projects.

You probably know about a positive thing that was done, which has not been mentioned today—I refer to the additional authorisation that was given to the LECs. We considered more than 300 projects that had been approved as part of the process, most of which were good. The idea and intent were to control spend in the appropriate areas. Without such control, people will end up with major balancing jobs. As members have said, there could be collateral damage from the impact on some smaller guys. The core issue is that the different elements can be maintained and protected if expenditure is well controlled.

Secondly, there is the flexibility of the budgeting. There is absolutely no question but that in an agency such as Scottish Enterprise that tries to spend vast sums of money, particularly on portfolio investments—all of which could slide from one year to the next—a way of moving spending is needed, as Sir John Ward has said. I think that Shiona Baird said that she did not know how a business in the same position as Scottish Enterprise could be run. If a business received funding of £27 million in 2004-05 for big projects, but moved those projects to the next year, with the £27 million gone, it would be under big pressure. That was one of the embedded pressures that existed. I am not defending what happened, because at the end of the day what happened was not acceptable in any way, shape or form. However, the embedded pressures must be removed in future because they can potentially have a collateral impact on the small guys—that is Christine May's point. The two things that I have mentioned need to happen.

Christine May: I want to pursue that. If there is no change and no three-year budgeting cycle, which local authorities have, for example, is there real potential for what has happened recurring?

Fred Hallsworth: It is inevitable, given that Scottish Enterprise is currently compelled to control its budgets annually in compliance with RAB. The non-executive directors in particular would be keener on having an underspend rather than an overspend, which can lead to controversy such as the one that we are experiencing.

Without solutions that provide flexibility—for example, as Jack Perry said, a move to a system in which the cash follows the project even if the project slips—we will have, de facto, a risk-averse economic development agency, which is an oxymoron.

Christine May: Will you comment on the impact on those who are currently non-executive directors and the potential for attracting other people from the business world to take up those positions?

Fred Hallsworth: The non-executive directors all thought long and hard about the outputs of the work that Charlie Morrison and I led. One of the conclusions in the report is that the inherent financial risk in the environment within which Scottish Enterprise operates is much greater than it has ever been. That derives directly from the fact that, as you heard earlier, the percentage of Scottish Enterprise's spend that is driven by large, fixed-cost, multiyear programmes is increasing. By virtue of that, the percentage of available, uncommitted cash spend is reducing. We are therefore in a higher risk environment.

The non-executive directors were interested in the internal audit committee's report at the special meeting that Sir John Ward mentioned earlier. I would not say that there are any coats on shaky pegs as far as our support for the organisation is concerned—indeed, we support what the executive directors have achieved because there are some positive aspects to that. However, we will now look closely at the budget versus the actual spend monthly rather than quarterly and we will examine the full RAB figures rather than just the cash figures.

I remind the committee that the non-executive directors started asking questions about the potential overspend from October onwards. In future, given the variables associated with the big projects, it is inevitable that as the year end approaches we will want to be satisfied that we are not going to overspend. It is therefore more likely that we will underspend. I do not think that that is to the benefit of the nation.

Charlie Morrison: Christine May knows—because she has been on the board—that every single non-executive director wants to help by bringing to the table whatever skills and talent they have picked up over the years. Their desire to do that has not diminished. They are determined people who are passionate about Scotland being successful and about the organisation being successful. They will be watching carefully and hoping that there is some flexibility.

The points about design and resource management are okay. We can understand the approach, from a finance point of view, which is to minimise investment in assets. However, the development agency exists in a world of portfolio management and it makes investments and bets on behalf of Scotland. That is a challenge. There is no question but that Scottish Enterprise will be looking for a bit of flexibility.

Christine May: Convener, for the avoidance of doubt, I should perhaps say to the committee that I was a member of the Scottish Enterprise board until December 2002 or January 2003, which is, obviously, before the time when the resource—

Charlie Morrison: Not in 2005-06. [*Laughter.*]

The Convener: She has now been demoted to being an MSP.

Christine May: Speak for yourself.

Murdo Fraser: Good afternoon, gentlemen. In paragraph 2 of your report, in the section on the forecast overspend for 2005-06, you state:

> "Non Executive Directors regularly questioned and challenged the Executive Directors at SE Board meetings from October 2005 onwards on this issue. However, while the Executive Board attempted to contain expenditure within budget, despite their efforts SE is still currently forecasting an overspend of £33m."

Is there intended to be a suggestion in that paragraph that the non-executive directors think that the board was somehow dilatory in dealing with the problem?

16:30

Charlie Morrison: I think that that is just a fact. There was some pretty robust questioning and debate at the board meeting in October, which was in Dundee, I think. Looking at the history of events, we can see how the situation heated up. In late August or early September, it started to become apparent from the information that was appearing that the system was potentially overheating and that there were some pretty robust challenges.

I heard Karen Gillon's earlier point. I do not believe that there was any malice aforethought on the part of the management team. They were genuinely trying to wrestle with the pipeline of projects, which was firming up. For 15 or 16 years, underspends followed by overforecasts were in every bone of people's bodies. I am not talking only about the finance people—person by person, hundreds of project managers and the entire organisation had lived their lives and careers in a world of overforecasting and underspending because of constant project slippages.

We have heard the remark that one has to double one's forecast to make one's budget. We challenged things but people were working on assumptions that were not so much based on resource accounting as on cash reserves. By and large, those cash reserves were generated by Scottish Enterprise through efficiencies and good investment decisions.

I have not yet addressed Shiona Baird's point. From an internal point of view, I will not defend things for a second. It must have felt pretty galling not to be able to use some of those cash reserves for offsetting purposes when new projects were being pumped through. We have examined all those projects and they were good-quality projects for the Scottish economy.

A series of things were being done and it was assumed that a few would come out positively—I think that the expression was that the jumbo would land on the postage stamp. However, Sod's law applied and everything went bad. The whole situation became negative and the board just did not make it.

Through October and November, the board, under Sir John Ward, challenged the management team hard. The team kept arriving at the management judgment that it could still make it. Jack Perry has been honest enough to say that, in November, the budgets could have been capped and the cheque books taken away. I believe that that did not happen because—I will let Fred Hallsworth talk about this—it would have sent out a huge signal about the whole process.

As Fred Hallsworth said earlier, if the team had decided that job 1 was to make the budget and not overspend, it could have achieved that. It could have made that decision in November, but it made the wrong call. It is as simple as that. An interesting question is whether that was the wrong call for Scotland in the long term. The money that we have spent would have been spent anyway. This is probably a phasing issue—money going out of 2005-06 and into 2006-07.

Fred Hallsworth: I will risk using too many numbers here but it is important to use a few. We have talked about the pipeline and the forecast overspend, and Iain Carmichael said earlier that things were not all committed to by any stretch—whether through legal commitments or purchase orders. At one end of the spectrum, there is a general agreement to go ahead with a project; at the other end, there is a fully committed project.

We can track the so-called forecast overspend over the period from just before Jack Perry implemented his chief executive officer change agenda. The numbers that I will give all derive from the various reports that we have given the committee. The internal audit report shows that, in December 2004, when the executive board was considering the forecast for 2005-06—the next full year and the one in which we had the budget overspend—it was looking at an overspend of £109 million. All of these figures are cash-basis figures, not RAB-cash figures.

Jack Perry implemented his CEO change agenda at the beginning of April 2005. Just after, the forecast overspend dipped to about £75 million. It then rose again at the end of the Q1 review—Q1 is the quarter to June. By the time the numbers were prepared and a detailed review had taken place for every single project—in August—the forecast overspend was back at £100 million. The forecast had therefore gone from £109 million to £75 million to £100 million. The figure sticks at £100 million—or £103 million—in November 2005 at the end of the Q2 review. Q2 is the quarter to September, the results of which came out in November.

It is at that point that the executive board under Jack Perry's leadership decided to call the meeting of the business units and the LECs to request reductions of around 15 to 25 per cent. It was also agreed to accelerate the Q3 review, which showed a reduction in the forecast to £70 million.

In January, when it emerged that the LECs and the business units had not fully implemented the requested 15 to 25 per cent reductions, the overspend came down to £48 million. The figures are in the table in paragraph 2.2.1 of appendix one to the internal report by the audit committee. The final figure that came out was a cash overspend of £9 million.

As a non-executive director and deputy chair of the audit committee, I feel disappointed rather than misled; I do not feel misled at all. I think that the organisation genuinely believed that at the end of Q2 and going into Q3, as in previous years, the forecast pipeline would start to drop.

I am disappointed because, as we said to Karen Gillon during the suspension, at today's meeting we should have been celebrating the fact that the CEO change agenda worked. We had numerous high-quality projects in the pipeline. For the first time in the organisation's recent history, if not for the first time ever, we had more opportunities to develop the Scottish economy than we had money for in the budget. In around Q3 of last year, we could have engaged with the sponsor department—and perhaps even with the minister—in a meaningful discussion about how the projects in the pipeline could be prioritised. That opportunity was lost because of what happened in November and December, to which Jack Perry has referred.

Murdo Fraser: That is very helpful.

The internal audit committee's recommendation at paragraph 4.2.1 of its report into the 2005-06 forecast budget overspend is that

"SE needs to institute monthly, rather than the existing quarterly forecasting reviews".

As someone who sits on the board of various charitable companies, my view is that monthly management accounting and forecasting is the norm. Is it not surprising that Scottish Enterprise has not had monthly forecasting up until now? If it had had such forecasting, would that have made any difference to the current situation?

Charlie Morrison: We have a pretty detailed monthly process—accounting work is done and management reports are produced every month. Historically, the challenge that the organisation has faced relates to the forecasting process, given that it is responsible for 5,000 projects and between 400 and 500 project managers, not to mention the LECs. It is not trivial to pull all that together. The result has been that a heavy-duty piece of work on forecasting is done every quarter.

Given the increased financial risks that Fred Hallsworth mentioned, the reality is that we must get modelling tools that provide forecasting data that will allow us to know with LaserJet accuracy where we will be from month to month; I spoke about that in reply to Christine May. That will allow us to make the necessary adjustments without having to take big, bludgeoning actions at the end of a quarter when we wake up to discover that we have a problem.

Our point is that it was five weeks after the month end before the detail was available. That is not fast enough. Most corporations that are of the same size and scale as Scottish Enterprise would debate the month's business seven or eight days after the month end—that is what all the large FTSE companies do. Scottish Enterprise is the closest that we have to a private sector organisation in the public sector in Scotland. The ability to have access to surplus cash reserves from one year to the next is part of a self-management psyche that we must have. Quarterly analysis is no longer good enough, particularly if there is an oversubscription of projects. We must be on top of matters, because we cannot let happen what we have all been discussing.

Fred Hallsworth: The organisation was caught out by being unable to respond to a unique situation, which was a pipeline of an unsustainably high number of projects. If Murdo Fraser were to ask his question next year, the answer would be, "It is negligent not to have monthly forecasting," but if he had asked it last year, people would probably have wondered why he was asking it.

Murdo Fraser: I understand that, but if monthly forecasting had been in place, we would probably not have experienced to the same extent the problems that we have had this year.

Charlie Morrison: If good-quality monthly forecasts had been available, the issue may have been flushed to the surface sooner, but I am not sure that the organisation had the information systems and the tools to do that job. With the benefit of hindsight, if the recommendation to have monthly forecasting had been implemented in 2005-06, there is no question but that that would have helped us to avoid the situation that arose, so you are right.

Karen Gillon: Thank you for your interesting report. You mention in one of the papers that

"A detailed … reporting schedule will be prepared and published by 5th April. This will include details on the timing and nature of monthly and quarterly reviews."

Charlie Morrison: What paper are you referring to?

Karen Gillon: The quotation is on page 15 and in section 3 of the internal audit report "Review of Resource Allocation".

Charlie Morrison: I am sorry—there are too many papers.

Karen Gillon: Could we see the reporting schedule when it is produced?

Fred Hallsworth: Section 3 lists the recommendations of the internal audit. Which recommendation did you quote?

Karen Gillon: The second entry under report reference 1.4, which says:

"A detailed in year reporting schedule will be prepared and published by 5th April. This will include details on the timing and nature of monthly and quarterly reviews."

Charlie Morrison: I believe that that schedule has been produced.

Karen Gillon: Could we see it before our next meeting with Scottish Enterprise?

Charlie Morrison: Sure. I will give the committee the schedule.

Karen Gillon: We have had a good kick at the ball in relation to where we are and how we got here; we have had a frank discussion with you about that. I will ask about the board's role in moving forward. How do we ensure that the little man does not bear the brunt of the problems this year or of sorting them out next year? That links to an answer that you gave Christine May. If projects such as the one at Ravenscraig do not achieve planning permission or are involved in a lengthy planning process the following year and do not meet the targets that you have set or spend the money that you expect them to spend, how will you ensure that the little man at the bottom—the grass-roots projects in which I am interested and which provide economic development—is not squeezed? Would it be better to separate out some work?

Charlie Morrison: Those questions impinge on the 2006-07 budget discussions, so I do not know the answers—I do not think that Sir John Ward or Jack Perry know the answers yet. I can only speculate—not as a member of the audit committee but as a non-exec board member. However those discussions turn out, I imagine that we will do everything in our power to ensure that the budget is balanced and that everybody has a share of the cake—we will protect that approach. It will be for those who have financial stewardship of the organisation to make damn sure that the situation is not repeated and that we protect those projects and the little guy.

You proposed running work for the smaller guy separately. Scottish Enterprise has a good and well-balanced strategic direction and we know what to do from the point of view of industry-metropolitan region strategies. I am involved in two small businesses and I know that many smaller guys fit inside those industry strategies. Small businesses and I look for Scottish Enterprise to provide support. I think that many of the support mechanisms are in place, but that is just an opinion.

The wider point relates to the audit committee. We must achieve the right budget balance. Whatever we end up with, we must protect everybody and ensure that we do not compound any of this year's felonies by having a repeat of what has happened.

Fred Hallsworth: I will respond more as a non-exec director of Scottish Enterprise than as the deputy chair of the audit committee. I am passionate about what SE can do for the Scottish economy. Equally, I am interested in the outcome of the budget discussions for 2006-07, because the organisation and therefore the non-execs who sit around the board must have a meaningful role. That will depend largely on the budget allocation.

To be honest, if the budget allocation is constrained such that members find that there is no meaningful effect in their constituencies and the board finds that we cannot have the meaningful impact on the economy that the organisation was set up to achieve, we will have to take that on board and consider whether our time is being used to best effect.

16:45

Shiona Baird: How optimistic are you that the Scottish Executive will work with Scottish Enterprise to create the more flexible budget that you recommend, particularly in relation to cash reserves?

Charlie Morrison: I have been impressed by the good working relationship between Scottish Enterprise and the Executive. Jane Morgan attends our audit meetings, which are constructive and positive. Throughout this situation, I have witnessed no defensiveness; the relationship has been positive and open and the reality has simply been laid bare.

I think that the Executive recognises that what Scottish Enterprise—which is a big organisation—does is a bit different; I also think that some of the inflexibility is to do with Treasury rules. Those are common to England and Scotland, so that might be where some of the challenges are, but I am hopeful. We are not in an adversarial situation, with two organisations at war with each other. From what I observe at operational and staff levels, nothing could be further from the truth.

I am hopeful that we will get some flexibility because I think that common sense will prevail. It always does in life. When there are challenges, we get round the table and sort them out.

Fred Hallsworth: First and foremost, in my role as deputy chair of Scottish Enterprise's audit committee, my responsibility is to ensure that the organisation complies with whatever accounting framework is in place. Right now, the framework is RAB, so that is non-negotiable.

However, it is instructive to examine the past three years, which culminated in the 2005-06 overspend. In the first year in which RAB came into use—2003-04—Scottish Enterprise tucked away £17 million into its cash reserves as a result of the realisation of its investment in Wolfson Microelectronics; that cash is now inaccessible. In the following financial year, it handed back £17 million of excess proceeds on property sales, which came in five days before the end of that year and therefore could not be used. A further £10 million went into the central unallocated provision, which makes a total of £27 million.

If we examine the statement that the organisation came in on budget in 2004-05, we see that the jumbo jet landed short of the runway that year; Scottish Enterprise handed £27 million back to the Executive and we now have an overspend of £9 million. I would like to think that, with Scottish Enterprise having such a history of creating value and locking it away, someone could come up with a creative way of accessing those funds, because they are stuck where they are at the moment.

The Convener: Unfortunately, we have run out of time, because we have three more agenda items to consider, but I think that we have covered all the points that we wanted to cover. Your report was comprehensive and extremely helpful, and we had a two-hour evidence-taking session before we spoke to you. However, if there are any outstanding points, we might write to you as chair and deputy chair of the audit committee. Thank you very much indeed for your evidence; it was extremely helpful.

As members know, we decided last week to invite witnesses from Scottish Enterprise back next week. However, I suggest that we introduce a bit of flexibility into that arrangement because I understand that Scottish Enterprise's meeting with the minister will be held next Tuesday morning and, by Tuesday afternoon, it might not be absolutely clear what its budget is or which projects, if any, are likely to fall by the wayside. Rather than stick to next week, are members content to leave it up to me and the clerks to agree a date and time for Scottish Enterprise witnesses to come back to discuss next year's budget?

Christine May: Ideally, we would also like to speak to the minister. We should have a committee discussion about how to progress the matter. If that means that we leave evidence taking for next week and take further evidence the following week—fair dos.

The Convener: I will put a discussion on the way forward on the agenda although, from what I hear, we will probably see the minister on 9 May. However, we need a degree of flexibility. We also probably need to catch up a bit on the Bankruptcy and Diligence etc (Scotland) Bill next week, because we are falling a wee bit behind on that work and have made a commitment to completing it by a certain date. Are members happy with that? We will try to work around the next two meetings if we possibly can.

Members *indicated agreement*.

Bankruptcy and Diligence etc (Scotland) Bill: Stage 1

16:50

The Convener: We will now have a briefing on the Bankruptcy and Diligence etc (Scotland) Bill from our special adviser, Nicholas Grier.

Nicholas Grier (Adviser): I ask members to find the paper that I have prepared. I will try to keep my comments brief. The first three matters about which I have been asked to speak are small, technical amendments to the Debt Arrangement and Attachment (Scotland) Act 2002. They concern electronic signatures, the removal by sheriff officers of perishable items and a tidying-up amendment to deal with the valuation of attached assets.

No one should take exception to any of the amendments, which should make the 2002 act more effective. One or two of the provisions that they propose were omitted by oversight, and when the 2002 act was passed, there was no awareness of the possibility of having an electronic link between money advisers and the Accountant in Bankruptcy.

Wider questions about the debt arrangement scheme arise from the 2002 act, and I have tried to summarise them in my paper. I do not propose to go through the way in which the DAS works because members will have had the opportunity to look at that information. It might be more useful to the committee if I were to highlight some of the elements of the scheme that are not working terribly well.

It seems that the debt arrangement scheme works, but only for a restricted group of people, such as debtors with multiple debts who might not be very good at handling their money but who are willing to let somebody else do so and are sufficiently motivated to go and see someone who can help them. Without that motivation, it is arguable that the scheme is not terribly helpful.

Other criticisms can be made of the debt arrangement scheme, as has been discussed in committee previously. The scheme is not of much use to no income, no assets debtors; there is some overlap with protected trust deeds; interest continues to run; a scheme could last forever, as there is no cut-off point; and difficulties can arise if the debtor ceases to have an income, because the scheme depends on continuing income.

On a more technical point, the debt arrangement scheme is not available if someone has a large number of debts to a single creditor, such as someone who owes money to HM Revenue and Customs that has built up over a long time. On top of that, the scheme does not give any debt relief, so people might not want to enter into it. All those problems need to be addressed.

There seem to be further problems with money advisers. There is no doubt that they are extremely well trained and that good training has been organised for them, but there has not been a large take-up by people who want to be money advisers. Although the major reason for that could be that it is early days yet, another reason could be that the job is seen as rather arduous and that it is hard work to become a money adviser. Perhaps it is cynical of me to say that there are easier ways of earning a living, but there might be something in that. There are questions about how useful it is to train as a money adviser in some communities where there might not be many people who can get to the point of advice, know about the scheme or even would accept advice if it were offered.

There is a practical point, too. Sometimes when money advisers dole out money to the creditors, they hand over small sums of money that are uneconomic for the creditors to receive—it is scarcely worth processing cheques for £2 or £3, and it is also expensive for the money adviser to send them out.

Therefore, there are specific problems, and I have also tried to indicate certain problems with the wider perception of the debt arrangement scheme. I hope that this will not cause any offence, but the scheme does not seem to offer help to those who most need it, it does not seem very popular yet to become a money adviser and the system does not seem to be very well known. I know that people talk about the scheme, but it has not achieved the publicity that one might have hoped for.

However, one good thing about the debt arrangement scheme is that it is free for the debtor, which is an immense benefit for them. People do not have to pay large sums of money to the questionable debt consolidation agencies that bundle up all people's debts and then charge a large sum of money to pay them off, which is sometimes a great deal more than the debtor would have paid otherwise. Another virtue of the debt arrangement scheme is that money advisers seem to be doing their work extremely well.

Suggestions have been made, including by people present, about how the debt arrangement scheme could be improved. I have listed some of those suggestions on page 4 of my paper. A common theme is that there should be freezing of interest. That sounds attractive, but it has a lot of practical problems, because, for example, for some loans, all the interest is payable at the front or at the end. We would need a pretty clever system if we wanted to take that approach. That is not beyond the wit of man, but it would take a good deal of consideration.

There seems to be agreement that a scheme should not last more than 10 years but, equally, we would not want people to pay absolutely nothing or very small amounts for 10 years and then have their debts just written off. Another suggestion is that creditors should be deemed to consent to a scheme if they fail to respond. Another is that it should be possible to have any action of sequestration sisted—which means delayed—once a form 4, which is one of the forms that are sent out under the scheme, has been issued. Those are big questions that tie into the issues that we considered previously about New Zealand and England. The issues should be considered together. I hope that I have said enough for the time being about the debt arrangement scheme.

The provisions on the disclosure of information will run parallel with the proposed legislation in England. The issue is the provision of pooled information to creditors about the likely success of trying to get money out of debtors who have not paid their debts. The aim is to make the business slightly more effective and to be kinder to debtors. If creditors know more about debtors' financial circumstances, they will not waste their time trying to effect diligence against debtors when that will clearly be of no benefit. Creditors will also be able to target effective diligence against those who clearly can pay. The disclosure of information should be a good tool, or so the Executive believes, for the won't pays, although it probably will not be terribly helpful for the could pays or the can't pays, except to the extent that they might not receive a totally inappropriate burden of diligence.

There are problems with the disclosure of information, such as human rights and privacy issues. Not everyone will necessarily want all their financial information to be displayed. It is suggested that such matters should go to the court, which would try to balance the interests of creditors and debtors. Obviously, the system needs to be worked out, but that will be difficult because it is being done in tandem with the Department for Constitutional Affairs, which is running a similar exercise. The idea is that the English and Scottish systems should broadly go together so that neither country is disadvantaged. There have been suggestions that we should have a different system in Scotland, but having a different system, or no system, here could result in Scottish creditors being at an informational disadvantage, given that some creditors, such as HM Revenue and Customs, are based predominantly in the south. The Executive thinks that we ought to have a system that is similar to the English one.

We do not really know how such a system will happen—it is early days yet. Under the bill, the Executive proposes that ministers be given the power to implement regulations—which we have not yet seen—on how that will be done. As we do not know what the regulations will be like, questions could be asked about approving the concept of allowing them to be drawn up without necessarily knowing the finer detail. Of course, people cannot know the finer detail until the Department for Constitutional Affairs has worked it out. Under the bill, the Executive wants the opportunity to make regulations, should they be judged necessary at a later date.

I hope that that did not go on for too long.

17:00

The Convener: That was very good, Nicholas. Thank you very much.

I apologise to our witnesses. The previous evidence-taking sessions went on much longer than we anticipated. I know that some members have to leave within the next half hour or so. If we do not get through everything now, we might need to have a further session, although we should try to avoid that for reasons of time.

Our witnesses are: Susan McPhee and Beccy Reilly, who are both from Citizens Advice Scotland—I think that they are well known to the committee by now; Yvonne Gallacher, who is from Money Advice Scotland; John Campbell, who is from the Society of Messengers-at-Arms and Sheriff Officers; and Hillary Wilson, who is from Midlothian Council, but is here today in her capacity as vice-president of the Institute of Revenues, Rating and Valuation (Scottish Association). Thank you all very much for coming. I invite the witnesses to say a few quick words of introduction. I will then open up the discussion to members.

Susan McPhee (Citizens Advice Scotland): We are very pleased to be given this opportunity to give evidence on the debt arrangement scheme. CAS has long been a supporter of the debt arrangement scheme, from as far back as 1992. In 2000, we produced our own version of how we thought the scheme could work. We remain firmly committed to the concept of the scheme. As the system operates now, it includes some of the elements that we originally proposed, in particular voluntary participation, deemed creditor consent and the DAS register.

However, we have always maintained that, to make the DAS effective for our clients, there is a need to freeze interest rates and on-going default charges; to introduce some kind of composition of debts; to introduce a fixed time period; and to allow for full discharge at the end of the scheme.

As it runs now, the DAS does not incorporate any of those provisions. As a result, it does not, in the main, have an impact on our client group, and there is a shortfall in accredited money advisers. The DAS does not affect our client group because they have an average debt to income ratio of 22:1—that is, for every £1 of income, they owe nearly £22 of debt. Interest and charges continue to be imposed on clients who cannot pay their debts, so their debts can spiral further, which prevents repayment.

We know that the Scottish Executive is undertaking a review of the DAS. We are very pleased about that, and we hope that substantial changes will be introduced shortly. Unless all four of the elements that we have outlined are in place, we do not think that the scheme will work for our clients. If all the elements are implemented and have a clear impact on our debtor client group, we anticipate a huge increase in the number of money advisers.

As it operates now, the DAS works for debtors who have surplus income. They are able to repay their debts, although they might need a bit more time to do so, as they could be juggling four or five debts. When the debtor enters a scheme, they get protection from formal diligence and, in theory at least, they will not be harassed informally by creditors. The downside is that, even if interest is frozen by the creditors—which can happen voluntarily now—the scheme will still not be of any use to citizens advice bureau debt clients without composition of debts. Typically, our clients have a monthly income of £801; a quarter of them have an income of less than £400 a month. They owe an average of five debts, totalling just under £13,500. The freezing of interest will not in itself solve the problem for our clients.

If the DAS was amended to introduce our four key elements, it would still not be appropriate for all our debt clients, particularly those with no income and no assets. We know from our research that about a third to a half of CAB debt clients fall into the no income, no assets category. Benefits are the sole income of about two thirds of them, and they have an average of five debts, amounting to around £11,000. We would really like amendments to the DAS to be made, as I have outlined, as well as further assistance for people in the NINA category.

Yvonne Gallacher (Money Advice Scotland): Thank you very much for the opportunity to come before the committee once again. To endorse some of the points on which Susan McPhee has reflected with regard to the DAS, I thought that it would be helpful if I talked about how we at Money Advice Scotland, together with Citizens Advice Scotland, are involved in providing the certification scheme.

There has been much debate about the lack of effectiveness of the debt arrangement scheme, but I regard the glass as half full, rather than half empty. Many people who use the scheme have found it effective, because entering a scheme stays diligence and gives them the opportunity to make regular payments through a payment distributor.

I want to correct a point in Nicholas Grier's briefing. Money advisers do not collect the money; they merely set up and administer the programme. The payment distributor makes the payments. Money advisers never deal with the money; that is not their role.

It is unfair to say that the debt arrangement scheme has been a complete failure, because people have benefited greatly from it. However, I endorse what Susan McPhee said. The scheme needs other characteristics. We welcome the Executive's review of the scheme and we support the approach that Susan McPhee described, which would include the freezing of interest rates and composition of debts.

When the Bankruptcy (Scotland) Acts of 1985 and 1993 came into effect, they were not very successful. However, perhaps we are considering alternative approaches because aspects of that legislation became very successful—I am thinking in particular about the cost to the public purse of the administration of protected trust deeds. There are many benefits to be gained from amending the DAS, which would be ideal for the people who currently go to fee chargers—mention was made of the money that fee chargers make. I agree that there should be publicity about the DAS in places where fee chargers and debt consolidators advertise, which would offer a way of addressing the apparent low take-up of the scheme. A balance needs to be struck and there should be better, or at least different, publicity for the DAS.

Like Citizens Advice Scotland, Money Advice Scotland was involved in the working group that produced the consultation document, "Striking the Balance—a new approach to debt management". We considered many aspects of debt management and regarded money advice as central to the issue. That has not changed; money advisers are integral to the system. There are many reasons why people do not come forward to train as money advisers, not least because the work is arduous, time-consuming and administrative in nature, as Nicholas Grier said in his briefing. Many money advisers do a job that is similar to the job that is done by CAB staff, but there is a particular issue for local authority money advisers because they are regulated and receive no additional pay when they administer a debt arrangement scheme. There is an issue about local authorities' implementation of single status and equal pay, and we discussed the need for salary scales that reflect the added responsibilities. The problem is therefore much bigger than the fact that the job is arduous; it is to do with how people are remunerated for their work.

It is much less expensive to keep money advisers in their role than it would be to hive off the work to the fee-charging sector. We know how much it costs to administer protected trust deeds and how much creditors get back. The debt arrangement scheme could fall into the same category as protected trust deeds, with some exceptions to do with the minor adjustments that would be made to reflect individual circumstances.

Take-up of the debt arrangement scheme has been slow, but it is early days and there is a long way to go before we can say that it will not work for people in Scotland. I think that it will work, and that is the position of Money Advice Scotland.

Mr John Campbell (Society of Messengers-at-Arms and Sheriff Officers): The society has no comment on the proposed amendments to the debt arrangement scheme or on the system itself.

The society supports information disclosure orders, which should significantly reduce the number of unnecessary, abortive and unsuccessful diligences. Many debtors experience diligences in which creditors are clearly engaging in fishing expeditions to obtain information to instruct a more targeted diligence thereafter. The introduction of the orders will therefore significantly reduce the number of unnecessary diligences.

Hillary Wilson (Institute of Revenues, Rating and Valuation (Scottish Association)): The Institute of Revenues, Rating and Valuation is pleased to have been asked to participate in today's meeting. Broadly speaking, we welcome all the proposals in the bill, although we acknowledge that they are mainly minor and include no significant changes to the current process.

The institute is pleased to see the proposals to allow the introduction of the disclosure of information provisions, which would be useful to us only as long as the process is administratively effective and not cumbersome or too costly.

To date, the majority of local authorities have little or no direct experience of debtors who have entered the DAS, because of the low take-up so far. The main concern for us is that the proposals do nothing to address the main issue, which is that lack of take-up. Local authorities need an administratively effective scheme that meets the needs of both debtors and creditors. Although take-up to date has been low, the institute believes that that can and will be rectified in time.

Murdo Fraser: I have a question for Yvonne Gallacher on what she said about the debt arrangement scheme and money advisers. I have read the written evidence on the DAS certification toolkit, seen all the flowcharts and considered the volumes of documents that must be filled in. Is part of the reason why so few people have wanted to become money advisers the fact that the work that is involved is so onerous? Perhaps the thresholds need to be reduced a little.

Yvonne Gallacher: Distinguishing between a money adviser who is already operating outside the DAS and an approved adviser is worth while. The scheme that Citizens Advice Scotland and Money Advice Scotland jointly set up took into account what was alleged to be common practice in the field. Therefore, it is not necessarily the case that we have put an additional burden on people. Quality checks are already in place in many organisations.

Our experience is that where quality checks and systems were not in place, people sometimes struggled to meet standards. We have considered making access to certification easier because criticisms were made about the number of cases involved and about how they were to be presented when people who were training had to come up with a range of cases in their six initial cases. We addressed that and changed the mix of cases, rather than the qualitative or quantitative parts of the process, which seems to have gone some way towards addressing some of the issues. We also do spot checks every six months.

The process is new to some organisations, but some may have had systems in place and may have already operated to those standards. Casework recording was a real issue. We have raised standards right across the board in the process, not only in respect of potential DAS cases, but in respect of all cases that money advisers hold. We are aware of the issue that Murdo Fraser has raised and have tried to address it, but at the end of the day, we do not want to dilute the certification process, otherwise it will not be worth the paper that it is written on.

Beccy Reilly (Citizens Advice Scotland): We must remember that the certification and approval process for money advisers is designed to ensure that they are competent to carry out a statutory function. It is important to ensure that they are well qualified and competent to carry out that function. The toolkit's instructions are quite lengthy, but the criteria for assessment are easily broken down. The toolkit is specifically designed to test competence in the areas of money advice that are covered by schedule 4 to the Debt Arrangement Scheme (Scotland) Regulations 2004 (SSI 2004/468), under which money advisers need to be competent in order to go forward for approval under the scheme.

Christine May: I have three questions. Vida Gow, who has given evidence to the committee, briefed me in Fife on her experience of how things work. The changes that you are seeking reflect what she said. My first question is, given the experience of accredited money advisers and the comments that they have made, how much sympathy is being given to your attempts to have the debt arrangement scheme modified?

My second question, which is for all the witnesses, is whether there is a role for both an amended debt arrangement scheme and a protected trust deed scheme. Are both schemes still relevant?

My third question is primarily for John Campbell but might well apply to other witnesses. Disclosure orders are, in theory, a good thing—after all, as we have discussed with the Committee of Scottish Clearing Bankers, any means of sharing information is welcome—but I am really concerned about certain personal information issues that they raise, particularly the potential for intrusiveness. What safeguards would you seek in that respect?

17:15

Susan McPhee: On the changes to the debt arrangement scheme, front-line advisers and I have fed into the Scottish Executive's review of the scheme, and we are awaiting an announcement on the matter. I certainly think that significant changes will be made, although if the only change relates to the freezing of interest, I do not think that that will have much impact on our clients. All the matters that we have raised have been discussed and are being examined; we simply have to await the outcome of those deliberations.

Beccy Reilly: I have nothing to add to Susan McPhee's comments on changes to the debt arrangement scheme—we have been lobbying together on the issue—but in answer to your second question I certainly think that there is a role for both a debt arrangement scheme and a protected trust deed scheme, because they are interdependent. We have to see what changes will be made to the debt arrangement scheme before we can think about the changes that need to be made to protected trust deeds—although that might happen the other way round. In any case, the work forms part of the process of putting together the Scottish Executive's integrated debt management framework, and we cannot change one scheme without closely examining the other.

Yvonne Gallacher: How sympathetic the money adviser field will be to any modifications of the scheme will obviously depend on the extent of such modifications. There are some trailblazers, who want to be the first past the post to become an approved adviser. The picture is not completely bleak, but the success of the amended scheme will depend on what it looks like and whether issues such as the freezing of interest, composition of debts and so on have been taken into account. Moreover, as I pointed out earlier, the scheme must be publicised, because people need to know much more about what is happening. Although there is an excellent website, people unfortunately still do not have access to the internet. There are various leaflets and information packs, but we need more interaction with the public to ensure that they know about the scheme.

Therefore, as far as sympathy from money advisers is concerned, they are looking to their own position—and for some of them, like the policeman, their lot is not a happy one. Many people out there are very keen to become involved in the scheme, and if we can encourage and cajole them to do so, that will be all the better for debtors in Scotland.

On the question whether there is a role for both the DAS and protected trust deeds, I think that it depends on what the schemes look like. Given their current composition and what they could look like in future, the two schemes could co-exist. They are different beasts, serve different purposes and, as Beccy Reilly has just pointed out, are part of the overall framework that the Executive is reviewing. Indeed, money advisers might well have a role in administering protected trust deeds in future. Who knows? It might be a much cheaper option.

Information disclosure is a hot topic, and we are concerned about certain human rights issues, such as privacy, that Nicholas Grier highlighted. However, the credit industry and credit reference agencies have carried out a lot of work on increasing the level of datasharing that goes on. These things are already happening, and will happen more in future. The current systems are very sophisticated and not only carry out credit scoring but look at people's behaviour. Indeed, with the use of IT, a whole raft of new measures and systems can tell the industry more about people than perhaps they know themselves.

Shiona Baird: Do you know how many people have entered into a debt arrangement scheme?

Yvonne Gallacher: It is more than 100. I do not know the exact figure; it changes on a daily basis.

Shiona Baird: Over what period? A year?

Yvonne Gallacher: Since the beginning of the scheme. The number is not high.

Beccy Reilly: Can Shiona Baird clarify whether she is talking about the number of approved advisers or the number of debtors who are going through the scheme?

Shiona Baird: I am talking about the number of debtors.

Yvonne Gallacher: It is more than 100.

Shiona Baird: Therefore, a very small number of people are involved in the formal debt arrangement scheme. However, when clients come to you with debt problems, I assume that you involve them in informal debt arrangement schemes. Is that the bulk of your work?

Susan McPhee: Yes.

Yvonne Gallacher: Those informal repayment arrangements are known as voluntary repayment programmes.

Susan McPhee: The difficulty with an informal debt arrangement scheme is the fact that, when we contact creditors, they often do not reply. One of the benefits of the formal DAS is that the creditor is deemed to have consented to it. Also, in an informal scheme, interest is not necessarily frozen, and because some creditors have taken part and others have not, the debtor often has to repay at a higher rate creditors who are outwith the informal scheme. Another factor is that some banks instigate consolidations, which are not always in the best interests of the client. Although the debt is amalgamated into one repayment, our clients may have to make payments over a longer period of time and borrow more money to deal with their debt.

Shiona Baird: Okay. I just wanted clarification on how such schemes work.

Susan McPhee: People who are absolutely determined to pay off their debts may agree to debt payment programmes of 25 years, for example, which will not work; something always happens during that period and it will all fall down. The person will have committed themselves to an arrangement that is unpayable.

Beccy Reilly: The other big advantage of the statutory scheme is the protection against diligence, formal debt recovery and bankruptcy during the time that the debtor is in the formal scheme. That is not possible with an informal scheme.

Shiona Baird: I have one final, quick question on disclosure of information. Does Citizens Advice Scotland have any concerns about human rights and privacy issues?

Susan McPhee: We discussed the issue some time ago, when we gave evidence on bank arrestments, way back in 2000. We agree in principle with disclosure. It is one way of ensuring that clients do not overborrow.

One of the issues that we have raised elsewhere and with the committee is that of the same creditor continuing to lend to a debtor. Some sort of disclosure provision to prevent them from doing that would be a good thing, although it would, of course, depend on the circumstances. For example, our clients are already obliged to disclose information such as their employment to a local authority. It will depend on the amended scheme; we need to see what it is.

Shiona Baird: Yes, I can see that that is the problem. I put the question to Hillary Wilson. Do you have concerns about the disclosure of information, or would it be of benefit to your organisation?

Hillary Wilson: It would be of benefit to local authorities to be able to obtain further information. A number of debtors provide the statutory information, but others fail to do so. It would be useful if we could share information that comes from third parties.

I return to a point that Shiona Baird raised earlier. Prior to approaching a CAB or Money Advice Scotland, a number of debtors will already have made informal arrangements with their local authority. Those will either have been maintained for a period before they fail or they may have failed at the outset. A great number of informal arrangements may have been attempted before someone enters a debt arrangement scheme.

Shiona Baird: Thank you. That is useful.

The Convener: I think that we have covered all the areas. Indeed, we discussed a lot of the subject matter at the beginning of our evidence taking. I apologise yet again for the delay in starting the session and I thank all our witnesses, whose evidence was extremely helpful.

Everyone will be glad to hear that this is our second-to-last evidence-taking session—we see the minister next week. After that, we will prepare our stage 1 report. I understand that the stage 1 debate on the bill will take place around the last week of May. It is clear that the Executive is still in some detailed discussions with others on proposed amendments to the bill. I have asked Nicholas Grier and Stephen Imrie to prepare a note to summarise the outcome of our deliberations.

A National Anthem for Scotland

17:25

The Convener: Given the time, I ask Michael Matheson if he would agree to prepare a paper for circulation to the committee.

Nicholas Grier: He could sing it.

The Convener: That would chase everybody away.

Michael Matheson: You have not heard me sing.

The Convener: We could discuss the paper in a fortnight's time. Is that okay, Michael?

Michael Matheson: Yes.

The Convener: Are we all agreed?

Members *indicated agreement*.

Meeting closed at 17:25.

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