

# Highlands and Islands Enterprise

Report on the 2006/07 Audit



November 2007





# Highlands and Islands Enterprise

**Report on the 2006/07 Audit**

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# Executive Summary

## Introduction

In 2006/07 we looked at the key strategic and financial risks being faced by Highlands and Islands Enterprise. We audited the financial statements and we also reviewed aspects of performance management and governance. This report sets out our key findings.

## Financial Position

Highlands and Islands Enterprise met its key financial target to stay within its resource budget this year. The organisation had a total resource budget of £114.4 million for 2006/07. The outturn for 2006/07 was an underspend of £0.4 million, or 0.3% of the overall resource budget.

Scottish Ministers have agreed a resource budget for Highlands and Islands Enterprise of £111.74 million for 2007/08. Current projections forecast expenditure of £132.3 million for 2007/08, which is in line with levels planned for the year.

The future settlement proposed in the detailed spending plans for 2008-11 reflect a tighter operational focus, and includes a cut in direct capital funding reflecting assumptions around the network's ability to fund capital projects through receipts from asset sales and collaboration with the private sector. The challenge for Highlands and Islands Enterprise is to prioritise spending and review future commitments to ensure continued delivery of organisational objectives.

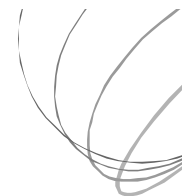
## Financial Statements

We have given an unqualified opinion on the financial statements of Highlands and Islands Enterprise Network for 2006/07.

We have also concluded that in all material respects, the expenditure and receipts shown in the financial statements were incurred or applied in accordance with applicable enactments and relevant guidance, issued by Scottish Ministers.

## Performance

Highlands and Islands Enterprise achieved all of its eight primary targets, which cover the key themes of strengthening communities, skills and learning, growing businesses and global connections. The 2006/07 definitions for the primary targets were made more challenging in response to our comment last year where we noted there was some scope for more challenging targets to be set for the primary measures, matching the challenges evident in key measures of progress. Given the continued performance well in excess of target it appears there remains some scope to review targets again in 2007/08 to ensure they are challenging as well as being achievable.



## **Best Value**

The organisation has made good progress against its action plan for Best Value. A number of awareness sessions to identify and take forward detailed work on developing arrangements have been held resulting in more detailed work being carried out on aspects of Best Value such as sustainable development and equalities. Over the next year we will be developing and refining our approach to the audit of public bodies' arrangements to secure economy, efficiency and effectiveness in the use of resources, as this is one of our key objectives as auditors, set out within the new Code of Audit Practice approved by the Auditor General. This will inform our ongoing work to develop an approach to the audit of Best Value across the Scottish public sector. We intend to consult with both clients and stakeholders at key stages of these initiatives.

## **Governance**

Corporate Governance is concerned with the structures and process for decision making, accountability, control and behaviour at the upper levels of an organisation. Overall the corporate governance and control arrangements for the Authority operated satisfactorily during the year, as reflected in the Statement on Internal Control.

We examined the key financial systems which underpin the organisation's control environment. We concluded that financial systems and procedures operated sufficiently well to enable us to place reliance on them.

## **Looking forward**

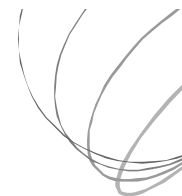
The final part of our report notes some key risk areas for Highlands and Islands Enterprise going forward. Following the reform announcement made by the Scottish Government there will be changes which will have a significant long term impact on how Highlands and Islands Enterprise will operate and function in the future. During a period of change there are increased risks for any organisation, for example continuing to meet targets and ensuring that services are delivered, while staff and functions are transferred. We will consider as part of our 2007/08 audit how the organisation is developing and implementing good change management processes to minimise risk while implementing these reforms.

**Audit Scotland  
November 2007**



# Introduction

1. This report summarises the findings from our 2006/07 audit of Highlands and Islands Enterprise. The scope of the audit was set out in our Audit Plan, which was presented to the Audit Committee on 12 March 2007. This plan set out our views on the key business risks facing the organisation and described the work we planned to carry out on financial statements, performance and governance.
2. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officers and members of Highlands and Islands Enterprise during the course of our audit. This report will be submitted to the Auditor General for Scotland and will be published on our website, [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk).



# Financial Statements

3. In this section we summarise key outcomes from our audit of Highlands and Islands Enterprise financial statements for 2006/07, and comment on the key financial management and accounting issues faced.

## Our responsibilities

4. We audit the financial statements and give an opinion on:
  - whether they give a true and fair view of the financial position of Highlands and Islands Enterprise and its expenditure and income for the period in question;
  - whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements, and
  - the regularity of the expenditure and receipts.
5. We also review the statement on internal control by:
  - considering the adequacy of the process put in place by the chief executive as accountable officer to obtain assurances on systems of internal control, and
  - assessing whether disclosures in the statement are consistent with our knowledge of Highlands and Islands Enterprise.

## Overall conclusion

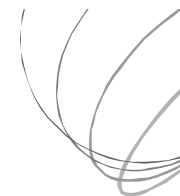
6. We have given an unqualified opinion on the financial statements of Highlands and Islands Enterprise for 2006/07.

## Financial Position

### Outturn 2006/07

7. Highlands and Islands Enterprise is required to work within the resource budget set by the Scottish Government Enterprise, Energy and Tourism Directorate. In 2006/07 Highlands and Islands Enterprise stayed within both the cash and non cash elements of its resource budget – see exhibit 1 below.





### Exhibit 1 – Performance against Resource Budget 2006/07

Resource Allocation (£million)	Budget	Actual Outturn	Difference
Grant in Aid – cash	100.4	100.4	0.00
Resource cover – non-cash	14.0	13.6	0.4
<b>Total</b>	<b>114.4</b>	<b>114.0</b>	<b>0.4</b>

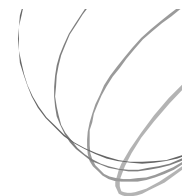
### 2007/08 Budget

8. Scottish Ministers have agreed a resource budget for Highlands and Islands Enterprise of £112.87 million for 2007/08. This comprises:
- £97.75 million cash – grant-in-aid. This represents an increase compared to cash resource available in 2006/07; and
  - £13.99 million to cover non-cash costs.

### Exhibit 2 – 2007/08 Resource Plan

	TOTAL	'CASH'	'NON CASH'
	£m	£m	£m
Grant in Aid (baseline)	88.98	88.98	0.00
Grant in Aid (additions)	8.77	8.77	0.00
Non cash resource	13.99	0.00	13.99
<b>Resource Budget</b>	<b>111.74</b>	<b>97.75</b>	<b>13.99</b>
Other Income Sources	18.89	18.89	0.00
<b>Total Operating Plan</b>	<b>130.63</b>	<b>116.65</b>	<b>13.99</b>
<b>Analysed as:</b>			
Grant in Aid		97.75	
Other sources		18.89	
<b>'Total Cash'</b>		<b>116.64</b>	
<b>'Non cash' resource</b>		<b>13.99</b>	
<b>Total Operating Plan</b>		<b>130.63</b>	

9. The 2007/08 Operating Plan budgets for expenditure, including non cash costs of £13.99 million. Current projections forecast expenditure of £132.3 million for 2007/08, which is in line with levels planned for the year.
10. The future settlement proposed in the detailed spending plans for 2008-11 reflect a tighter operational focus, and includes a cut in direct capital funding reflecting assumptions around the network's ability to fund capital projects through receipts from asset sales and collaboration with the private sector. The challenge for Highlands and Islands Enterprise is to prioritise spending and review future commitments to ensure continued delivery of organisational objectives.



## Issues arising from the audit

11. As required by auditing standards we reported to the audit committee in 11 September 2007 the main issues arising from our audit of the financial statements. The key issues reported were:
12. **EU Grants and de-commitment of Expenditure** - Highlands and Islands Enterprise have been involved in ongoing discussions between the Scottish Executive and EU auditors around the sufficiency of evidence to support EU Objective 1 grants. In September 2006 the EU auditors issued a further draft of their report to the Scottish Executive. Included in the EU auditors' report, which covers projects undertaken by all partner organisations under Objective 1, is a potential error of £7.2 million relating to Highlands and Islands Enterprise Network projects. The EU auditors have also proposed an extrapolated error across the whole programme of €32 million (approximately £23 million). These potential errors are being contested by the Scottish Executive, Highlands and Islands Enterprise and other partners. Additional evidence was provided to the EU auditors in October and November 2006. The Scottish Executive has indicated to Highlands and Islands Enterprise it will meet any liability that may arise in relation to this issue.
13. During a review of compliance with EU requirements under the Highlands and Islands Special Transitional Programme (HISTP), Highlands and Islands Enterprise Network staff identified a potential error of around £3.4 million of grant applied to expenditure which was ineligible or inadequately supported. Following discussions with HISTP and the Scottish Executive, Highlands and Islands Enterprise intend to apply £2.4 million of this grant to new projects or extensions to current projects under HISTP. The balance of £1 million will be de-committed. As noted in the Statement of Internal Control, action is being taken to address weaknesses identified in the control environment, including the establishment of an officer post covering compliance issues.
14. **Payment in Advance of Need** – Internal Audit's review of significant payments during the year highlighted payments of £174,000 made to a project in advance of expenditure being incurred, principally as a result of established payment release procedures not being followed. A number of specific recommendations have been made by Internal Audit to ensure procedures are applied consistently across the network. The accounts were prepared to reflect this transaction as a prepayment within the debtors balance.

## Statement on Internal Control

15. The Statement on Internal Control provided by Highlands and Islands Enterprise Accountable Officer reflected the main findings from both external and internal audit work. This recorded management's responsibility for maintaining a sound system of internal control set out Highlands and Islands Enterprise's approach to this.



## Regularity Assertion

16. The Public Finance and Accountability (Scotland) Act 2000 imposes a responsibility on auditors that requires us to certify that, in all material respects, the expenditure and receipts shown in the accounts was incurred or applied in accordance with applicable enactments and guidance issued by the Scottish Ministers. We have been able to address the requirements of the regularity assertion through a range of procedures, including written assurances from the Accountable Officer as to his view on adherence to enactments and guidance. No significant issues were identified for disclosure.



# Governance

## Overview of arrangements

17. This section sets out our main findings arising from our review of Highlands and Islands Enterprise governance arrangements. This year we reviewed:
- key systems of internal control;
  - internal audit; and
  - aspects of information and communications technology (ICT).
18. We also discharged our responsibilities as they relate to prevention and detection of fraud and irregularity; standards of conduct; and the organisation's financial position (see paragraphs 7-10). Our overall conclusion is that arrangements within Highlands and Islands Enterprise are sound and have operated through 2006/07

## Strategic change

19. Recent announcements were made by the Scottish Government on the establishment of a new skills body in Scotland, as part of the launch of the Skills for Scotland Strategy. Plans to merge Careers Scotland, a significant part of Highlands and Islands Enterprise network, with learndirect Scotland, to form a new skills agency, were set out.
20. In September 2007, the Cabinet Secretary for Finance and Sustainable Growth announced reform of the enterprise networks in Scotland. Specific reforms announced included:
- The establishment of a Scotland Enterprise Forum, to be convened by Ministers on a quarterly basis, bringing together the chairs and chief executives of Scottish Enterprise, Highlands and Islands Enterprise and VisitScotland. This is intended to:
    - support closer working on growing Scotland's economy more sustainably and effectively, and
    - drive a process for sharing services amongst the organisation's to avoid duplication of effort, waste and improve efficiency in use of public resources.
  - The removal of local enterprise company and local enterprise forum structures and the establishment of a regional delivery model for enterprise in Scotland. This will have the effect of reducing structures from 21 local enterprise companies to 6 regional operations. Highlands and Islands Enterprise will become a single regional operation.



- The transfer of certain functions to local authorities, including Business Gateway which provides advice to new start and local businesses. This service will also now be offered in the Highlands and Islands region.
  - The continuation of small business grant scheme by Highlands and Islands Enterprise, until a review of this is completed in the longer term.
  - The transfer of the skills and training elements of the enterprise networks to the new skills body, although Highlands and Islands Enterprise, and its sister organisation Scottish Enterprise, will retain aspects of this where they form a crucial part of their function, including leadership development programmes and business mentoring schemes.
21. Clearly these changes will have a significant long term impact on how Highlands and Islands Enterprise will operate and function in the future, and the detailed implications of the announcements are currently being considered. During a period of change there are increased risks for any organisation, for example continuing to meet targets and ensuring that services are delivered, while staff and functions are transferred. We will consider as part of our 2007/08 audit how the organisation is developing and implementing good change management processes to minimise risk while implementing these reforms.

## **Systems of internal control**

22. Key controls within systems should operate effectively and efficiently to accurately record financial transactions and prevent and detect fraud or error. This supports a robust internal control environment and the effective production of financial statements. In her annual report for 2006/07 the head of internal audit provided her opinion that, based on the internal audit work undertaken during the year, there was reasonable assurance on the adequacy and effectiveness on the systems of internal control.
23. As part of our audit we reviewed the high level controls in a number of Highlands and Islands Enterprise systems that impact on the financial statements. Our overall conclusion, subject to the specific exception noted below, key controls were operating effectively. We agreed with Highlands and Islands Enterprise that weaknesses relating to the authorisation procedures for creditor payments at the Network Data Centre in Benbecula were not considered significant enough for specific disclosure in the Statement of Internal Control.

## **Internal Audit**

24. The establishment and operation of an effective internal audit function forms a key element of effective governance and stewardship. We therefore seek to rely on the work of internal audit



wherever possible and as part of our risk assessment and planning process for the 2006/07 audit we assessed whether we could place reliance on Highlands and Islands Enterprise internal audit function. We concluded that the internal audit service operates in accordance with the Government Internal Audit Manual and therefore placed reliance on their work in number of areas during 2006/07, as we anticipated in our annual audit plan.

## **Information and Communication Technology**

25. Highlands and Islands Enterprise has made a significant investment in the introduction of a network management system (NMS) to integrate key management information within the organisation. Main functionality on the system was achieved in January 2007, and work is continuing on the development of remaining areas including data migration solutions, management reporting, and website infrastructure.
26. The NMS is expected to deliver a number of benefits over the longer term. During the year we undertook a joint review with Internal Audit to establish whether appropriate plans are in place to identify and monitor the realisation of benefits from the system.
27. The review identified a number of areas of good practice, including the continued resourcing of the project in the medium term and regular progress reporting to the project board. However, a number of issues need to be taken forward to ensure the process remains on track, including
  - agreeing business ownership of the NMS;
  - documenting key benefits and milestones within a benefits realisation plan, and monitoring progress in achievement;
  - devising a comprehensive and fundamental set of measures for transforming knowledge management, to enable full benefits of the NMS infrastructure to be realised, and
  - completing outstanding functionality and achieving sign off from Highlands and Islands Enterprise Finance.
28. We will continue to monitor the progress made in identifying the benefits realised through this project.

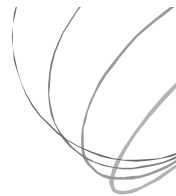


# Performance Management

29. Public audit is more wide-ranging than in the private sector and covers the examination of, and reporting on, performance and value for money issues. As part of our audit we are required to plan reviews of aspects of the arrangements to manage performance, as they relate to economy, efficiency and effectiveness in the use of resources.
30. Accountable officers also have a duty to ensure the resources of their organisation are used economically, efficiently and effectively. These arrangements were extended in April 2002 to include a duty to ensure 'best value' in the use of resources.

## Best Value developments

31. In 2006 the Management Team agreed an action plan to take forward the Best Value agenda. This included aspects of sustainable development and equal opportunities characteristics where there were clear opportunities for Highlands and Islands Enterprise to develop and implement a strategic vision and focus for the whole organisation. In August 2007 an update of progress against this action plan was prepared which concluded good progress had been made in implementing the agreed actions.
32. To increase awareness of Best Value across the Network a series of Best Value workshops were held which covered:
  - awareness of Best Value
  - financial resource allocation
  - sustainable development
  - equal opportunities
  - business development.
33. The sustainable development workshop identified seven key actions and outcomes with specific timescales for completion to improve arrangements for sustainability across the Network. One of the main actions was to measure Highlands and Islands Enterprise's carbon footprint, as a baseline, and external consultants have been engaged to measure the carbon footprint of the network, including where the organisation works with partners.
34. A number of actions and outcome targets were also agreed in relation to equal opportunities as a result of the workshop awareness sessions. A specific action being taken forward is training for staff



in equal opportunities, to improve awareness of current legislation and the organisations' commitment to equal opportunities within the Network and with its stakeholders.

35. Other developments being taken forward include consideration of models for allocating financial resources aligned with the strategic and human resource planning. This is an area we will focus on in 2007/08 as part of the development of Audit Scotland's approach to Best Value in public services.

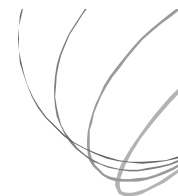
## Efficient Government

36. We commented last year that Highlands and Islands Enterprise had not been set any specific targets by the Scottish Government in relation to Efficient Government, and that it would be important that the organization identified local efficiency targets and monitored the delivery of these savings and efficiencies. Highlands and Islands Enterprise has now developed technical notes which has enabled the organisation to agree three year cash releasing and time releasing efficiency targets with the Scottish Government. Organisational, architectural, property and supply partnering efficiencies are being targeted over this three year period. Targets for 2007/08 of £0.928 million cash savings and projected time releasing savings of £0.273 million are expected to be exceeded.
37. Given the tight spending review settlement for Highlands and Islands Enterprise and future reorganisation it is important that further efficiencies can be achieved to support the delivery of the organisation's objectives.

## Performance Management

38. As part of our 2006/07 audit we looked at the organisation's performance management framework focusing on the arrangements for setting and monitoring performance targets for primary measures including how to measure the achievement of targets.
39. Highlands and Islands Enterprise has two tiers of performance measures. The first tier are key measures of progress, and comprise the twelve outcomes on which Highland and Islands Enterprise's success in delivering its strategy will be most closely judged over the coming years. Current outcomes include progress on major projects such as the University of the Highlands and Islands, the Centre for Health Science and Broadband. The second tier of measures are called the primary measures of progress. These are numeric targets relating to the number of projects supported under the strategic themes of *Strengthening Communities, Skills and Learning, Growing Businesses and Global Connections*.
40. In each financial year Highlands and Islands Enterprise produces a half yearly report and a full year report on its performance. These reports are submitted to the Management Team for consideration





before being submitted to the Board. After review by the Board the reports are forwarded to the Scottish Government. Exhibit 3 below sets out the 2006/07 year end position against the primary targets.

**Exhibit 3 - Performance against 2006/07 Primary Targets**

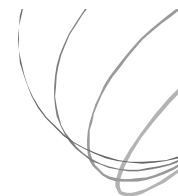
<b>Description</b>	<b>2006/07 Target</b>	<b>2006/07 Actual</b>	<b>Actual as % of target</b>
<b>Strengthening Communities</b>			
No. of new/enhanced community assets	450	502	112
No. of community groups with increased capacity	150	198	132
<b>Skills and Learning</b>			
No. of people supported to move towards and into sustainable employment	2,405	2934	122
No. of businesses supported to engage in developing the skills of those in work	655	787	120
<b>Growing Businesses</b>			
No. of new business starts	550	560	102
No. of business growth projects	300	306	102
<b>Global Connections</b>			
No. of businesses engaging in International Business Development	160	175	109
Private Sector Earnings Index for Network assisted jobs	109	126	116

41. The organisation has exceeded all of its targets in 2006/07 by some margin, with performance being 2% to 32% above target, and in two cases targets were made more challenging during the year.

Explanations provided in the Network year end review for exceeding targets include:

- Exceeding the performance target for the number of community groups supported was due to this measurement enabling Network staff to prioritise activity with communities.
- The most significant factor contributing the actual outturn for the number of people supported to move towards and into sustainable employment was the on-going improvement in output measures across all National Programme interventions.
- The target for private sector earnings index was exceeded mainly as a result of careful prioritisation being undertaken throughout the Network.

42. The 2006/07 definitions for the primary targets were made more challenging in response to our comment last year where we noted there was some scope for more challenging targets to be set for the primary measures, matching the challenges evident in key measures of progress. Given the continued performance well in excess of target it appears there remains some scope to review targets



again in 2007/08 to ensure they are challenging as well as being achievable. The planned targets for the 2007-2010 Operating Plan are set out below.

**Exhibit 4 - Primary Targets set out in the Operating Plan 2007-10**

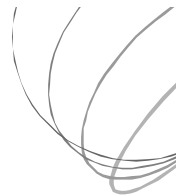
Description	Operating Plan 2006-09		Operating Plan 2007-10	
	2006/07 Target	2006/07 Actual	2007/08 Target	2008/09 Target
<b>Strengthening Communities</b>				
No of new/enhanced community assets	450	502	200	200
No. of community groups with increased capacity	150*	198	120	120
<b>Skills and Learning</b>				
No of people supported to move towards and into sustainable employment	2,405	2,934	2,405	2,405
No of businesses supported to engage in developing the skills of those in work	655	787	655	655
<b>Growing Businesses</b>				
No. of new business starts	550*	560	550	550
No. of business growth projects	300	306	200	200
<b>Global Connections</b>				
No. of businesses engaging in International Business Development	160	175	200	200
Private sector earnings index for Network-assisted jobs	109	126	112	115



# Looking Forward

43. Highlands and Islands Enterprise faces a number of challenges in 2007/08, which include:

- **Strategic Change** – Following the reform announcement made by the Scottish Government there will be changes which will have a significant long term impact on how Highlands and Islands Enterprise will operate and function in the future. During a period of change there are increased risks for any organisation, for example continuing to meet targets and ensuring that services are delivered, while staff and functions are transferred. We will consider as part of our 2007/08 audit how the organisation is developing and implementing good change management processes to minimise risk while implementing these reforms.
- **Future resources and budgets** – The refocusing of enterprise networks within Scotland will result in the transfer of responsibility for national training and skills programmes to a new body at some point in the future, and some local activities being delivered by local authorities instead of the enterprise networks. Once agreement is reached as to the precise nature of activity to be transferred, the relevant staffing and infrastructure needs to be identified and detached from the rest of the Highlands and Islands Enterprise's activities. It is important that the costs associated with these resources are fully identified as this will form the basis of resource transfers and future budget adjustments.
- **Funding settlement** - Notwithstanding the impact of this restructuring, the future settlement proposed in the detailed spending plans for 2008-11 reflect a tighter operational focus, and includes a cut in direct capital funding reflecting assumptions around the network's ability to fund capital projects through receipts from asset sales and collaboration with the private sector. The challenge for Highlands and Islands Enterprise is to prioritise spending and review future commitments to ensure continued delivery of organisational objectives.
- **IFRS** – Highlands and Islands Enterprise will be required to produce financial accounts in accordance with the International Financial Reporting Standards (IFRS) by March 2009. This change will have no implication on the 2007/08 accounts and audit. However, the 2007/08 accounts will need to be restated in accordance with the IFRS's to provide comparatives for the 2008/09 accounts. It will be important that this restatement is tackled early in 2008/09, particularly if there are other changes required as a result of the reform of the local network to one regional operation.
- **Best Value** - As part of the 2007/08 audit we will be reviewing the progress that Highlands and Islands Enterprise has made in strengthening their arrangements for securing Best Value since our baseline review work in 2005/06. Over the next year we will also be developing and refining our approach to the audit of public bodies' arrangements to secure economy, efficiency and effectiveness in the use of resources, as this is one of our key objectives as auditors, set



out within the new Code of Audit Practice approved by the Auditor General. This will inform our ongoing work to develop an approach to the audit of Best Value across the Scottish public sector. We intend to consult with both clients and stakeholders at key stages of these initiatives.

- **Highlands and Islands Community Energy Company (HICEC)** – This company was incorporated in December 2004 to promote community confidence, resilience and wealth through sustainable energy development. Highlands and Islands Enterprise is currently reviewing the future of HICEC and options for delivery of its programme of community renewable energy development activity. We will monitor the progress and outcome of this review as part of our audit work in 2008.