

# Highlands and Islands Enterprise

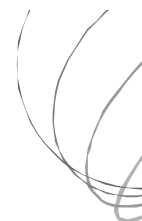
Report on the 2008/09 Audit

November 2009



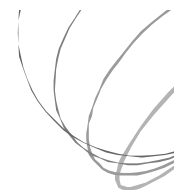
AUDIT SCOTLAND





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# Key messages

In 2008/09 we looked at the key strategic and financial risks being faced by Highlands and Islands Enterprise (HIE). We audited the financial statements and we also reviewed the use of resources and aspects of performance management and governance. This report sets out our key findings.

## Financial statements

We have given an unqualified opinion on the financial statements of HIE for 2008/09. 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.

## Financial position and use of resources

HIE's resource budget was set at £74 million for the year by the Scottish Government Enterprise, Energy and Tourism Directorate. This £74 million budget included resource cover of £8 million for non-cash costs. HIE operated within this budget with an outturn for the year of £72.7 million, an underspend of £1.3 million. This underspend arose following a lower than anticipated diminution in asset value during the year.

HIE's resource budget for 2009/10 has been set at £73.1 million, slightly less than the final resource allocation in 2008/09. However, the cash resource allocation has been reduced by almost £7 million. In addition, the operating plan budget reflects an anticipated reduction in capital receipts during the year as a result of current economic conditions. A significant amount of budgeted investment expenditure is already committed at the start of the 2009/10 financial year on a range of projects. This limits the organisation's scope to fund major new investment opportunities and HIE will have to closely monitor this to ensure delivery of financial and other performance targets for the year.

The Auditor General for Scotland undertook a review of the Cairngorm Funicular Railway during the year, examining HIE's involvement over the 17 years since the original project inception. The review looked at key decision making stages of the project and how public funds were used and monitored. A number of recommendations were made in the study report to ensure HIE learns from the experience, and to ensure it is adopting good practice. We will follow up action on these recommendations during 2009/2010 and the progress on developing a new business model for the funicular railway.

## Governance and accountability

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 HIE operated satisfactorily during the year, as reflected in the Statement on Internal Control, although some areas were identified where there was scope for improvement.



We examined the key financial systems which underpin the organisation's control environment and concluded that we could place reliance on HIE's key financial systems and procedures for our audit.

## **Performance**

The 2008-11 corporate plan categorises HIE's activities into three broad areas: supporting high growth businesses; creating the infrastructure and conditions to improve regional competitiveness; and strengthening communities, particularly in fragile parts of the area. A range of key performance areas have been established to monitor delivery of these activities.

In 2008/09, HIE exceeded all five of its business growth targets within its enterprise programme, along with three of its four strengthening communities targets. For 2009/10 these key indicators have been refreshed, with stretching targets. In addition to the enterprise programme growth targets, HIE reported good progress in achieving milestones for their transformational projects.

## **Looking forward**

The final part of our report notes some key risk areas and issues for HIE going forward. We highlight a number of national issues which affect all public sector bodies, as well as some issues specific to HIE, including the National Performance Framework; the impact of international financial reporting standards; the delivery of transformational change projects and the Cairngorm funicular. HIE also faces significant financial pressure over the next two years of the spending review to achieve financial balance. We will continue to monitor financial planning arrangements and HIE's financial position.

The assistance and co-operation given to us by Board members and staff during our audit is gratefully acknowledged.

**Audit Scotland**  
**November 2009**



# Introduction

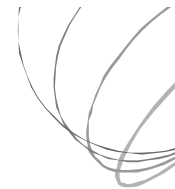
1. This report summarises the findings from our 2008/09 audit of HIE. The scope of the audit was set out in our Audit Plan, which was presented to the Audit Committee on 9 March 2009. This plan set out our views on the key business risks facing the organisation and described the work we planned to carry out on financial statements, performance and governance.
2. We have issued a range of reports this year, and we briefly touch on the key issues we raised in this report. Each report set out our detailed findings and recommendations and HIE's agreed response.
3. Best value duties apply across the public sector and, in central government, best value is a formal duty on all accountable officers. Audit Scotland has adopted a generic framework for the audit of best value across the public sector and throughout this report we comment on aspects of HIE's arrangements.

**Exhibit 1: Framework for a best value audit of a public body**





4. Our comments are made on the basis of information made available in the course of the annual audit. We do not make an overall best value judgement because we do not have enough evidence to conclude on all relevant areas. Our intention is to build up the corporate assessment over time. This report is the first step towards that goal.
5. Another building block for our assessment of best value is the national study programme carried out by Audit Scotland on behalf of both the Auditor General for Scotland and the Accounts Commission. We mention the key findings from all relevant reports, and the implications for HIE throughout this report. Full copies of the study reports can be obtained from Audit Scotland's website, [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk).
6. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by management and Board members of HIE during the course of our audit. This report will be submitted to the Auditor General for Scotland and will be published on our website.



# Financial Statements

7. In this section we summarise key outcomes from our audit of HIE financial statements for 2008/09 and the accounting issues faced. The financial statements are an essential means by which the organisation accounts for its stewardship of the resources available to it and its financial performance in the use of those resources.

## Our responsibilities

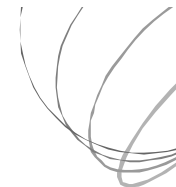
8. We audit the financial statements and give an opinion on:
  - whether they give a true and fair view of the financial position of HIE's Network and its expenditure and income for the period in question
  - whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements
  - the consistency of the information which comprises the Management Commentary within the financial statements
  - the regularity of the expenditure and receipts.
9. We also review the statement on internal control by:
  - considering the adequacy of the process put in place by the acting Chief Executive as Accountable Officer to obtain assurances on systems of internal control
  - assessing whether disclosures in the statement are consistent with our knowledge of HIE.

## Overall conclusion

10. We have given an unqualified opinion on the financial statements of HIE for 2008/09.
11. As agreed the unaudited accounts were provided to us on 13 July 2009, supported by a comprehensive working paper package. We provided our proposed opinion to the Audit Committee on 15 September 2009 as timetabled, subject to satisfactory review of further papers supporting late adjustments by HIE. Following our review, a revised set of accounts were presented to Audit Committee on 6 October, and signed on 9 October 2009.

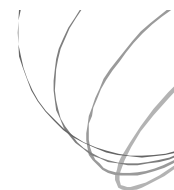
## Issues arising from the audit

12. As required by auditing standards we reported to the audit committee on 15 September 2009 the main issues arising from our audit of the financial statements. The key issues were as follows:



13. **Provisions** – A number of late adjustments were proposed by HIE during the audit process in relation to provisions. These included provisions against specific investments, future income streams and lessee costs. Following discussion at Audit Committee, and subsequent audit review of supporting papers, agreed adjustments were reflected in the certified accounts. For 2009/10 and subsequent years, HIE will ensure that the review and identification of provisions takes place earlier in the accounts preparation process. This review will assess proposed provisions in relation to the principles of IAS37, in particular the nature and estimation of provision values.
14. **Financial instruments** – Financial Reporting Standards on financial instruments came into effect for HIE for the financial year ended 31 March 2009. During 2007/08, HIE commissioned Johnston Carmichael to review its investment portfolio to identify any implications arising from implementation of these new standards, and they highlighted a number of issues were highlighted within the report, most notably the requirement for HIE to classify liability investments as loan assets within its accounts. However, the draft accounts provided for audit did not disclose any financial instruments.
15. HIE confirmed that liability investments had been reviewed, and were not considered to be material in the context of the entire investment portfolio. Narrative disclosures on financial instruments were enhanced in the 2008/09 accounts to clarify the position. HIE also committed to ongoing review of this as part of its preparations for the implementation of International Financial Reporting Standards from 2009/10 onwards.
16. **HIE pension scheme** – The April 2006 actuarial valuation of HIE's pension scheme indicated a significant potential deficit. Since then, HIE has implemented a recovery plan to address the shortfall. A lump sum payment of £2.5 million was included in the accounts for 2008/09, with a further payment of £2.5 million to be made during 2009/10. Employer contributions to the scheme will be maintained at existing levels until 2016, the duration of the recovery plan.
17. In April 2008, a number of former HIE staff within the scheme transferred to Skills Development Scotland (SDS). HIE and SDS are currently discussing the treatment of the pensions liability associated with these former employees. Following the triennial actuarial valuation of the pension fund over the course of 2009/10, the underlying deficit in respect of former SDS staff will transfer to SDS. As such, the £2.5 million lump sum payment to be made by HIE in 2009/10 will relate only to those employees who continue to be employed by HIE.
18. **Cairngorm Mountain Limited:** Cairngorm Mountain Limited (CML), which operates the funicular mountain railway and skiing facilities, became a wholly-owned subsidiary of HIE on 16 May 2008, and was been incorporated into HIE's group network accounts accordingly. Since the acquisition, HIE has provided CML with working capital funding, on which it charges interest, to facilitate ongoing trading.





19. The draft accounts provided for audit only included limited reference to the acquisition of CML. Financial reporting standards require, as a minimum, a brief description in the accounts relating to companies acquired during the year, along with commentary on the effect of the acquisition on the parent body's financial position. HIE expanded the disclosures in respect of CML to meet these reporting requirements.

## Regularity

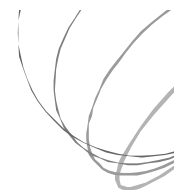
20. The Public Finance and Accountability (Scotland) Act 2000 imposes a responsibility on auditors that requires us to certify that, in all material respects, the expenditure and receipts shown in the accounts were incurred or applied in accordance with applicable enactments and guidance issued by the 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.

## International financial reporting standards (IFRS)

21. As announced by the Chancellor in the 2008 Budget report on 12 March 2008 (Budget report paragraph C103), Government departments and other public sector bodies will report using International Financial Reporting Standards (IFRS) from 2009/10. The Scottish Government announced on 25 April 2008 that all Scottish Government Departments, Executive Agencies, Health Bodies and Non-Departmental Public Bodies would be required to produce shadow IFRS based accounts for financial year 2008/09. This was to include a restated balance sheet as at 1 April 2008.
22. In terms of the audit of the IFRS opening balance sheet at 1 April 2008, there were two key dates to achieve as outlined below:
- **28 November 2008** – opening 2008 IFRS-based balance sheet were to be presented to auditors for dry-run audit
  - **28 February 2009** – dry-run audit of opening balances was to be completed, resulting in a letter to management highlighting the work done, auditors' findings and areas for further work.
23. The opening balance sheet and supporting documentation were submitted by HIE for audit for review by the deadline date of 28 November 2008.
24. The restated balance sheet and supporting working papers were comprehensive. HIE appointed Ernst and Young (E&Y) to undertake an initial IFRS impact assessment, and prepare the opening balance sheet. As part of the impact assessment E&Y produced a commentary for management to consider covering seventeen different IAS and two IFRS, and focusing attention on potential areas for change.



25. HIE management reviewed the E&Y assessment and prioritised work on risk areas where the impact on accounting policies and budgets was deemed to be potentially significant. The outcome of this review work was reflected in the restated balance sheet submitted for audit review.
26. We made some recommendations for the delivery of the next stage of IFRS reporting – the production of the shadow accounts for 2008/09, and will consider progress on these when we review the shadow accounts later in 2009. These included:
- **International Accounting Standards** - completion of the ongoing reviews of IAS 17 (Leases), IAS 12 (Income Taxes), IAS 31 (Interests in Joint Ventures), IAS 28 (Investments in Associates), IAS 39 (Financial Instruments: Recognition and Measurement).
  - **Accounts Direction** - clarification of proposed Accounts Direction, and impact of changes on restated accounts.
  - **Investment Properties** - review and restatement of investment properties as property, plant and equipment, including assets under construction.
  - **Government Grants** - review and restatement of government grants received to recognise as deferred income.
  - **Dilapidations** - review of identified potential dilapidations listing and subsequent recognition as provision and/or contingent liability.
  - **Segmental reporting** – IFRS 8 requires that financial information is reported on the same basis as that used internally for allocating resources and evaluating performance. HIE was to consider the implications of recording and reporting segmental information as part of the shadow accounts.



# Use of Resources

27. Sound management and use of resources (people, money and assets) to deliver strategic objectives is a key feature of best value. This section sets out our main findings from our review of HIE.

- financial position
- financial management
- Cairngorm funicular railway
- management and use of information and communications technology (ICT)
- national studies.

## Financial Position

### Outturn 2008/09

28. HIE is required to work within the resource budget set by the Scottish Government Enterprise, Energy and Tourism Directorate. In 2008/09 HIE operated within both the cash and non-cash elements of its resource budget – see exhibit 1 below.

**Exhibit 2 – Performance against resource budget 2008/09 (£ million)**

Limits	Budget	Actual Outturn	Difference
Non-cash	8.0	6.7	(1.3)
Cash	66.0	66.0	0.0
<b>Total</b>	<b>74.0</b>	<b>72.7</b>	<b>(1.3)</b>

29. HIE was provided with an initial non-cash allocation of £14 million. During the financial year, a review was undertaken to assess whether the full allocation was necessary, and a number of factors were identified which were likely to lead to a significant underspend. Despite the economic downturn, the Centre for Health Science maintained a stable asset valuation as a consequence of its strong rental covenant and long term leases. This, combined with an error in other property valuation information from the valuer led to a lower than anticipated diminution in asset value. As a consequence, £6 million non-cash resource cover was transferred back to the Scottish Government during the year, and a £1.3 million underspend arose at the financial year end.



## Financial sustainability and the 2009/10 budget

30. Scottish Ministers have agreed a resource budget for HIE of £73.1 million for 2009/10, a decrease of around £1 million on the 2008/09 final allocation. Baseline cash resources have decreased by almost £7 million from 2008/09 levels. The resource budget comprises:

**Exhibit 2 – 2009/10 Resource Plan**

	<b>TOTAL</b>	<b>'CASH'</b>	<b>'NON CASH'</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Grant in Aid (baseline)	59.1	59.1	0.00
Non cash resource	14.0	0.00	14.0
<b>Resource Budget</b>	<b>73.1</b>	<b>59.1</b>	<b>14.0</b>
Other Income Sources	12.3	12.3	0.00
<b>Total Operating Plan</b>	<b>85.4</b>	<b>71.4</b>	<b>14.0</b>
<b>Analysed as:</b>		<b>£m</b>	
Grant in Aid		59.1	
Other sources		12.3	
<b>'Total Cash'</b>		<b>71.4</b>	
<b>'Non cash' resource</b>		<b>14.0</b>	
<b>Total Operating Plan</b>		<b>85.4</b>	

31. HIE is expected to achieve 2% of efficiency savings per year from 2009/10 to 2011/12 and grant in aid will not be uplifted for pay or general inflation as this is expected to be met from HIE's efficiency savings each year. In addition, the operating plan budget reflects an anticipated reduction in capital receipts during the year as a result of current economic conditions.
32. Budgeted investment expenditure for the year is £49.4 million. A significant amount of this budget is already committed at the start of the 2009/10 financial year on a range of projects, including the Beechwood Campus, UHI and the European Marine Energy Centre. This limits the organisation's scope to fund major new investment opportunities and HIE will have to closely monitor this to ensure delivery of financial and other performance targets for the year.

## Financial management

33. As part of our audit plan for 2008/09, it was our intention to undertake a best value review during the summer of HIE's financial management arrangements. The review takes the form of an initial self assessment by HIE against a good practice checklist, with subsequent audit verification and challenge through documentation review and interviews. However, as a result of work pressures on key finance staff, the review will now be covered as part of our early 2009/10 audit work.



## Cairngorm Funicular Railway

34. In October 2008, the Auditor General for Scotland decided to undertake a review of the Cairngorm Funicular Railway. The funicular had been the subject of public and media interest since it was first proposed. The operator, Cairngorm Mountain Limited (CML) struggled financially since the funicular opened and, in May 2008, HIE took CML over.
35. The study examined HIE's involvement with the funicular over 17 years. Although the project was initiated before devolution, the review looked at the key decision-making stages from the funicular's inception and how public funds were used and monitored.
36. The key messages from the study were:
- The business case was subject to appraisal by HIE, the Scottish Office and the EU, and met requirements at the time.
  - A number of changes took place in the early stages of the project. HIE did not review and adjust the business case before construction started, to take account of the increased risks.
  - Although HIE provided ongoing support, CML continued to struggle and HIE took CML into public ownership in May 2008.
  - Consultants report that the funicular has delivered the anticipated employment and wider benefits to the Strathspey area.
  - HIE is working with CML to develop a new model for the business.
37. A number of recommendations were made in the study report to ensure HIE learns from this experience and to ensure it is adopting good practice. We will follow up action on these recommendations during 2009/2010 and the progress on developing a new business model for the funicular railway.

## Management and use of ICT

38. In 2006/07 we undertook a computer services review of HIE and identified key risks for the organisations and areas where there was scope for improvement. As part of the 2008/09 audit we followed up HIE's progress in implementing actions to address the identified risks.
39. Our review found that HIE had addressed a number of risks identified in the original report, including:
- undertaking benefits realisation reviews of the HIE Management System project (HMS) to ensure processes now bed-in and benefits are being monitored



- setting up an Information Security Working Group to review system security, policies, data handling and security training
  - reviewing and updating access and password procedures.
40. However a number of risks had not been fully addressed at the time of our review, and actions still to be implemented during 2009 included:
- developing and approving a HIE IS strategy
  - implementing replication services on key systems and servers across business areas to increase overall business continuity arrangements
  - participating in the Your Business @ Risk (YB@R) information governance survey
  - undertaking a gap analysis review of the information security standard ISO 27001 and developing an action plan
  - developing and implementing a business continuity management strategy within HIE business areas that covers both ICT/IS and the wider business.

## National Studies

41. Audit Scotland published three national study relevant to HIE's use of resources. These were use of consultancy services, improving energy efficiency and improving public sector purchasing.

## Use of consultancy services

42. The overall aim of the study was to review central government's use consultancy services and to make recommendations to improve the public sector's use consultants' knowledge, skills and resources to help deliver new services and initiatives quickly and expertly. The key findings were as follows:
- The public sector is strengthening the way it buys goods and services.
  - Central government does not have a clear strategy for its use of consultants or for linking use to its priorities or financial and workforce plans.
  - In most cases, central government buys consultancy services well but some improvements can be made.
  - Central government could improve how it manages consultancy projects through more consistent and formal evaluation of consultants' work and learning more from them.
  - Central government could make savings of up to £13 million a year through better planning and buying of consultancy services.



43. The report made specific recommendations for public bodies:
- confirm they have clear processes for approving and recording the use of consultants and monitoring progress, and reinforce these as required
  - plan their use of consultancy services when developing their forward work programme to ensure that consultants are used where their knowledge and skills bring greatest value for money
  - always evaluate the option to use consultants against the option to use their own staff
  - gather and share consistent information on the consultancy skills bought and why consultants are used
  - improve the quality of their invitations to tender through better and earlier discussion with consultants about their consultancy needs
  - increase the use of framework agreements where possible by ensuring that existing agreements are used and new ones developed as appropriate
  - select and use the most economical competition routes by using framework agreements, restricted competitions and closed tendering approaches when appropriate
  - evaluate the work of consultants more systematically and share findings from these reviews
  - work closely with consultants to increase assurance on quality and make use of opportunities to learn from consultants and ensure knowledge transfer, where appropriate.
44. HIE considered the findings of this study when scoping its internal audit review of use of consultants within the organisation. The internal audit review findings, which were reported to the Audit Committee in June 2009, reflected a number of issues identified in the study. HIE has prepared an action plan to address their findings, with progress on implementation monitored by the Audit Committee.

## **Improving energy efficiency**

45. Audit Scotland assessed how councils, NHS bodies and central government bodies were improving energy efficiency in relation to buildings and transport use. This included examination of a range of issues including whether public bodies demonstrate commitment to improving energy efficiency; how public bodies are performing against their objectives and targets for improving energy efficiency; and if public bodies are delivering continuous improvement in this area.
- Funding has been made available by the Scottish Government and public bodies to improve energy efficiency. While energy consumption in buildings has fallen, spending on energy increased in the three years to 2006/07.

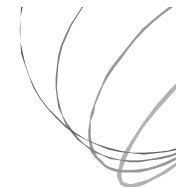


- There is a need for stronger leadership by the Scottish Government and within public bodies to improve energy efficiency and ensure that the necessary cultural and behavioural changes are made.
  - A robust strategy is central to the coordination of activities to improve energy efficiency, however, there are inconsistencies in the quality of strategies being implemented.
  - There is a lack of formal monitoring and reporting of progress in improving energy efficiency by public bodies and the Scottish Government.
46. HIE has not formally considered the results of the study and the issues it raises, however it has in place a number of internal initiatives to help improve energy efficiency, including a sustainable construction policy which is applied to the specification and design of buildings it procures. Following a review of their Building Management System, an ongoing staff education and awareness programme has been put in place to promote energy efficiency in HIE staff offices.
47. Externally HIE is committed to supporting the development of a range of technologies at both commercial and community scale to support improved energy efficiency. In recent years, HIE has worked closely with the renewables industry to produce economic conditions conducive to advancing the technology and creating jobs. A collaborative approach has been used with local and central government organisations, the renewables sector and local communities and has resulted in the establishment of the European Marine Energy Centre in Orkney and the Highlands and Islands Community Energy Company, now known as Community Energy Scotland.

## **Improving public sector purchasing**

48. The Audit Scotland report *Improving public sector purchasing* was published on 23 July 2009. It provides a position statement on the progress and impact of the Public Procurement Reform Programme (the Programme), which aimed at improving purchasing practice and making savings of about three per cent a year.
49. The report finds that the public sector in Scotland is improving its purchasing and has estimated it has saved a total of £327 million in the first two years of the Programme, which has cost £61 million so far to implement.
50. The current economic climate means that more than ever, the public sector needs to find cash savings without cutting services or quality. Because of the public sector's size and combined purchasing power, there is still potential for it to buy goods and services more efficiently and deliver more significant savings through increased collaboration and better management. There has been progress in recent years but it has varied across the country and been slower than planned.





51. The report recommends that the public sector should increase the use of collaborative contracts. These are a key feature of the Programme, but are being developed more slowly than expected. The health sector has been the most successful in this, introducing 150 new contracts and saving £54 million in the two years to 2007/08. Other high level recommendations highlight the good purchasing practice that public bodies should adopt to demonstrate Best Value.

**Extract from Audit Scotland report *Improving public sector purchasing***

52. *To demonstrate Best Value when purchasing goods and services public bodies should:*

- Have high-quality purchasing strategies and plans in place, including a plan to meet future workforce needs.
- Have up-to-date information on their purchasing activities such as supplier details, volume of transactions, value and type of spend.
- Ensure all purchasing practices, including control of spending, comply with good practice as set out in national and centre of expertise guidance.
- Work with the Scottish Government and centres of expertise to identify and develop opportunities for collaboration and for improved purchasing practice.
- Use procurement Best Practice Indicators to assess their performance and to continually improve how they buy goods and services.
- Report savings and other benefits on a regular and consistent basis.

53. HIE officers are currently represented on the procurement collaboration group of the Central Government Centre of Purchasing Excellence (CGCoPE). Purchasing performance is monitored using procurement best practice indicators, and savings reported via CGCoPE on a regular basis. A procurement capability assessment of HIE's procurement function by CGCoPE will also be undertaken shortly.
54. In addition, a procurement strategy and operating plan outlining the future progress of the procurement function has recently been developed, and Internal Audit has undertaken a review of procurement practice in HIE, including reference to the key findings in the Audit Scotland report.



# Governance and Accountability

55. High standards of governance and accountability, with effective structures and processes to govern decision-making and balanced reporting of performance to the public, are fundamental features of best value. This section sets out our findings arising from a review of HIE's arrangements.
56. Increasingly services are being delivered across the public sector through partnership working, sometimes involving complex governance and accountability arrangements. Best value characteristics also include effective partnership working to deliver sustained improvements in outcomes.

## Overview of arrangements

57. This year we reviewed:
- key systems of internal control
  - internal audit
  - arrangements for the prevention and detection of fraud and irregularity, including standards of conduct.
58. Our overall conclusion is that whilst there is some scope for improvement in certain areas, as noted in the following paragraphs, arrangements within HIE are generally satisfactory and have operated through 2008/09.

## Systems of internal control

59. 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 2008/09, HIE's head of audit and compliance provided her opinion that based on the internal audit work undertaken during the year, the systems of overall internal control were satisfactory, although opportunities were noted for improvement in areas such as information management, arrangements for managing subsidiaries, and outsourced management agency arrangements.
60. As part of our audit we reviewed the high level controls in a number of HIE's systems that impact on the financial statements. This audit work covered a number of areas including creditors, debtors, cash and bank, main accounting and payroll. Our overall conclusion was that key controls were operating effectively and that HIE has adequate systems of internal control in place. We did identify a number



of areas where controls could be strengthened and agreed an action plan of improvements with management. This will be followed up in 2010 to confirm that improvements have been made.

## **Statement on Internal Control**

61. The Statement on Internal Control provided by HIE's 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 and set out HIE's approach to this. The statement recognises scope for improvement in HIE's information management arrangements. A strategic approach will be developed by HIE during 2009/10 to address information and data handling issues currently being experienced. It also recognises the need to improve operational and governance arrangements for dealing with subsidiaries, and guidance is currently being developed for application in 2010.
62. The Accountable Officer has also highlighted the significant risks to non-achievement of financial targets in the future, as a consequence of market factors outwith the control of the organisation, and of the difficulties in comparing the value of short-term and long term benefits from investment.

## **Internal Audit**

63. 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 2008/09 audit we assessed whether we could place reliance on HIE's internal audit function. We concluded that HIE's audit and compliance section operates in accordance with the Government Internal Audit Manual and therefore placed reliance on their work in number of areas during 2008/09, as we anticipated in our annual audit plan. This included reliance on aspects of internal audit's systems work to avoid duplication of effort.

## **Prevention and detection of fraud and irregularities**

64. HIE has appropriate arrangements in place to prevent and detect fraud, inappropriate conduct and corruption, including policies and codes of conduct for staff and Board members.
65. Following allegations of plagiarism relating to reports commissioned from Rocket Science Ltd., a consultancy firm then chaired by the Chairman of HIE, Internal Audit undertook a review of tendering and payment arrangements for contracts with Rocket Science Ltd. The review covered payments made from September 2004 to March 2009. Although the review highlighted some issues around document retention, there was no indication of fraud or irregularity in relation to payments made.



## National Studies

66. Audit Scotland published one national study relevant to HIE's governance arrangements. This was a review of major capital projects.

### Major capital projects

- This report was the first systematic review of major capital projects in Scotland. It considered the progress of all 43 projects completed in the five years between April 2002 and March 2007, and a sample of current major projects. It looked at progress against cost and time estimates, quality specifications and project management in general. The main findings from the report were as follows:
    - In general, the achievement of cost and time targets improved significantly as projects progressed.
    - Early cost and time estimates at project approval stage were too optimistic for many major projects.
    - Performance against cost and time estimates is better after contracts are awarded, as plans are more certain and risks clearer.
    - Most completed projects have successfully delivered the required roads, hospitals and other assets, and all current projects are forecast to do so. However, few projects have been evaluated to demonstrate that they have delivered the expected wider benefits which originally justified the investment.
    - Nine current projects examined had awarded the main construction contract, which should increase cost certainty. However, four projects had significant increases in estimated cost before reaching this stage.
    - Project management and governance arrangements within individual projects are broadly effective, although room for improvement remains. A more strategic approach to managing the programme of capital projects could improve value for money.
67. HIE's approach to managing major capital projects is detailed in its project appraisal manual, which covers methodology and approaches to developing and appraising projects, including option appraisal, risk assessment and market failure considerations. The manual also sets out effective approaches for monitoring and evaluating projects. Internal audit has also used the Audit Scotland report to benchmark its own findings in recent reviews of major HIE capital projects.
68. As part of a review of its approach to project management, HIE is currently considering an operational and governance tool for major projects, which will draw on good practice identified in this Audit Scotland report.



# Performance

69. 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. Key features of best value include:
- setting a clear vision of what the organisation wants to achieve, backed up by plans and strategies to secure improvement, with resources aligned to support their delivery
  - a performance management culture which is embedded throughout the organisation and a performance management framework which is comprehensive and supports the delivery of improved outcomes.
70. In this section we comment on:
- HIE's operating plan
  - performance against targets
  - risk management
  - HIE's efficiency programme

## Vision and strategic direction

71. HIE published its corporate plan for 2008 – 2011 in March 2008. The plan articulates the contribution HIE is making towards implementing the Government Economic Strategy. This national strategy identifies five strategic priorities critical to economic growth:
- Learning, skills and wellbeing
  - Supportive business environment
  - Infrastructure development and place
  - Effective government
  - Equity.
72. In addressing these issues, HIE has focused its activities around three broad headings:
- Supporting high growth businesses and sectors
  - Creating the infrastructure and conditions to improve regional competitiveness
  - Strengthening communities, particularly in fragile parts of the area.



73. A range of key performance indicators to monitor delivery of these activities have been established and agreed with the Scottish Government. Progress against targets is monitored quarterly by HIE management, with six-monthly reporting to the Board and Scottish Government.

## Performance overview

74. In 2008/09, HIE measured its enterprise programme performance against nine growth measures, covering high-growth businesses and strengthening communities.

**Exhibit 3 - Performance against 2008/09 Growth Measures**

Description	2008/09 Target	2008/09 Actual	Actual as % of target	2009/10 target (where measure the same)
<b>High growth businesses</b>				
No. of account managed businesses with growth plans	100	103	103%	150
Added value to national growth through account managed businesses (£m)	£50m	£70m	140%	£85m
Increase in productivity in HIE assisted businesses	20%	38%	190%	n/a
No. of businesses deepening engagement in international business activity	100	129	129%	n/a
Private sector earnings index	120	160	133%	125
<b>Strengthening communities</b>				
No. of account managed social enterprises with growth plans	40	39	98%	40
Increase in turnover in the social economy	£1m	£2.1m	210%	£2m
No. of community groups supported to invest in renewable energy	30	60	200%	n/a
Decrease in carbon dioxide emissions (tonnes)		4,628		n/a

75. All five growth business targets were achieved, most by a considerable margin. Three of the four strengthening communities targets were achieved also, with the fourth target, the number of account managed social enterprises with growth plans, only narrowly missed.
76. A revised set of growth measures with stretching targets has been agreed for 2009/10 and these are set out in the 2009-12 operating plan. Four of the 2008/09 measures have been dropped, as noted in the above table. These have been replaced with three new indicators; the cumulative totals of account managed businesses and account managed social enterprises, and the number of account managed communities with growth plans. For those indicators that remain, the targets have been amended to ensure they are challenging, taking account of the level of achievement in 2008/09.



77. In addition to the growth measures, HIE monitors its performance in progressing transformational projects, as identified in its 2008-11 operating plan. Key indicators and outcomes include:

- **University of the Highlands and Islands** - working with UHI and partners towards achievement of university title, and complete an estates strategy and progress the development of high quality campus facilities at two key sites during the financial year. An infrastructure and organisational development programme has been put in place to deliver more robust management and organisation within UHI, and an estates strategy was prepared at the end of the financial year.
- **Beechwood Campus development** - securing land and planning consent for the campus master plan with a view to commencing work in 2011/12. A master-planning exercise involving all key stakeholders was concluded in January 2009, and planning application prepared for submission by April 2009.
- **Inward investment** - attracting six significant high growth inward investment projects in line with strategic priorities. A number of key investments were secured during the year, including the establishment of Essentially Scottish Botanicals in Kiltarlity, attracting Welcon Towers Ltd to Machrihanish to develop a wind tower manufacturing facility, and the relocation of Molecular Tools Europe Ltd from Glasgow to Dunstaffnage.
- **European Marine Energy Centre (EMEC)** - securing partnership support and implementing a five-year business plan and strategy to strengthen EMEC's position at the forefront of the global marine renewables industry. An overall £3 million funding package has been agreed between partners, and a capital works programme commenced to improve off-shore infrastructure.
- **Arnish development** - develop the use of the facility in line with the long-term development plan. A market review was completed early in the financial year, and a benefits realisation plan implemented for the site. Existing activities continue to be supported, including Hebridean Seaweed, and new operators such as Burntisland Fabrications have been attracted to the site.

78. We will continue to monitor HIE's performance delivery through 2009/10.

## Risk management

79. There are a number of key challenges and risks for HIE in delivering its plan. The Board has put in place systems for the identification and management of risk with the adoption of an organisation wide risk registers and a high level risk register. Risk assessments are undertaken at individual project level, with independent reviews for high risk projects. During 2008/09 revised reporting arrangements were introduced as part of a new corporate wide reporting framework. High level risks are assessed



reviewed by management and the Board at least quarterly, with key risks regularly reported to the Scottish Government.

80. The main risk areas are:

- **Beechwood Campus** – The proposed Beechwood campus project is a significant financial commitment for the organisation, amounting to £25 million over a five year period. There is a risk that the scale of project impacts negatively on HIE's ability to undertake other activity.
- **Global economy** – There is a risk that changes in the economy constrain potential economic growth in the Highlands and Islands.
- **Cairngorm Funicular** – The Board are due to consider a consultants report later this year on future business model options for the funicular. Following this, it is anticipated the operation of the funicular will be put out to tender. There is a risk that the current approach fails to secure an appropriate or manageable ongoing solution
- **University of the Highlands and Islands** – HIE has committed a significant amount of resources to advance of UHI in terms of organisational and infrastructure development, including significant enhancement of research expertise. There is a risk that this investment in UHI fails to realise anticipated benefits.
- **Resources** – HIE, in common with other public bodies, is working in an environment of tight financial constraints, with less certainty over future anticipated funding levels. There is a risk that resources are insufficient to deliver current and anticipated commitments, resulting in failure to deliver operating plan targets.

81. These risk areas are complex and comprise multiple issues which will require careful management to resolve. We will continued to monitor HIE's progress in each of these areas over the course of the coming year.

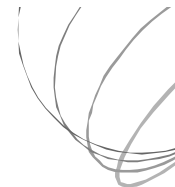
## Efficiency

82. HIE agreed an efficiency target of £2.295 million cash savings for 2008/09 with the Scottish Government. This target was surpassed in the year with savings of £2.409 million being realised, primarily from the programme of voluntary severance implemented at 31 March 2008. Other savings were achieved through efficiency gains arising from Visit Scotland's co-location in Cowan House.
83. Going forward, the budget settlement from 2009/10 and 2010/11 has a 2% efficiency target built into the baseline allocation, and HIE is looking to deliver cumulative efficiencies of £2.758 million for 2009/10. HIE has put in place monitoring arrangements to demonstrate the ongoing delivery of efficiency savings.





84. Given the potential for increased demand for assistance, and the reduction in value of investments and property as a consequence of global financial position, both of which will impact on resources available, it is important that further efficiencies can be achieved to support the delivery of the organisation's objectives.
  
85. HIE has highlighted that the key risk to achieving financial balance is the effective management of commitment levels through the financial year. Income sources are likely to be lower than originally planned as a consequence of reduced property disposals in the current economic climate, and the 2009/10 investment programme was heavily committed at the start of the financial year. Programme commitment levels will be subject to regular review during the year to ensure they are on target and identify any need for de-commitment or acceleration of other projects.
  
86. We will continue to monitor the financial position and the actions taken by HIE to manage these risks.



# Looking Forward

87. HIE faces a number of challenges in 2008/09, which include:

- **Delivering transformational change** – HIE has classified a number of projects it undertakes as transformational projects, based on their strategic importance to the area and the level of HIE resources involved. These projects by their nature are usually longer term and require clarity over anticipated outputs and outcomes. Measurable milestones are also necessary, along with regular monitoring to ensure they remain on track. HIE currently use HMS to track and monitor projects and it is important that that progress can be demonstrated going forward.
- **Cairngorm funicular** – It is anticipated the preferred future business model for the funicular will be determined by the Board later this year, with arrangements then put in place to invite tenders for the operation. HIE has already identified there is a risk that the current approach fails to secure an appropriate or manageable ongoing solution and is managing this risk.
- **Efficiencies and future funding** - Budgets for 2009/10 and the immediate future will need to be managed within a tighter funding regime. HIE needs to deliver an additional £0.545 million of savings in 2009/10 to achieve financial balance. The challenge for HIE is to prioritise spending, identify efficiencies and review commitments to ensure delivery of key targets and objectives.
- **National Performance Framework** - The Scottish Government is continuing to develop its approach to performance management based on the National Performance Framework and local authority single outcome agreements. HIE refreshed its performance targets in 2008/09 to align to this framework, and have updated these again for 2009/10 to ensure they remain properly focused. We will consider the organisation's target setting process to establish how challenging these are for the future.
- **IFRS** - The timetable for IFRS implementation requires that central government accounts in Scotland to become IFRS compliant with effect from the 2009/10 financial year. As part of the timetable for the implementation for IFRS, shadow accounts will require to be produced for 2008/09 for audit review by the end of November 2009. These processes will require significant resource to complete and it will be important that these issues are addressed early in 2009/10.
- **Data handling** - The Scottish Government carried out a review of data handling arrangements in Scotland, in response to failures in UK government body's procedures and practices during 2007. The review considered current policies and procedures on data and identified good practice across the public sector, making a number of recommendations for improvement. HIE has made limited progress in considering the implications for the organisation, and we will review progress in this area as part of our 2009/10 audit.