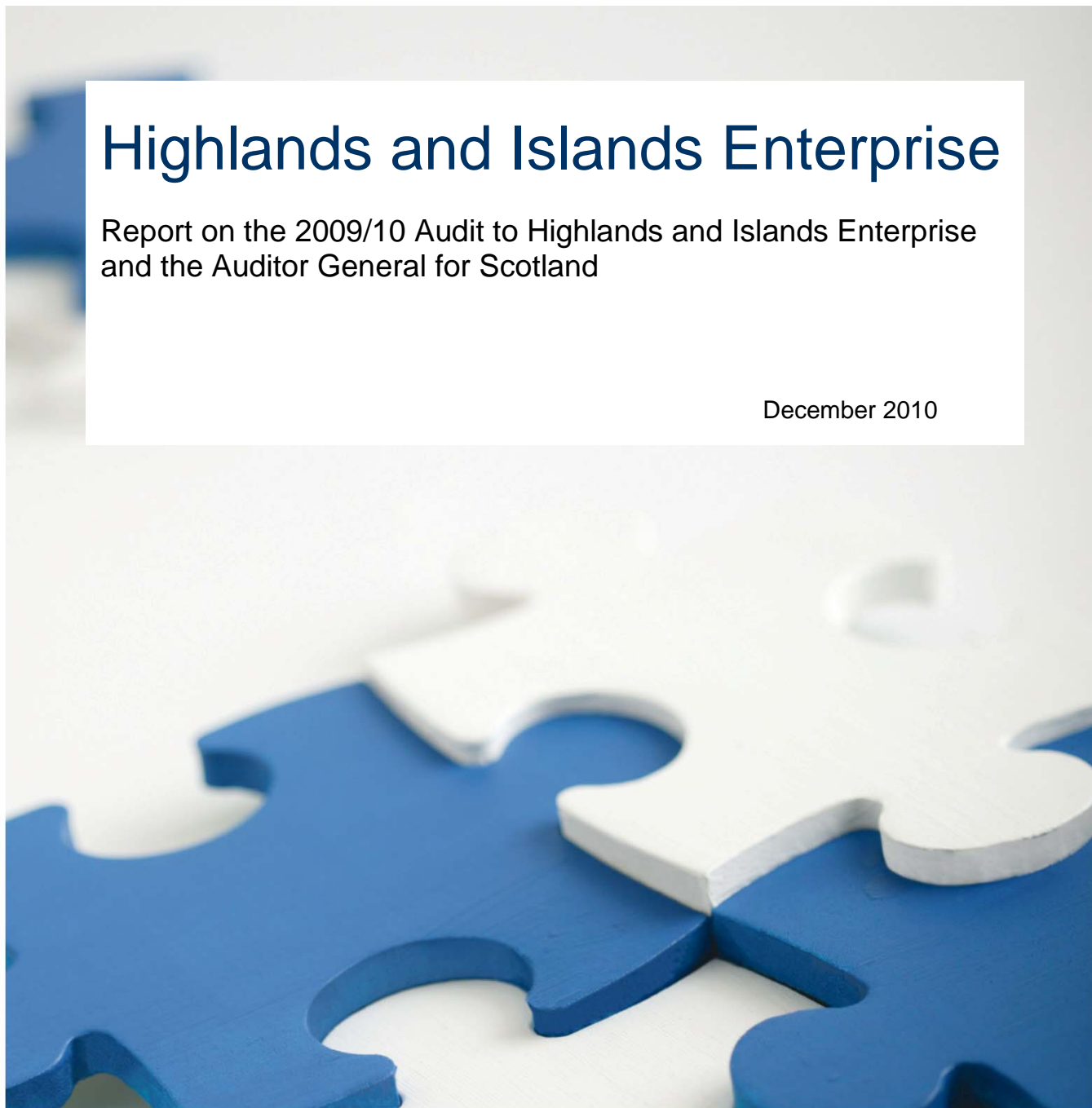


Highlands and Islands Enterprise

Report on the 2009/10 Audit to Highlands and Islands Enterprise
and the Auditor General for Scotland

December 2010

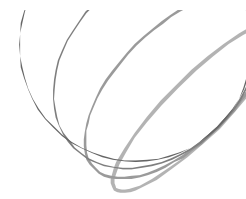


 AUDIT SCOTLAND



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Key messages

In 2009/10 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 2009/10. 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

Scotland's economy is recovering from recession and the public sector is under the greatest financial pressure since devolution ten years ago. It will be very challenging to maintain current levels of public services and meet new demands when resources are tight. It remains unclear how the economy will perform beyond 2010/11. The Scottish budget is likely to reduce in real terms but the full extent of this is not yet known. Two percent efficiency savings will not be sufficient beyond 2011 to bridge the gap between public spending and the smaller budget available. In the current economic climate difficult decisions will have to be made across the public sector about priority spending programmes.

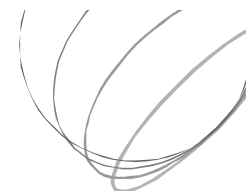
HIE's resource budget was set at £72.7 million for 2009/10 by the Scottish Government Enterprise, Energy and Tourism Directorate. This included £14 million of non-cash costs. HIE operated within this budget with an outturn of £71.5 million, underspending by £1.2 million of non-cash resources. Scottish Ministers have agreed a resource budget of £68.5 million for 2010/11.

A selective voluntary severance programme completed in March 2010 resulted in a reduction of 53 members of staff. The cost of the scheme was £3.8 million with a payback period of 1.9 years. In recent years voluntary severance has resulted in a reduction of 112 staff from HIE's establishment at a cost of £8.2 million.

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.

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, and noted areas where we considered improvement is still required.



An acting Chief Executive was appointed in August 2009, to cover an extended period of illness. Subsequent to his return, the former Chief Executive resigned on 14 March 2010 and took up a post with the Scottish Government. The acting Chief Executive appointment was extended until 1 August 2010, with a new Chief Executive taking up his post on 2 August 2010.

Performance

HIE's Operating Plan focuses on three key areas: supporting significant and high growth businesses; strengthening communities especially in fragile parts of the area and creating the infrastructure and conditions to improve regional competitiveness. To monitor the delivery of each section, key performance indicators have been established. For 2009/10 these indicators were refreshed and the targets made more challenging. In a year of testing economic conditions, not all of the targets were achieved. Under the Business Growth heading out-turn ranged from 88-103% of target set and under the Strengthening Communities heading out-turns ranged from 88-117% of target set.

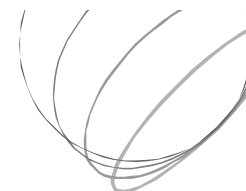
In 2010 a report on Cairngorm Funicular Railway was presented to the Scottish Parliament Public Audit Committee under Section 23 of the Public Finance and Accountability (Scotland) Act 2000. The decision to invest in the Cairngorm funicular was taken over a decade ago in 1997. The process complied with guidance and procedures at the time, but HIE did not take account of new risks that emerged before construction started. It has cost much more to build the funicular than expected but consultants' reports indicate it has delivered the anticipated employment and wider benefits. HIE provided comment to the Public Audit Committee on the process, and is continuing to work with the operator CML to ensure a viable business model is in place. HIE intends to revisit the Cairngorms Estate benefits realisation plan in late 2010, and to assess the future operating arrangements.

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. In 2010/11 HIE will continue to face significant financial pressure to ensure financial balance is achieved.

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

**Audit Scotland
December 2010**

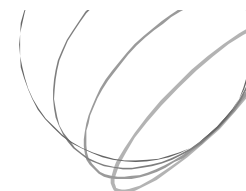


Introduction

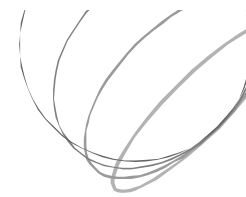
1. This report summarises the findings from our 2009/10 audit of HIE. The scope of the audit was set out in our Audit Plan in accordance with the Code of Audit Practice, which was presented to the Audit Committee on 18 March 2010. This plan set out our views on the key business risks facing the organisation 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 the Board's agreed response.
3. Best value duties apply across the public sector and are 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 this has been further developed during 2009/10 with the completion of its bank of best value Toolkits which, although primarily designed for audit use, are available to all public bodies for reference.

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





4. A linked development here has been the Scottish Government's work to refresh its 2006 best value Guidance for Public Bodies. This latter initiative, due for issue later in 2010, will result in clearer guidance to public bodies, and particularly those in the Central Government and Health sectors, on securing continuous improvement in performance, with due regard to the balance between cost and quality.
5. Throughout this report we comment on aspects of HIE arrangements in this area. 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 yet have enough evidence to conclude on all relevant areas. Our intention is to build up the corporate assessment over time. This report represents a further step towards that goal.
6. 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. Where these have a bearing on the activities, risks or performance of HIE, we make reference to these reports in this document. Full copies of the study reports can be obtained from Audit Scotland's website, www.audit-scotland.gov.uk.
7. 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

8. In this section we summarise key outcomes from our audit of HIE financial statements for 2009/10 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

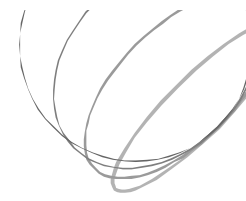
9. We audit the financial statements and give an opinion on:
- whether they give a true and fair view of the financial position of HIE and the HIE Group and its expenditure and income for the period in question
 - whether they were prepared properly in accordance with relevant legislation, applicable 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.
10. 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
 - assessing whether disclosures in the statement are consistent with our knowledge of HIE.

Overall conclusion

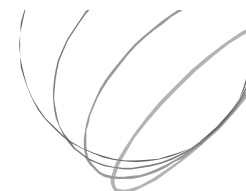
11. We have given an unqualified opinion on the financial statements of HIE for 2009/10.
12. As agreed the unaudited accounts were provided to us on 12 July 2010, supported by a working papers package. However, as reported to the Audit Committee, there was scope for improvement in the quality of the working papers submitted. We concluded our audit within the agreed timetable and provided our proposed opinion to the Audit Committee on 15 September 2010 as timetabled, subject to the satisfactory review of further papers supporting issues raised. Following this review, a final set of the accounts was signed by the Accountable Officer on 4 October 2010.

Issues arising from the audit

13. As required by auditing standards we reported to the Audit Committee on 15 September 2010 the main issues arising from our audit of the financial statements. The key issues were as follows:



14. **Submission of the accounts for audit** – Following a number of late adjustments to the 2008/09 accounts, we agreed to work closely with HIE finance team to ensure a realistic timetable was agreed and adhered to for the 2009/10 accounts. Critical to that was the delivery of a full set of complete accounts for the commencement of the final audit visit including a full set of IFRS adjustments and new disclosures. Our audit of the accounts and issue of a proposed opinion to the Audit Committee was planned on the basis of receiving a complete set of unaudited accounts, with adequate supporting documentation, prepared under IFRS.
15. The timetable for the preparation and submission of the accounts for audit and approval was proposed by HIE and agreed with us early in the audit process. The accounts for HIE were presented for audit on 12 July 2010 in line with the timetable, however these draft accounts were incomplete in a number of material respects including,
 - group consolidation was not complete and therefore information in primary statements and accompanying notes did not contain the group position
 - the cashflow statement and associated notes were not provided
 - a number of disclosure notes covering HIE core information were incomplete, including administration allocation; segmental information; explanation and reconciliation of the transition to IFRS; reconciliation of group profit on sales; provisions for loss; losses statement and tax computation.
16. Further sets of revised accounts were provided during the audit, correcting errors and omissions and reflecting late adjustments proposed by HIE. Following the clearance meeting on the 27 August HIE agreed to revise the accounts in a number of areas and provide a final set of accounts and final working papers for final audit review by the 3 September. These revised accounts were provided however a number of further corrections were required to this version.
17. Errors and omissions in the accounts and supporting papers initially submitted for audit meant that the clearance of the accounts for Audit Committee placed unnecessary pressures on both the finance and audit teams to deal with late corrections and final adjustments. The additional work to prepare IFRS compliant accounts added to the difficulties for HIE officers. It is important that HIE develop a timetable for the full production of the 2010/11 accounts which is attainable, and that the necessary resources and expertise are deployed in support of the delivery of these accounts.
18. **Letter of Representation** – In 2008/09 we reported to the Audit Committee on the presentation of late adjustments to provisions for investments, property rental income and EU funding within HIE's accounts. At that time we noted that the consistency and evidence base for the estimation of provisions would be an essential element of our consideration of any future adjustments. We carried out detailed reviews of HIE's provisions again in 2009/10 and discussed the appropriateness and consistency of the estimation of provisions with HIE officers, agreeing a number of final adjustments to



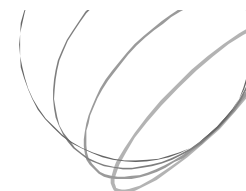
the accounts to reflect these principles. We requested specific assurances within the letter of representation from the Accountable Officer on the consistency and appropriateness of these estimates within the accounts.

Regularity

19. 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)

20. UK Government departments and other public sector bodies prepared their accounts in accordance with International Financial Reporting Standards (IFRS) for the first time in financial year 2009/10. The transition arrangements to IFRS required bodies to prepare IFRS shadow accounts for 2008/09, including revised opening balances as at 1 April 2008.
21. During 2009/10 we were required to review the shadow accounts and report on them to HIE by 28 February 2010. The purpose of this exercise was to consider whether the shadow accounts had been properly prepared and report any matters that might prevent them forming a reliable basis for the first set of IFRS based accounts in 2009/10.
22. The shadow accounts and supporting documentation for the 2008/09 financial year were submitted by HIE for audit for review by the deadline date of 28 November 2009. When the accounts were submitted officers informed us of some areas which had not been resolved and could not be updated in the submission. These were matters that should have been resolved earlier in the process by HIE, and these issues in part contributed to the difficulties in the preparation of the 2009/10 accounts. This included the restatement of investment property, revised presentation of government grants and valuation of investments. We did make some further recommendations for the production of the 2009/10 accounts, and considered progress on these when we audited the 2009/10 accounts.



Use of Resources

23. 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 a review of HIE's

- financial position
- financial management
- management and use of ICT

Financial Position

Outturn 2009/10

24. HIE is required to work within its resource budget set by the Scottish Government Enterprise, Energy and Tourism Directorate. HIE operated within the cash and non cash elements of its resource budget. The initial allocation was reduced by a non-cash budget virement of £4.5m during the year. There was also a Selective Voluntary Severance Scheme which was completed in March 2010. Approval for this was obtained from the sponsor team. HIE's statement of financial position at 31 March 2010 shows net assets of £27.919 million (2008/09 net assets of £25.077 million).

25. HIE operated within the resource budget limits set by the Scottish Government for cash expenditure and non cash costs. – see exhibit 2 below:

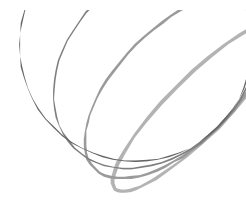
Exhibit 2 – Performance against resource budget 2009/10 (£ million)

Limits	Budget	Actual Outturn	Difference
Non Cash Expenditure	14.0	12.8	1.2
Cash	58.7	58.7	0.0
Total	72.7	71.5	1.2

Selective Voluntary Service

26. In 2009/10 a selective voluntary severance programme was completed. The scheme led to the departure of 53 members of staff at a cost of £3.8 million. The scheme was offered to all staff, with those under 50 being offered a severance based on their age, length of service and contractual or minimum terms as defined in legislation. Employees aged over 50 were offered an enhanced early retirement package.

27. An organisation wide review was carried out to ensure decisions were made with consideration for not only individual business units but for the organisation as a whole. Final decisions were made by a panel which consisted of the Chief Executive, The Chair of the Remuneration Committee and the



Head of Human Resources. A total of 77 applications were received for consideration by the panel, and as a result of the review 18 requests were not granted and the remaining 6 chose not to take up the offer.

28. The 2009/10 voluntary severance scheme follows on from a similar scheme in March 2008, which resulted from Scottish Government's enterprise review. At that time, a total of 59 staff left the organisation, at a cost of £4.4 million. The total costs of severance in recent years have been £8.2 million to reduce staffing levels by 112.

Scotland's public finances

29. The Auditor General's report on *Scotland's public finances, published in November 2009*, contained an overview of the financial environment in Scotland and the pressures and challenges facing the public sector. The aim of this report was to help to inform the debate on the future of public finances in Scotland. The key messages from this report were:

Extract from Auditor General's report *Scotland's public finances*

The public sector is coming under the greatest financial pressure since devolution.

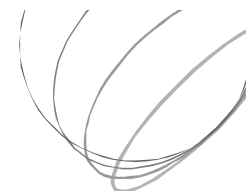
- Scotland's economy is in recession and the public sector is under the greatest financial pressure since devolution ten years ago. It will be very challenging to maintain current levels of public services and meet new demands when resources are tight.
- The Scottish Government and the wider public sector need to work together to develop better activity, cost and performance information. This information is needed to enable informed choices to be made between competing priorities, and to encourage greater efficiency and productivity.

The Scottish Government faces significant challenges in balancing the budget while also delivering on its commitments and meeting increasing demands for public services.

- It remains unclear what impact the current recession will have beyond 2010/11. The Scottish budget is likely to reduce in real terms but the full extent of this is not yet known.
- In many cases, the public sector uses income from various sources to pay for services. Income levels anticipated before the recession are unlikely to be realised, reducing the amount available to spend.
- The Scottish public sector faces significant challenges in balancing its budget while also delivering on its commitments. Changes in Scotland's population and rising unemployment rates will increase demand for public services.
- Two per cent efficiency savings will not be sufficient beyond 2011 to bridge the gap between public spending and the smaller budget available.

In the current economic climate difficult decisions will have to be made about priority spending programmes.

- The Scottish Government's annual budget is largely developed on an incremental basis which involves making adjustments at the margin to existing budgets. This approach is not suitable for budgeting in a financial downturn because it does not easily allow informed choices to be made about priorities, based on robust information about activity, costs and performance.



- The Scottish Parliament has an important role in scrutinising the government’s spending plans. Better information linking spending to costs, activities and service performance, and a rolling programme of performance reviews, would support the Scottish Parliament in fulfilling this role.

30. There is an ongoing effort by HIE to prioritise financial support, and they continue to review delivery of activities to ensure that Best Value is achieved. The continuous improvement group within the organisation is tasked with identifying and implementing business improvement activities across HIE.

31. HIE considers the process improvements generated through streamlined project appraisals have encouraged more strategic decision making with increased emphasis on benefits realisation. Project management tools have also been developed to improve delivery. We will continue to monitor HIE’s progress in this area over the coming year.

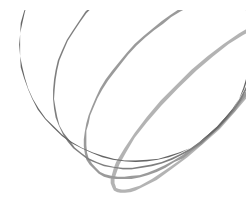
Financial sustainability and the 2010/11 budget

32. Scottish Ministers have agreed a resource budget for HIE of £68.5 million for 2010/11, a decrease of £4.6 million on the prior year initial allocation. This is to be funded as follows:

Exhibit 3 – 2010/11 Resource Plan

	TOTAL	'CASH'	'NON CASH'
	£m	£m	£m
Grant in Aid (baseline)	54.5	54.5	0.0
Non cash resource	14.0	0	14.0
Resource Budget	68.5	54.5	14.0
Other Income Sources	14.4	14.4	0.0
Total Operating Plan	82.9	68.5	14.0
Analysed as:	£m		
Grant in Aid	54.5		
Other sources	14.4		
'Total Cash'	68.9		
'Non cash' resource	14.0		
Total Operating Plan	82.9		

33. HIE is expected to achieve 2% of efficiency savings through 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. Delivering efficiencies year on year while absorbing pay inflation and other cost pressures represents a significant challenge for the organisation. HIE agreed a target saving of £3.97 million with Scottish Government for 2010/11. £2.2 million of this will be achieved through salary savings as a consequence of deletion of posts through the voluntary severance scheme in March 2010. It is anticipated a further £1 million savings will be achieved through other reductions in pay costs.



- 34. There is likely to be sustained pressure on HIE’s budget and their ability to strip out any costs from core activities will be challenging given the reductions in activities and staffing numbers that have already happened in recent years.

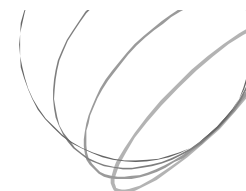
Financial management

- 35. In 2009/10 we undertook a best value review of HIE’s financial management arrangements, which took 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 with a range of HIE officers.
- 36. Our conclusion is that HIE demonstrates better practice in many areas of its financial management, including its approach to financial strategy and planning, and various aspects of internal reporting and monitoring of financial performance. However, there is scope for improvement in a number of areas, particularly around financial management skills across the organisation and external financial reporting.
- 37. There were eleven themes we considered as part of the review, and we assessed HIE’s practice against these themes as follows:

Exhibit 4 – Assessment of HIE’s practices

Theme	Assessment			
	Does not meet basic requirement	Basic Practice	Better Practice	Advanced Practice
Leadership			✓	
Financial Management skills			✓	
Financial Challenge			✓	
Financial Planning			✓	
Medium to long term financial strategy		✓		
Understanding Costs			✓	
Investment appraisal and monitoring			✓	
Reporting of outputs			✓	
Financial monitoring			✓	
Financial Reporting		✓		
External performance reporting			✓	

- 38. An assessment of basic or better practice does not automatically mean an organisation is underperforming in a particular area, and it may be the optimal performance level appropriate to that



organisation's circumstances. However, the assessment of basic practice in a number of key areas for HIE reflects our view of where the organisation is underperforming, and action is necessary to improve. The key areas for improvement we identified in our report, included:

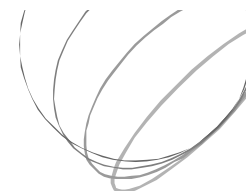
- considering skills mix and training requirements of finance staff throughout the organisation
- developing the financial modelling techniques used to support policy decisions and resource allocation
- financial benchmarking internally and with other organisations
- improved quality control and resource planning on the preparation of financial statements
- earlier consideration of significant areas of work through the financial year.

39. HIE has already taken action already to address some of the points above. However HIE should assess the optimal performance levels appropriate to it as an organisation, and develop an action plan to address the other improvement areas noted and assist the transition across levels of performance.

Management and use of ICT

40. In 2007 we undertook a computer services review of Highlands & Islands Enterprise (HIE) and actions were agreed to address the issues identified in the report. We followed up the report during 2009 however a number of actions were still outstanding. We reviewed the position in 2010 to ascertain the position and updated the initial findings:

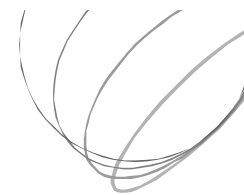
- **Developing and approving an IS Strategy** - User acceptance testing of the new HMS development phase is being finalised and the IS Strategy will be finalised by December 2010.
- **Implementing replication services on key systems and servers across business services** - Further discussions are planned with Scottish Natural Heritage (SNH) regarding the offsite SAN to SAN replication pilot. HIE hope to agree a Memorandum of Understanding with SNH by October 2010.
- **Information Security** –New information security guidance has been developed and issued to staff. A review of compliance with the information security policy is ongoing. A “gap analysis” action plan will be developed by December 2010.
- **Developing and Implementing Business Continuity Management** - Internal Audit undertook a review of business continuity management in 2009 and noted a number of issues to be taken forward. HIE have indicated that some progress has been made in formally developing business continuity plans and disaster recovery plans although the timescales have slipped as a result of staff reorganisation . This work will continue and be completed by March 2011.
- **Information Management Issues** – An upgrade to eRDM is planned for October 2010 and this will include review of all eRDM processes.



41. HIE is currently considering options for future ICT delivery arrangements, which could impact on some of the actions originally planned in relation to this report. We will continue to monitor developments over the coming year.

National Studies

42. Audit Scotland published a national study on 23 July 2009, *Improving public sector purchasing*. This provided a position statement on progress made by the Public Procurement Reform Programme, which was aimed at improving purchasing practice and making savings of about three per cent a year.
43. The report found that the public sector in Scotland is improving its purchasing and estimated it had saved a total of £327 million in the first two years of the Programme, which has cost £61 million so far to implement. Because of the public sector's size and combined purchasing power, there is 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.
44. The report recommended that the use of collaborative contracts in the public sector should increase. 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. Public bodies also need to ensure that staff have the appropriate skills and that better information and management systems are in place to facilitate more effective purchasing. Audit Scotland will follow up this report with further audit work on public sector purchasing.
45. HIE's Internal Audit carried out a review of procurement in year, and noted the recommendations made in the Audit Scotland report. HIE's Procurement Strategy has not been fully implemented across the organisation and an action plan has been put in place. We will follow up on this action plan in 2010/11.



Governance and Accountability

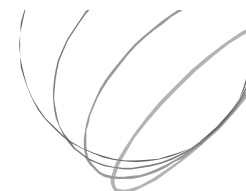
46. High standards of governance and accountability, with effective structures and processes to govern decision-making and balanced reporting of performance to the public, are fundamental features of best value. This section sets out our findings arising from a review of HIE arrangements.
47. Increasingly 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

48. 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.
49. Our overall conclusion is that arrangements within HIE are sound and have operated through 2009/10.
50. During the 2009/10 financial year, an acting Chief Executive was in post from August 2009, to cover an extended period of illness. Subsequent to his return, the former Chief Executive resigned on 14 March 2010 and took up a post with the Scottish Government. The acting Chief Executive appointment was extended until 1 August 2010, with the new Chief Executive taking up his post on 2 August 2010.

Systems of internal control

51. 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 the annual report for 2009/10 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, during the financial year were satisfactory, with the exception of the following areas where a number of significant issues need to be addressed in relation to: information management; procurement; project management arrangements; consultancy; travel and subsistence; Cairngorm Mountain; resource allocation.



52. 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 trade payables, trade receivables, cash and cash equivalents, main accounting, payroll and non current assets.
53. 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 2011 to confirm that actions have been implemented and improvements have been made.

Statement on Internal Control

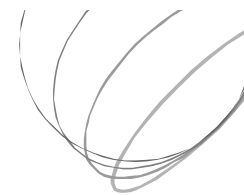
54. The Statement on Internal Control provided by HIE's Accountable Officer reflected the main findings from both external and internal audit work. This recorded management's responsibility for maintaining a sound system of internal control and set out HIE's approach to this.
55. Information management reviews completed by internal audit identified the need for a strategic approach to address the information and data handling issues being experienced by HIE. Arrangements are in place to take this forward to 2010/11 as part of the system development and continuous improvement activities.

Internal Audit

56. 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 2009/10 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 a number of areas during 2009/10, 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

57. 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.
58. Internal audit carried out a review on the potential conflict of interest with the former Chief Executive and the proposed new Inverness Campus site. Information was provided to Audit Scotland and the Standards Commission which indicated appropriate arrangements had been put in place to ensure the Chief Executive was not involved in the decision making process.

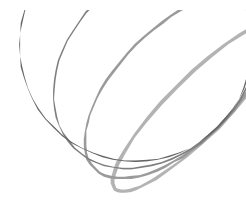


Performance

59. 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.
60. In this section we comment on HIE's:
- vision and strategic direction
 - performance
 - risk management
 - efficiency programme.

Vision and strategic direction

61. HIE published its operating plan for 2009 – 2012 in March 2009. The plan details the contribution HIE is making towards implementing the Government Economic Strategy, which identifies five strategic priorities critical to economic growth:
- Learning, skills and wellbeing
 - Supportive business environment
 - Infrastructure development and place
 - Effective government
 - Equity.
62. To address these activities HIE has focused its activities in three areas:
- Supporting significant and high growth businesses and sectors
 - Creating the infrastructure and conditions to improve regional competitiveness
 - Strengthening communities especially in fragile parts of the area.



63. A range of key performance indicators monitoring delivery of these activities are in place. Progress against targets is monitored quarterly by HIE management and bi annual reports are presented to the Board and the Scottish Government.

Performance overview

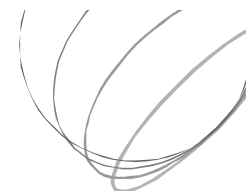
64. In 2009/10 HIE measured the enterprise programme performance against 8 growth measures. These measures were amended from 2008/09. Some of the previous indicators were dropped and those that remained were amended to ensure they continue to be challenging.

Exhibit 5 - Performance against 2009/10 Growth Measures

Description	2009/10 Target	2009/10 Actual	Actual as % of target	Reason for not attaining target
High growth businesses				
Number of account managed businesses with growth plans	150	136	91%	Greater focus was placed on conversion of existing plans into actual growth.
Cumulative total of account managed businesses	250	238	95%	Stock of account managed business relationships building well.
Added value to national growth through account managed businesses (£m)	£85m	£75m	88%	Preliminary out-turn will be subject to review as part of a future evaluation of account management activities.
Private Sector Earnings Index	125	129	103%	
Strengthening communities				
Number of account managed social enterprises with growth plans	40	35	88%	Current economic climate is causing many social enterprises to be cautious about growth.
Cumulative total of account managed social enterprises	80	73	91%	Stock of account managed social enterprises developing well.
Increase in turnover in the social economy	£2m	£2.33m	117%	
Account managed communities with growth plans	18	20	111%	

65. HIE also monitors its performance in progressing transformational projects as identified in the 2009-12 operating plan. Key indicators and outcomes for 2009/10 include:

- **University of the Highlands and Islands** - the development of the regional university is progressing. The title bid document was prepared with a view to submission in May 2010. This will be scrutinised by Quality Assurance Agency on Higher Education and



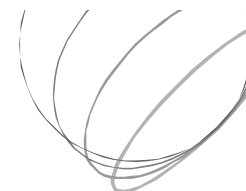
recommendations to the Privy Council will be made early in 2011, with the final decision expected in spring 2011.

- **Inverness Campus Development** - Progress against project targets and milestones is reported to be on track. Work is scheduled to commence in Spring 2011 and the Board have commenced the tendering procedures.
- **European Marine Energy Centre (EMEC)** - The expansion of the test centre for full-scale wave and tidal energy machines increased its capacity by a third - enabling new prototype devices to go into the water this year. Funding of EMEC's development, co-ordinated by HIE, has involved other partners including the Scottish and UK Governments, Scottish Enterprise, Orkney Islands Council, the Carbon Trust and European Commission.

66. We will continue to monitor HIE's performance delivery against the updated operating plan for 2010-13 through 2010/11.

Cairngorm Funicular Railway

67. In 2010 a report on Cairngorm Funicular Railway was presented to the Scottish Parliament Public Audit Committee under Section 23 of the Public Finance and Accountability (Scotland) Act 2000. The decision to invest in the Cairngorm funicular was taken over a decade ago in 1997. The process complied with guidance and procedures at the time, but HIE did not take account of new risks that emerged before construction started. It has cost much more to build the funicular than expected but consultants' reports indicate it has delivered the anticipated employment and wider benefits.
68. HIE provided a written response to several of the points raised in the Public Audit Committee report and noted that the Cairngorm funicular railway had been a uniquely challenging and complex project, not only for HIE, but for Scotland.
69. High levels of snow in January 2010 led to the best winter trading environment for many years thus increasing revenue and also the number of skiers to the area. As a result operators CML, a fully owned subsidiary of HIE, is now repaying cash to reduce their borrowing requirements. After discussions with CML, an updated Action Plan was presented to the HIE Board in February.
70. Targets set include: preparation of a new risk management plan, implementation of the summer marketing plan, review of Scottish skiing and the winter sports market and ensuring the information from the Audit Scotland report is contained in all work areas. HIE is working with CML to develop a business plan for the facility, which will inform a viable business model for the longer term operation of the facility. HIE intends to revisit the Cairngorms Estate benefits realisation plan in late 2010, with a view to assessing the current position and agreeing a potential exit strategy in 2011.
71. We will continue to monitor progress in this area as part of our work in 2010/11.

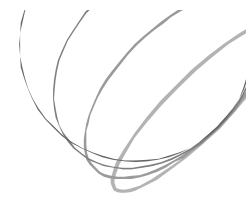


Risk management

72. There are a number of key challenges and risks for the Board in delivering its plan. The Board has put in place robust systems for the identification and management of risk with the adoption of organisation wide register risk registers and a high level risk register. Risk assessments are carried out at individual project level, with independent reviews undertaken for high risk projects. High level risks are reviewed and assessed by management and the Board at least quarterly. Key risks are reported to the Scottish Government.
73. The main risk areas are:
- **Global economy** – The risk that changes in the economy constrain potential economic growth in the Highlands and Islands continues. Insufficient investment in the region's infrastructure could restrict the rate of growth.
 - **Staff Pension Arrangements** – An affordable solution is not reached on staff pension arrangements.
 - **Inverness Campus** – Failure to have appropriate operational arrangements in place could jeopardise the project delivery.
 - **Resources** – In an environment of financial constraints and future reductions in funding, HIE must make best use of their resources, both financial and personnel, to ensure delivery of current and anticipated commitments and ensure the operating plan delivers on target.
 - **Programmes** – Failure to deliver HIE objectives in fragile areas.
74. These risk areas are complex and comprise multiple issues which will require careful management to resolve. We will continue to monitor the HIE's progress in each of these areas over the course of the year.

Improving public sector efficiency

75. The Audit Scotland report *Improving public sector efficiency* was published on 25 February 2010. It provided a position statement on the first year (2008/09) of the Efficient Government Programme (the Programme), which aims to deliver £1.6 billion efficiency savings over the three years to 2010/11. It also gave an update on how the Scottish Government and public bodies have addressed the recommendations made in the 2006 report about the previous efficiency programme.
76. The report found that Scottish public bodies reported more efficiency savings than the Government's two per cent target. But there are serious financial challenges ahead – the biggest since devolution – and making the required savings through efficiency will become increasingly difficult.



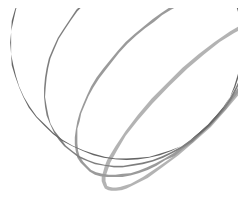
77. The report recommended that to deal with reduced future funding and increase savings public bodies need to consider fresh approaches to improving efficiency and productivity. They must take a more fundamental approach to identifying priorities, improving the productivity of public services, and improving collaboration and joint working.
78. The drive to improve efficiency and productivity is not just an exercise for managers and service providers. It requires strong leadership and engagement from the very top of public bodies. Leaders and senior decision-makers within an organisation have a responsibility to check, challenge, monitor and support their organisations in delivering efficiency and productivity improvements. The report's recommendations highlighted areas that public bodies' key decision makers should look at to assess their organisation's development and to challenge existing arrangements (see below).

Extract from Audit Scotland report *Improving public sector efficiency*

In order to improve the delivery of efficiency savings public bodies should:

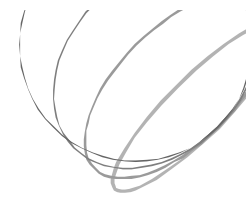
- ensure they have a priority-based approach to budgeting and spending
- continue to improve collaboration and joint working, overcoming traditional service boundaries
- consider using alternative providers of services, if these providers can improve the efficiency, productivity or quality of services
- improve information on costs, activity, productivity and outcomes, including setting baselines to measure performance against
- give greater urgency to developing benchmarking programmes
- maintain the momentum of activities and initiatives to improve purchasing and asset management and extend shared services
- ensure there is a joined-up approach to efficiency savings across the public sector, avoiding duplication
- ensure that plans are in place to deliver savings, clearly setting out what action will be taken, the level of savings to be delivered and how these will be measured
- strengthen the involvement of front-line staff, service providers and users in redesigning public services
- reduce reliance on non-recurring savings to meet financial targets and generally use these as part of a wider and longer term strategy
- report efficiency savings consistently.

79. To support these high-level recommendations, Audit Scotland, the Northern Ireland Audit Office and the Wales Audit Office have drawn on their combined experience to develop a detailed good practice checklist. The checklist is intended to promote detailed review and reflection and, if necessary, a basis for improvement. We recommend that those responsible for leading efficiency and improvement work should consider assessing themselves against each question, and recording the results.



80. HIE's target for 2009/10 efficiencies was £2.69 million and the total for the year was £2.72 million which was £0.03 million over. Targets were met through a variety of initiatives including reorganisation of delivery teams, a review of financial resources, procurement efficiencies and the consolidation of offices across the organisation.

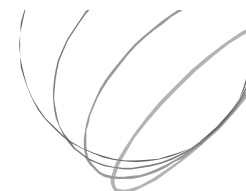
81. In 2010/11 a target of £3.9 million has been set for HIE. HIE plan to achieve the bulk of the planned efficiencies through reduction in pay costs, and savings generated through reduction in posts arising from the voluntary severance scheme in 2009/10.



Looking Forward

82. HIE faces a number of challenges in 2009/10, which include:

- **Efficiencies and future funding** - Scottish public bodies reported more efficiency savings than the Government's two per cent target in 2009/10 but there are serious financial challenges ahead – the biggest since devolution – and making the required savings through efficiency will become increasingly difficult. The recent Comprehensive Spending Review announcements indicated an overall cut in next year's Scottish budget of £1.3 billion - including an £800 million reduction in capital spending. In addition, cuts in defence spending are likely to have a significant impact on the local economy in and around Moray.
- To deal with reduced future funding and increase savings, fresh approaches to improving efficiency and productivity must be considered, taking a more fundamental approach to identifying priorities, improving the productivity of public services, and improving collaboration and joint working.
- **Moray Air Bases** HIE has set up a task force with the local council and other agencies to try to prevent base closures at RAF Kinloss and Lossiemouth, and to address issues arising from potential job losses and base closures at and the wider impact on the local area. HIE is leading the task force to try to prevent closure. At the same time extensive efforts will be taken re-deploy displaced workers and avoid an exodus of families from the region.
- **Scottish Parliament Review of Enterprise Agencies** - As part of its consideration of the 2010-11 budget, the Economy, Energy and Tourism Committee raised questions about the purpose of the enterprise network and its role in economic development. As a result a Committee has been set up to carry out an inquiry which will analyse the current structure of, and activities carried out by, Scotland's enterprise network. At the end of the inquiry, the Committee will produce a report to Parliament, making a series of conclusions and recommendations for actions to be taken by the Scottish Government and others. HIE presented a submission to the Committee as required by the deadline of 3 September.
- **Inverness Campus** - The campus is considered as one of the most important developments proposed for the Highlands and Islands in the next 20 years. Construction will soon be underway to create a multi-stakeholder academic and research Campus that will deliver significant economic benefits by creating a modern centre of excellence for education, research and innovation.
- **Cairngorm Mountain Ltd** – Following the best winter trading conditions for a number of years, CML has enjoyed a healthy trading performance, and has been able to repay working capital to HIE. HIE has been supporting CML in the operation of the funicular, and its implementation of a revenue enhancement model, which focuses on improving the summer product offering,



introducing car parking charges and revisiting maintenance arrangements. Progress is being made in these areas, and also in the development of an exit strategy for HIE, however, there is still further work needed before HIE will be able to fully implement this, and conclude a benefits realisation plan.

- **Best Value** - The concept of best value is seen as a key driver of modernisation and improvement in public services. Audit Scotland has continued its commitment to extending the best value audit regime across the whole public sector and significant development work has taken place over the last year including the finalisation of its best value toolkits. This has been matched by the Scottish Government's commitment to refreshing its Best Value Guidance for Public Bodies. HIE should continue to respond to this important initiative as it develops.