

# Highlands and Islands Enterprise

2018/19 Annual Audit Report



 AUDIT SCOTLAND

Prepared for Highlands and Islands Enterprise and the Auditor General for Scotland

14 August 2019

## Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- the Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance
- the Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government
- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



## About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public
- identifying risks, making clear and relevant recommendations.

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# Contents

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Key messages	4
Introduction	5
Part 1 Audit of 2018/19 annual report and accounts	8
Part 2 Financial management	14
Part 3 Financial sustainability	18
Part 4 Governance and transparency	21
Part 5 Value for money	25
Appendix 1 Action plan 2018/19	28
Appendix 2 Significant audit risks identified during planning	32
Appendix 3 Summary of national performance reports 2018/19	37

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# Key messages

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## 2018/19 annual report and accounts

- 1 The financial statements of HIE and its group give a true and fair view of the year-end financial positions and the net expenditure for 2018/19.
- 2 The expenditure and income in the financial statements were incurred or applied in accordance with applicable enactments and guidance.
- 3 The other information in the annual report and accounts is consistent with the financial statements and has been prepared in accordance with legal requirements.

## Financial management

- 4 HIE has effective financial management arrangements. It overspent its overall resource budget for 2018/19, with the prior approval of the Scottish Government
- 5 Key controls in core financial systems operated effectively during the year. We identified areas where controls could be strengthened, and management has agreed to take corrective action.

## Financial sustainability

- 6 HIE has effective financial planning arrangements and has set a balanced budget for 2019/20.
- 7 HIE faces significant financial challenges and uncertainties, not least related to the funding of activities on Cairngorm Mountain and the repair of the funicular railway. These matters may affect HIE's ability to operate within budget and its overall financial position.

## Governance and transparency

- 8 HIE has effective governance arrangements that support the scrutiny of decisions with scope to further enhance openness and transparency.
- 9 HIE's performance report meets the requirements of the FReM. HIE has made good progress in developing its performance report.

## Value for money

- 10 HIE has a well-developed performance framework. There is scope to review target ranges to ensure they remain challenging and support continuous improvement.
- 11 HIE's three-year strategy sets out its ambitions for the region and acknowledges the importance of collaborative working with partners.

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# Introduction

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1. This report summarises the findings from our 2018/19 audit of Highlands and Islands Enterprise (HIE).

2. The scope of our audit was set out in our Annual Audit Plan presented to the March 2019 meeting of the Risk and Assurance Committee. This report comprises the findings from:

- an audit of the HIE's annual report and accounts
- consideration of the four audit dimensions that frame the wider scope of public audit set out in the [Code of Audit Practice 2016](#) as illustrated in [Exhibit 1](#).

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## Exhibit 1 Audit dimensions



Source: *Code of Audit Practice 2016*

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3. The main elements of our audit work in 2018/19 have been:

- a review of the HIE's main financial systems
- an audit of HIE's 2018/19 annual report and accounts including the issue of an independent auditor's report setting out our opinions
- consideration of the four audit dimensions of public audit.

## Adding value through the audit

4. We add value to HIE through the audit by:

- identifying and providing insight on significant risks, and making clear and relevant recommendations for improvements that have been accepted by management
- sharing intelligence and good practice through our national reports ([Appendix 3](#)) and good practice guides
- providing clear and focused conclusions on the appropriateness, effectiveness and impact of corporate governance, performance management arrangements and financial sustainability.

5. In so doing, we aim to help HIE promote improved standards of governance, better management and decision-making and more effective use of resources.

6. Our audit this year included reviews and discussions with management concerning HIE's interests in Cairngorm Mountain and the funicular railway. In particular, this required close review of the events, the action which HIE has taken and the implications for HIE's accounts.

## Responsibilities and reporting

7. HIE has primary responsibility for ensuring the proper financial stewardship of public funds. This includes preparing an annual report and accounts that is in accordance with the accounts direction from the Scottish Ministers. The HIE annual report and accounts includes the following:

- performance report
- accountability report (which includes the corporate governance report, remuneration and staff report and parliamentary and accountability report)
- financial statements and supporting notes.

8. HIE is also responsible for establishing appropriate and effective arrangements for governance, propriety and regularity that enable the Board to successfully deliver its objectives.

9. Our responsibilities as independent auditor are established by the Public Finance and Accountability (Scotland) Act 2000 and the [Code of Audit Practice 2016](#), and supplementary guidance and International Standards on Auditing in the UK.

10. As public sector auditors we give independent opinions on the annual report and accounts. Additionally, we conclude on:

- the appropriateness and effectiveness of the performance management arrangements
- the suitability and effectiveness of corporate governance arrangements
- the financial position and arrangements for securing financial sustainability.

11. In doing this we aim to support improvement and accountability. Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#) and supplementary guidance.

**12.** This report raises matters from the audit of the annual report and accounts and consideration of the audit dimensions. Weaknesses or risks identified are only those which have come to our attention during our normal audit work and may not be all that exist. Communicating these does not absolve management from its responsibility to address the issues we raise and to maintain adequate systems of control.

**13.** Our annual audit report contains an agreed action plan at [Appendix 1](#). It sets out specific recommendations, responsible officers and dates for implementation. It also includes any outstanding actions from last year and progress against these.

**14.** We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services. The 2018/19 audit fee of £136,160 was set out in our Annual Audit Plan. We will assess the additional time required this year on key issues which emerged during our audit work and may seek additional fees. We will explain the basis for any additional fees to management and seek to agree the amounts involved. We are not aware of any relationships that could compromise our objectivity and independence.

**15.** This report is addressed to both HIE and the Auditor General for Scotland and will be published on Audit Scotland's website [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk) in due course.

**16.** We would like to thank all management and staff for their cooperation and assistance during the audit.

# Part 1

## Audit of 2018/19 annual report and accounts



### Main judgements

**The financial statements of HIE and its group give a true and fair view of the year end financial positions and the net expenditure for 2018/19.**

**The expenditure and income in the financial statements were incurred or applied in accordance with applicable enactments and guidance.**

**The other information in the annual report and accounts is consistent with the financial statements and has been prepared in accordance with legal requirements.**

The annual report and accounts are the principal means of accounting for the stewardship of its resources and its performance in the use of those resources.

### Audit opinions on the annual report and accounts

**17.** The annual report and accounts for the year ended 31 March 2019 were approved by the Risk and Assurance Committee on 13 August 2019. We reported within the independent auditor's report that:

- the financial statements give a true and fair view and were properly prepared
- expenditure and income were regular and in accordance with applicable enactments and guidance issued by Scottish Ministers
- the audited part of the remuneration and staff report, performance report and governance statement were all consistent with the financial statements and properly prepared in accordance with the relevant legislation and directions made by Scottish Ministers.

**18.** Additionally, we have nothing to report in respect of misstatements in other information presented with the financial statements, the adequacy of accounting records or the information and explanations we received.

### Submission of annual report and accounts for audit

**19.** The timetable for the financial statements audit is challenging for HIE and the audit team. We were advised in late May that HIE were behind schedule with the preparation of the annual accounts and discussed the impact on the audit process. We received the unaudited annual report and accounts on 14 June 2019, in line with our agreed audit timetable, but as expected, these were incomplete. In particular, parts of the performance and accountability report, including the financial commentary, had not been updated from 2017/18 and some figures were omitted. In addition, the accounts presented for audit did not reflect significant matters relating to HIE's interests in Cairngorm Mountain and HIE's pension arrangements.

**20.** The performance and accountability reports contain key financial and performance information which require close consideration. We plan our audits carefully to ensure efficient deployment of staff; delays receiving key information resulted in additional pressure on the audit team late in the process. Management accept that there are lessons to be learned and we will discuss this further with them in planning for next year's audit.

**21.** The working papers provided with the financial statements presented for audit were generally of a good standard. Finance staff provided reasonable support to the audit team which helped ensure that, overall, the final accounts audit process was completed within the agreed timetable.

## Risk of material misstatement

**22.** [Appendix 2](#) provides a description of the audit risks of material misstatement in the annual report and accounts and any wider dimension audit risks we identified during audit planning. It also summarises how we addressed each of these audit risks and our conclusions.

**23.** We report a number of issues resulting from our work on these audit risks throughout this report and include appropriate recommendations in the action plan at [Appendix 1](#).

## Materiality

**24.** Misstatements are material if they could reasonably be expected to influence the economic decisions of users taken based on the financial statements. The assessment of what is material is a matter of professional judgement and involves considering both the amount and nature of the misstatement.

**25.** Our initial assessment of materiality for the annual report and accounts was carried out during the planning phase of the audit. With regards to the annual accounts, we assess the materiality of uncorrected misstatements both individually and collectively.

**26.** On receipt of the unaudited annual report and accounts we reviewed our materiality bases and concluded that they remained appropriate. We updated our materiality amounts as shown in [Exhibit 2](#).

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## Exhibit 2

### Materiality values

Materiality level	Single entity	Group
Overall materiality	£920,000	£940,000
Performance materiality	£370,000	£380,000
Reporting threshold	£50,000	£50,000

Source: Audit Scotland

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## Significant findings from the audit in accordance with ISA 260

**27.** International Standard on Auditing (UK) 260 requires us to communicate significant findings from the audit to those charged with governance, including our view about the qualitative aspects of the body's accounting practices covering accounting policies, accounting estimates and financial statements disclosures.

**28.** Our significant findings, including those relating to qualitative aspects, are summarised in [Exhibit 3](#). Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in [Appendix 1](#) is included.

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### Exhibit 3 Significant findings from the audit of financial statements

Issue	Resolution
<p><b>1. Valuation of Cairngorm ski resort</b></p> <p>The accounts presented for audit valued the Cairngorm ski resort at £0.520 million as at 31 March 2019.</p> <p>We noted that the valuer's report, based on instructions from HIE, assumed (i) 'that the funicular railway was fully operational and had been fully repaired' and (ii) rental income was as due under the rental agreement with the previous owners, Cairngorm Mountain Limited.</p>	<p>We discussed the valuer's report and the valuation of Cairngorm ski resort with HIE's Director of Finance &amp; Corporate Services and a revised valuation was obtained which reflected the non-operation of the funicular railway and the reduced rent agreed with the new operators Cairngorm Mountain (Scotland) Limited (CMSL).</p> <p>Management agreed to amend the accounts to include this revised valuation.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>
<p><b>2. Valuation on investment in Cairngorm Mountain (Scotland) Limited</b></p> <p>HIE invested £0.461 million in shares in CMSL. The accounts presented for audit valued this investment at cost. As CMSL made a loss in the period to 31 March 2019, we would expect HIE's investment to be impaired as at that date.</p>	<p>We discussed the valuation of the investment in CMSL with management who agreed to impair this investment by 90% in HIE's accounts. There is no impact on the group accounts.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>
<p><b>3. Obligation to repair the funicular railway</b></p> <p>The funicular railway on Cairngorm Mountain has been non-operational since September 2018. The accounts presented for audit did not recognise a liability for the costs of repairing the funicular. If the funicular is not repaired, as owner of the Cairngorm ski resort, HIE is responsible for the costs of removal of equipment and reinstatement of the mountain to its natural condition.</p>	<p>Management agreed to amend the accounts to include a provision of £9.581 million for the estimated costs of repairing the funicular railway.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>
<p><b>4. Impairment of rent due from Cairngorm Mountain Limited</b></p> <p>The accounts presented for audit included £0.079 million in relation to rent due from Cairngorm Mountain Limited which is in administration. No impairment was recognised to reflect the uncertainty about how much (if any) of this will be recovered from the administrators.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>

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Issue	Resolution
<p><b>5. Trade and other receivables: accrued income</b></p> <p>During the audit, finance staff identified that £0.879 million of accrued income in respect of EU funding had been included twice.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>
<p><b>6. Revaluation of non-current assets</b></p> <p>HIE did not receive the valuer's final report until after the accounts were presented for audit. The accounts were based on an interim valuation of non-current assets which was understated by £0.760 million.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p> <p><a href="#">Appendix 1, Recommendation 2</a></p>
<p><b>7. Financial assets – IFRS 9</b></p> <p>The Government Financial Reporting Manual (FReM) requires that IFRS 9 – Financial Instruments is adopted from 1 April 2018. HIE reviewed its financial assets in line with this new requirement and made an adjustment for the initial assessment of an expected credit loss on the financial assets at 1 April 2018 of £0.175 million.</p> <p>The other reserve balance at 1 April 2018 relating to investments (£0.115 million) was not, however, transferred to the general reserve. In addition, we noted errors in how the IFRS 9 transactions for 2018/19 had been classified in the accounts presented for audit resulting in net expenditure being overstated, and other comprehensive expenditure being understated by £0.069 million.</p>	<p>Management agreed to amend the accounts to correct these misstatements.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>
<p><b>8. Pension liability – McCloud judgement</b></p> <p>The courts have ruled that the transitional protections provided as part of the 2015 public service pension scheme changes discriminate on the grounds of age.</p> <p>HIE's own pension scheme is unaffected but it also contributes to local government pension schemes which will be impacted by this ruling.</p>	<p>HIE's actuary provided revised IAS 19 reports which include an increased liability of £0.288 million due to the McCloud ruling, and a late adjustment to pension asset valuations.</p> <p>Management agreed to amend the accounts to include this adjusting post balance sheet event.</p>
<p><b>9. Classification of provision for VAT liability</b></p> <p>HIE overclaimed VAT recovery in previous years. In addition, HMRC has asked HIE to review its methodology for calculating VAT recovery which is likely to involve an additional VAT liability.</p> <p>The accounts presented for audit included a provision of £4.534 million in relation to this VAT liability. This provision was incorrectly included within trade payables and other current liabilities within both the group and HIE accounts.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>
<p><b>10. Valuation of investment in HIE Ventures</b></p> <p>HIE calculated the value of its shares in HIE Ventures as at 31 March 2019 but did not include this valuation in the accounts presented for audit. As a result, financial assets were understated by £0.150 million in HIE's accounts. There is no impact on the group financial statements.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p> <p><a href="#">Appendix 1, Recommendation 1</a></p>

## Other findings

**29.** The taxation calculations were not available until after the accounts had been submitted for audit. As a result, net expenditure and long-term liabilities were overstated, and taxpayers' equity was understated by £0.069 million. Management agreed to amend the accounts for this omission.

**30.** The courts have ruled that UK defined benefit pension schemes must compensate members for differences attributable to guaranteed minimum pensions (GMPs). HIE's actuary's general advice is that a 'trigger event' has yet to occur. HIE has added a contingent liability note to its accounts to explain and disclose this matter. We are content with this disclosure.

**31.** In our 2018/19 management report we reported that our early substantive testing of income transactions identified income which should have been recognised in the 2017/18 accounts but had not been accrued. Our year-end testing identified additional cut-off errors between years. In total we identified £0.674 million of income relating to previous years which was not recognised until 2018/19 due to delays in raising sales invoice requests. Of this amount, £0.448 million related to the reclaim of costs incurred on behalf of Orkney Research and Innovation Campus which were not invoiced until February 2019 (refer to paragraph 46 for the impact this had on HIE's cash flow). Although the overall amount is not material to our opinion on HIE's accounts, we developed further audit procedures to gain additional assurance in this area for our 2018/19 audit opinion and no issues were identified.

## How we evaluate misstatements

**32.** There were two material adjustments to the annual accounts presented for audit. One related to the provision for the obligation to repair the funicular railway (£9.581 million) and the other to the misclassification of the VAT provision (£4.534 million). As both these adjustments reflect the full extent of the potential misstatement, further audit procedures were not required.

**33.** In assessing the remaining misstatements identified in [Exhibit 3](#) we recognised that four of these individually exceeded our performance materiality value of £0.370 million. In three cases (valuation of the Cairngorm ski resort, valuation of the investment in CMSL, and revaluation of non-current assets) the adjustments reflect the full extent of the potential misstatement and so further audit procedures were not required.

**34.** The fourth misstatement relates to the double-counting of accrued EU income. We performed additional tests to ensure that there were no other errors of this nature. No issues were identified.

**35.** It is our responsibility to request that all misstatements, other than those below the reporting threshold, are corrected although the final decision on making the correction lies with those charged with governance. Management agreed to amend the financial statements for all of the presentational and monetary misstatements identified during the audit and so there are no unadjusted misstatements to bring to the attention of those charged with governance.

**36.** The net effect of the adjustments identified during the audit and processed by management was to increase HIE's single entity net expenditure by £11.4 million and decrease other comprehensive expenditure by £0.6 million with a corresponding increase in net liabilities of £10.8 million. Adjustments processed to the group accounts resulted in an increase in net expenditure of £11.2 million and a decrease in other comprehensive expenditure of £0.6 million with a corresponding increase in net liabilities of £10.6 million. These adjustments reflect compensating amounts.

## Finance team capacity and expertise

**37.** Last year we recommended that HIE review its financial management capacity to ensure that it had sufficient financial skills and capacity to meet its needs. A review was undertaken by the Director of Finance & Corporate Services and the results were reported to the Risk and Assurance Committee in March 2019.

**38.** In relation to this year's accounts, HIE had planned to supplement its resources with a temporary qualified accountant. In the event, it was unable to recruit a suitable candidate. HIE staff from outwith the finance team were brought in to help with the preparation of the annual accounts. As a consequence, most of work on the VAT compliance review was postponed. As noted in paragraph 19, we received the annual report and accounts for audit on time, but they were incomplete.

**39.** More generally, the nature of its business means that HIE needs to account for complex transactions. Examples this year include transactions associated with Cairngorm Mountain and with pensions which we would have expected HIE to have addressed prior to presenting the accounts for audit. Our discussions with finance staff this year also suggest the need for more capacity and expertise to support routine year-end financial accounting, for example, in relation to the accounting requirements resulting from the revaluation of non-current and financial assets. HIE also uses external resources to support the preparation of its annual accounts.



### Recommendation 3

**HIE should consider whether its finance team has the capacity and expertise required to account for the range of complex transactions it is involved with and whether tasks currently outsourced to accountancy firms should be brought in-house.**

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## Follow up of prior year recommendations

**40.** We reviewed progress made in implementing the agreed actions included in our 2017/18 annual audit report. We concluded that HIE has made some progress during 2018/19 and have included revised recommendations in [Appendix 1](#).

# Part 2

## Financial management



### Main judgements

**HIE has effective financial management arrangements. It overspent its overall resource budget for 2018/19, with the prior approval of the Scottish Government.**

**Key controls in core financial systems operated effectively during the year. We identified areas where controls could be strengthened, and management has agreed to take corrective action.**

Financial management is about financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

### Financial performance in 2018/19

**41.** The main financial objective for HIE is to ensure that the financial outturn for the year is within the budget allocated by Scottish Ministers.

**42.** HIE and its group reported an outturn of £65.9 million for 2018/19 against a resource budget of £64 million, an overspend of £1.8 million. This was within the overspend of £2.3 million approved by the Scottish Government to cover the costs of Cairngorm Mountain operations. HIE's financial performance against Departmental Expenditure Limits (DEL) is shown in [Exhibit 4](#).

### Exhibit 4 Performance against DEL in 2018/19

Performance	Initial budget £m	Final budget £m	Outturn £m	Over (under) spend £m
Resource DEL	30.400	32.277	34.175	1.898
Capital DEL	26.190	31.690	31.608	(0.082)
<b>Total cash DEL</b>	<b>56.590</b>	<b>63.967</b>	<b>65.783</b>	<b>1.816</b>
Non-cash DEL	15.000	5.000	2.115	(2.885)
<b>Total DEL</b>	<b>71.950</b>	<b>68.967</b>	<b>67.898</b>	<b>(1.069)</b>

Source: August 2018 Grant In Aid Letter; July 2019 Spring Budget Revision Grant in Aid Letter; HIE 2018/19 Annual Report and Accounts

**43.** HIE overspent its Annually Managed Expenditure (AME) budget by £15.2 million. AME can be volatile and includes amounts such as accounting provisions and impairments. The excess of expenditure over the AME allocation is largely due to recognition of provisions for the obligation to repair the funicular railway (£9.6 million) and the VAT liability resulting from the ongoing HMRC investigation (£4.2 million).

## 2018/19 financial position

**44.** The Group Statement of Financial Position summarises what is owned and owed by HIE and its group. This shows taxpayers' equity – an accounting measurement of the amount invested that has continuing public benefit. It shows how much of this has arisen from the application of revenues and that which has resulted through changes over time in the value of physical assets.

**45.** The financial statements show that HIE and its group:

- has net liabilities of £19.3 million. This has changed from a net assets position of £0.8 million as at 31 March 2018. The majority of this change is due an increase in pension liabilities (£8.4 million) and the inclusion of provisions for a VAT liability resulting from an HMRC investigation (£4.2 million) and for repairs to the funicular railway (£9.6 million)
- the pension schemes are in deficit with liabilities exceeding assets by £47.4 million (2017/18: net liability £39 million). The HIE pension scheme accounts for most of this deficit with an excess of liabilities over assets of £41.8 million as at 31 March 2019 (£34.7 million as at 31 March 2018). Following the 2012 triennial valuation, HIE implemented a recovery plan, including lump sum employer contributions and increasing members' contribution rate, to address the deficit on its pension scheme.

**46.** HIE experienced significant pressure on its cash flow during February and March 2019. This was mainly due to delays between incurring expenditure (on the Orkney Research and Innovation Campus (ORIC) development and projects part-funded by European funding) and the reclaim and reimbursement of these costs. HIE managed its cash flow during this period by working to standard 30-day trade credit terms rather than its 10-day prompt payment policy. As a result, HIE's trade creditors were £5.4 million higher as at 31 March 2019 than the previous year. This impacted on its performance against the Scottish Government's prompt payment policy which decreased from 86% of invoices paid within 10 days in 2017/18 to 77% in 2018/19.

**47.** We consider HIE's future financial position and key risks to financial sustainability in the following section of this report.

## Budgetary processes

**48.** A number of adjustments were made to the original budget: inclusion of £7 million in respect of funding for Wave Energy Scotland (capital DEL), and £0.431 million for the strengthening communities programme (resource DEL) which was partly off-set by reductions in Resource DEL to support various initiatives (£0.163 million). The Scottish Government also approved a transfer of £1.5 million from resource to capital DEL.

**49.** Our review of the Board's budget monitoring and control processes concluded that effective arrangements are in place. Budget monitoring reports are regularly presented to the Board and monthly management accounts are prepared. HIE's progress against budget and its financial position are discussed at every meeting of the Leadership Team.

## Systems of internal control

**50.** As part of our audit we identify and inspect the key internal controls in those accounting systems which we regard as significant to produce the financial statements. Our objective is to confirm that the controls are operating as expected and that HIE's systems for recording and processing transactions provide a sound basis for the preparation of the financial statements.

**51.** The findings from our review of systems of internal controls were included in the management report presented to the Risk and Audit Committee in June 2019. We identified two key control risks relating to access to HIE's ledger system and processes for ensuring that income was recognised in the correct financial year. Management agreed to take corrective action. We developed further audit procedures to gain assurance in these areas and no significant issues were identified.

**52.** Apart from the above, no significant internal control weaknesses were identified during the audit which could affect HIE's ability to record, process, summarise and report financial and other relevant data to result in a material misstatement in the financial statements.

## Internal audit

**53.** HIE has an in-house internal audit team, which is supplemented by a contract with a firm of chartered accountants which provides audit services. Specialist IT audit services are provided by an independent third party on behalf of HIE and its partners in Enterprise Information Services (EIS). EIS is the shared IT arrangement with Skills Development Scotland (SDS) and Scottish Enterprise (SE).

**54.** We reviewed the adequacy of the in-house internal audit function and concluded that, overall, it operates in accordance with the Public Sector Internal Audit Standards (PSIAS) with sound documentation standards and reporting procedures in place. The requirement to comply with PSIAS is built in to all outsourced internal audit services including those jointly tendered with SDS and SE. An independent review of HIE's internal audit function was also undertaken during the year which concluded that it generally conforms with PSIAS, with no areas of significant non-compliance. Several areas of good practice were also identified.

**55.** In 2018/19 we placed reliance on the Business Improvement and Internal Audit (BIIA) section's testing of significant transactions. We planned to review internal audit report findings on information governance and systems, and financial controls as part of our wider dimension audit responsibilities but these reports have yet to be finalised.

## Standards of conduct for prevention and detection of fraud and error

**56.** Public bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, and bribery and corruption and to ensure that their affairs are managed in accordance with proper standards of conduct.

**57.** We reviewed HIE's arrangements including the staff and Board members' Codes of Conduct. We also reviewed the whistleblowing policy, and the counter fraud, bribery and corruption strategy and policy. We concluded that there are established procedures for preventing and detecting any breaches of these standards.

**58.** Given the nature of its business, which involves close working with communities in its area, HIE requires all staff and Board members to complete a register of interest declaration to highlight any circumstances which may pose the potential for a conflict of interests. Staff are required to update their disclosures if changes occur during the year. Board members and directors are required to update their declarations every six months.

**59.** In our 2018/19 management report we noted that registers of interests had not been published for the three new Board members appointed in September 2018, and that registers of interests for the remaining eight Board members had not been updated since April 2018. As part of our year-end audit we reviewed the website and noted that registers of interest for all members of the Board and Leadership Team had been updated as at April 2019.

**60.** As part of its conflicts of interest policy the Board operates a 'prior approval process' which requires the Chief Executive to approve, in advance, any transaction between HIE and any organisation in which the HIE Chairman, HIE Board members or Executive Grade staff have a 'high-risk' interest. The Business Improvement and Internal Audit section reviewed all transactions in this category during 2018/19 to ensure that the process had been followed.

**61.** We consider that the arrangements for recording and monitoring conflicts of interest represent good practice but highlight the need for these to be kept up to date in accordance with HIE's policy.

## National Fraud Initiative

**62.** The National Fraud Initiative (NFI) in Scotland is a counter-fraud exercise coordinated by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different financial systems, to identify 'matches' that might suggest the existence of fraud or irregularity.

**63.** HIE has responded well to the latest NFI exercise and is pro-active in investigating matches and documenting the results. To date, HIE has investigated 86% of its 495 matches. Three errors, totalling £12,835, have been identified resulting from the payment of duplicate invoices to suppliers and steps are being taken to recover these overpayments. The remaining matches on the duplicate invoices report are currently being reviewed. HIE's Business Improvement and Internal Audit section has prepared a report on NFI testing to date which will be considered at the Risk and Assurance Committee meeting in August 2019.

## Dependency on key suppliers

**64.** The impact of a failure or collapse of a key supplier can be significant to an organisation and can result in either delays or non-completion of major contracts or, disruptions in the continued provision of vital services. This has brought into focus the risk of key supplier failure and the risk of under-performance in suppliers that are experiencing difficult trading conditions.

**65.** HIE has considered the risk of key supplier failure and is of the view that the most significant risk lies with providers of advice to businesses that HIE supports. The risk is mitigated by the contract being managed via a framework arrangement which is subject to annual monitoring.

**66.** HIE is also reliant on external suppliers for delivery of its shared IT service (EIS) which is managed by Skills Development Scotland (SDS). The SDS external auditor confirmed that SDS maintains close contact with suppliers and discusses emerging issues at planned regular contract management meetings. No significant issues were identified.

# Part 3

## Financial sustainability



### Main judgements

**HIE has effective financial planning arrangements and has set a balanced budget for 2019/20.**

**HIE faces significant financial challenges and uncertainties, not least related to the funding of activities on Cairngorm Mountain and the repair of the funicular railway. These matters may affect HIE's ability to operate within budget and its overall financial position.**

Financial sustainability looks forward to the medium and longer-term to consider whether the organisation is planning effectively to continue to deliver its services or the way in which they should be delivered.

### Financial planning

**67.** The Board approved the 2019/20 budget in April 2019. HIE has received an initial grant in aid allocation for 2019/20 of £56 million, of which £29.5 million relates to resource allocation, £25.5 million to capital allocation, and £1 million to financial transactions. The budget also anticipates income from other sources of £11 million: £3.2 million from European Funding, £3.6 million from property disposals and loan repayments, and £4.2 million from revenue receipts.

**68.** HIE has agreed a programme of expenditure across the business objectives to match the total anticipated income (£67 million). This is a reduction of £1.2 million (1.8%) compared to the amount originally budgeted for 2018/19. The decrease results mainly from decreased grant in aid (£0.7 million) and EU funding (£1.8 million), offset by forecast increases in capital (£0.8 million) and revenue (£0.5 million) receipts.

**69.** HIE faces significant financial risks and uncertainties in 2019/20 and the agreed budget includes a number of key assumptions in relation to these:

- that there will be no loss of income from the sale of the Centre for Health Science in 2019/20. This is dependent on the Scottish Government agreeing to transfer existing funding from University of the Highlands and Islands (UHI) to HIE
- that the back-dated VAT liability (included as a provision in the 2018/19 accounts) will be funded by the Scottish Government or treated as an 'authorised overspend'
- that exceptional Cairngorm Mountain related expenditure (capital and revenue) as well as any HIE costs related to repairs to the funicular railway and other capital projects will be funded by Scottish Government or treated as an 'authorised overspend' (see paragraphs 72 to 78 below).

**70.** HIE is also involved in other significant projects which have the potential to involve financial risks and uncertainties including the Space Hub Sutherland project, which will require funding during 2019/20. The initial funding package for this project is £17.3 million with HIE's contribution being £9.8 million. Design work and scoping for environmental impact studies are well underway and HIE recently signed an option for it to lease land once planning consent for the project has been granted. Recent indications are that the costs of the project are increasing, and it is not yet clear how these will be funded. HIE recognises this project is high risk and is in active discussions with key stakeholders including Scottish Government and the United Kingdom Space Agency.

**71.** In agreeing the 2019/20 budget, the Board acknowledged that it will be challenging to deliver, and that without additional support from the Scottish Government it will be difficult to manage these financial pressures without significant operational consequences.

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#### Recommendation 4

**HIE should continue to keep its financial plans under close review during 2019/20 so that it is able to take early and informed decisions on options for dealing with the financial challenges it faces.**

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#### Cairngorm Mountain (Scotland) Limited

**72.** In September 2018, Cairngorm Mountain Limited (CML), as operator of the Cairngorm ski resort, took the funicular railway out of service. This followed a detailed inspection of the railway's infrastructure which raised potential safety concerns.

**73.** The non-operation of the funicular impacted on CML's business and in October 2018, HIE rejected CML's request for a working capital loan of up to £1.8 million because it concluded that CML could not afford to repay the loan and CML's parent company, Natural Assets Investments Ltd (NAIL) was not offering any security if CML defaulted. On 29 November 2018, CML directors placed the company into administration due to mounting cash flow and creditor pressures.

**74.** In December 2018, HIE set up a new wholly-owned subsidiary, Cairngorm Mountain (Scotland) Limited (CMSL), which purchased the business and assets of CML, and CML staff transferred to the new company. [Exhibit 3](#) includes reference to some of the more significant implications of these events for HIE's annual accounts.

**75.** The Auditor General for Scotland has decided to prepare a report under section 22 of the Public Finance and Accountability (Scotland) Act 2000 to highlight to the Scottish Parliament key issues in HIE's 2018/19 accounts relating to Cairngorm Mountain and the funicular railway. This report will be laid in the Scottish Parliament with HIE's audited accounts.

**76.** Addressing the challenges of Cairngorm Mountain is a priority for HIE. Key issues are the cost of bringing the funicular back to full working order and the need to develop a business strategy which will provide for the long-term sustainability of the resort. In November 2018, consultants identified potential for investment of £27 million to transform the resort over the next five-to-ten years. An addendum to the original report, in June 2019, provides immediate investment priorities while the funicular railway is out of operation. HIE has confirmed that the funicular will remain out of service over the 2019/20 winter.

**77.** The future of the Cairngorm Mountain funicular railway is important to the local economy and has generated significant public interest. While HIE's intention is to repair and reopen the funicular, it is still not clear how much it will cost to do so, how it will be afforded, or what impact it will have on HIE's financial sustainability. HIE has recognised these risks and raised them directly with the Scottish Government. Tough decisions are likely to be required over the coming months.

**78.** The Auditor General for Scotland has decided to prepare a further report on the Cairngorm funicular railway under section 23 of the Public Finance and Accountability (Scotland) Act 2000. This report will build on the section 22 report referred to above and will involve a wider review of issues relating to Cairngorm Mountain and the funicular. The Auditor General expects to present this report to the Scottish Parliament by spring 2020.

## **Changing landscape for public financial management and medium to long term financial planning**

**79.** Scottish public finances are fundamentally changing, with significant tax-raising powers, new powers over borrowing and reserves, and responsibility for some social security benefits. This provides the Scottish Parliament with more policy choices but also means that the Scottish budget is subject to greater uncertainty and complexity

**80.** A new Scottish budget process has been introduced, which is based on a year-round continuous cycle of budget setting, scrutiny and evaluation. As part of the new budget process, the Scottish Government published an initial five-year Medium-Term Financial Strategy (MTFS) in May 2018. The five-year outlook for the Scottish budget, set out in the MTFS, provides useful context for bodies' financial planning.

**81.** Last year we reported that HIE is developing a comprehensive approach to financial planning which will provide a firm basis for financial planning and sustainability in the longer term. Work continued during 2018/19 and scenario planning was used to develop the 2019/20 budget. Indicative figures for 2020/21 and 2021/22 were also developed which show a reduction in income from other sources (e.g. property disposals) in these years.

**82.** Maintaining and developing longer-term financial plans will be crucial to support HIE in dealing with the financial challenges it faces and to support informed decisions on how to apply the funding it has available.

## **EU withdrawal**

**83.** European Union (EU) withdrawal will inevitably have implications for devolved government in Scotland and for public bodies, and so it is critical that public-sector bodies understand, assess and prepare for the likely impact on their business.

**84.** As part of our interim audit we undertook a high-level review of HIE's preparedness for EU withdrawal focusing on three key areas: people, regulations and funding. We reported our findings in our 2018/19 Management Report and concluded that HIE has taken reasonable steps to prepare for the impact of EU withdrawal.

# Part 4

## Governance and transparency



### Main judgements

**HIE has effective governance arrangements that support the scrutiny of decisions, with scope to further enhance openness and transparency.**

**HIE's performance report meets the requirements of the FReM. HIE has made good progress in developing its performance report.**

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making and transparent reporting of financial and performance information.

### Governance arrangements

**85.** HIE is governed by a Board that is accountable to Scottish Ministers. At 31 March 2019, the Board consisted of the chair, ten non-executive members, one shadow member and the chief executive. In 2018/19, there were six Board meetings. In addition, the Board met a further five times to consider specific issues. The Board is supported by two sub-committees: risk and assurance (RAC), and remuneration. HIE established a sub-group in November 2018 to consider issues related to Cairngorm Mountain.

**86.** The RAC met six times in 2018/19, including two additional meetings to consider specific issues. We attend all RAC meetings. Agendas follow a standard format and papers are circulated to members in advance, allowing adequate time for members to review. From attendance at RAC meetings, we are satisfied that members provide appropriate scrutiny of submitted reports.

**87.** The Cairngorm Sub-Group met six times during 2018/19 to consider the governance associated with the decision to set up the new operating company, Cairngorm Mountain (Scotland) Limited, and to make recommendations for improvement. The sub-group reports directly to the Board.

### Openness and transparency

**88.** There is an increasing focus on how public money is used and what is achieved. In that regard, openness and transparency supports understanding and scrutiny. Transparency means that the public has access to understandable, relevant and timely information about how the Board is taking decisions and how it is using resources such as money, people and assets.

**89.** Board meetings are not held in public. Instead, HIE holds regular engagement events with businesses and communities throughout the Highlands and Islands. HIE is also proactive in publishing information on its website. An online 'reading room' provides public access to a variety of information, including, for example, Freedom of Information requests relating to the development and management of Cairngorm Mountain. HIE also publishes lists of funding that has been approved each quarter which show its investments in businesses, social enterprises, communities and projects across the Highlands and Islands.

**90.** Agendas and supporting papers are not published, but Board and Risk and Assurance Committee minutes should be available on HIE's website. Our review of the website noted that there was a significant delay in uploading Board minutes during 2018/19 and that RAC minutes have not been published since December 2016.

**91.** While it is for each organisation to determine what papers are made available, we are of the view that, in the interests of enhanced openness and transparency, Board and sub-committee papers should be published on HIE's website unless they contain confidential or sensitive information.

## Performance report

**92.** In addition to the opinion on the performance report covered in Part 1 of this report, we also consider qualitative aspects of the performance report included in the annual report and accounts.

**93.** The purpose of a performance report is to provide information on a body, its main objectives and strategies, and the principal risks that it faces. It is required to provide a fair, balanced and understandable analysis of performance. It is important in helping stakeholders understand what the organisation has achieved from the public money made available to it, and the connections between performance and the financial statements.

**94.** There are a number of characteristics which make for a high-quality performance report. Audit Scotland published a Good Practice Note on performance reports in February 2019. We highlighted this to management in advance of our year-end audit.

**95.** We are pleased to report that HIE has improved the presentation of its performance report. In particular, we note the increased use of infographics to improve accessibility and understanding of the performance information presented.

**96.** Following our review, HIE made further amendments to its performance report to further improve its balance and understandability. We concluded that HIE's performance report meets the requirements of the FReM and that HIE has made good progress in developing its performance report. In our view, this is a welcome contribution to enhanced openness and transparency.

## Enterprise and skills

**97.** In May 2016, the First Minister announced a review of the roles, responsibilities and relationships of Scotland's enterprise, development and skills agencies.

**98.** One of the key developments arising from the review was the establishment of the Enterprise and Skills Strategic Board. The Strategic Board's purpose is to maximise the impact of the collective investment in enterprise and skills development, and to create the conditions conducive to delivering inclusive and sustainable growth. It is tasked with improving the overall performance of the economy. Its membership is drawn from the chairs of each of the enterprise and skills agencies, as well as non-executive members from academic and private-sector bodies.

**99.** In June 2018, the Strategic Board published its outline Strategic Plan that set out its initial priorities (referred to as 'missions'). The full Strategic Plan was published in October 2018 and provided further detail on each of the missions:

- Business Creation and Growth – business creation can spur productivity growth

- Business Models and Workplace Innovation – harness the full potential of progressive business models, workplace innovation and Fair Work
- Future Skills Needs – providing the future workforce with the required complex skill-set
- Exporting – significantly improve Scotland’s productivity through export growth.

**100.** Each mission aims to maximise the effect of the enterprise and skills system on productivity and inclusive growth, with a focus on ‘hard alignment’ between the agencies. Teams have been set up to develop the four missions and a Strategic Planning Joint Working Group ensures coherence among them. The Strategic Plan also identified 14 actions for the agencies and 18 recommendations for the Scottish Government which are set out around the four inter-connected missions. The Scottish Government has established an Analytical Unit, to support the Strategic Board in its decision-making and assessment of the agencies’ performance.

**101.** Annual Ministerial Letters of Guidance are developed jointly and issued to the enterprise agencies at the same time. The Scottish Government issued an additional Letter of Guidance to the four agencies in January 2019. The letter makes clear that individual agencies are to undertake operational and strategic planning in line with the Strategic Board’s Strategic Plan, and collectively pursue its actions. There is an expectation that the individual agencies work collaboratively with the other agencies, with the Scottish Government, and more widely as required to support the Strategic Board’s aims.

**102.** There are also signs of increased collaboration among the agencies. For example, HIE officers are currently on secondment to assist with the development of the new South of Scotland Enterprise body.

**103.** We published a briefing paper in May 2019 titled [Enterprise and Skills Review: Core areas of audit interest](#). This paper outlines progress since the review was announced and highlights core areas of audit interest. We will continue to monitor progress at HIE and at a national level.

## Risk management

**104.** As part of our planning work we reviewed HIE’s risk management arrangements, including the risks identified during the year. The Board reviews these arrangements annually and considers the risks and the risk appetite for different categories of risk. The corporate risk register is presented to each meeting of the Risk and Assurance Committee and is managed by the Leadership Team. Each business unit has its own risk register, which feeds into the corporate risk register. We concluded that HIE’s risk management arrangements are effective and reporting arrangements are appropriate.

## Cyber security

**105.** The Scottish Government issued a Public Sector Action Plan on Cyber Resilience in November 2017. This requires all public sector bodies to carry out a review to ensure their cyber security arrangements are appropriate. As noted above, HIE is a partner in the EIS shared IT service. Last year we reported that HIE intended to attain cyber essentials accreditation in October 2018. This timescale was extended during 2018/19 and HIE has yet to achieve this accreditation.



## Recommendation 5

**HIE should continue to work with its EIS partners to ensure cyber essentials is achieved. This will be further developed as the partnership moves towards cyber catalyst recognition.**

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### Business continuity

**106.** In our Annual Audit Plan, we noted that there was a risk to HIE's business continuity as it did not have a business continuity plan in place setting out how it would respond if it could not access its key locations or if its IT systems were unavailable.

**107.** HIE has recently developed a draft Business Continuity Plan for its head office in Inverness. The plan includes prioritised activities, immediate actions, communications and a recovery checklist. It also considers reliance on information technology and the time the business can be sustained without IT systems. An Incident Management Team has also been established to manage HIE's response to any incident.

**108.** The plan will be tested in late August and once finalised will serve as a template for other offices to use to develop their own local business continuity plans. We will continue to keep this area under review as part of our 2019/20 audit.

# Part 5

## Value for money



### Main judgements

**HIE has a well-developed performance framework. There is scope to review target ranges to ensure they remain challenging and support continuous improvement.**

**HIE's three-year strategy sets out its ambitions for the region and acknowledges the importance of collaborative working with partners.**

Value for money is concerned with using resources effectively and continually improving services.

### Best value

**109.** *Ministerial guidance to Accountable Officers* for public bodies and the *Scottish Public Finance Manual* (SPFM) sets out the Accountable Officer's duty to ensure that arrangements are in place to secure best value.

**110.** Compliance with the duty of best value requires public bodies to take a systematic approach to self-evaluation and continuous improvement. Achieving and demonstrating continuous improvement in performance and outcomes is a core requirement for all public bodies.

**111.** The interim Chief Executive of HIE is the interim Accountable Officer. A range of processes are in place to help the Accountable Officer demonstrate best value. The annual report and accounts outline how the best value attributes and practices are embedded through its assurance and self-assessment processes. These include:

- sound and developing corporate governance arrangements to reflect the changing roles and structures within the organisation
- the development of a three-year strategic plan together with an annual business plan
- regular monitoring of budgets and resources
- a systematic approach to risk management
- regular monitoring of the achievement of outcomes.

**112.** In our Annual Audit Plan, we noted that we intended to review Internal Audit's work on best value to support our work in this area. Internal Audit did not prepare a separate report on this area during 2018/19. Instead, increased reporting against the best value characteristics was included in HIE's annual report and accounts.

## Performance management

**113.** HIE's performance framework is derived from the Scottish Government's National Performance Framework, and Scotland's Economic Strategy. Eight key performance measures were included in the 2018-19 Operating Plan, which cover the four main themes which have been established as the main drivers of growth in the Scottish economy: innovation, internationalisation, investment and inclusive growth. Progress against these measures is regularly reported to the Board and summarised in the 2018/19 annual report and accounts.

**114.** Exhibit 5 shows that, as in previous years, all the key performance measures have been achieved with the majority exceeding the top of the target range. This indicates a strong performance but also suggests there is scope for HIE to review the target ranges to ensure these remain stretching.

### Exhibit 5 Key performance measures 2018-19

Performance measure	Range	Outturn
Forecast increase in turnover by supported businesses £m	80-100	117.9
Forecast increase in international sales by supported business and social enterprises £m	30-40	46.7
Jobs Supported (Created/retained) FTE	700-900	1015
Fragile Jobs Supported (Created/retained) FTE	125-175	166.75
Average salary from jobs supported £	25,000	26,487
Increase in turnover in social economy £m	3-4.5	4.8
Turnover generated in social economy by community owned assets	1.5-2	3.04
Number of new/improved income generating assets	25-30	25

Source: HIE Annual Report and Accounts 2018/19

**115.** We concluded that HIE has an effective performance management framework. There is scope, however, to review the target ranges to ensure that they remain challenging and support continuous improvement in the way services are delivered.

## 2019-22 strategy

**116.** In June 2019, HIE published a new three-year strategy setting out its ambition to 'develop sustainable and inclusive growth, in each and every part of the region'. The strategy is set within the context of Scotland's overall economic agenda as outlined by the Scottish Government and the Enterprise and Skills Strategic Board.

**117.** The corporate strategy sets out HIE's priorities for the next three years:

- Strong, capable and resourceful communities

- Conditions for growth
- Successful, productive and resilient businesses.

**118.** The strategy is supported by the 2019/20 operating plan which sets out twelve key measures against which HIE's performance will be assessed. Progress against these measures will be reported regularly to the Board.

**119.** HIE's 2019-22 strategy notes the importance of collaborative working among the economic and skills agencies and that HIE is committed to developing a joint agency approach to delivery of its shared vision for Scotland's economy.

## Superfast broadband for Scotland: a further progress update

**120.** In November 2015 and August 2016, we published national performance audit reports on the roll-out of superfast broadband in Scotland. The 2016 report concluded that, at the time of writing the report, the Scottish Government and HIE had made good progress in the roll-out of fibre broadband in Scotland although it was noted that most of the roll-out has been concentrated on easier-to-reach areas.

**121.** During 2018, Audit Scotland undertook a further performance audit which examined:

- whether the Scottish Government achieved its target of providing access to a fibre network to 95 per cent of Scottish premises by 31 December 2017
- the progress being made with the Scottish Government's plans (R100) to ensure 100 per cent of premises can access speeds of 30Mbps, as part of its vision to have world-class digital infrastructure.

**122.** The report, published in September 2018, concluded that:

- the Scottish Government met its target of providing access to fibre broadband to 95 per cent of premises in Scotland by 31 December 2017. The Scottish Government and HIE paid BT £259 million by 31 March 2018 through two contracts. Higher than expected take-up and lower than expected costs are expected to allow the programme to reach 60,300 more premises than planned. Ninety per cent of premises connected through the contracts are now estimated to be able to receive speeds of greater than 24 Mb/s.
- the Scottish Government has committed £600 million in an initial investment to deliver superfast broadband to 147,000 premises, with contracts to be awarded in early 2019. Further investment may be required to reach all premises. It will be difficult for the Scottish Government to deliver its ambitions by the end of 2021.

**123.** The report made five recommendations for the Scottish Government to consider including publishing clear timescales for R100 by summer 2019, communicating effectively with stakeholders so rural communities know what to expect, and publishing an overall strategy for delivering its world-class vision.

## Other national performance audit reports

**124.** Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. In 2018/19 several reports were published which may be of interest to HIE. These are outlined in [Appendix 3](#).

**125.** HIE has arrangements for considering and reviewing national reports including any locally agreed actions.

# Appendix 1

## Action plan 2018/19



No.	Issue/risk	Recommendation	Agreed management action/timing
1	<p><b>Accounts preparation process</b></p> <p>We identified a number of errors and omissions in how HIE reflected transactions within its financial statements.</p> <p><b>Risk:</b> the accounts do not give a true and fair view of HIE and its group's financial position and net expenditure.</p>	<p>Accounts preparation processes should be reviewed prior to the preparation of the 2019/20 annual report and accounts.</p>	<p>Agreed.</p> <p><b>Responsible officer:</b> Director of Finance &amp; Corporate Services</p> <p><b>Agreed date:</b> 31 January 2020</p>
2	<p><b>Accounts preparation timetable</b></p> <p>The accounts presented for audit did not include the final revaluations of non-current assets or the tax computations.</p> <p><b>Risk:</b> the accounts do not give a true and fair view of HIE and its group's financial position and net expenditure.</p>	<p>HIE should ensure that the valuer's report and the taxation calculations are received in sufficient time to enable final figures to be included in the annual accounts presented for audit.</p>	<p>Agreed.</p> <p><b>Responsible officer:</b> Head of Financial Services Head of Property &amp; Infrastructure</p> <p><b>Agreed date:</b> 30 June 2020</p>
3	<p><b>Finance team capacity and expertise</b></p> <p>The nature of its business means that HIE needs to account for complex transactions. We have identified issues with the accounting of these complex transactions again this year. We also note that HIE outsources the preparation of some annual account areas.</p> <p><b>Risk:</b> HIE does not have sufficient financial capacity and skills to meet its needs.</p>	<p>HIE should consider whether its finance team has the capacity and expertise required to account for the range of complex transactions it is involved with and whether tasks currently outsourced to accountancy firms should be undertaken in-house.</p>	<p>Agreed.</p> <p><b>Responsible officer:</b> Director of Finance &amp; Corporate Services</p> <p><b>Agreed date:</b> 31 January 2020</p>



No.	Issue/risk	Recommendation	Agreed management action/timing
4	<p><b>Financial sustainability</b></p> <p>HIE faces significant financial risks and uncertainties in 2019/20 and the agreed budget includes key assumptions in relation to these. Without additional support or authorisation from the Scottish Government it will be difficult to manage these financial risks and uncertainties without significant operational consequences.</p> <p><b>Risk:</b> HIE is unable to deliver all of its financial commitments or meet performance targets within its existing resource allocation.</p>	<p>HIE should continue to keep its financial plans under close review during 2019/20 so that it is able to take early and informed decisions on options for dealing with the financial challenges it faces.</p>	<p>Agreed.</p> <p><b>Responsible officer:</b> Chief Executive</p> <p><b>Agreed date:</b> Ongoing</p>
5	<p><b>Cyber security</b></p> <p>Cyber essentials has not yet been achieved.</p> <p><b>Risk:</b> key systems are not resilient enough to deal with a cyber-attack.</p>	<p>HIE should continue to work with its EIS partners to ensure cyber essentials is achieved. This will be further developed as the partnership moves towards cyber catalyst recognition.</p>	<p>Agreed.</p> <p><b>Responsible officer:</b> Director of Finance &amp; Corporate Services</p> <p><b>Agreed date:</b> EIS Cyber Essentials application to be submitted to the Scottish Government by 31 October 2019</p> <p>Wider review of cyber strategy by 31 March 2020 to be led by EIS on behalf of the EIS shared service partners</p>

### Follow up of prior year recommendations

1	<p><b>Accounts preparation and financial capacity</b></p> <p>We identified a number of errors in how transactions were accounted for within the unaudited financial statements.</p> <p>There is a risk that the accounts do not give a true and fair view of Highlands and Islands Enterprise's group financial position and net expenditure.</p>	<p>Accounts preparation processes should be reviewed prior to the preparation of the 2018/19 annual report and accounts.</p>	<p>This matter has been carried forward to the 2018/19 action plan (point 1).</p> <p><b>Ongoing</b></p>
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No.	Issue/risk	Recommendation	Agreed management action/timing
2	<p><b>Financial management capacity</b></p> <p>Highlands and Islands Enterprise uses external resources to supplement its finance team's preparation of the annual accounts. Issues have been identified with the administration of VAT in previous years. In addition, our audit identified a number of issues with how transactions had been accounted for and disclosures made within the accounts.</p> <p>There is a risk that Highlands and Islands Enterprise does not have sufficient financial skills and capacity to meet its needs.</p>	<p>Highlands and Islands Enterprise should review its financial management capacity to ensure that it has sufficient financial skills and capacity to meet its needs.</p>	<p>The Director of Finance &amp; Corporate Services reviewed the capacity and skills within the finance team during 2018/19.</p> <p>This matter has been carried forward to the 2018/19 action plan (point 3).</p> <p><b>Ongoing</b></p>
3	<p><b>Transparency</b></p> <p>The performance section of the annual report and accounts was improved to meet the requirements of the 2017/18 FReM but there is scope to further improve the performance analysis and financial commentary in future.</p> <p>There is a risk that the annual report does not provide a clear picture of how resources spent link to outcomes achieved and the risk and uncertainties impacting on performance.</p>	<p>Highlands and Islands Enterprise should review its performance analysis and financial commentary to better explain the risks and uncertainties affecting its performance measures and how its funding links to its outcomes.</p>	<p>HIE has improved the presentation of its performance report. In particular, we note the increased use of infographics to improve accessibility and understanding of the performance information presented.</p> <p><b>Closed</b></p>
4	<p><b>Medium to long-term financial planning</b></p> <p>Although Highlands and Islands Enterprise has a rolling five-year financial plan, it is not based on different funding and cost scenarios for the business. This information would support management decision-making and consideration of its financial sustainability.</p>	<p>We recommend that the rolling five-year plan should include scenario plans (best, worst, most likely) including a clear assessment of the impact of budget assumptions on Highlands and Islands Enterprise's activity and any residual risks.</p>	<p>A comprehensive review of HIE's approach to financial planning began in 2017/18. Good progress has been made and once complete the revised model will provide a firm basis for financial planning and sustainability in the longer term.</p> <p><b>Ongoing</b></p> <p><b>2018/19 update:</b> work continued during 2018/19 and scenario planning was used to develop the 2019/20 budget. Indicative figures for 2020/21 and 2021/22 were also developed which show a</p>



**No. Issue/risk**



**Recommendation**



**Agreed management action/timing**

reduction in income from other sources (e.g. property disposals) in these years.

**Ongoing**

# Appendix 2

## Significant audit risks identified during planning

The table below sets out the audit risks we identified during our planning of the audit and how we addressed each risk in arriving at our conclusion. The risks are categorised between those where there is a risk of material misstatement in the annual report and accounts and those relating our wider responsibility under the [Code of Audit Practice 2016](#).

Audit Risk	Assurance procedure	Results and conclusions
<b>Risks of material misstatement in the financial statements</b>		
<p><b>1 Management override of controls</b></p> <p>ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls to change the position disclosed in the financial statements.</p>	<p>Detailed testing of journal entries.</p> <p>Review of accounting estimates.</p> <p>Focused testing of accruals and prepayments.</p> <p>Evaluation of significant transactions that are outside the normal course of business.</p> <p>Substantive cut-off testing of income and expenditure to ensure that these have been recognised in the correct financial year.</p>	<p>We reported our findings on the submission of the annual report and accounts in Part 1 of this report.</p> <p>There were a number of amendments required to the accounts presented for audit and these are set out in Part 1 (<a href="#">Exhibit 3</a>) of this report.</p> <p>Based on our consideration of these issues and the results of our wider audit testing, we concluded that there was no management override of controls.</p>
<p><b>2 Risk of fraud over income and expenditure</b></p> <p>HIE receives a significant amount of income (£8.3 million) in addition to Scottish Government funding. The extent and complexity of income means that, in accordance with ISA 240, there is an inherent risk of fraud.</p> <p>In public sector audit there is also a risk of fraud over aspects of expenditure for public sector bodies which have an overall net expenditure. HIE and its group recorded gross expenditure of £94 million in 2017/18.</p> <p>The Code of Audit Practice requires auditors to consider the risk of fraud over certain types of public sector expenditure. This includes grants and other claims made by individuals and</p>	<p>Review HIE's anti-fraud arrangements.</p> <p>Walk-through of controls over receivables and payables.</p> <p>Detailed testing of revenue transactions focusing on the areas of greatest risk.</p> <p>Review of property income which is managed by a third party.</p> <p>Substantive testing of expenditure transactions with reliance on internal audit's work on significant transactions.</p> <p>Assessment of the results from HIE's participation in the National Fraud Initiative (NFI). This will be considered for Audit Scotland's national report in due course.</p>	<p>We reviewed HIE's anti-fraud arrangements and concluded that they were satisfactory.</p> <p>Our controls work did not identify any issues with the system for the processing or payment of trade payables or receivables.</p> <p>Our review of property income processes did not identify any significant matters arising.</p> <p>We reviewed internal audit's work on significant transactions and concluded we could place reliance on it.</p> <p>We reported our findings on Highlands and Islands Enterprise's participation in the NFI at Part 4 of this report. No significant matters were noted.</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>organisations. HIE provided grants of £27.3 million to third parties in 2017/18.</p>		
<p><b>3 Estimations and judgment</b></p> <p>There is a significant degree of subjectivity in the measurement and valuation of the material account areas of land and buildings (£37 million), pensions (£39 million) and investments (£3 million). Valuation and disclosure of investments may also be affected by the adoption of IFRS 9 (Financial Instruments) in 2018/19.</p> <p>The subjectivity in these areas and management's judgements represent an increased risk of misstatement in the financial statements.</p>	<p>Review the work of an expert for the professional valuers (pensions liabilities and non-current assets)</p> <p>Focused substantive testing of year end balances.</p> <p>Review of management's assessment of the appropriateness of the assumptions used in the valuation of these assets and liabilities.</p> <p>Liaise with management to determine the impact of IFRS 9 and test as appropriate.</p>	<p>We reviewed the valuations of land, buildings and pensions liabilities prepared by management's experts.</p> <p>We were satisfied with the judgements made by the actuary and concluded that we could place reliance on the experts' valuation of the pension liability, including in relation to the McCloud case judgement.</p> <p>As noted in <a href="#">Exhibit 3</a>, the valuer initially valued Cairngorm ski resort on the basis that the funicular railway was fully operational and repaired. Following discussions with HIE's Director of Finance &amp; Corporate Services, a revised valuation was obtained. We have reviewed the revised valuation and concluded that we could place reliance on it.</p> <p>We considered the impact of IFRS 9 and concluded that HIE had appropriately applied the credit loss model. We noted a number of errors in how the IFRS 9 transactions had been classified in the accounts presented for r audit (see <a href="#">Exhibit 3</a> for details).</p> <p>We also reviewed the valuation of investment balances included in the accounts. Our findings regarding the value of CMSL and HIE Ventures shares are included at <a href="#">Exhibit 3</a>.</p>
<p><b>4 Financial management capacity</b></p> <p>The nature of its business means that HIE needs to account for complex transactions including loans made at preferential interest rates, VAT, corporation tax and the consolidation of subsidiaries and associated companies.</p> <p>Last year we recommended that a review be undertaken to ensure that there is sufficient financial skills and capacity within the finance team.</p>	<p>Regular meetings with the Director of Finance &amp; Corporate Services to identify any issues in respect of the finance team's capacity and the impact on the preparation of the financial statements.</p> <p>Review of HIE's spend on consultants during 2018/19.</p> <p>Review the progress of the ongoing VAT investigation and the implications for HIE's accounts, including HIE's correspondence with HMRC and related advice from HIE's advisors. Review the accounting treatment for VAT</p>	<p>The finance team was short of resource for the preparation of the annual report and accounts and advised us, in late May, that they were around two weeks behind schedule. The accounts were presented for audit in line with the agreed timetable but, as expected, were incomplete.</p> <p>As in prior years HIE made use of external support to prepare certain areas of the accounts including providing support for the impact of the implementation of IFRS 9.</p> <p>We reviewed the progress of the ongoing VAT investigation and concluded that the additional</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>The ongoing HMRC VAT investigation continues to put pressure on the finance team during 2018/19.</p> <p>HIE has established a new subsidiary (Cairngorm Mountain (Scotland) Ltd) to acquire the assets and business of the previous operator from its administrators until a longer-term solution can be found.</p>	<p>related liabilities and test the impact on the accounts.</p> <p>Review of Board papers relating to the establishment and operation of the new subsidiary.</p> <p>Review the accounting treatment for the new subsidiary and test the impact on the group accounts.</p>	<p>provision for the back-dated VAT liability had been misclassified in the accounts.</p> <p>We reviewed the establishment and operation of CMSL. <a href="#">Exhibit 3</a> sets out the issues we identified with how HIE accounted for transactions with CMSL in the accounts presented for audit.</p>
<p><b>5 Cairngorm funicular railway</b></p> <p>HIE owns the assets comprising Cairngorm estate including the funicular railway which was closed in October 2018 due to safety concerns. A more detailed structural review has recently been completed. HIE is currently considering this review and a further peer review is being undertaken.</p> <p>There is a risk that funicular's asset valuation is materially misstated in the accounts.</p>	<p>Reviewed Board papers including the structural review.</p> <p>Substantive testing of asset valuation included within the accounts, including impairment reviews.</p>	<p>As noted in <a href="#">Exhibit 3</a>, the valuer initially valued Cairngorm ski resort on the basis that the funicular railway was fully operational and repaired. Following discussions with HIE's Director of Finance &amp; Corporate Services, a revised valuation was obtained. We have reviewed the revised valuation and concluded that we could place reliance on it</p> <p>In view of the public interest, the Auditor General has signalled her intention to report under section 22 of the Public Finance and Accountability (Scotland) Act 2000 to draw the Scottish Parliament's attention to matters relating to Cairngorm Mountain reflected in HIE's 2018/19 accounts.</p>

### Risks identified from the auditor's wider responsibility under the Code of Audit Practice

<p><b>6 Financial management and sustainability</b></p> <p>HIE faces financial pressures including in areas where there is uncertainty about the timing and amount of potential costs (see 4 and 5 above).</p> <p>There is a risk that HIE may face additional, unplanned costs that will affect its overall financial position.</p>	<p>Review financial monitoring reports and the financial position at the year-end including performance against resource limits set by the Scottish Government.</p> <p>Review progress made with the development of medium- and long-term financial planning including reporting to the Board.</p>	<p>HIE overspent its resource allocations (RDEL and CDEL) by £1.8 million in 2018/19 but this is less than the authorised overspend (£2.3 million) permitted by the Scottish Government.</p> <p>HIE experienced significant cash-flow pressures in February and March 2019 due to delays in reclaiming reimbursement of costs incurred on behalf of ORIC and EU funded projects. It managed its cash flow during this period by delaying the payment of its creditors.</p> <p>HIE set a balanced budget for 2019/20 but faces a number of financial risks which are currently unfunded. These include providing working capital to CMSL.</p>
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Audit Risk	Assurance procedure	Results and conclusions
		<p>The 2019/20 budget contains a number of budgetary pressures and will be challenging to deliver.</p> <p>Work on the development of medium and longer-term financial planning continued during 2018/29 with scenario planning used to develop the 2019/20 budget.</p> <p>We have recommended that HIE continues to closely monitor and report its financial position.</p>
<p><b>7 European Union (EU) withdrawal</b></p> <p>There are considerable uncertainties surrounding the implications of EU withdrawal. Public bodies should assess the potential impact on their operations and identify specific issues and planned responses.</p> <p>There is a risk that HIE is not prepared for the impact of EU withdrawal on the delivery of services.</p>	<p>Review of Risk and Assurance Committee/Board papers.</p> <p>Assess HIE's preparations for EU withdrawal through discussions with its EU co-ordinator.</p> <p>Consider how HIE responds to any emerging issues after March 2019.</p>	<p>We reviewed HIE's preparations for EU withdrawal and concluded that it has taken reasonable steps to prepare for the impact of EU withdrawal.</p> <p>(refer to paragraphs 83 &amp; 84).</p>
<p><b>8 Enterprise and Skills Review</b></p> <p>In October 2018, the enterprise and skills strategic board published its first strategic plan. The plan should clarify the strategic direction to HIE and other enterprise and skills agencies. It aims to increase productivity and drive inclusive and sustainable economic growth in Scotland. Actions set out in the strategic plan require HIE to increase collaboration and alignment with the other enterprise and skills bodies.</p>	<p>Reviewed how HIE is responding to the strategic plan and what impact the new enterprise and skills arrangements are having on its:</p> <p><b>governance arrangements:</b> clarity around new roles, responsibilities and accountabilities</p> <p><b>strategic direction and its operations:</b> capacity to deliver on the existing and new duties and responsibilities and its income and expenditure</p> <p><b>performance management:</b> whether appropriate measures are in place to determine and report on the impact of the new arrangements.</p>	<p>HIE has developed a three-year strategy in response to the Strategic Board's strategic plan. There is evidence of collaborative working with HIE staff seconded to support the development of the new South of Scotland Enterprise body.</p> <p>We published a briefing paper in May 2019 titled '<a href="#">Enterprise and Skills Review: Core areas of audit interest</a>'. This paper outlines progress since the review was announced and highlights core areas of audit interest. We will continue to monitor progress locally and at a national level.</p>
<p><b>9 Cyber security and business continuity arrangements</b></p> <p>HIE and Enterprise Information Systems (EIS), which delivers ICT services to the enterprise and skills bodies, have not yet achieved Cyber Essentials accreditation. This is mainly due to legacy systems including</p>	<p>Reviewed EIS's internal audit's work on disaster recovery and cyber security arrangements.</p> <p>Reviewed cyber security and business continuity reports to the Risk and Assurance Committee and/or Board.</p>	<p>We have reviewed EIS's internal audit's work on disaster recovery and cyber security arrangements and concluded that we could place reliance on the work undertaken.</p> <p>HIE has yet to achieve Cyber Essentials accreditation (refer to paragraph 105).</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>HIE's management system (its key IT system).</p> <p>HIE does not have a business continuity plan in place setting out, for example, how it would respond if it could not access its key locations or if its IT systems were unavailable.</p> <p>These matters may represent a risk to HIE's business continuity.</p>	<p>Reviewed progress made in developing a business continuity plan for HIE.</p>	<p>A draft Business Continuity Plan has recently been prepared for HIE's head office in Inverness. The plan is due to be tested in late August 2019, and once finalised will be used as a template for other offices to use to prepare local business continuity plans.</p>

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# Appendix 3

## Summary of national performance reports 2018/19

		 <b>2018/19 Reports</b>	
Local government in Scotland: Challenges and performance 2018		<b>Apr</b>	
Councils' use of arm's-length organisations		<b>May</b>	 Scottish Fire and Rescue Service: an update
Scotland's colleges 2018		<b>Jun</b>	
		<b>Jul</b>	 The National Fraud Initiative in Scotland 2016/17
Forth Replacement Crossing		<b>Aug</b>	 Major project and procurement lessons
Children and young people's mental health		<b>Sept</b>	 Superfast broadband for Scotland: further progress update
NHS in Scotland 2018		<b>Oct</b>	
Health and social care integration: update on progress		<b>Nov</b>	 Local government in Scotland: Financial overview 2017/18
		Dec	
		Jan	
		Feb	
		<b>Mar</b>	 Local government in Scotland: Challenges and performance 2019

### Central Government relevant reports

[Scottish Fire and Rescue Service: an update](#) – May 2018

[Scotland's colleges 2018](#) – June 2018

[The National Fraud Initiative in Scotland 2016/17](#) – July 2018

[Forth Replacement Crossing](#) – August 2018

[Major project and procurement lessons](#) – August 2018

[Superfast broadband for Scotland: further progress update](#) – September 2018

# Highlands and Islands Enterprise

## 2018/19 Annual Audit Report

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