

Highlands and Islands Enterprise

Report on the 2005/06 Audit



Contents

Key Messages	1	Performance Management	10
Introduction	3	Best Value	13
Financial Stewardship	4	Efficient Government	15
Our responsibilities	4	Future performance	17
Overall conclusion	4	Governance	17
Financial Position	4	Systems of internal control	17
Investment projects	7	Internal Audit	17
Other issues arising from the audit	8	Network Management System	17
Prior Year Issues	9	European Projects	17
Statement on Internal Control	9	Looking Forward	17
Regularity Assertion	9	Appendix A: Action Plan	17
Performance Management	10		



Key Messages

Introduction

In 2005/06 we looked at the key strategic and financial risks being faced by Highlands and Islands Enterprise. We audited the financial statements and we also reviewed aspects of performance management and governance. This report sets out our key findings.

Financial Position

Highlands and Islands Enterprise met its key financial target to stay within its resource budget from the Scottish Executive this year. The organisation had a total resource budget of £99.01 million for 2005/06. The outturn for 2005/06 was an underspend of £0.09 million, or 0.09% of the overall resource budget.

We have given an unqualified opinion on the financial statements of Highlands and Islands Enterprise Network for 2005/06.

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.

We have also reviewed the other issues which we are required to consider as part of our audit opinion, such as the management commentary, the remuneration report and the statement on internal control. We can confirm that there are no further matters that we need to bring to the attention of Highlands and Islands Enterprise.

Performance Management

Efficient Government

During 2005/06 Audit Scotland completed a management arrangements review of Efficient Government activities across the public sector. Our aim was to obtain baseline information on arrangements across a range of Efficient Government related topics. We also carried out an assessment of the management of the overall programme by the Delivery Division and a review of claimed savings within Efficiency Statements.

The findings from this work are currently being analysed and will be made available to the Executive in the near future. The Auditor General has indicated his intention to issue a report incorporating the key messages from our review under Section 23 of the Public Finance and Accountability Act 2000.



Although the Scottish Executive did not set any savings targets for Highlands and Islands Enterprise in 2005/06, Highlands and Islands Enterprise has a programme, in conjunction, with community partners to find savings through joint procurement, use of information technology, property and ground maintenance and the co-location of services.

Governance

The establishment and operation of an efficient and effective internal audit function forms a key element of effective governance and stewardship. We reviewed internal audit and concluded that they continue to comply with Government Internal Audit Standards and were able to place reliance on their work for the purposes of our audit of Highlands and Islands Enterprise.

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 to mitigate the risks of material misstatement of the accounts, error or fraud.

Looking Forward

The final part of our report notes some key risk areas for Highlands and Islands Enterprise going forward. Highlands and Islands Enterprise is developing a new network management system which is intended to be one single integrated financial and information system for the organisation. It will allow the sharing of information across the Network and is a significant investment by Highlands and Islands Enterprise. It is important that the system becomes embedded across the Network, to ensure it functions effectively, efficiently and economically.

EU auditors raised concerns on quality and sufficiency of evidence to support objective one grant claims. Negotiations are ongoing between the Scottish Executive and EU Auditors to resolve the issues raised. It is essential this matter is resolved to ensure the potential value of any clawback of EU funding is built into financial plans.

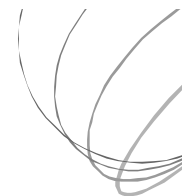
This is the final year of our current appointment to the audit of Highlands and Islands Enterprise. From 2006/07 we have been re-appointed and will be the organisation's appointed auditor for a five year period to 2010/11.

**Audit Scotland
November 2006**



Introduction

1. This report summarises the findings from our 2005/06 audit of Highlands and Islands Enterprise. The scope of the audit was set out in our Audit Risk Analysis & Plan, which was presented to the Audit Committee on 30 May 2006. This plan set out our views on the key business risks facing the Board 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 Highlands and Islands Enterprise's agreed response. Appendix A of this report sets out the key risks highlighted in this report and the action planned by management to address them.
3. This is the final year of our current appointment to the audit of Highlands and Islands Enterprise. From 2006/07 we have been re-appointed and will be the organisation's appointed auditor for a five year period to 2010/11. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officers and members of the Highlands and Islands Enterprise during the course of our appointment. This report will be submitted to the Auditor General for Scotland and will be published on our website. www.audit-scotland.gov.uk



Financial Stewardship

4. In this section we summarise key outcomes from our audit of Highlands and Islands Enterprise's financial statements for 2005/06, and comment on aspects of the reported financial position and performance to 31 March 2006. We also provide an outlook on future financial issues, including our view on potential financial risks.

Our responsibilities

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

Overall conclusion

7. We have given an **unqualified** opinion on the financial statements of Highlands and Islands Enterprise for 2005/06.

Financial Position

Outturn 2005/06

8. Highlands and Islands Enterprise is required to work within the resource budget set by the Scottish Executive's Enterprise, Transport & Lifelong Learning Department. In 2005/06 Highlands and Islands Enterprise stayed within both the cash and non cash elements of its resource budget—see exhibit 1 below.

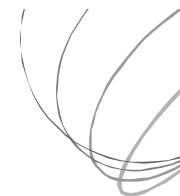


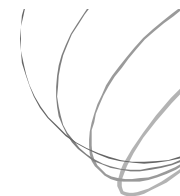
Exhibit 1 – Performance against Resource Budget 2005/06

Resource Allocation (£million)	Budget	Actual Outturn	Difference
Grant in Aid —cash	85.02	85.58	(0.56)
Resource cover —non-cash	13.99	13.34	0.65
Total	99.01	98.92	0.09

9. Within the Highlands and Islands Enterprise Network, staff are either members of the organisation's own superannuation scheme or local government pension funds. The assets of these funds are managed by independent investment managers, as appointed by the trustees for that scheme. An actuarial gain of £11.954 million was recorded in the 2005/06 accounts of Highlands and Enterprise, in relation to these funds/schemes. This gain arose from improved performance of the stock markets, trustees changing one of the investment managers and previous lump sum contributions to the funds by Highlands and Islands Enterprise. It significantly reduced the organisation's pension liabilities, from £16.645 million in 2004/05, to £5.309 million in 2005/06. The actuarial gain is also the principal reason for the improvement in the value of net assets in the balance sheet from £32.127 million in 2004/05 to £44.107 million in 2005/06.

Financial Strategy

10. We commented in our audit plan that to deliver the strategic priority of supporting sustainable economic growth, Highlands and Islands Enterprise needs to put in place a financial strategy which funds the longer term objectives of the Operating Plan, whilst meeting its annual resource budgets agreed with the Scottish Executive.
11. The Management Group and the Board receive regular financial statements and commitment reports. Financial statements set out the actual financial position for the year to date compared to the budget to date. It also provides a trend analysis and details progress against Highlands and Islands Enterprise Resource Allocation Budget (RAB). Commitment reports highlight progress on key approved and funded projects above £0.25 million in value including summarising the current position on projects above £0.5 million. It also includes information on pipeline projects, i.e. projects that might come to fruition and are being considered and progressed through Highlands and Islands Enterprise's assessment process.
12. The Director of Corporate Services meets LEC Chief Executives and Core Group Directors on a regular basis to discuss expenditure patterns and income generation. The purpose of the meetings is to try and ensure an even spend profile over the financial year and be aware of progress of pipeline projects.



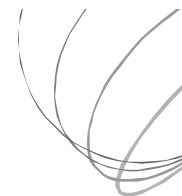
2006/07 Budget

13. Scottish Ministers have agreed a resource budget for Highlands and Islands Enterprise of £103.06 million for 2006/07. This comprises:
- £89.07 million cash —grant-in-aid. This represents an increase compared to cash resource available in 2005/06, and
 - £13.99 million to cover non-cash costs.

Exhibit 2 – 2006/07 Resource Plan

	TOTAL	'CASH'	'NON CASH'
	£m	£m	£m
Grant in Aid (baseline)	80.98	80.98	0.00
Grant in Aid (additions)	8.09	8.09	0.00
Non cash resource	13.99	0.00	13.99
Resource Budget	103.06	89.07	13.99
Other Income Sources	17.00	17.00	0.00
Total Operating Plan	120.06	106.07	13.99
Analysed as:			
Grant in Aid		89.07	
Other sources		17.00	
'Total Cash'		106.07	
'Non cash' resource		13.99	
Total Operating Plan		120.06	

14. The 2006/07 Operating Plan budgets for expenditure, including non cash costs of £120.06 million. Current projections forecast cash expenditure of £106 million for 2006/07, against planned cash expenditure of £106 million.
15. Non-cash cover is fixed until the next spending review in 2007. The impact of non-cash expenditure on financial outturn could be significant for Highlands and Islands Enterprise, because of the potential for fluctuations on property valuations each year, outwith the organisation's control. Highlands and Islands Enterprise manages this risk by asking network staff to provide information on the cost of projects and the probable valuation of each stage of the project. This allows Highlands and Islands Enterprise to monitor the probable impairment on investment projects in advance of final valuations being obtained at the year end for inclusion in its financial statements.



16. Given the complexity of issues relating to the creation of capital assets and the resultant potential impact on non cash costs, it is important Highlands and Islands Enterprise has a reasonable basis for estimating the probable outturn against its non-cash resource allocation.

Investment projects

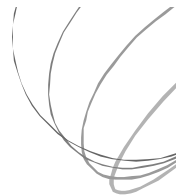
Arnish

17. Highlands and Islands Enterprise own a renewable energy fabrication yard at Arnish on the Isle of Lewis and has invested £10.595 million in the infrastructure at the yard, to support the renewable energy industry. CamCal Ltd lease the yard from Highlands and Islands Enterprise and operate a wind turbine fabrication business. Since 2004 Highlands and Islands Enterprise has made a significant investment in CamCal Ltd, now totalling £2.599 million, and including nearly £2.55 million in preference shares.
18. The company is currently in financial difficulty and Highlands and Islands Enterprise has made full provision for its investment within the 2005/06 accounts. Highlands and Islands Enterprise will not invest further additional sums in CamCal Ltd and have kept the sponsoring Department fully informed of what is happening with this investment project. We understand there are several operators interested in taking over its business. This is the second operator of the yard to suffer financial difficulty and it is essential that an operator is in place who can secure the long term viability of the investment in Arnish.

Refer to action point 1

Working capital advances

19. The network is supporting a company which is developing wave and tidal power generation. This industry is an area predicted to grow in the future. Highlands and Islands Enterprise is working with business partners to support the local economy to harness the benefits of potential growth for the local economy. Internal Audit reviewed a working capital advance made to this company and considered whether this constituted a prepayment and therefore an adjustment in the Network financial statements. The Director of Corporate Services advised us that £0.275 million of the working capital advance to the company from Orkney Enterprise was treated in the accounts as a prepayment. The advance was made to support the organisation during a period of growth and expansion, with a view to supporting its long term viability.
20. The Head of Internal Audit in her report on the working capital advance recommended that the organisation should consider whether further guidance is required in the internal *Rule Book* on



validating working capital advances. We concur with the views of the Head of Internal Audit, and in particular would encourage the organisation to ensure that the circumstances for making any capital advance are transparent and appropriately documented.

Other issues arising from the audit

21. As required by auditing standards we reported to the audit committee in September 2006 the main issues arising from our audit of the financial statements. The key issues reported were:

European Union Grants and Contingent Liabilities

22. We reviewed a number of internal audit reports on the quality and sufficiency of information held to support European Union (EU) grant claims. Internal audit's work was undertaken after concerns were raised by EU auditors on evidence to support objective one grants. Highlands and Islands Enterprise have made us aware that negotiations are ongoing between the Scottish Executive and EU Auditors about the issues they have raised. The process of negotiation with the EU auditors can be a lengthy process and there is a risk that there could be a clawback of funding.

23. Highlands and Islands Enterprise does not anticipate that any significant repayment will be made and that evidence provided to the EU auditors will be sufficient for their purposes. As a consequence Highlands and Islands Enterprise has not included a contingent liability in the accounts for EU grant funding. Officers agreed to monitor this position to ensure that if any liability arises it is identified and provided for within overall financial plans.

EU Grant Repayment

24. Within the overall review of EU grant claims, internal audit reported it had concerns about specific EU grants made to a company through Highlands and Islands Enterprise. These concerns primarily related to:

- governance, clarity of roles and responsibilities and the nature of funding provided to the company; and
- issues surrounding compliance with the management statement, European procurement directives and compliance with state aid rules.

As a result of Internal Audit's review £303,832 of EU funding was repaid to the Scottish Executive. Highlands and Islands Enterprise have agreed an action plan to address weaknesses identified from the review, and to ensure these issues do not re-occur.



Prior Year Issues

25. In our report on the Audit 2004/05 we indicated that the analysis of expenditure on Growing Businesses and Making Global Connections in a note to the network Income and Expenditure Account was based on a formula. This used the split of budgets across the Network calculated at the start of the financial year and not an actual expenditure basis supported by underlying records. We recommended that expenditure is analysed in future years' accounts based upon and supported by underlying records of actual expenditure incurred.
26. Officers agreed to our recommendation and noted they would implement it as part of the implementation of the Network Management System. We found that this recommendation was not implemented in 2005/06 as the NMS project was not complete. Expenditure on Growing Businesses and Making Global Connections in the 2006/07 financial statements should be analysed on the basis of actual expenditure incurred.

Refer to action point 2

Statement on Internal Control

27. The Statement on Internal Control provided by Highlands and Islands Enterprise's Accountable Officer reflected the main findings from both external and internal audit work. The Statement refers to the need to improve the internal control environment to ensure compliance with European audit requirements by retaining supporting documentation for EU funded schemes and European direct funded projects. Highlands and Islands Enterprise has set up a working group to address this issue.

Regularity Assertion

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

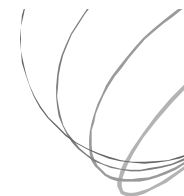


Performance Management

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

Performance Management

31. Within the 2005-2008 Operating Plan Highlands and Islands Enterprise state that the organisation exists to create a sustainable and measurable impact on the highlands and islands economy. Measuring the impact of assistance by an economic development agency on economic development is complex. A recent report by the Audit Scotland on performance management within Scottish Enterprise highlighted that *measuring the impact of an economic development agency is complex and there is no easy way to assess the impact of its investment on overall economic performance*. However, without a robust performance management framework in place Highlands and Islands Enterprise risks being unable to demonstrate their contribution to economic growth and consequently to demonstrate the value from public funding.
32. As part of our 2004/05 audit we undertook a broad review of procedures related to performance management within the Highlands and Islands Enterprise Network. We concluded that Highlands and Islands Enterprise had established appropriate arrangements for setting and monitoring performance targets including how to measure the achievement of targets. We also concluded there was scope to take a more proactive approach to revising targets during the year. We were advised that the Board is concerned to ensure that targets are not simply rolled forward and they take account of changes within the Network. For the 2005/08 Operating Plan Highlands and Islands Enterprise reduced the number of performance targets to a smaller number of measures. This was to ensure that targets remained focused, relevant and challenging, were clearly identified and subject to regular measurement and review.
33. Highlands and Islands Enterprise has two main performance target areas. The first —*key measures of progress* - relate to progress on major projects such as the University of the Highlands and Islands, the Centre for Health Science and the Inverness Airport Business Park that will improve the economic environment in the Highlands and Islands. The second are the *primary measures*, which relate to the

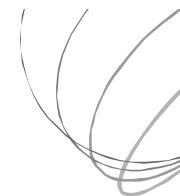


delivery of programmes under the headings of *Strengthening Communities, Skills and Learning, Growing Businesses and Global Connections*.

34. In each financial year Highlands and Islands Enterprise produces a half yearly report and a full year report on its performance. These reports are submitted to the Management Group for consideration before being submitted to the Board. After review by the Board the reports are forwarded to the Scottish Executive.
35. Highlands and Islands Enterprise has twelve qualitative targets —key measures of progress - related to longer term projects, and progress towards milestones for these targets is reported regularly. For example, at the end of 2005/06 satisfactory progress has been reported on the establishment of the University of the Highlands and Islands, the construction of the Centre for Health Science and the provision of affordable broadband access within the Highlands and Islands. Where progress is less than planned against key milestones this is also reported, for instance the use of the yard at Arnish (see paragraph 17) and further action identified to progress the projects. Exhibit 3 below sets out the organisation’s year end assessment of performance against the key measures of progress for 2005/06.

Exhibit 3 - Performance against 2005/06 Key Measures Of Progress

Key Measure	Progress Achieved
University of Highlands and Islands - route to title	Very good
- ARC	Good
Centre for Health Science	Very good
Broadband —2 measures	Very good
Renewable Energy	Good
Community Energy Company	Good
Arnish	Lesser
Dounreay Decommissioning	Good
ABSL —complete battery technology research and development programme	Lesser
Scottish Year of Highland Culture 2007	Good
Eden Court Theatre Redevelopment	Good



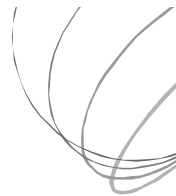
36. Exhibit 4 below sets out the 2005/06 year end position against the primary measures

Exhibit 4 - Performance against 2005/06 Primary Measures

Description	2005/06 Target	2005/06 Actual	Actual as % of target
Strengthening Communities			
No. of new/enhanced community assets	450	559	124
No. of community groups with increased capacity	115	178	155
Skills and Learning			
No. of people supported to move towards and into sustainable employment	2,405	2,999	125
No. of businesses supported to engage in developing the skills of those in work	655	983	150
Growing Businesses			
No. of new business starts	500*	576	115
No. of business growth projects	355	356	100
Global Connections			
No. of businesses engaging in International Business Development	115	166	144
Private Sector Earnings Index for Network assisted jobs	108	117	108
* The target was increased during the year from 400 to 500.			

37. The organisation has met or exceeded all of its primary measures in 2005/06, with performance typically being 15% to 55% above target. Explanations provided in the Network year end review for exceeding targets include:

- 2005/06 was a pilot year for community capacity credits scheme (included in the measure of the number of community groups with increased capacity) and Highlands and Islands Enterprise will review the experience of the pilot with a view to refining the model.
- The actual outturn for the number of businesses supported to engage in developing the skills of those in work was due to high levels of engagement throughout the Network via a range of skills development initiatives.
- The target for private sector earnings index was exceeded mainly as a result of high wage job creation approvals in the second half of the year.



38. The introduction of the qualitative and quantitative targets signalled a fundamental change in the way Highlands and Islands Enterprise measures its performance. The key measures of progress are intended to provide a stretching set of measures while the primary measures cover Highlands and Islands Enterprise's main areas of programme delivery. The re-balancing of the targets in this way reflected the increased importance of strategic projects under A Smart, Successful Highlands and Islands. Given the performance attained in 2005/06 for the primary measures, the expectations embedded within the targets set within the 2006-09 Operating Plan appear to provide scope for more challenging targets to be set for the organisation in the future, matching the challenges evident in key measures of progress.

Refer to action point 3

Best Value

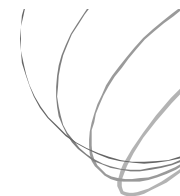
39. There is no statutory duty of best value in the wider public sector in Scotland (the Scottish Executive and its Executive Agencies, Executive NDPBs, and the NHS). Instead, the Scottish Executive issued high level guidance in May 2003, followed by more detailed draft secondary guidance in August 2003. This duty can be described as:

- to make arrangements to secure continuous improvement in performance (while maintaining an appropriate balance between quality and cost);
- to have regard to economy, efficiency and effectiveness, and the equal opportunity requirements; and
- to contribute to the achievement of sustainable development.

40. In May 2005, Ministers decided that they would not bring forward legislation which extends best value in the wider public sector. However, Ministers do wish to encourage and embed the principles of best value across the wider public sector, and further guidance was issued in May 2006.

41. During 2005/06 Audit Scotland carried out a baseline review to establish the arrangements in place across the central government and NHS sectors which support best value and continuous improvement, and to identify areas of good practice. The results of these reviews are currently being analysed and will be issued shortly. It should be emphasised that this exercise does not represent a best value audit across the public sector. Audit Scotland is considering what type of audit approach might be suitable for non-statutory best value. The results from this review will inform that thinking.

42. As part of the work carried out with Highlands and Islands Enterprise to contribute to this baseline review, we considered the organisation's arrangements for best value. We also agreed an assessment of the stage of development of each best value characteristic to be included in the

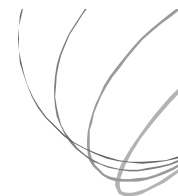


summary review —see exhibit 5 below. The purpose of our review was to provide an overview of the management arrangements in place to support the best value agenda and provide a gap analysis for the Board and Management Group.

43. The baseline review looked at nine characteristics considered necessary to underpin the achievement of best value. For each characteristic, the stage Highlands and Islands Enterprise has reached in ensuring arrangements are in place is assessed into one of four categories ranging from 'not yet planned', 'planned', 'under development' to 'well developed'. Our findings are set out in Exhibit 5 below.
44. Highlands and Islands Enterprise had commissioned consultants to work with the Internal Audit Team and Strategy Group on undertaking a best value review prior to our work commencing on the baseline review. This internal review provided an assessment of compliance with best value guidance and the strengths and weaknesses of delivery against each best value characteristic. It also enabled Highlands and Islands Enterprise to benchmark its development and progress against best value characteristics in the future. We used the outcomes from this review to inform our work. A detailed action plan has been developed by the organisation in response to the commissioned best value review, and these actions are being addressed in support of continuous improvement.

Exhibit 5 - Developing arrangements to demonstrate best value

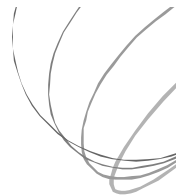
Characteristic of best value and assessment	Examples of good practice
<p><i>Commitment and leadership</i></p> <p>Well developed.</p>	<p>Operational Plan (4 years) sets out the strategic aims and objectives for the short and longer term.</p> <p>Programme of workshops held to cascade the operational plan down through the organisation.</p>
<p><i>Sound governance at a strategic and operational level</i></p> <p>Well developed.</p>	<p>Clear linkage between strategic, operational and business plans.</p> <p>The Operating Plan contains key indicators/ measures by which performance is assessed.</p> <p>Staff trained on conflict of interest policy and ethical standards to ensure high ethical standards are maintained.</p>
<p><i>Accountability</i></p> <p>Well developed.</p>	<p>Strategic and operational plans and Annual Report are available to the public.</p> <p>The organisation has an openness policy.</p>
<p><i>Sound management of resources and contractual relationships</i></p>	<p>Regular reporting to the Board and Management Group of progress on major projects.</p> <p>Monthly financial reports presented to the Board and Management Group.</p>



Characteristic of best value and assessment	Examples of good practice
Well developed.	
<i>Responsiveness and consultation</i> Well developed.	Extensive consultations with stakeholders to inform its strategy. The results of consultations also inform the future strategic direction of the organisation.
<i>Use of review and options appraisal</i> Well developed.	Continuous review of the provision of services by e.g. the product and process review.
<i>Contribution to sustainable development</i> Under development.	Projects in progress or under consideration include renewable energy and innovative use of information technology.
<i>Equal opportunities</i> Under development	The organisation has policies to comply with equal opportunities legislation such as the Equal Pay Act, Sex Discrimination Act, Race Relations Act, etc. It also considered the implications of the age discrimination legislation prior to it receiving Royal Assent. Highlands and Islands Enterprise is a member of the Highlands & Islands Equality Forum which raises awareness of equality and diversity issues in its area.
<i>Joint working</i> Well developed.	The importance of joint working is recognised in the Operating Plan 2006-09.

Efficient Government

45. The Efficient Government Initiative is a central part of the government's programme of investment, reform and modernisation. The Initiative is aimed at attacking waste, bureaucracy and duplication in Scotland's public sector. A key feature of the Initiative is that it focuses on the public sector as a whole, rather than individual organisations, with the intention of realising efficiencies through joint initiatives with other public sector bodies. The primary objective is to deliver the same services with less money or to enable frontline services to deliver more or better services with the same money.
46. In February 2005, the Scottish Executive invited Audit Scotland to audit the performance of the Scottish public sector in achieving the efficiency gains set out in the Efficient Government Plan



published in November 2004. The Efficient Government Plan set an aspirational target to achieve efficiency savings of £1,500 million over a three year period to 2007-08.

47. The Minister for Finance and Public Sector Reform published the Outturn Efficiency Report in September 2006 which identified that the Executive had made claimed efficiency savings of £441 million against an in-year savings target of £405 million.
48. As a first step Audit Scotland commented on the Scottish Executive's Efficiency Technical Notes for cash releasing savings in May 2005 and on time releasing savings in July 2005. In both cases we identified a number of areas where improvement was needed if the Notes were to provide a sound basis for the Executive to monitor the achievement of efficiency savings. We informed the Executive that if these changes were not made then it will not be possible for audit to provide assurance on the achievement of savings.
49. During 2005/06 Audit Scotland completed a management arrangements review of Efficient Government activities across the public sector. Our aim was to obtain baseline information on arrangements across a range of Efficient Government related topics. We also carried out an assessment of the management of the overall programme by the Delivery Division and a review of claimed savings within Efficiency Statements.
50. The findings from this work are currently being analysed and will be made available to the Executive in the near future. The Auditor General has indicated his intention to issue a report incorporating the key messages from our review under Section 23 of the Public Finance and Accountability Act 2000.
51. The Scottish Executive has not set any specific savings targets for Highlands and Islands Enterprise although the organisation is aware of the requirements of Efficient Government and the need for a clear programme for delivering efficiency savings, to monitor the effectiveness of change programmes, to take corrective action where necessary and ensure effective leadership throughout the process. This means planning for efficiency gains every year while continuing to improve performance and make best use of available resources in the longer term. It is important that Highlands and Islands Enterprise identify local efficiency targets and monitor the delivery of these savings and efficiencies, to support the organisation in demonstrating its contribution to the Initiative.
52. Highlands and Islands Enterprise commissioned a study on behalf of its community planning partners to identify the scope for efficiencies through partnership working within the Highland area. Highlands and Islands Enterprise, Highland Council and other community planning partners (under the umbrella of the Highland Wellbeing Alliance) were awarded £145,000 from the Scottish Executive's Efficient Government Fund to establish a business improvement team. Initially the business improvement team is concentrating on four areas as part of stage 1 of the project. These are:



- joint procurement;
- information technology;
- property and ground maintenance, and
- co-location of services.

53. The work of the team culminated in a further bid, in August 2006, for funding for stage 2 which will support further work to deliver identified efficiency savings. Savings from the project are currently estimated at £1.8 million in the period to 2010.

Future performance

54. In our audit plan, we identified some of the strategic risks for Highlands and Islands Enterprise in delivering its objectives and priorities. In this section we have provided an update on these risks.

55. The strategic risks identified were:

- supporting sustainable economic growth;
- using resources effectively;
- financial strategy (see paragraphs 10-12);
- performance management (see paragraphs 31-38); and
- best value and Efficient Government (see paragraphs 39-53).

Supporting Sustainable Economic Growth

56. In our plan, we commented that the key risk for Highlands and Islands Enterprise is that its approach to strategic planning and key investment decisions does not deliver sustainable economic growth and the improvements set out in *A Smart Successful Scotland* and *A Smart, Successful Highlands and Islands*. The environment within which Highlands and Islands Enterprise operates is complex and its planning processes need to appropriately reflect in developing plans to meet key priorities.

57. As the result of an organisational review Highlands and Islands Enterprise made changes to the boundaries of its local enterprise companies (LECs). The geographical area which was the responsibility of Ross and Cromarty Enterprise Ltd (RACE) was re-allocated and the number of LECs was reduced from ten to nine. The areas of Easter Ross and the Black Isle were transferred to the Inverness, Nairn, Badenoch and Strathspey Enterprise Company Ltd and its name changed to Highlands and Islands Enterprise Inverness and East Highland. The area of Wester Ross was



transferred to Skye and Lochalsh Local Enterprise Company Ltd and its name changed to Highlands and Islands Enterprise Skye and Wester Ross.

58. Highlands and Islands Enterprise requires to work with many partners but a failure to effectively plan and work with them is a risk to the achievement of its key objectives. It is, therefore, essential that partnerships are developed and effectively managed in achieving strategic objectives.
59. The organisation is a member of the Highland Wellbeing Alliance. The group was formed in 1996 and comprised five public sector organisations committed to the improvement of the wellbeing of the people of the Highlands and Islands. Legislation in 2003 required the setting up of community planning partnerships across Scotland. The Highland Wellbeing Alliance, with an expanded membership, has taken on that role across the Highland area. Other members of the Alliance include Highland Council, Highlands and Islands Fire and Rescue Service, NHS Highland, Scottish Natural Heritage, Northern Constabulary and representatives from the private and voluntary sectors.
60. The development of effective partnerships across the public sector is an essential element of Highlands and Islands being able to demonstrate best value.

Using Resources Effectively

61. The key resources available to Highlands and Islands Enterprise in delivering its objectives include financial resources, experienced staff and the information and knowledge which they gather and review. Like many organisations, Highlands and Islands Enterprise needs to secure and effectively deploy all of these resources to optimise the impact of its Operating Plan.
62. In 2005/06 Highlands and Islands Enterprise implemented a leadership development programme for managers at team head level and above. The programme was originally aimed at eighty members of staff but it was extended to a further twenty managers. Nineteen managers completed the programme in June 2006 and a further twenty managers completed in September 2006. Three more cohorts of twenty will start the programme by February 2007.
63. Capturing, interpreting, managing and reporting appropriate and up-to-date information is critical to successfully delivering services as, without robust information management and technology arrangements, the Network will not be able to operate effectively, and plan for, the future.
64. Highlands and Islands Enterprise is introducing a new network management system which is intended to be one single integrated financial and information system for the organisation. It will allow the sharing of information across the Network, and is a continuation of the earlier *Product and Process Review*. It represents a significant investment by Highlands and Islands Enterprise and it is important that the system becomes embedded across the Network, to ensure it functions effectively, efficiently and economically. We comment further on this at paragraphs 70-75.



Governance

65. This section sets out our main findings arising from our review of Highlands and Islands Enterprise's governance arrangements. This year we reviewed:
- key systems of internal control;
 - internal audit; and
 - aspects of information and communications technology (ICT).
66. We also discharged our responsibilities as they relate to prevention and detection of fraud and irregularity; standards of conduct; and the organisation's financial position (see paragraphs 8-9).

Systems of internal control

67. Key controls within systems should operate effectively and efficiently to accurately record financial transactions and prevent and detect fraud or error. This supports a robust internal control environment and the effective production of financial statements. In her annual report for 2005/06 the Head of Internal Audit provided her opinion that, based on the internal audit work undertaken during the year, the systems of internal control were good with the exceptions of compliance with European Audit requirements (see paragraphs 76-79) and the fact that new Information Security Standards have not been issued.
68. As part of our audit we reviewed the high level controls in a number of Highlands and Islands Enterprise's systems that impact on the financial statements. Our overall conclusion was that, with the specific exceptions noted below, key controls were operating adequately. The exceptions related to the lists of authorised signatories for the accounts payable and payroll systems not being up to date. If the list of authorised signatories is not kept up to date there is a risk that expenditure is inappropriately incurred. We agreed an action plan whereby Highlands and Islands Enterprise will update the list of authorised signatories by September 2006.

Internal Audit

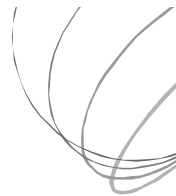
69. The establishment and operation of an effective internal audit function forms a key element of effective governance and stewardship. We therefore seek to rely on the work of internal audit wherever possible and as part of our risk assessment and planning process for the 2005/06 audit we assessed whether we could place reliance on Highlands and Islands Enterprise's internal audit function. We concluded that the internal audit service operates in accordance with Government



Internal Audit Standards and has appropriate documentation, standards and reporting procedures. We therefore placed reliance on a number of internal audit reviews.

Network Management System

70. Highlands and Islands Enterprise is introducing a new network management system (NMS) intended to be one single integrated financial and information system for the organisation. It represents a significant investment and it is important that the system becomes embedded across the Network, to ensure it functions effectively, efficiently and economically.
71. The organisation completed a review of the NMS project implementation team's user acceptance testing for Release 1 during January—March 2006. The review undertaken was split into two distinct exercises with:
- Internal Audit reviewing the user acceptance testing for release 1; and
 - External consultants reviewing performance, technical and security, including third party access issues, for release 1.
72. Internal audit made a number of recommendations in their report and the organisation is in the process of implementing them in future release processes.
73. The external consultant's concluded that the working files did not provide a clear audit trail from the objectives of the work undertaken, the evidence collected and the conclusions drawn. The project team has agreed to all recommendations in the report and the team is in the process of implementing them into future release processes.
74. There are two further releases before the project is completed. Release 2 will transfer Highlands and Islands Enterprise's website onto a new internet platform in the NMS. Release 3 will contain the mainstream financial and key management support systems. As user acceptance testing of Release 3 is paramount to ensuring the adequacy of controls and processes within the NMS prior to going 'live', we made a number of recommendations including:
- ensuring sufficient resources were employed to undertake the Release 3 testing;
 - all tests are fully completed, signed by the tester, reviewed, signed off by management and cross referenced to the decision log;
 - the test 'expected observation/reaction' is made clear on the test scripts to confirm a consistent interpretation of test results by different testers if applicable. Consideration should be given to include a copy of what the system screens should look like to help testers, and



- roles of key staff, project team and project board require to be reviewed to ensure all decisions are clear, concise and completed timeously.

75. Our recommendations were accepted and we will review the implementation of Releases 2 and 3 as part of the 2006/07 audit.

European Projects

76. After concerns were raised by EU Auditors on evidence to support EU Objective 1 grant claims Internal Audit reviewed the evidence to support payments made in respect of European funded projects and determine whether it complied with European audit requirements - see paragraphs 22-24.

77. Internal Audit's main findings were that:

- there were concerns over 133 out of 136 projects reviewed (98%);
- evidence held may not be sufficient to satisfy EU audit requirements in 93 occasions;
- release of assistance was made in advance of expenditure by the applicant on 6 occasions, and
- there was no evidence on file that European funding had been advertised as required.

78. Internal audit's recommendation was that Highlands and Islands Enterprise should devise an action plan to address issues identified from the audit such as:

- undertaking an exercise for projects already approved to ensure European compliance by identifying and filling gaps in information;
- reminding Project staff of their responsibilities for ensuring appropriate documentation is retained for all future European funded projects;
- clarifying procedures with the Scottish Executive and thereafter implementing these to ensure compliance by Network staff in the future, and
- feeding lessons identified in the report into the development of future strategy for the use of EU funding.

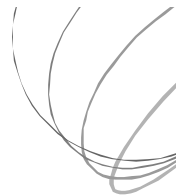
79. Internal Audit's recommendations were accepted and an action plan was agreed to address the issues found.



Looking Forward

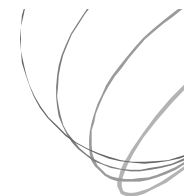
80. Highlands and Islands Enterprise faces significant challenges in 2006/07 which include:

- NMS - Highlands and Islands Enterprise is introducing a new network management system which is intended to be one single integrated financial and information system for the organisation, which will allow the sharing of information across the Network. It represents a significant investment by Highlands and Islands Enterprise and it is important that the system becomes embedded across the Network, to ensure it functions effectively, efficiently and economically. Release 3 is the critical stage of this project as it contains the mainstream financial and key management support systems. The system should go live in the autumn of 2006.
- Arnish - Highlands and Islands Enterprise has made a significant investment in the Arnish yard in Lewis. In addition, CamCal Ltd, the operator of the site is the second company to get into financial difficulty. It is essential that Highlands and Islands Enterprise gets another operator who can secure the long term viability of its investment in Arnish.
- Funicular Railway - We are also aware of the possible transfer of the Cairngorm Estate to the Forestry Commission. One issue arising from the proposed transfer of the estate is the need to re-instate the Cairngorm mountain if, for whatever reason, there is no operator of the funicular railway. We understand that the assets will transfer with the estate but Highlands and Islands Enterprise will retain responsibility for re-instatement of the Cairngorm mountain if this is necessary.
- EU funding - EU auditors raised concerns on quality and sufficiency of evidence to support objective one grant claims. Negotiations are ongoing between the Scottish Executive and EU Auditors to resolve the issues raised. The process of negotiation with the EU auditors can be a lengthy process and there is a risk that there could be a clawback of funding. It is essential this matter is resolved and the impact of any clawback of EU funding included in future financial plans.
- Shared services —The Scottish Executive has issued a consultation on a National Strategy for Shared Services. Scottish Enterprise, on behalf of the non departmental body chief executives' forum, commissioned a report on current support service arrangements across these organisations. The report makes a number of recommendations which are currently being considered. Taking forward this agenda and encouraging the development of shared services is a significant challenge for the public sector.
- Procurement —The Review of Public Procurement in Scotland report by John McClelland issued in March 2006 contained a significant number of findings and recommendations in



respect of procurement in the public sector. It will be important that the McClelland recommendations are acted upon to improve performance and that the benefits of the e-tendering strategy are fully realised.

- Best Value —Revised guidance on best value in the wider public sector has now been issued. Highlands and Islands Enterprise will need to ensure that it has mechanisms in place that enable it to demonstrate continuous improvement and that the principles of best value are embedded. Audit Scotland will be developing its approach to best value in the wider public sector in due course.
- Efficient Government - The achievement of future Efficient Government targets represents a challenge for the organisation and its partner organisations.



Appendix A: Action Plan

Key Issues and Planned Management Action

Action Point	Refer Para. No	Issue Identified	Planned Action	Responsible Officer	Target Date
1	18	The longer term viability of the investment in Arnish is at risk due to the difficulties of operators in attaining longer term financial stability.	Highlands and Islands Enterprise has already identified this as a key action and both WIE and Highlands and Islands Enterprise are being proactive in identifying opportunities to achieve sustainable economic development at the Arnish Business Park	Director of Area Operations	Reviewed on a monthly basis
2	26	Expenditure on Growing Businesses and Making Global Connections in the 2006/07 financial statements should be analysed on the basis of actual expenditure incurred.	With the introduction of NMS it is planned to progressively eliminate legacy cases for which there was no SSHI classification and therefore remove the need for percentage based allocations.	Director of Corporate Services	31 March 2007
3	37	Given the performance attained in 2005/06 for the primary measures, the expectations embedded within the targets set within the 2006-09 Operating Plan appear to provide scope for more challenging targets to be set for the organisation in future.	As part of its ongoing activities in this area Highlands and Islands Enterprise staff are currently reviewing the definition for its primary measures to ensure that these help achieve the maximum impact. These primary measures however should be considered in the context of the increased emphasis Highlands and Islands Enterprise now place on the key measures of progress against its strategic projects.	Director of Strategy	31 March 2007