

# Highlands and Islands Enterprise

## Annual report on the 2013/14 audit



Prepared for Members of Highlands and Islands Enterprise and the Auditor General for Scotland  
September 2014

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# Key Messages

## 2013/14

We have given an unqualified opinion that the financial statements of Highlands and Islands Enterprise for 2013/14 give a true and fair view of the state of the body's affairs and of its net expenditure for the year.

Highlands and Islands Enterprise, with approval from the Scottish Government, exceeded the resource budget for 2013/14. This was due to additional funding of £2.8 million which was provided to enable the purchase of plant and equipment. No associated budget was provided resulting in an agreed overspend against the DEL target for the year.

The extent of the changes to the financial statements during the audit process indicates that there are further improvements that could be made in the process of preparing the financial statements.

Previous audit issues on the accounting treatment for non-current assets have now been resolved with sound arrangements in place to identify and review the useful lives of assets.

# Introduction

1. This report is the summary of our findings arising from the 2013/14 audit of Highlands and Islands Enterprise. The purpose of the report is to set out concisely the scope, nature and extent of the audit. It summarises our opinions (i.e. on the financial statements) and conclusions on significant issues arising.
2. The report also reflects our overall responsibility to carry out an audit in accordance with the public sector audit model which is based on the Code of Audit Practice prepared by Audit Scotland (May 2011). This sets out the wider dimensions of the public sector audit which involves not only the audit of the financial statements but also consideration of areas such as financial performance and corporate governance. An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements prepared by management; however this does not relieve management of their responsibilities in this respect. This report has been prepared for the use of Highlands and Islands Enterprise and no responsibility to any third party is accepted.
3. Appendix A sets out the key audit risks identified at the planning stage and details how we addressed each risk in arriving at our opinion on the financial statements.
4. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that Highlands and Islands Enterprise understands its risks and has arrangements in place to manage these risks. Members should ensure that they are satisfied with the proposed management action and have a mechanism in place to assess progress.
5. This report is also addressed to the Auditor General for Scotland and will be published on our website after consideration by the Risk and Assurance Committee.

# Financial statements

## Conduct and scope of the audit

6. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in the Annual Audit Plan presented to the Risk and Assurance Committee on 11 March 2014, and follow the requirements of the Code of Audit Practice prepared by Audit Scotland in May 2011.
7. As part of the requirement to provide full and fair disclosure of matters relating to our independence we can confirm that we have not undertaken non-audit related services. The 2013/14 agreed fee for the audit was disclosed in the Annual Audit Plan and remains unchanged as we did not require to carry out any additional work outwith our planned activity.

## Audit opinion & accounting issues

8. We have given an unqualified opinion that the financial statements of Highlands and Islands Enterprise for 2013/14 give a true and fair view of the state of the body's affairs and of its net expenditure for the year. The audit opinion was issued and signed on 24 September 2014.
9. We received the unaudited financial statements on 26 June 2014 in accordance with the agreed timetable. The unaudited financial statements did not reflect some key changes in accounting standards and framework. This included the new employee benefits requirements (IAS 19) and strategic report disclosures, which we identified as risks in our Annual Audit Plan. The audited financial statements now incorporate these changes.
10. In order to improve compliance with the accounting framework, we agreed with management that the FReM and NAO disclosure checklist would be reviewed as part of the financial statements preparation process. The NAO disclosure checklist was completed by finance officers who stated that all requirements had been satisfied. This was the first year that Highlands and Islands Enterprise had used this checklist to help ensure compliance. There were some disclosure errors, for example in the strategic report, which resulted in detailed audit testing.
11. Net expenditure changed from £55.2 million to £53.8 million (£1.4 million reduction) between the unaudited and the audited financial statements. The net asset position also increased from £25.9 million to £27.3 million as a result of these adjustments. The major adjustments agreed during the audit process included:
  - adjustment of the depreciation policy and removal of depreciation charges for assets purchased on 31 March 2014 (-£0.7million)
  - recognition of land rental income omitted from the unaudited statements (-£0.6 million)
  - reduction in the value of investment reflecting position of unrealised losses at 31 March
  - taxation adjustments due to the timing of receipt of information (-£0.6 million)
  - removal of unrealised profits in associates from net expenditure (+£0.5 million).

12. The extent of the changes indicates that further improvements could be made in the process of preparing the financial statements. This could include:
- identifying and responding to changes in the accounting framework;
  - more detailed review / proof reading during the preparation process;
  - earlier discussion with audit on key issues / unusual transactions.

**Refer Action Plan No. 1**

13. The working papers were of a reasonable standard and the staff provided support to the audit team that enabled us to complete our on-site fieldwork on 31 July 2014. However staff availability sometimes proved difficult due to the conflicting priorities arising from the current job share arrangement for a key member of finance staff and we would welcome further consideration of this arrangement during the core audit period.
14. Highlands and Islands Enterprise is required to follow the accounting requirements contained in the 2013/14 FReM and, following the audit adjustments to the financial statements, we can confirm that the revised financial statements have been properly prepared in accordance with these requirements.

## Significant findings and key judgements (ISA260)

15. During the course of the audit we identified a number of significant issues regarding the appropriateness of accounting policies or accounting estimates and judgements, the timing of transactions, the existence of material unusual transactions or the potential effect on the financial statements of any uncertainties.
16. **Asset Purchase and Leaseback:** On 31 March 2014 Highlands and Islands Enterprise purchased plant and equipment from an existing land tenant at a cost of £2.8 million. Highlands and Islands Enterprise entered into an agreement on 31 March 2014 to lease-back the purchased plant and equipment to the tenant for a 5 year period. The plant and equipment have been included in the fixed asset register as a single asset of £2.8 million (this is supported by an independent valuation based on in situ value).
17. As the assets were purchased on 31 March 2014 based on the valuation provided, we agreed that it was inappropriate to charge a full year's depreciation to the 2013/14 financial statements. We also understand from officers that the equipment could have considerably longer lives than the four years initially identified. The depreciation charge of £0.7 million has therefore been removed from the audited financial statements and the finance team have agreed to separately identify the assets in the asset register and to obtain an accurate assessment of the associated useful lives during 2014/15.

**Refer Action Plan No. 2**

18. **Group Boundary:** Discussions have taken place with finance officers on whether Highlands and Islands Enterprise has significant influence over a specific investee, which would result in them being consolidated into the financial statements as an associate. Highlands and Islands Enterprise owns almost 20% of the share capital, the plant and equipment at the site and

controls the head lease on the land it rents to the investee. We have considered the case prepared by officers on this issue and agree with their view that the circumstances do not constitute "significant influence".

19. **State Aid:** As a result of the purchase and leaseback of plant and equipment detailed at paragraph 16, we sought assurances from officers that there were no "state aid" implications in connection with this transaction. The purchase price of the equipment was higher than the total (5-year) leaseback income. Highlands and Islands Enterprise entered into the arrangement in order to ensure ongoing tenancy on the land as they are committed to rental expenditure under a head lease for a further 46 years.
20. As part of the audit process we were provided with a legal opinion and we requested that Highlands and Islands Enterprise seek further clarification of the view of the Scottish Government State Aid Unit. On 5 September we received confirmation that they were content that there "appears a reasonably strong argument that the transaction...would meet the Market Economy Investor Principle, as such, it is likely that there is no state aid present". We have considered the audit evidence provided and concluded that there are no issues with the regularity of the transaction.
21. **Revision to Investment Valuation:** An investment was included in the unaudited financial statements at a valuation of £0.871 million. This reflects a significant reduction from the previous year (£1.7 million). However, we considered that the existing value is significantly impaired, based on current operating losses and the net asset position of the company. The auditor of the investee company has determined (at 31 March 2013) that the entity is a going concern on the basis of continuing support from the majority shareholder. There is evidence that this support is to end and expected losses to 31 March 2014 and beyond are likely to further erode the working capital position, unless the majority shareholder finds a buyer for this business. On the basis of our audit work the investment was further written down to reflect Highlands and Islands Enterprise's share of total net assets at 31 March 2014, which we projected to be £0.278 million (£1.4 million x 19.9%).
22. **CairnGorm Mountain Limited:** On 11 June 2014 CairnGorm Mountain Limited, a subsidiary of Highlands and Islands Enterprise, was sold to Natural Retreats. Highlands and Islands Enterprise recognised this as a non-adjusting event subsequent to the Statement of Financial Position date in accordance with IAS 10 - Events after the reporting date. The financial statements therefore disclose CairnGorm Mountain Limited as a discontinued operation in accordance with IFRS 5 with the associated transactions and balances separately identified in the core financial statements.
23. **Previous Audit Issues.** Last year we reported that the accounting treatment for depreciation and revaluation of non-current assets had been largely addressed as a result of action taken by officers. We noted that some further work was required during 2013/14, in particular the review of useful lives of assets as part of the annual valuation process. With the exception of the new assets identified at paragraph 16, this has now been completed.

- 24. Prior Period Adjustments:** The opening Statement of Financial Position and comparative information in the financial statements have been amended for the following:
- Change in accounting standard - Pension accounting. The provisions in IAS 19 - Employee Benefits have now been adopted in full resulting in a change in the prior year net expenditure of £0.366 million with no associated impact on the retirement benefit obligation within the Statement of Financial Position.
  - Transfer to another public sector body. On 25 March 2014 Highlands and Islands Enterprise resigned from Scottish Health Innovations Limited with the share transferring to NHS Scotland. In accordance with FReM this has been accounted for as a machinery of government change resulting in a small impact on the prior year net expenditure due to the elimination of the share of the profit made by the associate.
  - Subsidiary tax adjustment. As part of the completion of the 2012/13 financial statements Highlands and Islands Enterprise agreed to purchase tax losses of a subsidiary. This transaction was not eliminated during the preparation of the group financial statements but has now been adjusted to reflect the correct group tax position at the year end.

## Financial position

### 2013/14 Outturn

- 25.** The main financial objective for Highlands and Islands Enterprise is to ensure that the financial outturn for the year is within the resource budget that has been allocated by Scottish Ministers. For 2013/14 Highlands and Islands Enterprise, with approval from the Scottish Government, exceeded the resource budget (Cash DEL) as detailed in Table 1 below. The table also shows the budget changes that occurred for Highlands and Islands Enterprise during the financial year.

**Table 1: Resource Budget**

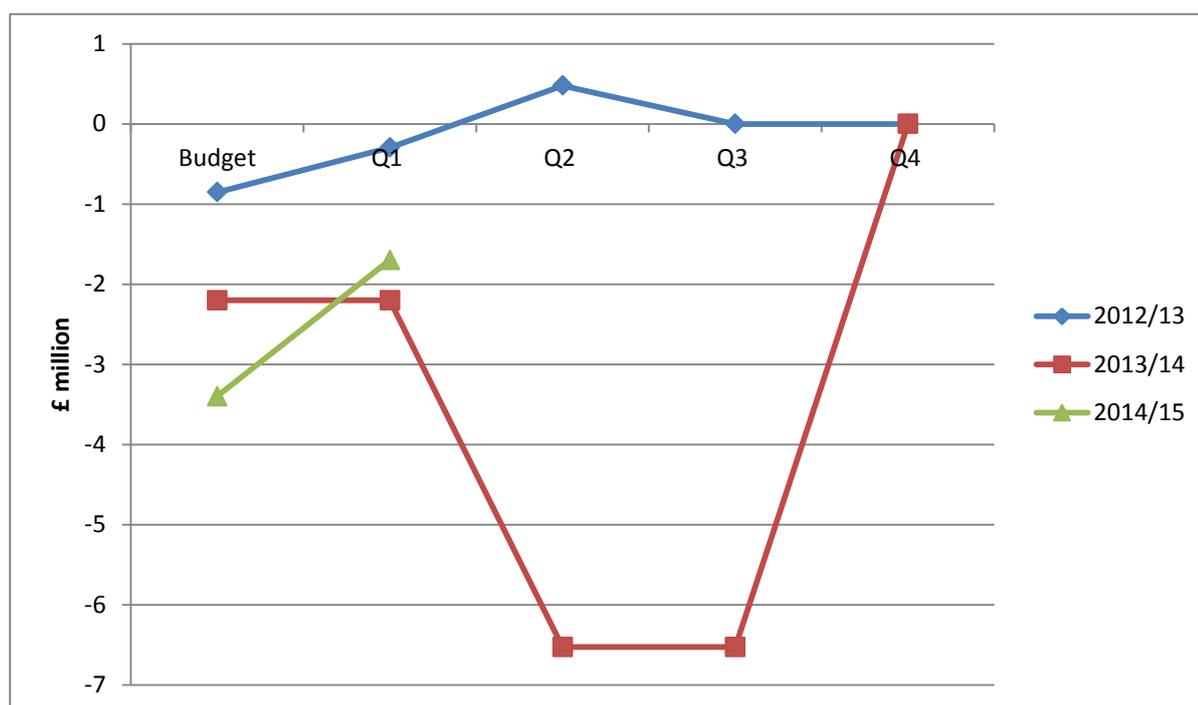
	Initial Budget (£'000)	Final Budget (£'000)	Actual Outturn (£'000)	Under / (Over) spend
Resource DEL	42,600	29,242	29,207	35
Capital DEL	10,670	28,600	31,400	(2,800)
<b>Total</b>	<b>53,270</b>	<b>57,842</b>	<b>60,607</b>	<b>(2,765)</b>
Non Cash DEL	12,697	12,697	3,202	9,495
AME (non-cash)	-	15,000	8,965	6,035

Source: Grant in Aid Funding letters

26. The Scottish Government agreed that £14 million of revenue funding would be transferred to capital during the year. Highlands and Islands Enterprise also received a number of additional funding streams for resource (£2.6 million) and capital (£1.2 million) as part of the budget revision process partly offset by the £2 million budget reduction reflecting Strategic Forum Savings targets.
27. In addition the Scottish Government provided an additional budget of £2.7 million for the Barmuckity shovel-ready project. No additional funding was provided for this initiative as it was included in the 2012/13 grant in aid drawn down. In March 2014 the Scottish Government agreed to provide additional funding of £2.8 million to enable the purchase of plant and equipment (see paragraph 16 for details). There was no associated budget provided with this funding resulting in an agreed DEL overspend for the year.

### Financial position

28. At 31 March 2014 the Statement of Financial Position shows an increase in net assets of £2.853 million (£3.124 million for the group), primarily due to additional property, plant and equipment, including the £2.8 million of assets detailed at paragraph 16.
29. The pension fund liability for Highlands and Islands Enterprise has seen a minor increase in year from £25.724 million to £25.979 million. During 2013/14 Highlands and Islands Enterprise, in agreement with the Pension Fund Trustees and Scottish Government, introduced a recovery plan to address the ongoing shortfall. From August 2014 the current pension scheme will be amended from a final salary scheme to a new career average scheme. The new scheme will have a revised retirement age of 65 and member contributions progressively rising to 6% to bring it in line with other public sector pension schemes.
30. In April 2014 the Board approved a budget for 2014/15 of £73.7 million. Built into the budget is Highland and Islands Enterprise's share of the Scottish Government's Strategic Forum Savings Target of £3.2 million (£2 million in 2013/14) which represents a reduction in funding that must be met from other sources. The budget also includes £3.4 million "negative reserve" which represents a funding gap that must be met from slippage in projects during the course of the financial year.
31. The inclusion of a negative reserve is in line with prior years' budget setting processes, however the initial 2014/15 balance of £3.4 million is higher than previous years and may be more challenging for Highlands and Islands Enterprise to achieve. The following chart shows how this negative reserve has been addressed in prior years and also shows that for 2014/15 the ongoing financial management arrangements have already reduced the funding gap to £1.7 million.

**Chart 2: Negative reserve position**

Source: *Financial reporting to the Board*

32. Recent financial reporting to the Board shows expenditure to the end of June 2014 of £12.486 million against a profile position of £18.625 million. The report shows a forecast outturn within budget for the year.
33. HIE receives 80% of its income from the Scottish Government with additional funding also provided for the broadband project. The remaining income sources have remained steady with future projections in line with current levels. Subject to the continuing funding support from the Scottish Government, we conclude that the financial position remains stable.

## Corporate governance and systems of internal control

### Overall governance arrangements

34. The Code of Audit Practice gives auditors a responsibility to review and report on audited bodies' corporate governance arrangements and overall we found that Highlands and Islands Enterprise had sound governance arrangements in place which included a number of standing committees overseeing key aspects of governance.
35. An area of good practice undertaken by Highlands and Islands Enterprise relates to staff and board members completing a Register of Interest form which highlights where there may be a potential conflict of interest. This process extends to all staff and is renewed annually. Details for non-executive board members are contained within the financial statements.

## Accounting and internal control systems

36. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.
37. No material weaknesses in the accounting and internal control systems were identified during the audit which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.
38. Internal audit is an important element of the governance structure for Highlands and Islands Enterprise. Our review established that the work of internal audit is of a good quality allowing us to place reliance on a number of areas including payroll controls and significant transactions testing. This not only avoided duplication of effort but also enabled us to focus on other key risk areas. We note that during 2013/14 there were a number of changes to the business improvement and internal audit team. To address this additional resources were procured from external consultants to ensure the work programme was delivered. The longer term resourcing of the team is currently being considered.
39. ATOS origin provides IT services to Highlands and Islands Enterprise, Skills Development Scotland and Scottish Enterprise. Skills Development Scotland led the development of a service audit report (ISAE 3402) for this service and a report was produced in August 2013 for the period 2012/13. No service audit report was produced for 2013/14 but there have been no major changes to the service and this has been disclosed in the Governance Statement.

## Prevention and detection of fraud and irregularity

40. In our Annual Audit Plan we highlighted the responsibility audited bodies have for establishing arrangements to prevent and detect fraud and other irregularities. In our opinion the overall arrangements for the prevention of fraud are satisfactory, although it should be noted that no system can eliminate the risk of fraud entirely.

## Standards of conduct and arrangements for the prevention and detection of corruption

41. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. No issues have been identified by us for inclusion in this report.

## Best value

### Best value

42. Achievement of Best Value or value for money depends on the existence of sound management arrangements for services, including procedures for planning, appraisal, authorisation and control. Audited bodies are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily. The Auditor General may require that we consider whether accountable officers have put in place appropriate arrangements to satisfy their corresponding duty of best value. Where such requirements are not specified we may, in conjunction with Highlands and Islands Enterprise, agree to undertake local work in this area.
43. Highlands and Islands Enterprise developed their CREATIVE vision following consideration of a range of best practice models and guidance. The CREATIVE characteristics are detailed in the Operating Plan 2014 - 2017 and the aim is to ensure that best value and continuous improvement are embedded in all activities. During the year the business improvement and internal audit team completed reviews using best value toolkits. The reviews of business unit benchmarking and delivery of 2020 outcomes included consideration of the use of resources and performance management toolkits.

### Performance audit

44. In 2013 Highlands and Islands Enterprise appointed BT to deliver Next Generation Broadband across its area, in line with the Scottish Government's commitment to deliver digital connectivity across Scotland by 2020. Audit Scotland is conducting a performance audit which considers the current progress of the work and project management arrangements. The review will be published in spring 2015.

### Acknowledgements

45. We would like to express our thanks to the staff of Highlands and Islands Enterprise for their help and assistance during the audit of this year's financial statements which has enabled us to provide an audit report within the agreed timetable.

# Appendix A: Key Audit Risks

## Key Audit Risks and Associated Audit Work

Audit Risk	Overview of the scope of audit work to address the risks
<p><b>Finance capacity and skills mix</b></p> <p>The capacity and skills mix in the finance team, noted during the 2012/13 financial statements audit, has not yet been fully addressed.</p> <p><i>If insufficient resources are available during the preparation of the unaudited financial statements this could lead to a delay in delivery or a higher than expected level of errors.</i></p>	<p>Our audit team included staff with extensive central government experience and previous involvement with Highlands and Islands Enterprise. We had ongoing discussions with finance officers about the capacity and skills mix however the extent of audit adjustments indicate that there are still some issues with the preparation of the financial statements.</p>
<p><b>Year end processing</b></p> <p>Due to Highlands and Islands Enterprise's expenditure profile a significant amount is incurred towards the financial year end.</p> <p><i>There is a risk that the expenditure is incorrectly applied or accounted for.</i></p>	<p>We relied on internal audit's work on significant transactions which covered £40 million of expenditure. We also reviewed expenditure in the period shortly before and after the financial year end to ensure it had been correctly accounted for.</p>
<p><b>Income</b></p> <p>Highlands and Islands Enterprise receive a significant amount of income in addition to SG funding.</p> <p><i>The extent and complexity of income at Highlands and Islands Enterprise means there is an inherent risk of fraud in accordance with ISA240.</i></p>	<p>A significant amount of income related to the Next Generation Broadband Project which was subject to audit testing. We also undertook detailed substantive testing of income transactions including a review of rental income.</p>
<p><b>Non current assets</b></p> <p>The accounting treatment for depreciation resulted in an adjustment to the 2012/13 financial statements.</p> <p><i>There is a risk that depreciation is not correctly calculated and accounted for.</i></p>	<p>We undertook detailed substantive testing of the depreciation calculations. This identified a small number of adjustments which have been amended in the financial statements.</p>

Audit Risk	Overview of the scope of audit work to address the risks
<p><b>Financial assets</b></p> <p>Highlands and Islands Enterprise enter into investment and loan arrangements which require complex accounting treatment.</p> <p><i>There is a risk that the financial assets are not correctly accounted for in the financial statements.</i></p>	<p>We undertook detailed substantive testing of the investment and loan accounting treatment. This identified a small number of adjustments which have been amended in the financial statements.</p>
<p><b>Accounting for CairnGorm Mountain Ltd</b></p> <p>A subsidiary is due to be sold after the financial year end and may be an adjusting event for the 2013/14 financial statements.</p> <p><i>The complexity of accounting for this subsidiary presents a risk to the financial statements.</i></p>	<p>We reviewed the sale of CairnGorm Mountain Ltd and confirmed that this was a non-adjusting event for the financial statements. A disclosure note has been included in accordance with IAS 10 - Events after the reporting period.</p>
<p><b>Management commentary disclosures</b></p> <p>The 2013/14 FReM introduces a new requirement to include a strategic report within the management commentary.</p> <p><i>There is a risk that Highlands and Islands Enterprise do not have arrangements in place to disclose the necessary information in the unaudited financial statements.</i></p>	<p>The unaudited financial statements contained a strategic report, however it did not comply with the 2013/14 FReM requirements. We identified this early in our audit work and requested necessary changes to ensure compliance with the new disclosure requirements.</p>
<p><b>Pension accounting</b></p> <p>IAS19 has been amended resulting in a change in accounting treatment and an increase in the disclosures required.</p> <p><i>There is a risk that Highlands and Islands Enterprise do not comply with the new requirements.</i></p>	<p>The unaudited financial statements did not comply with the new accounting requirements. We identified this through our audit testing and requested necessary adjustments in accordance with IAS 19 - Employee benefits.</p>

# Appendix B: Action Plan

## Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1	12	<p><b>Preparation of financial statements</b></p> <p>Adjustments to the financial statements during the audit indicates that further improvements could be made in the process of preparing the financial statements.</p> <p><b>Risk:</b> Ongoing issues with the financial statements provided to audit may result in additional audit fees being charged to deal with the additional workload.</p>	<p>The finance team will ensure sufficient time is built into the financial statements process to enable accurate technical accounting and ensure appropriate levels of oversight including:</p> <ul style="list-style-type: none"> <li>identifying and responding to changes in the accounting framework;</li> <li>more detailed review / proof reading;</li> <li>earlier discussion with audit on key issues / unusual transactions.</li> </ul>	Director of Finance and Corporate Services	31 May 2015
2	17	<p><b>Asset Accounting</b></p> <p>For 2014/15 further work is required to review and separately identify the plant and equipment purchased and ensure this is correctly depreciated in the financial statements.</p> <p><b>Risk:</b> The assets are not correctly accounted for in the financial statements.</p>	Work will be undertaken to review the asset listing and obtain an accurate assessment of the associated useful lives.	Head of Financial Services	31 March 2015