

Highlands and Islands Enterprise

2016/17 Annual Audit Report



 AUDIT SCOTLAND

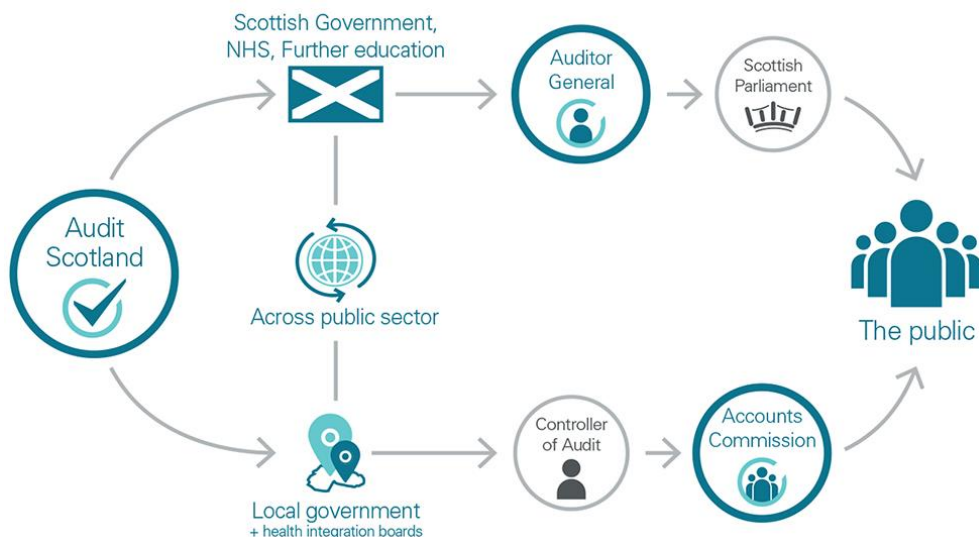
Prepared for Highlands and Islands Enterprise and the Auditor General for Scotland

5 September 2017

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.

Contents

Key messages	4
Introduction	5
Part 1 Audit of 2016/17 financial statements	7
Part 2 Financial management	12
Part 3 Financial sustainability	15
Part 4 Governance and transparency	17
Part 5 Value for money	21
Appendix 1 Action plan 2016/17	23
Appendix 2 Significant audit risks identified during planning	24
Appendix 3 Summary of national performance reports 2016/17	27

Key messages

Audit of the 2016/17 financial statements

- 1 The financial statements give a true and fair view of Highlands and Islands Enterprise and its group's state of affairs and their net expenditure for the year.
- 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 prepared in accordance with legal requirements.

Financial management

- 4 Highlands and Islands Enterprise has effective arrangements in place for financial management. It operated within its Grant in Aid resource limits for 2016/17.
- 5 Systems of internal control operated effectively during 2016/17.
- 6 There was good engagement with the National Fraud Initiative exercise.

Financial sustainability

- 7 Highlands and Islands Enterprise has a five year financial plan but it has yet to use scenario planning to model the impact of differing funding settlements.
- 8 Pension scheme liabilities exceeded assets by £56.3 million as at 31 March 2017. Highlands and Islands Enterprise previously implemented a recovery plan to address the deficit on its pension scheme. Work is currently ongoing to update this plan in order to secure the financial sustainability of the pension fund.

Governance and transparency

- 9 Highlands and Islands Enterprise has appropriate arrangements in place to support good governance, accountability and scrutiny.
- 10 Board meetings are not open to the public. Public meetings have been piloted in the past and led to the introduction of regular business and community engagement activity throughout the Highlands and Islands. With increasing public expectations for more openness in the conduct of public business, Highlands and Islands Enterprise needs to keep this area under review and consider whether there is scope to enhance transparency.
- 11 The Business Improvement and Internal Audit section operates in accordance with the Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

Value for money

- 12 A well developed performance management framework is in place which supports the achievement of value for money.

Introduction

1. This report is a summary of our findings arising from the 2016/17 audit of Highlands and Islands Enterprise.
2. The scope of our audit was set out in our Annual Audit Plan presented to the March 2017 meeting of the Risk and Assurance Committee. This report comprises:
 - an audit of the annual report and accounts
 - consideration of the wider dimensions set out in the [Code of Audit Practice 2016](#) as illustrated in [Exhibit 1](#).

Exhibit 1 Audit dimensions



Source: Code of Audit Practice 2016

3. The main elements of our audit work in 2016/17 have been:
 - an interim audit of Highlands and Islands Enterprise's main financial systems and governance arrangements
 - an audit of Highlands and Islands Enterprise's 2016/17 annual report and accounts including the issue of an independent auditor's report setting out our opinions.

- 4.** Highlands and Islands Enterprise is responsible for preparing financial statements that give a true and fair view, for the accuracy of the other information in the annual report and accounts, and for establishing effective arrangements for governance, propriety and regularity that enable the Board to successfully deliver its objectives.
- 5.** Our responsibilities as independent auditor are established by the Public Finance and Accountability (Scotland) Act 2000 and the [Code of Audit Practice 2016](#), supplementary guidance and, guided by the auditing profession's ethical guidance.
- 6.** These responsibilities include giving independent opinions on the financial statements, regularity, the remuneration and staff report, the performance report and the governance statement. We also review and report on the arrangements within Highlands and Islands Enterprise to manage its performance, regularity and use of resources. In doing this, we aim to support improvement and accountability.
- 7.** Further details of the respective responsibilities of management and the auditor can be found in the [Code of Audit Practice 2016](#) and supplementary guidance.
- 8.** The weaknesses or risks identified in this report are only those that have come to our attention during our normal audit work, and may not be all that exist. Also, our annual audit report contains an action plan at [Appendix 1](#). It sets out specific recommendations, responsible officers and dates for implementation.
- 9.** Communication in this report of matters arising from the audit of the annual report and accounts or of risks or of weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.
- 10.** As part of the requirement to provide fair and full disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2016/17 audit fee for the audit was set out in our Annual Audit Plan and as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.
- 11.** This report is addressed to both the Board and the Auditor General for Scotland and will be published on Audit Scotland's website www.audit-scotland.gov.uk.
- 12.** We would like to thank all management and staff who have been involved in our work for their cooperation and assistance during the audit.

Part 1

Audit of 2016/17 financial statements



Main judgements

The 2016/17 financial statements of Highlands and Islands Enterprise and its group give a true and fair view of the state of their affairs and of their net expenditure for the year.

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 prepared in accordance with legal requirements.

Unqualified audit opinions

13. The annual report and accounts for the year ended 31 March 2017 were approved by Highlands and Islands Enterprise on 5 September 2017. We reported, within our independent auditor's report:

- an unqualified opinion on the financial statements
- an unqualified opinion on regularity of expenditure and income, and
- an unqualified audit opinion on the remuneration and staff report, performance report and governance statement.

14. Additionally, we are satisfied that there are no matters which we are required by the Auditor General to report by exception.

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

Submission of annual report and accounts for audit

15. We received the unaudited annual report and accounts on 23 June, in line with our agreed audit timetable along with a completed disclosure checklist. The working papers provided with the unaudited financial statements were of a good standard and finance staff provided good support to the audit team.

Risk of material misstatement

16. [Appendix 2](#) provides a description of those assessed risks of material misstatement that were identified during the planning process which had the greatest effect on the overall audit strategy, the allocation of resources to the audit and directing the efforts of the audit team.

Materiality

17. Materiality defines the maximum error that we are prepared to accept and still conclude that our audit objective has been achieved. The assessment of what is material is a matter of professional judgement. It involves considering both the amount and nature of any misstatement.

18. Our initial assessment of materiality for the annual report and accounts was undertaken during the planning phase of the audit. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

19. On receipt of the draft annual report and group accounts we reviewed our original materiality calculations and updated these to reflect the reported outturn at 31 March 2017. Our revised materiality levels are summarised in [Exhibit 2](#).

Exhibit 2

Materiality values

Materiality level	Amount
Overall materiality – This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at 1% of gross expenditure for the year ended 31 March 2017.	£950,000
Performance materiality – This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality, this would indicate that further audit procedures should be considered. Using our professional judgement we have calculated performance materiality at 40% of overall materiality.	£380,000
Reporting threshold – We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This has been calculated at 2% of overall materiality.	£20,000

Source: Audit Scotland

Evaluation of misstatements

20. A number of presentational and monetary adjustments to the accounts were identified during the course of our audit. These were discussed with senior finance officers who agreed to amend the financial statements. There are no unadjusted misstatements.

21. There were a number of amendments processed to the accounts following the audit. As a result, total comprehensive net expenditure increased by £0.097 million, and net liabilities and taxpayers' equity increased by £0.372 million. The significant adjustments made are set out in [Exhibit 3](#) below.

22. As the total value of misstatements (£1.261million) exceeded our performance materiality level (£0.380 million) we are required to consider the impact on our audit approach. As noted at [Exhibit 3 point 4](#) below, we undertook additional testing on loans and receivables. We concluded that further audit procedures were not required for the other errors identified as these were isolated issues which do not indicate that further systematic errors exist within the account area, or more pervasively within the financial statements

Significant findings from the audit

23. International Standard on Auditing (UK and Ireland) 260 requires us to communicate significant findings from the audit to you. These 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](#) has been included.

Exhibit 3

Significant findings from the audit of financial statements

Issue	Resolution
<p>1. Going concern</p> <p>Auditors are required to consider an organisation's ability to continue as a going concern when forming an opinion on the financial statements. One of the indicators that may give rise to going concern considerations is an excess of liabilities over assets. In accordance with International Accounting Standard 19 (Employee Benefits), Highlands and Islands Enterprise has recognised its share of the net liabilities of the five pension schemes available to staff. This has resulted in a net liabilities position of £14.1 million (£12.8 million in the group accounts) on its statement of financial position at the year end.</p>	<p>This accounting requirement has no impact on the underlying basis for meeting current and on-going pension liabilities which will be met, as they fall due, by grant in aid from the Scottish Government. Highlands and Islands Enterprise previously implemented a recovery plan, including lump sum employer contributions and increasing member contribution rate, to address the deficit on its pension scheme. Work is currently ongoing to update this plan in order to secure the financial sustainability of the pension fund.</p> <p>We agree with management's view that it is appropriate to prepare the 2016/17 financial statements on the going concern basis.</p>
<p>2. Financial assets: investments</p> <p>Highlands and Islands Enterprise's statement of financial position records £3.7 million of investments (£3.4 million in the group accounts). These investments reflect Highlands and Islands Enterprise's objectives to deliver economic growth within the Highlands and Islands of Scotland.</p> <p>These investments are assessed at fair value using the knowledge and expertise of Highlands and Islands Enterprise's finance staff. There is no independent assessment of the value of the investments.</p>	<p>We reviewed the information provided by Highlands and Islands Enterprise and the methodology.</p> <p>Assurances have been received from the Accountable Officer confirming that the methodology applied provides a true and fair view of the value of these investments at 31 March 2017.</p>
<p>3. Financial assets : gains in revaluation of available for sale assets</p> <p>Gains and losses on the revaluation of available for sale assets should be shown within the Other Comprehensive Expenditure and Income section of the Statement of Comprehensive Net Expenditure. Gains totalling £0.3 million had been incorrectly offset against operating expenditure in the unaudited accounts. As a result, net expenditure and the other reserves balance were understated, and other comprehensive expenditure and the general reserve were overstated by £0.3 million.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p>

Issue	Resolution
<p>4. Financial assets: prior year adjustments</p> <p>The unaudited accounts included a prior year adjustment to reflect the correct treatment of an interest free loan previously included as a repayable grant. Trade receivables and the general reserve were increased by £0.6 million as at 31 March 2016 in the unaudited accounts. We examined the working papers provided in support of the prior year adjustment and noted an error in the calculation. As a result, we extended our testing to review all interest free loans and those that were provided at less than market rates. This identified a number of errors resulting in the overstatement of financial assets and the general reserve by £0.261 million as at 31 March 2017. Prior year figures included in the unaudited accounts were also overstated by £0.275 million as at 31 March 2016 and £0.319 million as at 31 March 2015.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p>
<p>5. Superfast broadband</p> <p>The unaudited accounts included an estimate (£4 million) for monies due to a supplier for the development of superfast broadband services, and for the income due from the Scottish Government to fund this scheme. The invoice, received during the audit, was for less than the estimate included in the unaudited accounts. As a result, income, expenditure, trade receivables and trade payables were overstated by £0.570 million.</p>	<p>Management agreed to amend the accounts to correct this misstatement.</p>
<p>6. Taxation calculations</p> <p>The taxation calculations were not available until after the unaudited accounts had been submitted for audit. As a result, net expenditure was understated by £0.105 million, trade receivables were overstated by £0.025 million and trade payables were understated by £0.080 million.</p>	<p>Management agreed to amend the accounts to include these amounts.</p>

Source: Audit Scotland

Other findings

24. We have highlighted below a number of other matters identified during our audit.

Financial investments

25. Note 10 of the financial statements refers to investments held at fair value of £0.975 million and records that Highlands and Islands Enterprise holds investments (loans and shares) in 33 companies at an original cost of £1.5 million (prior to revaluation) and excludes any interests which are consolidated. Highlands and Islands Enterprise acts as a passive investor and does not exercise control over these companies. As a consequence, they are not consolidated in the group accounts, but carried as investment assets which reflect Highlands and Islands Enterprise's aim to use investment as a tool to drive economic growth.

26. During 2016/17, Highlands and Islands Enterprise wrote off a number of debts including investment write-offs of £0.6 million. The Scottish Government were advised of any write off in excess of £250,000 in accordance with agreed procedures.

Accounts direction: additional disclosure requirements

27. The Accounts Direction (replicated on pages 69 and 70 of the annual report and accounts) requires additional disclosures in relation to investments. This additional information is disclosed at note 10 of the accounts.

Part 2

Financial management



Main judgements

Highlands and Islands Enterprise has effective arrangements in place for financial management. It operated within its Grant in Aid resource limits for 2016/17, underspending by £2 million on the Wave Energy Scotland allocation with the agreement of the Scottish Government. Once this is taken into account, a small underspend (£15,000) was achieved.

Systems of internal control operated effectively during 2016/17.

There was good engagement with the National Fraud Initiative exercise.

Financial performance in 2016/17

28. The main financial objective for Highlands and Islands Enterprise is to ensure that the financial outturn for the year is within the budget allocated by Scottish Ministers.

29. Highlands and Islands Enterprise has reported an outturn of £35.6 million, remaining within its overall resource budget for 2016/17 with an agreed underspend of £2 million (see paragraph 32). The financial performance against the Departmental Expenditure Limits (DEL) and other budget allocations is shown in [Exhibit 4](#).

Exhibit 4

Financial performance in 2016/17

Performance	Initial budget £m	Final budget £m	Actual outturn £m	Agreed overspend/ (underspend) £m
Resource DEL	30.0	37.6	35.6	(2.0)
Capital DEL	26.2	26.2	26.2	-
Total cash DEL	56.2	63.8	61.8	(2.0)
Non-cash DEL	11.0	11.0	1.8	(9.2)
Total DEL	67.2	74.8	63.6	(11.2)
Annually managed expenditure (AME)	7.0	7.0	23.7	16.7
Total allocation	74.2	81.8	87.3	5.5

Source: Highlands and Islands Enterprise Annual Report and Accounts 2016/17: Scottish Government Autumn and Spring Budget Revision letter to Highlands and Islands Enterprise 31 March 2017

30. A number of adjustments were made to the original budget: inclusion of £10 million in respect of funding for Wave Energy Scotland, £0.4 million to fund the green growth action plan, £0.361 million for the strengthening communities programme, and a reduction of £3.2 million, agreed at the start of the year, by the Scottish Government as part of its strategic forum savings.

31. An Annual Managed Expenditure (AME) budget of £7 million was also provided and was overspent by £16.7 million, with the agreement of the Scottish Government, due to the increase in the pension liability. Highlands and Islands Enterprise first received an AME budget in 2011/12 and there was no associated decrease in the non-cash DEL budget provided by the Scottish Government. Highlands and Islands Enterprise therefore reports a significant annual underspend in non-cash DEL. In 2016/17, non-cash DEL was underspent by £9.2 million.

Budget underspend agreed with the Scottish Government

32. During 2016/17 Highlands and Islands Enterprise agreed with the Scottish Government to underspend the ring-fenced Wave Energy Scotland allocation by £2 million. The £2 million underspend above includes this authorised underspend as the budget allocation was not adjusted by the Scottish Government. Once the agreed underspend is taken into account, Highlands and Islands Enterprise underspent its total cash DEL by £15,000.

Internal controls

33. As part of our audit we identify and review the key internal controls in those accounting systems which we regard as significant for the production of the financial statements. Our objective is to gain assurance that Highlands and Islands Enterprise has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

34. Our findings were included in an interim audit report presented to the Risk and Assurance Committee in June 2017. We concluded that the controls were operating effectively and identified one area for further improvement regarding the checks undertaken before supplier bank details are changed. Appropriate action was taken by management in response to this matter.

35. No significant internal control weaknesses were identified during the audit which could affect Highlands and Islands Enterprise's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

Budgetary processes

36. As part of our interim work we assessed the process for preparing budget information and reviewed budget monitoring reports presented to the Board. We concluded that the process and outputs were sufficiently robust to provide effective financial information for management decision-making.

Prevention and detection of fraud and irregularity

37. We assessed Highlands and Islands Enterprise's arrangements for the prevention and detection of fraud. Our review covered the whistleblowing policy, and the counter fraud, bribery and corruption strategy and policy. We concluded that Highlands and Islands Enterprise had appropriate and adequate arrangements in place for fraud detection and prevention during 2016/17.

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

National Fraud Initiative

38. 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 error ([Exhibit 5](#)).

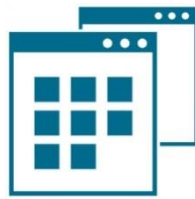
Exhibit 5

Total number of matches



1,223

Number recommended for investigation



74

Completed/closed investigations



175

Source: NFI database

39. We are pleased to note that Highlands and Islands Enterprise completed the self-assessment of NFI and reported this to the January 2017 meeting of the Risk and Assurance Committee. The Committee also considered the 2015/16 national NFI report. No issues were identified for further action.

40. The Business Improvement and Internal Audit section is responsible for reviewing NFI matches. As part of the 2016/17 NFI exercise, 1,223 matches were identified for Highlands and Islands Enterprise, of which 74 were recommended for follow up. All recommended matches have been investigated and concluded. No frauds were identified.

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

41. We reviewed the arrangements in place to maintain standards of conduct including the Staff Code of Conduct and Board members' Code of Conduct. As noted above we also reviewed the whistleblowing policy, and counter fraud, bribery and corruption strategy, policy and response plan. We concluded that appropriate arrangements exist for preventing and detecting any breaches of these standards.

42. Given the nature of its business, Highlands and Islands Enterprise requires all staff and Board members to complete an annual register of interests declaration to highlight any circumstances which may pose the potential for a conflict of interests (and to update as required during the year). We consider that this represents good practice. We concluded that Highland and Islands Enterprise has appropriate arrangements in place for the prevention and detection of bribery and corruption.

Part 3

Financial sustainability



Main judgements

Highlands and Islands Enterprise has a five year financial plan but it has yet to use scenario planning to model the impact of differing funding settlements.

Pension scheme liabilities exceeded assets by £56.3 million as at 31 March 2017. Highlands and Islands Enterprise previously implemented a recovery plan to address the deficit on its pension scheme. Work is currently ongoing to update this plan in order to secure the financial sustainability of the pension fund.

2016/17 financial position

43. The Statement of Financial Position summarises what is owned and owed by Highlands and Islands Enterprise. 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.

44. The financial statements show that Highlands and Islands Enterprise and its group:

- has net liabilities of £12.8 million. This is a decrease of £25.9 million compared to the restated 2015/16 position and is largely attributable to an increase in pension liabilities (£20 million), decrease in property, plant and equipment (£2.7 million), decrease in the cash and cash equivalents (£2.5 million), and a decrease in assets held for sale (£1.4 million)
- the pension schemes are in deficit with liabilities exceeding assets by £56.3 million (2015/16: net liability £36.3 million). The majority of the deficit relates to the Highlands and Islands Enterprise pension scheme (£50.2 million (£31.8 million as at 31 March 2016)). Highlands and Islands Enterprise previously implemented a recovery plan, including lump sum employer contributions and increasing member contribution rate, to address the deficit on its pension scheme. Work is currently ongoing to update this plan in order to secure the financial sustainability of the pension fund.

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

Financial planning

45. The Board approved the 2017/18 budget in April 2017. Highlands and Islands Enterprise has received an initial grant in aid allocation for 2017/18 of £55.7 million, of which £29.5 million relates to resource allocation, and £26.2 million to capital allocation. The budget also anticipates income from other sources of £10.2 million: £5 million from European Funding, £2 million from property disposals and £3.2 million from revenue receipts.

46. A programme of expenditure has been agreed across the business objectives to match the total anticipated income (£65.9 million). This is a reduction of £1.1 million (2%) compared to the amount originally budgeted (net of strategic forum savings agreed with the Scottish Government) for 2016/17. The reduction results mainly from forecast reduction in capital receipts. In addition to its own budget, Highlands and Islands Enterprise also manages budgets for Wave Energy Scotland (£8 million), superfast broadband (£19.3 million) and Community Broadband Scotland (£3 million).

Medium to long term financial planning

47. In last year's Annual Audit Report we recommended that Highlands and Islands Enterprise should develop a long term financial strategy (> 5 years) supported by detailed plans; and that these plans should be based on scenario planning to identify the potential budget impact on future decisions.

48. In response to our recommendation, Highlands and Islands Enterprise has prepared a five year rolling financial plan covering the period 2016/17 to 2020/21. Our review of this plan found that it was detailed in relation to transformational projects. It does not, however, consider alternative scenarios in relation to income and costs and the impact that these might have on its activities and spending in other areas. This limits its use in assessing Highlands and Islands Enterprise's financial sustainability. [Action Plan \(Appendix 1, point 1\)](#)

Part 4

Governance and transparency



Main judgements

Highlands and Islands Enterprise has appropriate arrangements in place to support good governance, accountability and scrutiny.

Highlands and Islands Enterprise Board meetings are not open to the public. Public meetings have been piloted in the past and this experience has been used to develop its approach to regular business and community engagement activity throughout the Highlands and Islands. With increasing public expectations for more openness in the conduct of public business, Highlands and Islands Enterprise needs to keep this area under review and consider whether there is scope to enhance transparency.

The Business Improvement and Internal Audit section operates in accordance with the Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

Governance arrangements

49. As part of the wider review of governance arrangements across the public sector, we completed a follow-up of our 'Role of Boards' national report, published in September 2010. This involved review of documentation, discussions with key officers and attendance at Risk and Assurance Committee meetings.

50. The Highlands and Islands Enterprise Board is well established, with members demonstrating commitment to their roles and responsibilities, continuous improvement and personal development. The arrangements in place also support effective working relationships between the Board and the Leadership Team.

51. We concluded that, overall, Highlands and Islands Enterprise has appropriate arrangements in place that support good governance, accountability and scrutiny.

Scottish Government Review of Enterprise and Skills

52. In May 2016, the First Minister announced a review of Enterprise and Skills with the aim of ensuring that businesses, workforce, training providers, colleges and universities and young people receive joined-up support. Phase One of this review reported in October and recommended:

- the creation of a new Scotland-wide statutory board to co-ordinate the activities of Highlands and Islands Enterprise, Scottish Enterprise (including Scottish Development International [SDI]), Skills Development Scotland and the Scottish Funding Council

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.

- the creation of a new vehicle to meet the enterprise and skills needs of the South of Scotland. This will be accountable to the new Scotland-wide statutory board alongside other enterprise and skills bodies
- a review of the role, position and governance of SDI and its possible establishment as a distinct and separate organisation under the new Scotland-wide statutory board delivering a broader range of international activities and support.

53. Phase Two of the review reported in June 2017 and confirmed:

- the creation of a new enterprise agency to boost growth in the South of Scotland
- the introduction of a Strategic Board to be set up in autumn 2017, guiding overall direction of the enterprise and skills agencies
- better co-ordination of international activity to boost trade and investment in Scotland.

54. An Implementation Board has been set up to develop an outline for the Strategic Plan and a performance framework; establish the cross-cutting priorities for the Strategic Board and, where helpful, establish the Strategic Committees to deliver these priorities. Highlands and Islands Enterprise continues to actively engage with the Review process. We will continue to monitor developments from this Review and consider their implications for Highlands and Islands Enterprise.

The governance statement

55. Under the Treasury's Financial Reporting Manual (FRoM), Highlands and Islands Enterprise must prepare an annual governance statement within the annual report and accounts. Guidance is set out within the Scottish Public Finance Manual (SPFM) for the content of the statement and provides assurances around the achievement of the organisation's strategic objectives.

56. The SPFM does not prescribe a format for the annual governance statement, but sets out minimum requirements for central government bodies. Within Highlands and Islands Enterprise all Leadership Team members and the consolidated subsidiaries are required to provide the Accountable Officer with certificates of assurance together with completion of a detailed internal control checklist. This process also applies to the ICT lead partner.

57. We concluded that the annual governance statement 2016/17 complies with the guidance issued by the Scottish Ministers and, based on our knowledge and work performed, presents a comprehensive picture of governance arrangements and matters.

Internal audit

58. Internal audit provides Highlands and Islands Enterprise and the Accountable Officer with independent assurance on the overall risk management, internal control and corporate governance processes.

59. Highlands and Islands Enterprise has an in-house internal audit function, which is supplemented by a contract with a firm of chartered accountants for the provision of audit services and support for the preparation of the financial statements. As reported in our Annual Audit Plan, we carried out a review of the adequacy of the internal audit function and concluded that it operates in accordance with the Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

60. To avoid duplication of effort we place reliance on the work of internal audit wherever possible. In 2016/17 we were able to place reliance on the Business Improvement and Internal Audit section's work on significant transactions and certificates of assurance/governance statements.

61. As reported in our interim report, we planned to rely on work done by the firm of chartered accountants for our assurances on payroll, accounts payable and accounts receivable. This work was not completed until June and the report was not finalised until August. In order to obtain the assurances necessary for our opinion on the financial statements we undertook additional substantive testing on these areas.

ICT risks

62. Highlands and Islands Enterprise's ICT is managed as part of a shared services arrangement with Scottish Enterprise (SE) and Skills Development Scotland (SDS) called Enterprise Information Systems (EIS). SDS is the lead partner for this EIS arrangement. As Audit Scotland also audits SDS and SE we undertook a high level review of IT arrangements across all three bodies. The draft report has been issued to officers and will be presented to the Risk and Assurance Committee once it is finalised.

63. In our Annual Audit Plan, we noted that a recent internal audit report identified a number of areas where Highlands and Islands Enterprise's ICT arrangements could be improved including clarification of the role of Enterprise Information Systems (EIS), service standards, cyber security, business continuity and disaster recovery arrangements. There is a risk that a cyber attack could disrupt Highlands and Islands Enterprise's systems, including key financial systems.

64. During 2016/17, Scottish Enterprise's internal auditors followed up their review of disaster recovery arrangements for IT services managed by EIS. Their follow up review concluded that progress was being made in respect of its business continuity arrangements. Further progress is required, including the need for a full scenario test.

65. Scottish Enterprise's internal auditors also reported on EIS's arrangements for cyber security in June 2016. They identified a number of areas of good practice and some areas where additional work was required. Work is ongoing within EIS to address the recommendations made in the report.

66. In addition, Highlands and Islands Enterprise's Business Improvement and Internal Audit section have issued two reports on cyber security including one on lessons learnt from the May 2017 cyber attack which impacted the NHS. This paper concluded that, while areas of improvement had been identified, Highlands and Islands Enterprise staff responded very positively to this incident and engaged actively to ensure the organisation was protected, and that they and EIS staff came together quickly to manage the situation.

Risk management

67. As part of our planning work, we reviewed Highlands and Islands Enterprise's risk management arrangements, including a review of the risk management strategy, policy and process. We concluded that appropriate arrangements were in place.

68. Over the last year, the Business Improvement and Internal Audit section have been reviewing Highlands and Islands Enterprise's approach to risk identification and management including:

- reviewing the top corporate risks
- increasing reporting and ensuring clear ownership of risk themes

- redeveloping the resource prioritisation framework
- the Leadership Team championing the use of risk management to support effective decision making and delivery.

69. Regular discussions have taken place with Risk and Assurance Committee members, the Leadership Team and the Board. Given the nature of its business, Highlands and Islands Enterprise recognises the need to clearly articulate its risk appetite. External support will be used to help support the organisation to articulate its appetite to risk and to inform the risk management strategy and processes.

Transparency

70. Transparency means that stakeholders, including the public, have access to understandable, relevant and timely information about how the Board is taking decisions and how it is using public resources. Highlands and Islands Enterprise Board meetings are not open to the public. Board and Risk and Assurance Committee minutes are published on the website but no other papers or minutes are published.

71. The Board piloted open Board meetings and used this experience to refine its approach to Board meetings and business and community engagement. This approach seeks to achieve an appropriate balance between consultation, engagement and transparency, and protecting the confidentiality of investment decisions. The Board operates a regular programme of business and community engagement at locations across the region which is aligned to its annual Board meeting programme. Highlands and Islands Enterprise is currently refreshing its approach to strategic engagement with a view to strengthening this aspect of its role.

72. With increasing public expectations for more openness in the conduct of public business, Highlands and Islands Enterprise needs to keep this area under review and consider whether there is scope to enhance transparency. This could include, for example, reviewing the availability of Board and committee papers and committee minutes.

Part 5

Value for money



Main judgements

Highlands and Islands Enterprise has a well developed performance management framework in place which supports the achievement of value for money.

73. Value for money is a key element of our audit approach. In 2016/17 we did not identify any significant value for money risks during our planning and, therefore, we did not undertake any specific value for money work this year. We will keep this area under review over the five-year audit appointment and will report as appropriate.

Performance management

74. Accountable officers have a specific responsibility to ensure that arrangements have been made to secure Best Value. Highlands and Islands Enterprise developed its CREATIVE vision following consideration of a range of best practice models and guidance. The CREATIVE characteristics are detailed in the Operating Plan 2016-2019 with the aim of embedding best value and continuous improvement within all activities.

75. Highlands and Islands Enterprise's performance framework is derived from the Scottish Government's National Performance Framework. A three-year Operating Plan 2016-19 is in place covering the four main themes which have been established as the main drivers of growth in the Scottish economy: innovation, internationalisation, investment and inclusive growth. This is in line with Scotland's Economic Strategy, published by the Scottish Government in February 2015 and reflects the priorities and actions outlined in the Scottish Government's Programme for Government.

76. There are 7 key measures included in the Operating Plan 2016-19. Progress against these is regularly reported to the Highlands and Islands Enterprise Board and is set out within the 2016/17 annual report and accounts. All of the key measures were achieved in 2016/17. The outturn for a number of these measures significantly exceeded the target range, particularly the increase in turnover by supported businesses and in the social economy. As we reported last year, this indicates a strong performance in year but also an opportunity for the targets to be reviewed to ensure that these remain challenging. We are pleased to note that revised target ranges (and key measures) have been included in the Operating Plan 2017/18.

77. We concluded that Highlands and Islands Enterprise has a well developed, effective performance management framework in place which supports the achievement of value for money and continuous improvement in the way services are delivered.

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

Superfast broadband for Scotland: a progress update

78. In August 2016, we published a follow up to our 2015 national performance audit report '*Superfast broadband for Scotland: a progress report*'. The 2016 report concluded that the Scottish Government and Highlands and Islands Enterprise have made good progress in the roll-out of fibre broadband in Scotland to date. So far, most of the roll-out has been concentrated on easier-to-reach areas. There is a continuing need to monitor carefully the progress and cost of further roll-out once it extends into more difficult areas if the 95 per cent coverage by December 2017 target is to be achieved.

79. Although progress with the contracts is good, many premises across Scotland currently do not get 10 Mb/s. There is still much to be done if the Scottish Government is to achieve its vision of a world-class digital infrastructure. Priority areas for development include:

- the finalisation of clear plans setting out how 100 per cent access to superfast broadband is to be achieved, so that no communities are digitally excluded.
- how best to use digital technologies and build a world-class digital infrastructure fit for the future.
- how best to continue to encourage take-up to ensure the benefits of investment are maximised.
- improved public reporting of progress and performance, to measure the benefits achieved from its investment and to allow benchmarking with other countries.

80. Highlands and Islands Enterprise has reflected on the findings of the report and built on the existing arrangements to ensure the successful delivery of the project. They continue to work closely with the Scottish Government to deliver on the commitment for superfast broadband.

81. Audit Scotland will continue to monitor the progress of the roll-out of fibre broadband. A further audit of the performance of the two contracts and progress towards the world-class vision will be undertaken and reported in 2018.

National performance audit reports

82. We carry out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2016/17, we published a number of reports which are of direct interest to the Board. These are outlined in [Appendix 3](#) accompanying this report.

83. Highlands and Islands Enterprise has processes in place to ensure that all relevant national performance reports are considered by the Risk and Assurance Committee.

Appendix 1

Action plan 2016/17

2016/17 recommendations for improvement



Page
no.

Issue/risk

Recommendation

Agreed management
action/timing

16

1. Medium to long term financial planning

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.

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.

The rolling five-year plan will be further developed to include scenario plans.

Responsible officer:

Director of Finance and Corporate Services

Target date:

31 December 2017

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 to our wider responsibility under the [Code of Audit Practice 2016](#).

Audit Risk	Assurance procedure	Results and conclusions
Risks of material misstatement in the financial statements		
<p>1 Risk of management override of controls</p> <p>ISA 240 requires that audit work includes consideration of 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>Substantive testing of transactions to confirm expenditure and income have been accounted for in the correct financial year.</p> <p>Evaluation of significant transactions that are outside the normal course of business.</p>	<p>We did not identify any issues as a result of our audit work that would indicate management override of controls affecting the year-end position.</p>
<p>2 Risk of fraud over income</p> <p>ISA 240 requires auditors to presume a risk of fraud where income streams, are significant (excluding Scottish Government funding). Highlands and Islands Enterprise receives a significant amount of income (£8.9 million in 2015/16) from third parties. The extent of income means that there is an inherent risk of fraud.</p>	<p>Analytical procedures on income streams.</p> <p>Detailed substantive testing of revenue transactions focusing on the areas of greatest risk.</p>	<p>Our controls testing did not identify any issues with Highlands and Islands Enterprise's revenue recognition procedures.</p> <p>We substantively tested a sample of income transactions. No issues were identified.</p>
<p>3 Risk of fraud over expenditure</p> <p>ISA 240 and the Code of Audit Practice require auditors to consider the risk of fraud over certain types of public sector expenditure. This includes grants and other claims made by individuals and organisations on the public purse. Highlands and Islands Enterprise incurs significant expenditure on grants (£28.2 million in 2015/16).</p>	<p>Controls testing over expenditure systems, with reliance on internal audit.</p> <p>Substantive testing of grant expenditure.</p> <p>Review action taken to review and clear data matches resulting from the National Fraud initiative exercise.</p>	<p>Our controls testing did not identify any issues with expenditure. We also placed reliance on Internal Audit's testing of significant expenditure transactions.</p> <p>Our substantive testing of grant expenditure did not identify any issues.</p> <p>Our work on following-up action taken to investigate and clear data matches did not identify any issues.</p>





















Audit Risk	Assurance procedure	Results and conclusions
	Undertake performance audit work on European funding as part of a national study.	Data for the Audit Scotland's performance audit on European funding was submitted and will be used to identify the potential impact of the withdrawal of this funding across the central government sector in Scotland.
<p>4 Estimation and judgements</p> <p>Non-current assets (land and buildings), pensions and investments are revalued annually at 31 March by third party expert valuers/actuaries.</p> <p>There is an inherent risk due to the extent of assumptions used in the calculations and the impact they can have on the financial statements.</p>	<p>Review the work of an expert for the professional valuers (pensions, investments and properties).</p> <p>Focused substantive testing of year-end balances.</p>	<p>We reviewed the valuations of land and properties, and pensions which were prepared by management's experts. Investments are valued by Highlands and Islands Enterprise's finance staff.</p> <p>We found these judgements to be sound and, as such, were able to place reliance on the experts' valuations.</p>
<p>5 Investment Write-Offs</p> <p>Highlands and Islands Enterprise's funding for investments and projects can result in the write-off of equity, loans or grants when those companies are in financial difficulty.</p> <p>There is a risk that write-offs are not correctly disclosed in the financial statements, or that they have not been approved appropriately.</p>	<p>Substantively test significant write-offs to ensure that</p> <ul style="list-style-type: none"> they have been approved in line with procedures, and they have been disclosed correctly in the financial statements. 	<p>We found that the approval process for write offs had been followed by Highlands and Islands Enterprise.</p> <p>The accounting treatment and disclosures were satisfactory.</p>
<p>Risks identified from the auditor's wider responsibility under the Code of Audit Practice</p>		
<p>6 Financial sustainability and financial management</p> <p>In June 2014, Audit Scotland reported on Scotland's Public Finances and identified that financial planning improvements were required by public bodies.</p> <p>The outcome of the EU referendum led to uncertainty over future European funding, which is a significant source of income for Highlands and Islands Enterprise.</p>	<p>Review progress in developing a medium term financial strategy.</p> <p>Undertake performance audit work on European funding as part of a national study.</p>	<p>See Part 2 and 3 of this report.</p> <p>Data for Audit Scotland's performance audit on European funding was submitted and will be used to identify the potential impact of the withdrawal of this funding across the central government sector in Scotland.</p>

Audit Risk	Assurance procedure	Results and conclusions
<p>7 Governance and Transparency Role of boards</p> <p>In September 2010, Audit Scotland published a report on 'The role of boards'. The report highlighted the need for boards to demonstrate strong leadership and strategic direction.</p> <p>The first phase of Scottish Government's Review of Enterprise & Skills has announced the creation of a new Board to oversee Enterprise Agencies.</p> <p>There is a risk that these changes impact on the Board's ability to fulfil its functions, and provide scrutiny and challenge</p>	<p>Follow up our 2010 'The role of boards' report.</p> <p>Monitor the Scottish Government's Review of Enterprise & Skills (phase 2) and consider the impact on the organisation.</p>	<p>See Part 4 of this report (paragraphs 49 to 51).</p> <p>Phase 2 was published on 22 June 2017. See Part 4 of this report (paragraphs 53 and 54).</p>
<p>8 Register of Interests</p> <p>The Register of Interests published on the website is not being kept up-to date for all Board Members and Directors.</p> <p>There is a risk that members have roles or interests which are not disclosed resulting in a risk to good governance and transparency.</p>	<p>Review the process for completion of the Registers of Interest including review of guidance and assessment of compliance.</p> <p>Compare against the related party disclosures in the 2016/17 financial statements.</p>	<p>See Part 2 of this report (paragraph 42).</p> <p>No issues identified.</p>
<p>9 ICT arrangements</p> <p>A recent internal audit report identified a number of areas where Highlands and Islands Enterprise's ICT arrangements could be improved including clarification of the role of Enterprise Information Systems (EIS), service standards, cyber security, business continuity and disaster recovery arrangements.</p> <p>There is a risk that failure to strengthen ICT arrangements, particularly those relating to business continuity, disaster recovery and cyber security may result in disruption to Highlands and Islands Enterprise's systems, including key financial systems.</p>	<p>Review follow-up work resulting from the recent internal audit report on information systems</p> <p>Review internal audit work on Disaster Recovery and Cyber Security.</p> <p>Liaise with management regarding further audit work, including Your Business @ Risk</p>	<p>See Part 4 of this report (paragraphs 62 to 66).</p> <p>See Part 4 of this report (paragraphs 62 to 66).</p> <p>No further audit work was undertaken in 2016/17. Highlands and Islands Enterprise staff have been liaising with EIS to ensure a joint partnership approach is taken to this exercise.</p>

Appendix 3

Summary of national performance reports 2016/17



Apr			
May		Common Agricultural Policy Futures programme: an update	
Jun		South Ayrshire Council: Best Value audit report	 The National Fraud Initiative in Scotland
Jul		Audit of higher education in Scottish universities	 Supporting Scotland's economic growth
Aug		Maintaining Scotland's roads: a follow-up report	 Superfast broadband for Scotland: a progress update
			 Scotland's colleges 2016
Sept		Social work in Scotland	 Scotland's new financial powers
Oct		Angus Council: Best Value audit report	 NHS in Scotland 2016
Nov		How councils work – Roles and working relationships in councils	 Local government in Scotland: Financial overview 2015/16
Dec		Falkirk Council: Best Value audit report	 East Dunbartonshire Council: Best Value audit report
Jan			
Feb		Scotland's NHS workforce	
Mar		Local government in Scotland: Performance and challenges 2017	 i6: a review
			 Managing new financial powers: an update

The following reports may be of particular interest:

[The National Fraud Initiative in Scotland](#) – June 2016

[Supporting Scotland's economic growth](#) – July 2016

[Superfast broadband for Scotland: a progress update](#) – August 2016

[Scotland's new financial powers](#) – September 2016

[Managing new financial powers: an update](#) – March 2017

Highlands and Islands Enterprise

2016/17 Annual Audit Report

If you require this publication in an alternative format and/or language, please contact us to discuss your needs: 0131 625 1500 or info@audit-scotland.gov.uk

For the latest news, reports and updates, follow us on:



Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 1500 E: info@audit-scotland.gov.uk
www.audit-scotland.gov.uk