

Highlands and Islands Enterprise

2022/23 Annual Audit Report



 AUDIT SCOTLAND

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

October 2023

Contents

Key messages	3
Introduction	5
1. Audit of 2022/23 annual report and accounts	7
2. Financial management	16
3. Financial sustainability	20
4. Vision, leadership and governance	22
5. Use of resources to improve outcomes	26
Appendix 1. Action plan 2022/23	28

Key messages

2022/23 annual report and accounts

- 1 Audit opinions on the annual report and accounts are unmodified.
- 2 As part of our audit, we carried out work on the key risks identified in our Annual Audit Plan. Significant findings and key audit matters from the audit are outlined in [Exhibit 2](#).
- 3 Officers made adjustments of £14.2 million to the annual report and accounts.

Financial management

- 4 Appropriate and effective financial management arrangements are in place with regular budget monitoring reports provided to the Board.
- 5 Highlands and Islands Enterprise reported an overspend of £1.8 million against its revised fiscal budget and an overspend of £7.6 million against its revised total budget. All overspends were reported and authorised by Scottish Government.
- 6 Standards for the prevention and detection of fraud remain appropriate. However, there is scope for enhancing some financial systems of internal control.

Financial sustainability

- 7 Appropriate arrangements are in place to continue to deliver services.
- 8 The 2023/24 opening budget included a budgeted over-commitment of £9.1m on Fiscal Capital, which Highlands and Islands Enterprise anticipate will be eradicated by slippage on projects over the course of the financial year.

Vision, leadership and governance

- 9 Highlands and Islands Enterprise has plans in place to implement its vision, strategy, and priorities.
- 10 Governance arrangements are appropriate, but some improvements can be made.
- 11 Senior management and non-executive directors demonstrate effective leadership, challenge, and scrutiny of the organisation's activity and performance.

- 12** Highlands and Islands Enterprise does not have a climate change strategy or digital strategy in place.

Use of resources to improve outcomes

- 13** Highlands and Islands Enterprise has appropriate arrangements in place for securing best value.
- 14** The majority of the primary outcome measures in the 2022/23 Operating Plan have been successfully delivered.

Introduction

1. This report summarises the findings from the 2022/23 annual audit of Highlands and Islands Enterprise. The scope of the audit was set out in an annual audit plan presented to the March 2023 meeting of the Risk and Assurance Committee. This Annual Audit Report comprises:

- significant matters arising from an audit of Highlands and Islands Enterprise's annual report and accounts
- conclusions on the following wider scope areas that frame public audit as set out in the [Code of Audit Practice 2021](#):
 - Financial Management
 - Financial Sustainability
 - Vision, Leadership, and Governance
 - Use of Resources to Improve Outcomes.

2. This report is addressed to the Risk and Assurance Committee of Highlands and Islands Enterprise and the Auditor General for Scotland and will be published on Audit Scotland's website www.audit-scotland.gov.uk in due course.

Audit appointment from 2022/23

3. I, Pauline Gillen, have been appointed by the Auditor General as auditor of Highlands and Islands Enterprise for the period from 2022/23 until 2026/27. The 2022/23 financial year was the first of my five-year appointment. My appointment coincides with the new [Code of Audit Practice 2021](#) which was introduced for financial years commencing on or after 1 April 2022.

4. My team and I would like to thank Board members, Risk and Assurance Committee members, executive directors, and other staff, for their cooperation and assistance in this year and we look forward to working together constructively over the course of the five-year appointment.

Responsibilities and reporting

5. Highlands and Islands Enterprise has primary responsibility for ensuring the proper financial stewardship of public funds. This includes preparing an annual report and accounts that are in accordance with the account's direction from the Scottish Ministers. Highlands and Islands Enterprise is also responsible for establishing appropriate and effective arrangements for governance, propriety, and regularity.

6. The responsibilities of the independent auditor are established by the Public Finance and Accountability (Scotland) Act 2000 and the [Code of Audit Practice 2021](#), and supplementary guidance and International Standards on Auditing in the UK.

7. Weaknesses or risks identified are only those which have come to our attention during our normal audit work and may not be all that exist. Communicating these does not absolve management of Highlands and Islands Enterprise from its responsibility to address the issues we raise and to maintain adequate systems of control.

8. This report contains an agreed action plan at [Appendix 1](#). It sets out specific recommendations, the responsible officers, and dates for implementation.

Auditor Independence

9. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services. We are not aware of any relationships that could compromise our objectivity and independence.

10. The Annual Audit Plan set out an audit fee of £188,180 for the 2022/23 audit. However, a rebate of £8,523 was issued, relating to previous years' audit fees, resulting in a final audit fee of £179,657.

11. We add value to Highlands and Islands Enterprise by:

- identifying and providing insight on significant risks, and making clear and relevant recommendations
- providing clear and focused conclusions on the appropriateness, effectiveness and impact of corporate governance, arrangements to ensure the best use of resources and financial sustainability.
- sharing intelligence and good practice identified.

1. Audit of 2022/23 annual report and accounts

Public bodies are required to prepare annual reports and accounts comprising financial statements and other related reports. These are principal means of accounting for the stewardship public funds.

Main judgements

Audit opinions on the annual report and accounts are unmodified.

As part of our audit, we carried out work on the key risks identified in our Annual Audit Plan. Significant findings and key audit matters from the audit are outlined in [Exhibit 2](#).

Officers made adjustments of £14.2 million to the annual report and accounts.

Audit opinions on the annual report and accounts are unmodified

12. The Risk and Assurance Committee approved the annual report and accounts for Highlands and Islands Enterprise and its group for the year ended 31 March 2023 on 3 October 2023. As reported in the independent auditor's report, in my opinion as the appointed auditor:

- the financial statements give a true and fair view and were properly prepared in accordance with the financial reporting framework,
- expenditure and income were in accordance with applicable enactments and guidance,
- the audited part of the Remuneration and Staff Report was prepared in accordance with the financial reporting framework, and
- the Performance Report and Governance Statement were consistent with the financial statements and properly prepared in accordance with the relevant legislation and directions made by Scottish Ministers.

The unaudited annual audit report and accounts and working papers were received in line with the agreed audit timetable

13. In line with the timetable set out in our Annual Audit Plan, we received the annual report and accounts and working papers in line with the agreed audit timetable. We received good support from management and the wider finance

team which enabled us to complete the audit in accordance with the agreed timetable.

Overall materiality was assessed as £1.6 million

14. Broadly, the concept of materiality is applied by auditors to determine whether misstatements identified during the audit could reasonably be expected to influence the economic decisions of users of the financial statements, and hence impact their opinion set out in the independent auditor's report. Auditors set a monetary threshold when considering materiality, although some issues may be considered material by their nature. It is ultimately a matter of the auditor's professional judgement.

15. Our initial assessment of materiality was carried out during the risk assessment and planning phase of the audit. This was reviewed and revised on receipt of the unaudited annual report and accounts and is summarised in [Exhibit 1](#).

Exhibit 1 Materiality values

Materiality level	Single Entity	Group
Overall materiality	£1.6 million	£1.7 million
Performance materiality	£ 0.8 million	£0.9 million
Reporting threshold	£80,000	£85,000

16. The overall materiality threshold was set with reference to gross expenditure, which we judged as the figure most relevant to the users of the financial statements.

17. Performance materiality is used by auditors when undertaking work on individual areas of the financial statements. It is a lower materiality threshold, set to reduce the probability of aggregated misstatements exceeding overall materiality. Performance materiality was set at 50% of overall materiality, reflecting a history of errors in prior years.

18. It is our responsibility to request that all misstatements, other than those below our reporting threshold, are corrected, although the final decision on making the correction lies with those charged with governance.

Significant findings and key audit matters

19. Under International Standard on Auditing (UK) 260 we communicate significant findings from the audit to the Risk and Assurance Committee, including our view about the qualitative aspects of the body's accounting practices.

20. The Code of Audit Practice 2021 also requires all audits to communicate key audit matters within the annual audit report under International Standard on Auditing (UK) 701. These are matters that we judged to be of most significance in our audit of the financial statements.

21. The significant findings are summarised in [Exhibit 2](#).

Exhibit 2

Significant findings and key audit matters from the audit of the annual report and accounts

Issue	Resolution
<p>1. Recognition of Pension Asset</p> <p>Highlands and Islands Enterprise operate two pension schemes being the Highlands and Islands Enterprise Superannuation Scheme and the Local Government Pension Scheme (LGPS).</p> <p>2022/23 represented the first year that the LGPS had recognised a net pension asset. Proper accounting practice, as outlined in International Accounting Standard (IAS) 19 and International Financial Reporting Interpretations Committee (IFRIC) 14 states that the pension asset should be recognised at the lower of the surplus or the pension asset ceiling.</p> <p>Highlands and Islands Enterprise recognised an asset of £5.0 million in their unaudited accounts. Following receipt of further information from the actuary, the pension asset ceiling had been calculated as “nil” as the cost of future employer contributions exceeded the cost of any future savings. Therefore, the overall net pension liability in the unaudited accounts had been understated by £5.0 million.</p> <p>The impact of this is to increase the actuarial (gains)/losses recognised in retirement benefit scheme and asset ceiling on the Statement of Comprehensive Net Expenditure by £5.0 million and increase the retirement benefit obligation on the Statement of Financial Position by £5.0 million.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p> <p>This was judged to be a key audit matter.</p>
<p>2. Accounting Treatment of Pension Asset Ceiling Applied</p> <p>As outlined for significant finding 1, the unaudited annual report and accounts were adjusted by £5.0 million to restrict the pension asset ceiling as required by IAS 19 and IFRIC 14. The total</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p> <p>This was judged to be a key audit matter.</p>

Issue	Resolution
<p>restriction to the asset ceiling was £6.0 million, with an adjustment of £1.0 million having already been processed in the unaudited annual report and accounts. However, this had been processed incorrectly directly through reserves in the Statement of Changes in Taxpayers' Equity.</p> <p>The impact of this is to increase the actuarial (gains)/losses recognised in retirement benefit scheme and asset ceiling on the Statement of Comprehensive Net Expenditure by £1.0 million and decrease the restriction of surplus in the Statement of Changes in Taxpayers Equity by £1.0 million. This has no impact on the net position.</p>	
<p>3. IFRS 16 Leases</p> <p>International Financial Reporting Standard (IFRS) 16 – Leases was effective from 1 April 2022 and has been adopted for the first time in the 2022/23 financial statements. However, a long-term lease was not included in the unaudited annual report and accounts in line with the requirements of IFRS 16.</p> <p>The impact of this is to increase property, plant equipment by £0.3 million, increase lease liabilities by £0.5 million and increase the revaluation reserve by £0.2 million on the Statement of Financial Position.</p>	<p>Management have adjusted for this in the audited annual report and accounts</p>
<p>4. Accounting Treatment of Revaluations for Property and Specialised Assets</p> <p>The unaudited annual report and accounts reported a gain of £0.7 million on the revaluation of specialised assets, which form part of the property, plant, and equipment balance. Highlands and Islands Enterprise calculates gains or losses on the revaluation of property, plant, and equipment as the difference between gross book value at each valuation date. This approach does not consider the impact of accumulated depreciation on the gains or losses and therefore results in the gains or losses calculated to be misstated. This also results in misstatements to the opening revaluation reserve balance as this is an accumulation of revaluation gains from previous years.</p> <p>The impact of this is to increase gains on revaluation of property, plant, and equipment by</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p> <p>Recommendation 1 (Refer Appendix 1, action plan)</p> <p>This was judged to be a key audit matter.</p>

Issue	Resolution
<p>£0.7 million and decrease depreciation and amortisation by £0.02 million in the Statement of Comprehensive Net Expenditure. The net impact of this is to increase the revaluation reserve in the Statement of Financial Position by £0.7 million.</p>	
<p>5. Negative Depreciation</p> <p>The unaudited annual report and accounts reported a negative depreciation charge of £0.2 million for plant and equipment, which forms part of the property, plant, and equipment balance. The negative charge was a result of incorrectly offsetting gains on revaluation of plant and equipment of £0.6 million against depreciation of plant and equipment of £0.4 million.</p> <p>The impact of this is to increase depreciation and amortisation and gains on revaluation of property, plant, and equipment in the Statement of Comprehensive Net Expenditure by £0.6 million. This has no impact on the net position.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p> <p>Recommendation 1 (Refer Appendix 1, action plan)</p> <p>This was judged to be a key audit matter.</p>
<p>6. Accounting Treatment of Dilapidations</p> <p>Highlands and Islands Enterprise have several leases in place for which they are the lessee. These leases contain conditions associated with the cost of dilapidations. However, the unaudited annual report and accounts did not include any provision for dilapidations equating to £0.7 million.</p> <p>The impact of this is to increase provisions in the Statement of Financial Position and other management expenditure in the Statement of Comprehensive Net Expenditure by £0.7 million.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p>
<p>7. Recognition of Third-Party Balance</p> <p>As at 31 March 2023, Highlands and Islands Enterprise recognised £0.7 million as cash and cash equivalents in their single entity accounts. This should have been removed and accounted for as a third-party balance held on behalf of a subsidiary.</p> <p>The impact of this is to decrease both cash and cash equivalents and trade payables on the Statement of Financial Position by £0.7 million. This has no impact on the net position.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p>

Issue	Resolution
<p>8. Non-Compliance with the Government Financial Reporting Manual (FReM)</p> <p>Two instances of non-compliance with the FReM were identified with the Performance Report.</p> <p>For example, the Performance Overview did not include a short summary explaining the purpose of the overview section.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p> <p>Recommendation 2</p> <p>(Refer Appendix 1, action plan)</p>
<p>9. Classification Error in Trade Receivables and Trade Payables</p> <p>The unaudited annual report and accounts provided to audit included a balance of £0.5 million for intercompany debtors within trade receivables. This should have been classified as owed to subsidiary undertakings.</p> <p>The impact of this is to decrease trade receivables and increase owed to subsidiary undertakings by £0.5 million in Note 17 of the annual report and accounts.</p> <p>The unaudited annual report and accounts provided to audit included a balance of £0.1 million for balances with similar public bodies within trade payables. This should have been £0.2 million.</p> <p>The impact of this is to increase balances with similar public bodies and decrease balances with bodies external to the government by £0.1 million in Note 20 of the annual report and accounts.</p> <p>Both of these adjustments have no impact on the net position and were due to issues with the formula used to derive the balances.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p>
<p>10. Classification Error in Statement of Changes in Taxpayers Equity (Group)</p> <p>The unaudited annual report and accounts incorrectly classified the balance for transfers between reserves. This was classified as the actuarial gain in the retirement benefit scheme when it should have been classified as transfers between reserves.</p> <p>The impact of this is to overstate the actuarial gain in retirement benefit scheme and understate transfers between reserves by £4.4. million in the Statement of Changes in Taxpayers Equity for the Group. This has no impact on the net position.</p>	<p>Management have adjusted for this in the audited annual report and accounts.</p>

Our audit work responded to the risks of material misstatement we identified in the annual report and accounts

22. We have obtained audit assurances over the identified significant risks of material misstatement in the annual report and accounts. [Exhibit 3](#) sets out the significant risks of material misstatement to the financial statements we identified in our 2022/23 Annual Audit Plan. It also summarises the further audit procedures we performed during the year to obtain assurances over these risks and the conclusions from the work completed.

Exhibit 3

Significant risks of material misstatement in the annual report and accounts

Audit risk	Assurance procedure	Results and conclusions
<p>1. Risk of material misstatement due to fraud caused by management override of controls.</p> <p>As stated in International Standard on Auditing (UK) 240, management is in a unique position to perpetrate fraud because of management's ability to override controls that otherwise appear to be operating effectively.</p>	<p>Assessed the design and implementation of controls over journal entry processing.</p> <p>Made inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.</p> <p>Tested journals at the year-end and post-closing entries and focus on significant risk areas.</p> <p>Considered the need to test journal entries and other adjustments during the period.</p> <p>Evaluated significant transactions outside the normal course of business.</p> <p>Assessed the adequacy of controls in place for identifying and disclosing related party relationship and transactions in the financial statements.</p> <p>Assessed any changes to the methods and underlying assumptions used to prepare accounting estimates compared to the prior year.</p>	<p>Results: Work undertaken included detailed testing of journal entries, accruals, prepayments and invoices; as well as review of accounting estimates and transactions for appropriateness. Specific enquiries were made of individual staff as to whether they had knowledge or awareness of manipulation of financial recording or processing of fraudulent journals.</p> <p>Conclusion: No incidents of management override of controls were identified.</p>

Audit risk	Assurance procedure	Results and conclusions
	<p>Substantive testing of income and expenditure transactions around the year-end to confirm they are accounted for in the correct financial year.</p> <p>Focussed testing of accounting accruals and prepayments.</p>	

23. In addition, we identified “areas of audit focus” in our 2022/23 Annual Audit Plan where we considered there to be risks of material misstatement to the financial statements. These areas of specific audit focus were:

- Estimations in valuation of land and buildings:** we assessed the design and implementation of controls over the valuation of land and buildings. We carried out ‘reliance on a management expert’ work on the valuer and concluded that we could place reliance on their valuation report for the property portfolio. We reviewed the revaluation adjustments throughout the financial statements and identified a number of significant findings as outlined in [Exhibit 2](#).
- Estimations in valuation of pension assets and liabilities:** we assessed the design and implementation of controls over the valuation of pensions. We carried out ‘reliance on a management expert’ work on the actuary. Based on the findings of the audit procedures performed we concluded that we could place reliance on the actuary’s valuation of the pension asset. We reviewed the pension adjustments throughout the financial statements and identified a number of significant findings as outlined in [Exhibit 2](#).

Officers made adjustments of £14.2 million to the annual report and accounts

24. It is our responsibility to request that all misstatements, other than those below our reporting threshold, are corrected, although the final decision on making correction lies with those charged with governance. There are no unadjusted misstatements to report.

25. Adjustments to the annual report and accounts totalled £14.2 million. This includes the adjustments set out in [Exhibit 2](#). Adjustments made in the audited annual report and accounts increased total comprehensive net expenditure in the Statement of Comprehensive Net Expenditure by £6.8 million and decreased net assets in the Statement of Financial Position by £5.9 million.

26. We have reviewed the nature and cause of these adjustments and have concluded that they arose from issues that have been isolated and identified in their entirety and do not indicate further systemic error.

Progress was made on prior year recommendations

27. Highlands and Islands Enterprise has made progress in implementing the audit recommendations identified in the prior year Annual Audit Report. For actions not yet implemented, revised responses and timescales have been agreed with management, and are set out in [Appendix 1](#).

2. Financial management

Financial management means having sound budgetary processes, and the ability to understand the financial environment and whether internal controls are operating effectively.

Conclusion

Appropriate and effective financial management arrangements are in place with regular budget monitoring reports provided to the Board.

Highlands and Islands Enterprise reported an overspend of £1.8 million against its revised fiscal budget and an overspend of £7.6 million against its revised total budget. All overspends were reported and authorised by Scottish Government.

Standards for the prevention and detection of fraud remain appropriate. However, there is scope for enhancing some financial systems of internal control.

Appropriate and effective financial management arrangements are in place with regular budget monitoring reports provided to the Board

28. Senior management and Board members receive regular and accurate financial information on Highlands and Islands Enterprise's performance against budgets. These reports allow officers and members to scrutinise financial performance effectively throughout the year.

Highlands and Islands Enterprise reported an overspend of £1.8 million against its revised fiscal budget for 2022/23. All overspends were reported and authorised by Scottish Government

29. 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, which can include any agreed overspends.

30. Highlands and Islands Enterprise has reported an outturn of £79.5 million against its overall fiscal budget of £77.7 million for 2022/23, resulting in an overspend of £1.8 million. The financial performance against fiscal resources is shown in [Exhibit 4](#).

Exhibit 4

Performance against fiscal resource in 2022/23

Performance	Initial budget £m	Final budget £m	Outturn £m	Over / (under) spend £m
Fiscal Resource	29.6	28.4	30.2	1.8
Fiscal Capital	30.0	48.3	48.0	(0.3)
Financial Transactions	2.6	1.0	1.3	0.3
Total	62.2	77.7	79.5	1.8

Source: Highlands & Islands Enterprise – 2022/23 Annual Report and Accounts

31. The overspends in [Exhibit 4](#) were in main due to:

- £1.8 million overspend primarily relates to costs associated with the Cairngorm Mountain Scotland Limited subsidiary which was not included in Highlands and Islands Enterprise budget allocation for 2022/23.
- £0.3 million overspend for Financial Transactions was due to a new loan opportunity arising post spring budget review to support an organisation.
- £0.3 million underspend for capital expenditure due to lower-than-expected expenditure within the Wave Energy Scotland subsidiary.

32. In addition to the fiscal resources outlined in [Exhibit 4](#), Highlands and Islands Enterprise receives allocations from the Scottish Government for non-cash costs (e.g. depreciation) and annually management expenditure (AME) (e.g. movements in provisions). There was an overspend of £0.2 million against the non-cash allocation and an overspend of £5.6 million against the AME allocation. Including the fiscal resource allocation overspend of £1.8 million, Highlands and Islands Enterprise overspent by £7.6 million against its budget allocations. The overspends were all agreed and authorised by the Scottish Government.

Budget processes were appropriate

33. Highlands and Islands Enterprise's budget was increased as part of the Autumn and Spring budget revisions. The most significant revisions over the course of the year included:

- An additional Fiscal Capital allocation of £18.3 million to cover expenditure incurred on various capital projects (e.g. the Cairngorm Funicular, Space Hub Sutherland, and Wave Energy Scotland).
- A reduction in the Financial Transactions allocation of £1.6 million to reflect a lack of demand during the year.

- A reduction in the Fiscal Resource allocation of £1.2 million to reflect IFRS 16 adjustments and the return of budget savings.

Net liabilities decreased by £14.4 million

34. Highlands and Islands Enterprise's net liabilities decreased by £14.4 million from £15.5 million in 2021/22 to £1.1 million in 2022/23. While the overall movement is a decrease in net liabilities, there have been significant upward and downward movements in assets and liabilities on the Statement of Financial Position. The most significant movements are:

- recognition of right of use assets of £10.9 million, finance lease receivables of £4.2 million, and finance lease liabilities of £15.2 million due to the implementation of IFRS 16, and
- a £6.7 million decrease in the retirement benefit obligation, mainly due to changes in actuarial assumptions as a result of changes in market conditions affecting yield and inflation rates.

35. Highlands and Islands Enterprise continues to be in a net liability position as at 31 March 2023. We considered this position as part of our work on the use of the going concern assumption to prepare the annual report and accounts and concluded that there were no issues with using the going concern assumption for their preparation. We also concluded there were no material uncertainties in the use of the going concern assumption to prepare the annual report and accounts.

There is scope for enhancing some financial systems of internal control

36. From our review of the design and implementation of systems of internal control (including those relating to IT) relevant to our audit approach, we noted the following areas where there is scope for improvement to the operation of certain internal controls:

- Fixed asset register (FAR) – Highlands and Islands Enterprise maintains its FAR on Excel workbooks. Management have advised that a review process is in place for any updates made to the workbook. However, these reviews are not formally evidenced.
- Impairment of non-current assets – management have informed that the processes around the impairment of non-current assets involves discussions between various teams / business groups. However, there is no formal policy or procedures in place around the process and how any decisions or judgements as a result of the discussions are documented.
- Authorisation of journal entries – our substantive testing of journal entries identified two instances where journals were processed and authorised by the same individual. Highlands and Islands Enterprise's process for journal entries requires these to be processed and authorised by separate individuals. Therefore, these journals were not in line with Highlands and Islands Enterprise's policy. These journals were the only instances of the same individual processing and authorising a journal in the year. As we reviewed these and concluded that there was no evidence of management override of controls with these journals, this issue did not impact on our audit approach.

Recommendation 3

Highlands and Islands Enterprise should implement improvements to address the internal control weaknesses identified.

Standards of conduct and arrangements for the prevention and detection of fraud and error are appropriate

37. Public sector bodies are responsible for implementing effective systems of internal control, including internal audit, which safeguard public assets and prevent and detect fraud, error and irregularities, bribery, and corruption.

38. We concluded that Highlands and Islands Enterprise has appropriate arrangements for the prevention and detection of fraud, error, and irregularities. We also reviewed arrangements to maintain standards of conduct, including the Board and staff code of conduct and register of interests. We concluded that Highlands and Islands Enterprise has established procedures for preventing and detecting any breaches of these standards.

National Fraud Initiative

39. The National Fraud Initiative (NFI) is a counter-fraud exercise across the UK public sector which aims to prevent and detect fraud. NFI data matches were issued to Highlands and Islands Enterprise in January 2023 as part of the NFI exercise for 2022/23. Highlands and Islands Enterprise have investigated and cleared all high risk matches and a sample of other matches that were identified through the NFI exercise prior to the deadline of 30 September 2023.

3. Financial sustainability

Financial Sustainability means being able to meet the needs of the present without compromising the ability of future generations to meet their own needs.

Conclusion

Appropriate arrangements are in place to continue to deliver services.

The 2023/24 opening budget included a budgeted over-commitment of £9.1m on Fiscal Capital, which Highlands and Islands Enterprise anticipate will be eradicated by slippage on projects over the course of the financial year.

Highlands and Islands Enterprise has a medium-term financial strategy in place

40. The Board considered Highlands and Islands Enterprise's draft *Financial Strategy 2023/24 – 2027/28* in June 2023. The purpose of the strategy is to maximise spend in the Highlands and Islands, whilst ensuring a balanced budget for each financial year. The strategy sets out the expected financial environment over the five-year period and this includes the resources that Highlands and Islands Enterprise is expected to have to deliver its priorities and the pressures that could impact on expected resources.

41. The strategy outlines funding from the Scottish Government is the most important variable for Highlands and Islands Enterprise's financial position as this underpins around 90% of the Fiscal Revenue, Fiscal Capital, and Financial Transactions budgets.

42. The strategy outlines a potential reduction in the Fiscal Revenue budget each year with the level of funding in 2026/27 to be 15.8% less than the 2022/23 baseline. The strategy outlines that if no action is taken and business as usual costs continue as they have, there could be a budget shortfall of £5.6 million in 2024/25, rising to £7.3 million in 2027/28 which will require action to address.

43. Scenario planning for the Fiscal Capital and Financial Transactions budgets highlights there will be no opportunity for new investment if these allocations are held at a flat cash basis in future years, and this position also requires considerable slippage between years to achieve a breakeven position.

44. Highlands and Islands Enterprise is operating in a challenging financial environment that will impact on resources over the medium and longer-term. In order to address these challenges, actions will have to be taken. The strategy outlines Highlands and Islands Enterprise has established two working groups to scrutinise and challenge costs in order to manage the pressures going forward.

45. Despite the challenging financial environment Highlands and Islands Enterprise is operating in, we have noted that senior management and Board members consider the medium to longer-term horizons as part of their strategic and operational decision making and this is also reflected in corporate plans and strategies. As a result, we are satisfied that there is effective medium to longer-term planning.

The 2023/24 opening budget included a budgeted over-commitment of £9.1m on Fiscal Capital, which Highlands and Islands Enterprise anticipate will be eradicated by slippage on projects over the course of the financial year

46. Highlands and Islands Enterprise's initial budget allocation from the Scottish Government for 2023/24 was £29.9 million for the Fiscal Resource allocation, £28.4 million for the Fiscal Capital allocation, and £1.9 million for the Financial Transactions allocation. The allocations can change over the course of the year as part of the Autumn and Spring budget revisions.

47. Highlands and Islands Enterprise's 2023/24 budget outlines a balanced position for the Fiscal Resource budget. This position is based on anticipated expenditure £33.2 million being offset against income of £33.2 million which comprises the initial budget allocation from the Scottish Government of £29.9 million, in-year additions of £0.7 million, and receipts of £2.6 million from various sources.

48. The 2023/24 opening budget included a budgeted over-commitment of £9.1m on Fiscal Capital, which Highlands and Islands Enterprise anticipate will be eradicated by slippage on projects over the course of the financial year. This position is based on anticipated expenditure of £44.3 million being offset against income of £35.2 million which comprises the initial allocation from the Scottish Government of £28.4 million, in-year additions of £3.2 million, and receipts of £3.6 million from various sources.

49. The 2023/24 budget outlines a balanced position for the Financial Transactions budget, and this is based on income and anticipated expenditure of £1.9 million.

4. Vision, leadership and governance

Public sector bodies must have a clear vision and strategy and set priorities for improvement within this vision and strategy. They work together with partners and communities to improve outcomes and foster a culture of innovation.

Conclusion

Highlands and Islands Enterprise has plans in place to implement its vision, strategy, and priorities.

Governance arrangements are appropriate, but some improvements can be made.

Senior management and non-executive directors demonstrate effective leadership, challenge, and scrutiny of the organisation's activity and performance.

Highlands and Islands Enterprise does not have a climate change strategy or digital strategy in place.

Highlands and Islands Enterprise has plans in place to implement its vision, strategy, and priorities

50. Highlands and Islands Enterprise launched its five-year strategy, *Highlands and Islands Enterprise Strategy 2023-28*, in August 2023. The vision outlined in the strategy is "The Highlands and Islands is a leading net zero region with a dynamic wellbeing economy, which benefits its growing population and makes a valued contribution to Scotland." The strategy is guided by national policy, principally the National Strategy for Economic Transformation (NSET) and sets out a strategic framework to deliver the strategy that aligns to NSET and the key outcomes that Highlands and Islands Enterprise will look to achieve through delivery of the strategy.

51. The strategy is supported by the annual operating plan which outlines the actions for each year that will allow the outcomes of the strategy to be met. The annual operating plan is updated each year and will reflect developments against the vision and outcomes in the strategy.

Governance arrangements are appropriate, but some improvements can be made

52. Highlands and Islands Enterprise's governance arrangements have been set out in the Governance Statement in the annual report and accounts. We have reviewed these arrangements and concluded that they are appropriate and support robust scrutiny and challenge of decision-making processes.

53. There is scope to enhance the process in place for providing annual assurances to the Accountable Officer. This process is led by the internal audit team and involves developing and implementing a tailored approach to obtain the required assurances and reflecting the outcome of this exercise in the Governance Statement. The internal audit team work to tight deadlines and this has resulted in several checklists and assurance statements provided for audit being incomplete. During the financial statements audit, this was subject to further follow-up by internal audit with all required assurances provided.

Recommendation 4

Highlands and Islands Enterprise should review the process in place for providing assurances to the Accountable Officer and ensure all checklists and certificates of assurance are fully complete.

54. Openness and transparency in how a body operates and makes decisions is key to supporting understanding and scrutiny. Transparency means that the public have access to understandable, relevant, and timely information about how the board is taking decisions and how it is using resources. Highlands and Islands Enterprise's website is clear and well structured. Board minutes are available to the public along with key publications including latest the annual report and accounts. We concluded that the Board conducts its business in an open and transparent manner.

Senior management and non-executive directors demonstrate effective leadership, challenge, and scrutiny of the organisation's activity and performance

55. The Chief Executive and senior leadership team are responsible for the delivery of critical day-to-day services as well as leading the changes to how services are accessed and delivered within Highlands and Islands Enterprise.

56. We have concluded that Highlands and Islands Enterprise's senior management and non-executive directors have demonstrated effective leadership and scrutiny of operational activity and performance in 2022/23. Going forward, senior management and non-executive directors will have some challenging decisions to make with regard to how services are best delivered in the current financial climate.

Climate change arrangements could be enhanced

57. Our 2022/23 Annual Audit Plan highlighted that tackling climate change is one of the great global challenges. The Scottish Parliament has set a legally binding target of becoming net zero by 2045 and has interim targets including a 75% reduction in greenhouse gas emissions by 2030. The public sector in Scotland has a key role to play in ensuring these targets are met and in adapting to the impacts of climate change.

58. *Highlands and Islands Enterprise Strategy 2023-28* emphasises the importance of climate change and seeks to embed Net Zero as a cross-cutting theme in the delivery of its vision for the economy. We note the importance placed on Net Zero internally with the establishment of a Net Zero Transition Group which takes a leadership role across the organisation. However, there is currently no separate, detailed strategy in place around climate change. Highlands and Islands Enterprise are also without up-to-date baselines for its carbon footprint as these are currently in the process of being developed.

Recommendation 5

Highlands and Islands Enterprise should work to prepare a climate change strategy and finalise up-to-date baselines for its carbon footprint.

59. The Auditor General and Accounts Commission are developing a programme of work on climate change. This involves a blend of climate change-specific outputs that focus on key issues and challenges as well as moving towards integrating climate change considerations into all aspects of audit work.

Cyber security arrangements could be improved

60. There continues to be a significant risk of cyber-attacks to public bodies, and it is important that they have appropriate cyber security arrangements in place. A number of recent incidents have demonstrated the significant impact that a cyber-attack can have on both the finances and operation of an organisation. In 2022/23, we considered Highlands and Islands Enterprise's arrangements for managing and mitigating cyber security risks.

61. The Risk and Assurance Committee receives regular updates on cyber security, the most recent delivered to the meeting in October 2023. In addition, cyber security has been identified in the corporate risk register, with a separate risk register for cyber security and systems implemented during 2022/23.

62. Highlands and Islands Enterprise achieved re-certification for Cyber Essentials Plus accreditation in September 2023.

63. Resource issues have delayed work to formalise IT related strategies. A recommendation was made in the 2021/22 Annual Audit Report around work Highlands and Islands Enterprise could do to improve its governance of cyber security arrangements ([Appendix 1](#), b/f 4).

64. Work carried out during the 2022/23 audit on cyber security and IT related arrangements identified that a formal digital strategy had not yet been

developed. Highlands and Islands Enterprise has carried out work during the financial year to develop a digital strategy, but this has yet to be formalised and approved by senior management and the Board.

65. It was also identified that Highlands and Islands Enterprise's business continuity planning arrangements were being revised. However, this work is not yet complete. Resourcing issues were cited as the reasons for delays in the development of these strategies and arrangements. [Appendix 1](#), b/f 4 has been updated to reflect the developments identified over the year.

66. Highlands and Islands Enterprise is part of the shared Enterprise Information Service (EIS) alongside Scottish Enterprise, South of Scotland Enterprise, and Skills Development Scotland. EIS manages a number of IT systems and services centrally that are used by all member organisations. Highlands and Islands Enterprise also use IT systems and services that are not part of EIS and are managed internally.

67. There is formal security, patching, backup, and restore from back up arrangements in place for both the EIS provided systems and services and Highlands and Islands Enterprise's own internal systems and services. However, through discussion with management, it was identified that back up files for EIS managed systems and services were not subject to regular testing during the year.

Recommendation 6

Management should perform regular testing of data back-up files to ensure that they can be regenerated without loss and that an up-to-date statement of assurance is obtained from EIS to evidence this.

5. Use of resources to improve outcomes

Public sector bodies need to make best use of their resources to meet stated outcomes and improvement objectives, through effective planning and working with strategic partners and communities.

Conclusions

Highlands and Islands Enterprise has appropriate arrangements in place for securing best value.

The majority of the primary outcome measures in the 2022/23 Operating Plan have been successfully delivered.

Highlands and Islands Enterprise has developed an appropriate Best Value framework

68. [Ministerial guidance to Accountable Officers](#) for public bodies and the [Scottish Public Finance Manual](#) (SPFM) sets out the Accountable Officer's duty to ensure that arrangements are in place to secure best value. The guidance sets out the key characteristics of best value and states that compliance with the duty of best value requires public bodies to take a systematic approach to self-evaluation and continuous improvement.

69. We consider whether Accountable Officers have put in place appropriate arrangements to satisfy their corresponding duty of best value. We may also, in conjunction with Highlands and Islands Enterprise, agree to undertake local work in this area. We did not undertake any specific work in 2022/23 but concluded that appropriate arrangements were in place for securing best value based on the outcome of our other audit work.

The majority of primary measures in the 2022/23 Operating plan have been successfully delivered

70. Highlands and Islands Enterprise monitored key performance indicators throughout the year with performance reported to the Board on a regular basis.

71. The 2022/23 Operating Plan outlined 12 primary outcome measures covering a range of areas. Outturn against the primary outcome measures was reported in the Performance Report in the annual report and accounts. Of the 12 primary outcome measures, 11 surpassed the target range with only one narrowly failing to achieve the target range.

72. Senior management and the Board should continue to review the primary outcome measure targets set each year to ensure they are challenging but achievable.

Appendix 1. Action plan 2022/23

2022/23 recommendations

Issue/risk	Recommendation	Agreed management action/timing
<p>1. Capital Accounting</p> <p>Our work on capital accounting identified significant issues with the accounting treatments applied and the clarity of working papers used to prepare the annual report and accounts.</p> <p>Risk – there is a risk that the annual report and accounts do not comply with accounting standards and accounting policies. Significant audit input is required to ensure the accounts are not materially misstated resulting in additional audit fees.</p>	<p>Highlands and Islands Enterprise finance staff should improve their understanding of capital accounting, including accounting for revaluations. Working papers used to prepare the annual report and accounts should be reviewed and overhauled to allow a clearer and more straightforward method of identifying how the annual report and accounts have been prepared.</p> <p>Exhibit 2</p>	<p>Agreed</p> <p>Responsible officer – Head of Financial Services</p> <p>Agreed date – 31 March 2024</p>
<p>2. Non-compliance with the FReM</p> <p>Two instances of non-compliance with the FReM were identified with the Performance Report.</p> <p>Risk – the Performance Report does not fully comply with the FReM.</p>	<p>Management should complete the disclosure checklists prepared by the National Audit Office (NAO) and review Audit Scotland’s good practice note on improving the quality of central government annual report and accounts when preparing their 2023/24 annual report and accounts.</p> <p>Exhibit 2</p>	<p>Highlands and Islands Enterprise will update its process in line with NAO and Audit Scotland’s good practice note.</p> <p>Responsible officer – Head of Financial Services</p> <p>Agreed date – 31 March 2024</p>
<p>3. Internal Controls</p> <p>We noted a number of areas where there is scope for</p>	<p>Highlands and Islands Enterprise should implement improvements to address the</p>	<p>We will implement revised procedures to ensure internal</p>

Issue/risk	Recommendation	Agreed management action/timing
<p>improvement to the operation of certain internal controls.</p> <p>Risk – there is a risk that internal controls do not operate effectively.</p>	<p>internal control weaknesses identified.</p> <p>Paragraph 36</p>	<p>control actions are clearly evidenced.</p> <p>Responsible officer – Head of Financial Services</p> <p>Agreed date – 31 March 2024</p>
<p>4. Assurances to Accountable Officer</p> <p>We identified that checklists and assurances provided to the Accountable Officer were not fully completed in all instances.</p> <p>Risk – there is a risk that all details requiring disclosure to the Accountable Officer and in the Governance Statement are not identified.</p>	<p>Highlands and Islands Enterprise should review the process in place for providing assurances to the Accountable Officer and ensure all checklists and certificates of assurance are fully complete.</p> <p>Paragraph 53</p>	<p>Highlands and Islands Enterprise will update the process for completion of the annual assurance returns to ensure no post submission changes or control issues identified up to year end.</p> <p>Responsible officer – Director of Business Improvement and Internal Audit</p> <p>Agreed date – 31 March 2024</p>
<p>5. Climate Change Strategy</p> <p>We noted that Highlands and Islands Enterprise does not have a formal climate change strategy in place or up-to-date baselines for its carbon footprint.</p> <p>Risk – there is a risk that Highlands and Islands Enterprise is not able to demonstrate its plans and actions to achieve climate related requirements and targets.</p>	<p>Highlands and Islands Enterprise should work to prepare a climate change strategy and finalise up-to-date baselines for its carbon footprint.</p> <p>Paragraph 58</p>	<p>Highlands and Islands Enterprise is completing a benchmarking of its carbon footprint and is working towards a climate change strategy.</p> <p>Responsible officer – Director of Strategy and Regional Economy</p> <p>Agreed date – Carbon footprinting – end of 2023/24.</p> <p>Climate Change Strategy to Highlands and Islands Enterprise Board in 2024/25.</p>
<p>6. Cyber Security Arrangements</p> <p>We noted that back-ups carried out by EIS were not tested for part of the year.</p> <p>Risk – there is a risk that data back-up files cannot be regenerated without loss if regular testing is not carried</p>	<p>Management should perform regular testing of data back-up files to ensure that they can be regenerated without loss and that an up-to-date statement of assurance is obtained from EIS to evidence this.</p> <p>Paragraph 67</p>	<p>Agreed</p> <p>Responsible officer – Director of Finance and Corporate Services</p> <p>Agreed date – 31 October 2023</p>

Issue/risk	Recommendation	Agreed management action/timing
out to identify any issues with processes.		

Follow-up of prior year recommendations

Issue/risk	Recommendation	Agreed management action/timing
<p>b/f 1. Accounts preparation</p> <p>The performance report included in the unaudited accounts had not been reviewed by Highlands and Islands Enterprise's leadership team or sponsor department prior to submission for audit. A revised performance report, including their comments, was not submitted until 20 October 2022. In addition, there were delays in providing documentation to support the disclosures in the revised performance report.</p> <p>Risk – the audit cannot be completed in line with the agreed timetable.</p>	<p>Highlands and Islands Enterprise should ensure its accounts preparation timetable includes sufficient time for its leadership team and sponsor department to review and comment on the performance report before it is submitted for audit. In addition, a clear audit trail should be maintained of the evidence used to source information included in the performance report in future years.</p>	<p>Complete.</p>
<p>b/f 2. Performance Report</p> <p>The Performance Report in the unaudited accounts did not meet the requirements of the FReM and there was no evidence that the content and presentation had been reviewed against the FReM or Audit Scotland's good practice guide.</p> <p>The overall presentation of the financial information was improved although there were a number of examples where figures were not consistent, or easily reconciled, with the financial statements. In addition, some of the</p>	<p>Highlands and Islands Enterprise should review the content and presentation of its performance report against Annex 5 of the FReM and Audit Scotland's good practice guide prior to submission for audit. It should also ensure consistency of disclosures both within the annual report and with the financial statements.</p>	<p>Complete.</p>

Issue/risk	Recommendation	Agreed management action/timing
<p>terminology used was potentially confusing to an informed reader of the annual report and accounts.</p> <p>Risk – Highlands and Islands Enterprise does not communicate its performance effectively to its stakeholders.</p>		
<p>b/f 3. Openness and transparency</p> <p>Openness and transparency in how a body operates and makes decisions is key to supporting understanding and scrutiny. Highlands and Islands Enterprise has set a target for Board and RAC minutes to be published on its website within 10 days of their approval. However, minutes of Board meetings in April and June have still to be published, as well as minutes from the RAC meeting in June. We also noted that funding approvals, which should be published quarterly, are not up to date on the website.</p> <p>Risk – Highlands and Islands Enterprise cannot demonstrate the openness and transparency of its decisions.</p>	<p>Highlands and Islands Enterprise should ensure that it publishes minutes of Board and RAC meetings in line with its target timescales and that funding approvals are published promptly after the end of each quarter.</p>	<p>Complete.</p>
<p>b/f 4. Governance and cyber security</p> <p>Highlands and Islands Enterprise is part of the shared Enterprise Information Service (EIS).</p> <p>Internal audit carried out a follow up review of EIS's cyber security arrangements in 2021/22. It concluded that cyber security remains a</p>	<p>Highlands and Islands Enterprise should continue to strengthen resilience in EIS's cyber security arrangements and continue to review and improve its own governance of cyber security.</p>	<p>Superseded – see Appendix 1, Action Plan Point 5.</p>

Issue/risk	Recommendation	Agreed management action/timing
<p>material risk for the partnership.</p> <p>Highlands and Islands Enterprise is taking a range of actions to improve its own cyber security arrangements.</p> <p>Risk – a cyber-attack could disrupt Highlands and Islands Enterprise’s key financial systems.</p>		
<p>b/f 5. Equality and diversity</p> <p>Highlands and Islands Enterprise’s diversity and equality policy was last updated in 2015.</p> <p>Risk – the policy is not up to date and may not be fit for purpose.</p>	<p>Highlands and Islands Enterprise’s diversity and equality policy should be reviewed and updated to ensure it is still fit for purpose.</p>	<p>Complete.</p>
<p>b/f 6. Performance reporting to the Board</p> <p>Our review identified that the majority of the performance indicators had changed since reporting to the Board as data quality checks had not been completed prior to preparation of the Board paper.</p> <p>Risk – the Board is not provided with an accurate assessment of Highlands and Islands Enterprise’s performance against its outcome measures.</p>	<p>Data quality checks should be completed before inclusion in Board papers, so members have an accurate assessment of performance against outcome measures.</p>	<p>Complete.</p>
<p>b/f 7. Capital Accounting</p> <p>Last year we reported that Highlands and Islands Enterprise needed to develop its understanding of capital accounting. This year we identified more issues with how Highlands and Islands Enterprise accounts for non-</p>	<p>Highlands and Islands Enterprise finance staff should improve its understanding of capital accounting, including accounting for revaluation and classification of non-current assets.</p>	<p>Superseded – see Appendix 1, Action Plan Point 1.</p>

Issue/risk	Recommendation	Agreed management action/timing
<p>current assets and capital receipts.</p> <p>Risk – the annual accounts do not comply with accounting standards and policies. Significant audit input is required to ensure the accounts are not materially misstated resulting in additional audit fees.</p>		
<p>b/f 8. Financial Capacity</p> <p>There is some evidence that the new posts have improved the finance team’s capacity. However, we have yet to see significant improvement in accounting for complex areas such as capital accounting, Financial Transactions, and Investments.</p> <p>Risk – the annual report and accounts submitted for audit are materially misstated or require significant adjustment.</p>	<p>Highlands and Islands Enterprise senior management should consider how to develop the required skills and experience to ensure complex areas are appropriately reflected in the annual report and accounts.</p>	<p>Outstanding</p> <p>Our audit work in 2022/23 identified there were still significant issues in accounting for complex accounting areas such as capital accounting and pensions accounting. Therefore, the risk still exists.</p> <p>Responsible officer – Director of Finance and Corporate Services</p> <p>Revised date – 31 January 2024</p>

Highlands and Islands Enterprise

Audit Scotland's published material is available for download on the website in a number of formats. For information on our accessibility principles, please visit:

www.audit-scotland.gov.uk/accessibility



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