



Comptroller and Auditor General

Jersey Innovation Fund

12 January 2017



JERSEY AUDIT OFFICE

R.3/2017

Jersey Innovation Fund

Introduction

- 1.1 There has been considerable public interest in the Jersey Innovation Fund, both generally and in respect of individual loans advanced.
- 1.2 I have undertaken a review of the operation of the Fund as a whole, informed by my consideration of some individual loans advanced. This report details my findings from that review.
- 1.3 Prior to preparing this report I sought advice from the Attorney General on specific matters concerning administrative law relevant to this review. I have carefully considered and as appropriate reflected that advice in preparing this report.
- 1.4 I have a separate statutory duty to report suspected criminal activity to the Attorney General. This duty extends to the conduct not only of Members, officers and appointees of the States but also to that of third parties. As discussed in paragraph 15.5 below, I am considering making such a report detailing my concerns about the conduct of third parties.

Background

- 1.5 The Economic Development and Diversification Strategy debated by the States Assembly in July 2012 included the concept of an Innovation Fund. The objective of the Fund was to promote competitiveness, improve infrastructure, develop innovation and diversify towards high value activity, creating good jobs for local people.
- 1.6 In 2013, following detailed consideration of proposals by a Scrutiny Panel, the States Assembly voted to establish the Innovation Fund ('the Fund') to make loans or grants to stimulate innovation and thereby economic growth. The States Assembly agreed the transfer of £5m to the Fund.
- 1.7 The Proposition establishing the Fund included the Operational Terms of Reference for the Fund. Those contained detailed provisions relating to the operation of the Fund including:
 - the establishment of an Advisory Board comprising both States officers and private sector members; and
 - the Minister for Economic Development, on a recommendation of the Board, making decisions on advancing individual loans.
- 1.8 In January 2015 the Minister for Economic Development delegated his power to make decisions on individual loans to the Assistant Chief Minister with responsibility for Innovation.

Financial performance of the Fund

1.9 As at December 2016, the Board had considered over 50 applications and the States had advanced seven loans to six borrowers with a total value of nearly £2.1 million. At that date only a quarter of repayments due had been received (see Exhibit 1) with recovery questionable in many cases (see Exhibit 2).

Exhibit 1: Jersey Innovation Fund: Key statistics to December 2016

Advances	£2,085,000
Capital repayments due to December 2016	£497,000
Interest payments due to December 2016	£245,000
Total payments due to December 2016	£742,000
Capital repayments received to December 2016	£130,000
Interest payments received to December 2016	£66,000
Total payments received to December 2016	£196,000
Payments as at December 2016 as a proportion of payments due	26%
Number of advances	7
In arrears: up to one quarter	2
In arrears: more than one quarter	4
In arrears: more than one quarter and winding up order	1

Source: Chief Minister's Department

Exhibit 2: Status of loans at December 2016

Payments as at December 2016 as a proportion of payments due	Status
82%	New investment received and early repayment of loan anticipated.
55%	Significant underperformance. External accountants appointed to advise on prospect for recovery.
0%	Significant underperformance. External accountants appointed to advise on prospect for recovery.
0%	Concerns evident from first monitoring report and minimal revenue generated. Following appointment of external accountants, winding up order on 17 October 2016.
1%	Significant undershoot on revenue and significant losses in each period since loan drawdown. Liaising with company to seek assurance on future sales route.
2%	Well behind forecast despite staff being taken on. External accountants appointed to advise on prospect for recovery. Payments of interest now being made.
75%	Trading and although behind forecast able to meet loan repayments.

1.10 An innovative initiative of this type inevitably involves expenditure of time and resources. Total expenditure on the operation of the Fund and interest receivable is summarised in Exhibit 3. The major expense in 2015 and 2016 relates to increasing the provision for doubtful debts. This stood at a total of £1,383,000 at 31 December 2016. Such a provision is required when it is unlikely that a debt due will be paid. But it is important to note that the debts to which provisions relate remain due and may subsequently be recovered in whole or in part.

Exhibit 3: Income and expenditure of the Fund

	2014	2015	2016 (forecast)
Income			
Interest receivable		£104,000	£162,000
Total income		£104,000	£162,000
Expenditure			
Board costs		£39,000	£37,000
Support costs	£25,000	£57,000	£145,000
Increase in provision for doubtful debts		£692,000	£691,000
Total expenditure	£25,000	£788,000	£873,000
Net expenditure	£25,000	£684,000	£711,000

Source: 2014 & 2015: Jersey Innovation Fund Annual Reports; 2016: Chief Minister's Department

The framework within which the Fund is operated

- 1.11 The Public Finances (Jersey) Law 2005 ('the 2005 Law') makes statutory provision for the establishment of 'Special Funds' by the States Assembly on a Proposition of the Minister for Treasury and Resources. Such funds, that are not separate legal entities, may be established for a specific purpose. The legislation allows for certain expenditure to be met from a fund and for certain income to be credited to it. In 2013, following a Proposition, a report from a Scrutiny Panel and a revised Proposition, the States established the Innovation Fund as a Special Fund. The resolution required that it should operate in compliance with the 'Operational Terms of Reference' that was appended to the Proposition.
- 1.12 But the establishment of a Special Fund does not remove the money involved from the scope of the wider provisions of the 2005 Law:
- the Minister for Treasury and Resources has a statutory power to appoint an Accounting Officer with a personal accountability for the proper management of the Fund. In exercise of those powers the Chief Officer for Economic Development was appointed as Accounting Officer for the Fund when the Fund was set up, a responsibility assumed by the Chief Executive of the Chief Minister's Department in November 2016; and

- the Treasurer of the States, with the consent of the Minister for Treasury and Resources, may issue Financial Directions comprising matters ‘as appear to the Treasurer to be necessary or expedient for the proper administration of this Law and of the public finances of Jersey’. In exercise of those powers the then Treasurer of the States issued a Financial Direction specific to the Innovation Fund in July 2014.

Objectives and scope of the review

1.13 The review discharges my statutory responsibility to provide independent assurance to the States Assembly on whether the Innovation Fund, as a Special Fund, is being regulated, controlled, supervised and accounted for in accordance with the 2005 Law and the Proposition that established the Fund. In so doing, the review considers:

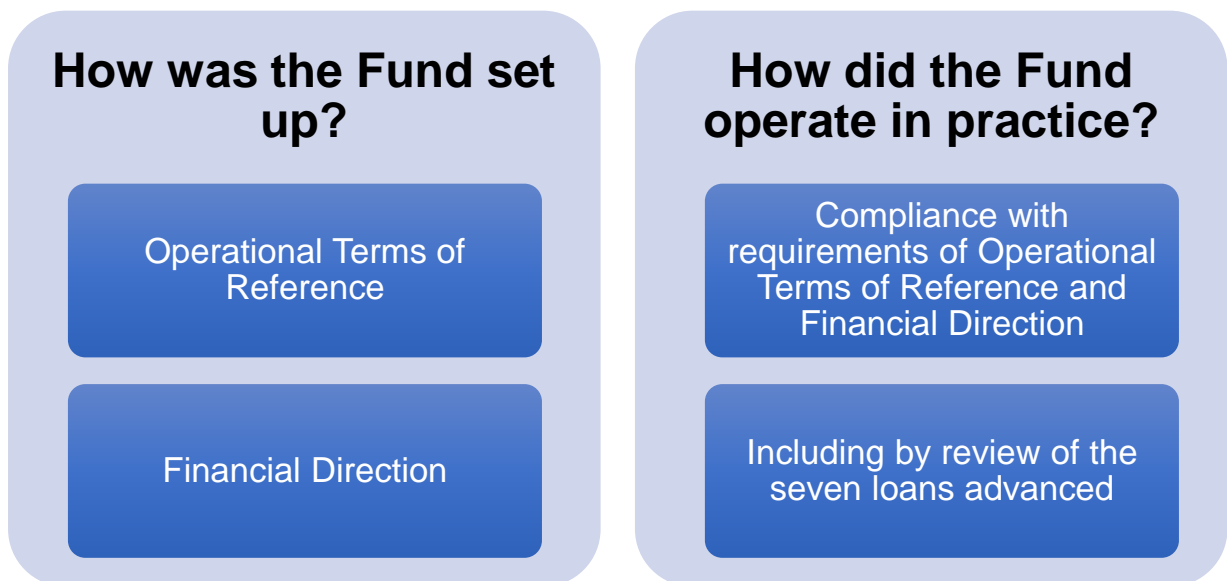
- general corporate governance arrangements;
- the effectiveness of internal controls; and
- whether resources are being used economically, efficiently and effectively.

1.14 The review extends to all monies advanced from the Fund.

Approach

1.15 The approach involves consideration of two dimensions – how the Fund was set up and how it operated in practice (see Exhibit 4).

Exhibit 4: Approach to the review



1.16 The review does not extend to:

- an evaluation of the methodology and criteria used for the preparation of Economic Impact Assessments (as opposed to the use of the results of the Assessments); or
- detailed review of the consideration of individual applications to the Fund that were unsuccessful.

1.17 I consider the operation of the Fund looking at different sections of the Operational Terms of Reference. The section in the Operational Terms of Reference entitled 'Reporting' embraces both reporting by borrowers and reporting to the Minister and, for clarity, I have considered these dimensions separately (see Exhibit 5).

Exhibit 5: Areas considered based on the Operational Terms of Reference

Management and governance
Financial and manpower implications
Risk
Scope of the Fund
Grants and loans
Royalties
Eligibility
Due diligence
Assessment framework
Recommendations and approval framework
Reporting by borrowers
Reporting to the Minister
Breaches and remedies

1.18 I attach in Appendices for reference:

- a chronology of the operation of the Fund (Appendix 1); and
- a summary of the terms of loans advanced (Appendix 2).

Management and governance

2.1 Good governance is at the heart of good government. A relevant, clear, comprehensive and consistent framework, applied in practice, is a cornerstone of effective management. And good governance, although of particular importance in the public sector, is just as applicable to other successful organisations. Good governance is not a barrier to an entrepreneurial approach but an essential mechanism for securing stewardship and accountability.

How it was set up

2.2 The Operational Terms of Reference set out how the Fund was to operate. To secure effective operation of the Fund they needed to be clear and accessible and ensure that there was adequate support to those advising on and making decisions on advances from the Fund.

2.3 However, the Operational Terms of Reference:

- are in places confusing: section 4.1 says both that interest rates will be recommended by the Board to the Minister for Economic Development and that they will be determined through consultation between the Board, the Treasurer and the Minister for Economic Development;
- substantially underestimate the officer resources required. The input from all departments is estimated at £50,000 per annum based on 800 hours input. But this input was exceeded by the 'Jersey Innovation Fund (JIF) Executive', an officer in the Department of Economic Development, Tourism, Sport and Culture, alone;
- do not allocate any specific roles to the Treasury and Resources representative or Economic Adviser, reflecting their expertise;
- provide for a substantial element of the support for the Fund to be provided by an officer designated as the JIF Executive with responsibilities spanning a wide range of skills that are unlikely to be discharged most effectively by a single individual. The tasks ranged from provision of secretarial and administrative support to undertaking due diligence, maintenance of risk registers and managing aftercare for loan recipients; and
- do not specify a mechanism for evaluating the overall performance of the Fund. Typically 'Key Performance Indicators' would be set by which the performance of the Fund can be measured both in policy terms (such as number of jobs created or tax revenue generated) and financial terms (such as write offs incurred).

- 2.4 Despite concerns about some gaps in the Operational Terms of Reference, Treasury and Resources did not issue a specific Financial Direction relating to the Fund until July 2014. Although the Financial Direction in part replicated the Operational Terms of Reference, in instances it went beyond them, for example in detailing due diligence to be undertaken.
- 2.5 I welcome the strengthening of controls around the operation of the Fund but, given the inherent risk associated with the Fund, I am concerned that comprehensive arrangements were not put in place at the outset. In my view, Treasury and Resources should have been more actively involved from the outset of the project in establishing robust arrangements to mitigate risks.
- 2.6 There is a potential inconsistency between the Operational Terms of Reference and the Financial Direction which increased the risk of confusion over who was responsible for what. The Operational Terms of Reference provided for both the Treasury and Resources and Chief Minister's Department representatives on the Board to be full voting members. In practice such voting rights were not extended and in my view it would have been better if the Terms of Reference had not provided for officers to have voting rights. The potential difficulty with voting rights being extended to officers is reflected in the Financial Direction. This gives the Treasury representative a responsibility for maintaining 'an independent overview of the processes undertaken by the Board to ensure that the financial interests of the States are being protected', a task that is incompatible with participation in its decision-making processes.
- 2.7 The Accounting Officer had a personal responsibility for the proper management of the Fund. The Fund was a new activity with a high risk profile. To mitigate risk significant reliance was placed upon the skills of individuals drawn from the private sector. But those skills needed to be complemented by a comprehensive and fit for purpose operational framework for the Fund. And, as illustrated throughout this report, there were substantial weaknesses in the arrangements as designed and as operated. The Accounting Officer should have done more to satisfy himself that robust arrangements were in place at the outset and operated consistently: the arrangements established were not fit for purpose and that should have been identified at the outset.

How it worked in practice

- 2.8 I am concerned that there were instances where the established arrangements were not complied with, where arrangements were only partially complied with or where the requirements were contested by key players:
- the Operational Terms of Reference attached to the Proposition adopted by the States clearly state that 'Board members will not be remunerated'. Despite this provision, the post of Chairman was advertised on a remunerated basis prior to the adoption of a Proposition to pay the private sector members of the Board. It has been suggested to me that the term

'Board members' in the Operational Terms of Reference should be interpreted to exclude the Chairman. I do not accept this interpretation: elsewhere the Operational Terms of Reference include the Chairman within 'members'. Moreover, when the Proposition to remunerate private sector members of the Board was subsequently laid, it covered remuneration to the Chairman and there was no suggestion that this was in any way authorised by the adoption of the previous Proposition;

- members of the Board on more than one occasion asserted that they did not have the time or expertise to undertake the key task of monitoring loans advanced from the Fund despite the duty in the Operational Terms of Reference for the Board to report to the Minister on the progress of loans made;
- on a number of occasions, the minutes show that private sector members recognised and declared direct financial interests in borrowers that were the subject of discussion by the Board but nevertheless participated in deliberations. Such an interest should, in accordance with normal standards adopted in the public sector (which are based on the Nolan principles), have meant that they did not take part in such deliberations. In my view officers should have provided a clear written framework for the management of such interests when the Board commenced its work;
- despite the unambiguous wording of the Operational Terms of Reference that the officer members (other than the Chief Officer) were voting members of the Board, the Board operated as if they were not;
- attendance by some key officer members at the Board in the first year of operation of the Board was poor, despite the high risk associated with the Board's activities; and
- a relatively junior member of staff served as the JIF Executive for a significant period. Notwithstanding the availability of support from other officers and the specific oversight of the Departmental Deputy Chief Executive in specific areas, some of the tasks assigned to the JIF Executive in the Operational Terms of Reference were appropriate to a more experienced officer or perhaps more reasonably should have been provided through access to other resources.

2.9 Some of these instances of non-compliance relate to areas where I believe there are weaknesses in the Operational Terms of Reference, some of which were identified by Board members. I recognise the complexity of the process required to amend the Operational Terms of Reference. However, addressing such weaknesses informally without changing the Operational Terms of Reference:

- created potential confusion about the framework under which the Fund was operating; and
- failed to reflect the constitutional authority of the States Assembly that had agreed the establishment of the Fund to be operated in accordance with the Operational Terms of Reference.

2.10 To the extent that weaknesses in the Operational Terms of Reference were recognised, the Accounting Officer should have developed proposals to vary the Operational Terms of Reference to make them fit for purpose and the Board should have continued to press for such proposals to be developed.

Financial and manpower implications

3.1 There are inevitably financial and other resource implications from implementation of a new initiative, particularly one such as this.

How it was set up

3.2 The Operational Terms of Reference included a short section covering finance and human resource implications. The relevant section estimated:

- costs of £100,000 charged to the Fund per year for company searches, background checks, market research, credit checks and legal advice in connection with due diligence, assessment and approval of applications; and
- costs of £50,000 per annum for the time of officers involved in the Fund in the then Economic Development Department, Treasury and Resources, the Law Officers' Department and the Economic Adviser's Unit. The Proposition stated that these costs would be absorbed in departmental budgets.

3.3 I am concerned that:

- staff costs were not measured and recharged to the Fund, reducing the transparency of the costs of operation of the Fund; and
- no quantification was included in the Proposition or accompanying Operational Terms of Reference of the amount (or potential range of amounts) of:
 - the expected costs to the Fund arising from provisions for doubtful debt and write offs; or
 - the expected interest income.

Despite the inherent uncertainty in the costs that were to be incurred, provision of an estimate of the likely range of such costs was essential information that should have been communicated to the States Assembly to inform its decision-making.

3.4 There was no explicit requirement for quantification of the likely level of non-repayment - or 'provision for doubtful debts' – to be calculated other than at the end of the financial year. Regular calculation, reporting and review of such a provision is a key means by which the financial performance of the Fund can be monitored. In my view the nature of the loans being advanced and the significant risk of non-repayment meant that such in-year reviews should have been required.

How it worked in practice

- 3.5 I am concerned that, in respect of finances, the Fund did not operate in accordance with the Operational Terms of Reference:
- despite the terms of the Operational Terms of Reference, an element of staff costs has been recharged to the Fund; and
 - there has been very limited use of appropriate external expertise of the type envisaged in the Operational Terms of Reference, potentially increasing the risks faced by the Fund.
- 3.6 As in the section on management and governance above, my concern is not that there were desirable departures from the original Operational Terms of Reference. Rather, I am concerned that these were made informally and without amendment of the Operational Terms of Reference that had been approved by the States Assembly. I also remain concerned that some changes led to a lack of clarity in roles and responsibilities.

Risk

4.1 Funding innovation carries the risk of default by borrowers. But risk needs to be managed by using the full range of possible mechanisms for doing so and applying those consistently. A transparent attitude to risk assists decision-making.

How it was set up

4.2 The Operational Terms of Reference accept the inherent risks in lending to businesses that cannot secure bank financing and the likelihood of loss.

4.3 The use of royalties to secure an upside gain was reflected in the Operational Terms of Reference. But there are other mechanisms that could have been included to manage risk:

- a requirement to advance funds in tranches with advances linked to milestones, to allow the option of not making further advances if initial plans were not fulfilled. This approach reduces the financial exposure of the States where business or financial plans are not achieved;
- controls over payments to directors, payment of dividends and transactions with related parties. These prevent money being moved out of a company to the potential detriment to the States as a lender; and
- a requirement for co-investment by directors as a condition for a loan. Such a requirement increases the alignment in interest between the States and a borrower.

4.4 The Operational Terms of Reference merely referred to 'some' risk being inherent in loans from the Fund. No quantification of potential write offs is contained in the section headed 'financial and manpower risks' which instead focusses on the ongoing costs of operating the Fund.

4.5 The Ministerial Answer to the Scrutiny Panel report, which predated the Proposition, quantified the risk as 20% of loans not securing objectives and of 10% of loans not being repaid. Against that background I am concerned that the Financial Direction for the Fund quantified the risk as a 50% chance that a loan would not be repaid, without the financial implications being explicitly considered by the States Assembly that had endorsed the Operational Terms of Reference.

4.6 The Operational Terms of Reference provide for maintenance of a risk register for individual loans. However, I am concerned that:

- responsibility for its compilation and maintenance rested with the JIF Executive without an explicit input from the Board which could have brought a wider view and an element of challenge;

- the requirement for reporting was only every six months despite the inherent high risk of the loans advanced; and
- there was no requirement for a risk register covering the operations of the Fund as a whole, rather than individual loans. As a result, there was a danger that risk and risk management were not viewed holistically and that lessons from one loan were not applied to others.

How it worked in practice

4.7 The States used a standard loan agreement although this was adapted for some loans. This is less prescriptive than in my view would be possible or appropriate:

- it does not restrict the application of funds advanced to the specific items specified in the loan agreement;
- it only contains very general requirements as to how the business is managed, such as not changing the ‘general scope and nature of the business’; and
- it does not prevent the licensing of intellectual property rights (or require the States’ consent to do so) despite such rights being the key assets of many innovative companies.

4.8 I am also concerned that risk was increased by:

- only obtaining security for two of the seven loans advanced;
- in one instance only obtaining a personal guarantee from one Director whereas the recommendation to the Minister and the Ministerial decision provided for personal guarantees from two Directors; and
- in instances advancing funds in a single tranche when it was feasible to split the advancement of funds. Although, as discussed in paragraph 4.3 above, this was not a requirement of the Operational Terms of Reference, it is an important tool for risk minimisation and was, indeed, adopted in instances. However, it was not adopted consistently. In one instance funds were advanced in a single tranche despite the application describing their use as being predominantly for staff costs over a 12 month period. If funds had been advanced in tranches the States would have had the option of not making further advances when it became evident that initial business plans were not being achieved.

4.9 I am concerned about the assessment of risk in the risk registers for individual projects. I have seen the achievability of revenue and profit projections evaluated as low risk for one project – despite the highly ambitious and unproven financial forecasts and the significant financial impact for the States if revenue was not secured. In my view, as compiled, this risk assessment was unrealistic and not an effective tool of management.

Scope of the Fund

How it worked in practice

- 5.1 To secure the implementation of policy objectives, it is essential that there is a flow from the objectives and scope of the Fund as established through to the application and assessment process.
- 5.2 The Operational Terms of Reference set out the 'Scope of the Fund' including:
- research projects that may improve the island's competitiveness;
 - enabling investments in infrastructure; and
 - establishing better links with universities to commercialise Intellectual Property – intangible property such as copyrights and patents arising from creativity.
- 5.3 Although some of the elements of the 'Scope' are reflected in the application and assessment processes, I cannot see how the elements detailed above are reflected in either. In consequence, there was a risk that any application was not assessed against the wording of the Operational Terms of Reference. Therefore, there was an increased risk that the original policy objective for the Fund was not achieved.

Grants and repayable loans

How it was set up

- 6.1 As the Fund was providing finance when no finance was available from commercial sources, a key question was the interest rate to charge on funds advanced. Whilst accepting that this was to be determined on a case by case basis, I am concerned that:
- there was no overall framework established within which to make the decision, reflecting, for example, the wider economic benefits assessed as likely to arise from a particular loan and the risk to which the States were exposed;
 - no framework or parameters were set for loan terms including interest rates, and repayment holidays. Decision-making on such matters was therefore undertaken in the absence of a clear framework; and
 - there was an apparent confusion in the Operational Terms of Reference in who had responsibility for determining interest rates, an issue I discussed in the 'Management and Governance' section above.
- 6.2 The original Proposition envisaged development of the Fund so that it could capture the 'upside' from successful investments, including through investing in companies by acquiring shares. No subsequent Proposition was laid before the States to facilitate such equity investments, even though one loan was advanced with a clause that would have permitted the debt to be converted to equity if the States' power to hold an equity stake had been agreed by the States Assembly.

Royalties

How it was set up

7.1 The Operational Terms of Reference allowed for the States to secure royalty payments as a condition of a loan. In the absence of the ability to take equity stakes this was a means for the States to secure an 'upside' from successful investments.

How it worked in practice

7.2 In practice, no royalty agreements were required as a condition of any of the seven loans advanced. I am concerned that:

- the necessary support for this option, such as template documents, was not in place; and
- there is no evidence this option was pursued with vigour. Members of the Board have advised me that royalty agreements were considered for each loan advanced. However, the Board minutes record such consideration only in the case of two of the loans and in one case it appears that the option was not pursued because of potential opposition to such an agreement from other investors.

Eligibility

8.1 Clear criteria for eligibility, consistently applied, are a key means of aligning the provision of financial support to the States' policy objectives.

How it was set up

8.2 The Operational Terms of Reference contain a long list of conditions for eligibility for support from the Fund. However, I am concerned that they are undermined by poor drafting:

- a number of the eligibility requirements are inherently unachievable: a requirement that an applicant **will** achieve the cashflows necessary to secure repayment of a loan requires certainty about an inherently uncertain future and is inconsistent with the explicit recognition that some loans will fail; and
- some of the conditions have the potential for quantification but are not quantified. For example, one criterion relates to 'significant' economic spillover (the creation of economic activity beyond the recipient of the loan). But in the absence of quantification of 'significant' the scope for substantially different interpretation is large.

How it worked in practice

8.3 I am concerned that although, in three cases, applicants did not provide all the information in the format required by the Operational Terms of Reference and Financial Direction as a precondition for a loan, the loans were made in any case. Not only does the relaxation of standards reduce the information available for evaluation of an application but it also sets a potentially dangerous tone for future interaction with a borrower.

8.4 My review has also shown that in only two cases was a detailed breakdown provided of the intended application of a loan. As a result, in the other cases:

- it was difficult to assess how the amount of the loan was justified; and
- it was more difficult subsequently to monitor performance of the loan recipient.

Due diligence

9.1 Due diligence is an essential process prior to making an investment. It involves making background checks on applicants and validating information provided to support a loan. Effective due diligence procedures are an important tool in reducing the risk of default, including default arising from fraud or deceit. Given the profile of lending made from the Fund, much of it unsecured, effective due diligence, including personal due diligence, was of heightened importance.

How it was set up

9.2 Although the Operational Terms of Reference referred to the requirement for due diligence and the responsibility for undertaking due diligence, there was limited detail on the procedures to be undertaken. These were, however, expanded on in the Financial Direction for the Fund issued in 2014.

How it worked in practice

9.3 I am concerned that the due diligence procedures undertaken were not as robust as they could or should have been:

- in the initial period, there is weak documentation of the extent and nature of due diligence undertaken;
- in the case of one loan, financial projections were only received for a two-year rather than the three-year period specified in the Financial Direction;
- in the case of another loan, I am unconvinced that adequate and effective due diligence was undertaken on the directors of the applicant company. Due diligence checks in relation to that company revealed a relevant issue that should have precluded a loan but a loan was nevertheless advanced; and
- in the case of one loan, the approach to investigating and taking security is at variance with the Financial Direction. The Financial Direction requires consideration of all reasonable security and for the Board to recommend how security is used to reduce risk. But in this instance, the recommendation for a loan involved two potential interest rates – one with a personal guarantee and the other, 2% higher, without. Instead of considering all forms of security available, the Board appeared to offer the applicant the option of offering no security for only a modest increase in the interest rate payable.

Assessment framework

10.1 A robust assessment framework, consistently applied, is a key means of ensuring that applications are proportionately, thoroughly and consistently considered prior to any decision to provide financial support.

How it was set up

10.2 The Operational Terms of Reference contain an extensive section on the assessment framework. This required the Board to adopt a robust approach to the assessment focusing on:

- the impact on employment, competitiveness and innovation;
- the impact on high value-added, high quality or high productivity activity; and
- the likely short and long term commercial viability of the project.

10.3 However:

- some criteria, such as 'high quality' are inherently subjective and ambiguous;
- as discussed above, it is not evident how some of the 'scope' elements are reflected in the provisions on the assessment framework;
- there is no clear focus on the recoverability of the States' investment (which may be possible even where a project is not commercially viable in the long term); and
- much of this section of the Operational Terms of Reference details **what** information is to be provided rather than **how** it is to be used in assessing the merits of different proposals.

How it worked in practice

10.4 The Board and JIF Executive established a mechanism for placing applications in three categories, one of which went forward for detailed consideration facilitated by a private sector member of the Board. However, there is no detailed documentation of the approach to be applied at this stage. It is therefore not possible to demonstrate consistency in the scope and depth of the evaluation undertaken.

- 10.5 Although there was provision in the Operational Terms of Reference for external expertise to be engaged to support the Board, including in evaluating applications, this facility was not used in a structured way. Instead in one case heavy reliance was placed on a brief testimonial provided by Digital Jersey without clear terms of reference for and scope of the advice sought being agreed in advance.
- 10.6 My review of the minutes of the Board and files maintained by officers identified limited evidence of effective challenge of business plans, finances, market assessments and assumptions. There should have been a more structured approach to documenting the process followed.
- 10.7 In the case of one loan, the business plan submitted assumed:
- skills that were unlikely to be available on-island in the volumes required;
 - a 12-fold profit growth in three years with no staffing increase; and
 - 700,000 product users despite minimal expenditure on marketing.
- 10.8 It is not possible to see from the minutes how the Board addressed significant concerns about the quality of some business plans and financial projections before making recommendations to the Minister to advance a loan:
- in one case, the Economic Impact Assessment stated that a positive economic outcome as a result of granting a loan was unlikely within three years; and
 - in another case, the potential benefits were assessed to be abstract and unquantifiable and the Chief Economic Adviser recommended that the loan application should not be supported.

Recommendations and approval framework

How it was set up

11.1 The Board is only advisory. The decision to make a loan is made by the Minister for Economic Development following advice from the Board. The existence of an advisory Board does not detract from the role of the Accounting Officer for the Fund.

How it worked in practice

11.2 I am concerned about the information provided to the Minister:

- in my view, some of the reports accompanying recommendations to advance loans were unduly positive. In one case I struggle to recognise within the report the concerns expressed in the minutes of a meeting of the Advisory Board;
- I am unconvinced that, in a number of cases, the requirements of the Operational Terms of Reference had been satisfied before a recommendation to make a loan was made. The Operational Terms of Reference require that loans are only advanced where it is unlikely that funding will be secured from other sources. However, my review shows that:
 - a recommendation to make one loan was made when the Directors had declined to pursue bank financing as it would require security being offered over stock;
 - another loan was advanced with insufficient documentary evidence that the company had exhausted other funding options; and
 - one loan was recommended as part of a wider funding strategy for the company which had already received investment and could potentially obtain funding from other sources.

Reporting by borrowers

- 12.1 Responsibilities do not cease when a loan is advanced. Loans require effective management by a lender and a prerequisite for that is regular, timely, meaningful and accurate reporting by borrowers.

How it was set up

- 12.2 The Operational Terms of Reference contain detailed requirements for quarterly reporting by borrowers. However, although there is a reference to 'aftercare' there is no detail as to the extent and nature of the aftercare offered to borrowers. In the absence of such clarity, the purpose and use of what should be essential and valuable quarterly monitoring is unclear.

How it worked in practice

- 12.3 Generally, there was poor operational compliance with the reporting requirements by borrowers as to timeliness and content. For example, some applicants did not provide an Annual Assurance Statement, some did not compare financial performance to forecasts and one provided no information on revenue.
- 12.4 In my view, there was insufficient urgency in escalating non-compliance and reinforcing at the most senior level the reporting requirements. Although there had been some intervention with individual borrowers, including by the Accounting Officer personally writing to one borrower in September 2015, it was not until March 2016 that the Accounting Officer wrote to all borrowers reminding them of the requirements.
- 12.5 In 2016 the Accounting Officer commissioned a report from a firm of accountants. They identified missing or incomplete information which made it impossible on the basis of the information held to assess the performance of some of the loans advanced.
- 12.6 I am also concerned that there may have been a responsibility gap that delayed corrective action being taken. The Operational Terms of Reference make the Board responsible for determining action in respect of breaches and reporting on performance to the Minister but it was given no explicit role in respect of aftercare.

Reporting to the Minister

13.1 An essential element of accountability is reporting on the performance of loans advanced to the Minister for Economic Development.

How it was set up

13.2 The Operational Terms of Reference required half yearly reports to the Minister, specified the timescale for their compilation and specified their content. Discharging this responsibility required input both from Board members and the officers supporting them.

How it worked in practice

13.3 I have identified both late and incomplete reporting to the Minister against the requirements of the Operational Terms of Reference (see Exhibit 6).

Exhibit 6: Annual Reports for the Fund for 2014 and 2015

Requirement of Operational Terms of Reference	2014	Comments	2015	Comments
Issued by 31 January	X	Draft 24 March 2015.	X	Draft 21 July 2016.
Income and Expenditure	√		Limited	Summary in narrative form.
Loan details	X	Companies only. No amounts or repayment details.	√	Details provided but anonymised.
Defaults	Limited	Report notes that all reporting obligations have been met but fails to note that these fell short of JIF requirements.	Limited	Repayment defaults noted but no details provided. Report notes that some reporting requirements were not fully satisfied.
Progress reports	X	No details although early stages.	X	No detail provided.
Company changes	-	None relevant at the time.	X	None referred to.

13.4 I am also concerned that reporting at Ministerial level was inaccurate or delayed:

- during 2015, the quarterly reports from the JIF Executive state that there were no breaches of conditions of loans, despite significant non-compliance with the requirements for reporting by borrowers and the known failure of one company to have complied with a specific requirement of a loan immediately after drawdown; and
- as discussed in paragraph 1.8 above, the Minister for Economic Development had delegated his power to decide on individual loan applications to the Assistant Chief Minister. However, there was a six-month delay in officers formally briefing the Assistant Chief Minister on issues concerning one loan. This was despite a need for this briefing having been identified and minuted at three meetings of the Board.

Breaches and remedies

- 14.1 Loan conditions are there to protect the position of the States. Effective action in response to breaches is a key component of effective management of the Fund.

How it was set up

- 14.2 The Operational Terms of Reference gave the Board a responsibility for advising on action when there were any breaches of loan conditions by borrowers. But the Board was not given an explicit role in aftercare or monitoring of loan performance. As drafted, the Operational Terms of Reference meant that the Board's role was solely reactive, dependent on breaches being brought to its attention. A requirement in the Operational Terms of Reference for an active role in monitoring loan performance would have been more appropriate, especially given the Board's duty to prepare reports to the Minister, including details of performance of individual loans.

How it worked in practice

- 14.3 Although there was an element of confusion about the role of the Board, as evidenced from its minutes, in practice the Board reviewed the status of each loan at each of its meetings.
- 14.4 When the deteriorating performance of the loan portfolio was identified, a firm of accountants was engaged to provide advice to the States, including in respect of recovery action.

Conclusions

15.1 A new and innovative scheme required an entrepreneurial approach. But the focus of the Fund and the risks inherent in its activities reinforce the need for clear, comprehensive, robust and fit for purpose processes, consistently applied. In my view that did not happen, in part because of fragmentation of responsibilities, an absence of a corporate approach across the States and an underdeveloped approach to risk management. But most of all this suggests a culture where good governance was not central to decision-making either at the establishment of the Fund or subsequently.

15.2 The arrangements for the Fund as detailed in the Operational Terms of Reference and Financial Direction were inadequate from the outset. In particular:

- there was a confusion about and poor articulation of roles and accountabilities;
- the objectives of the Fund were not translated into measurable outputs with associated targets (such as local jobs created per pound spent);
- key policy matters were either confused (the risk appetite of the Fund) or not addressed (the parameters to inform the setting of interest rates);
- internal resource requirements were underestimated;
- the potential financial performance of the Fund was not adequately considered;
- despite risk management arrangements for individual loans, there was insufficient focus on managing risk for the Fund as a whole;
- success criteria were not clearly articulated;
- mechanisms for securing upside gains from successful loans were not developed; and
- arrangements for aftercare were underdeveloped.

15.3 The operation of the Fund was deficient in many respects. In particular:

- there was poor compliance with many of the provisions of the Operational Terms of Reference;
- external expertise was not drawn upon as envisaged in the Operational Terms of Reference and it could have proved valuable;

- documentation of key decisions was not always sufficient to support recommendations and decisions and, in instances, it is difficult to understand the basis for recommendations made;
 - monitoring of performance of loans granted was inadequate; and
 - reporting of performance of loans granted was late, incomplete and inaccurate.
- 15.4 As a result, the States cannot demonstrate that good governance was in place, good internal control demonstrated and value for money secured from the Fund.
- 15.5 The weaknesses in governance and internal control create an environment in which any conduct of loan applicants and recipients that falls below expected standards is less likely to be detected. From my work I have identified concerns about the conduct of third parties that I am considering reporting to the Attorney General.
- 15.6 The Accounting Officer held personal responsibility for the proper management of the Fund. He therefore had a direct interest in ensuring that the arrangements established were fit for purpose and complied with in practice. In many respects the arrangements were not fit for purpose or not complied with.
- 15.7 The Board was only advisory in nature and does not have the same responsibilities as the Accounting Officer, the JIF Executive and other officers but I am concerned that:
- having been aware of weaknesses and confusion in arrangements, it should have been more proactive in challenging management; and
 - it cannot demonstrate how it addressed some concerns it had about loan applications before making recommendations to the Minister.
- 15.8 Treasury and Resources recognised weaknesses in the arrangements for the operation of the Fund. But issuing a Financial Direction that was inconsistent with the Operational Terms of Reference did not promote the clarity that is necessary for good governance.
- 15.9 I welcome the steps recently taken – to engage external accountants to manage the loan portfolio and to appoint a new Accounting Officer for the Fund.
- 15.10 Given the extent of the issues I have identified with both the design and operation of the Fund, in my view the States should undertake a fundamental review of this area and cease any further advances pending completion of that review.

15.11 Some of my findings – about a corporate approach, risk management and decision-making – echo findings of other reviews that I have undertaken. It is therefore important that the relevance of the findings from this review to other activities of the States is considered.

15.12 I have therefore made only a few high-level but extremely high priority recommendations.

Recommendations

- R1** Make no new advances from the Fund, pending a fundamental reconsideration of its design and operation.
- R2** Reconsider the best means of achieving the underlying policy objectives of the Fund.
- R3** If loans remain a preferred means of financial support for innovation:
- specify clear and quantifiable objectives against which the success of loan provision can be evaluated;
 - improve the arrangements to address all findings in this report; and
 - reconsider and clearly articulate the States' risk appetite and mechanisms for risk mitigation in light of that risk appetite.
- R4** Continue, with appropriate specialist support, action to protect the States' position in respect of underperforming loans.
- R5** As part of routine monitoring of debt recoverability, review the adequacy of provisions for doubtful debts routinely in the course of the year and revise as appropriate.
- R6** Consider the implications of the finding of this review that a culture of good governance was not central to decision-making in this case for the making and implementation of decisions across the States.

Chronology

Date	Activity
1 Jun 2012	Draft Economic Development and Diversification strategy lodged for debate at States Assembly
17 Jul 2012	Debate on strategy proposed by Council of Ministers. Led by Chief Minister in absence of Minister for Economic Development
Sept 2012	Draft Terms of Reference for Jersey Innovation Fund prepared
6 Nov 2012	States Assembly debate on Medium Term Financial Plan 2013-2015 including proposal for allocation of £5m to Fund
20 Nov 2012	Proposition P.124/2012 including above lodged and referred for scrutiny
27 Mar 2013	Economic Affairs Scrutiny Panel report
1 Apr 2013	Revised Operational Terms of Reference
17 Apr 2013	Amendment to Proposition lodged with revised Operational Terms of Reference (see P.124/2012 Amd.)
1 May 2013	States Assembly debate and resolution to establish the Fund
14 Jun 2013	Closing date for Fund Chairman applications
17 Jul 2013	Closing date for other Fund private sector member applications
13 Nov 2013	First Advisory Board meeting to discuss Operational Terms of Reference attended by JIF Executive
18 Dec 2013	Appointment letters signed for four private sector members of the Board
20 Dec 2013	Appointment letter signed for Chairman of the Board
Dec 2013	Application from Applicant A
15 Jan 2014	Second Board Meeting
26 Jan 2014	Applicant B first loan application
12 May 2014	Applicant A recommendation to Minister
30 May 2014	Application from Applicant C
06 Jun 2014	Application from Applicant D
27 Jun 2014	Loan drawdown by Applicant A
30 Jun 2014	Change in officer serving as JIF Executive
01 Jun 2014	Draft Financial Direction presented to Board
Jul 2014	Financial Direction finalised
15 Jul 2014	First loan to Applicant B recommendation to Minister

Date	Activity
24 Jul 2014	P.134/2014 lodged concerning Board remuneration
30 Jul 2014	Mid-year report due to Minister for Economic Development
04 Aug 2014	Loan drawdown by Applicant B
19 Aug 2014	Board advised of resignation of one Board member
10 Sep 2014	States Assembly adopted P.134/2014
23 Oct 2014	Application from Applicant E
06 Nov 2014	New appointment as Minister for Economic Development with responsibility for the Fund Assistant Chief Minister (Senator Ozouf) assigned responsibility for innovation
11 Dec 2014	Applicant C recommendation to Minister
15 Dec 2014	Loan drawdown by Applicant C
12 Jan 2015	Board advised that Assistant Chief Minister with responsibility for innovation would have delegated responsibility from Minister for Economic Development to approve loans from the Fund
16 Jan 2015	Applicant D recommendation to Minister
31 Jan 2015	Annual report due to Minister for Economic Development
11 Feb 2015	Application from Applicant F
20 Feb 2015	Drawdown by Applicant D
01 Mar 2015	One private sector member reappointed to Board
24 Mar 2015	Draft Annual Report prepared
26 Mar 2015	Applicant E recommendation to Minister
01 Jun 2015	Approval of loan applications delegated to Assistant Chief Minister with responsibility for innovation
01 Jun 2015	Second loan application by Applicant B
09 Jun 2015	Drawdown by Applicant E
15 Jun 2015	Applicant F recommendation to Minister
30 Jul 2015	Mid year report due to Minister for Economic Development
31 Jul 2015	Applicant F drawdown - first tranche
30 Sep 2015	Board advised of resignation of one private sector member
23 Oct 2015	Applicant B second loan recommendation to Minister
08 Dec 2015	Closing date for applications for new private sector members of the Board
14 Dec 2015	Drawdown of second loan by Applicant B
01 Jan 2016	Responsibility for Fund formally transfers to Chief Minister's

Date	Activity
	Department
01 Jan 2016	New JIF Executive takes up post on a temporary basis
31 Jan 2016	Annual report to Minister for Economic Development, Tourism, Sport and Culture due
22 Feb 2016	Firm of accountants engaged to review existing loans from the Fund
09 Mar 2016	Two new private sector members of the Board appointed
15 Mar 2016	Results of review undertaken by firm of accountants reported to the Board Board advised that production of quarterly monitoring reports on loans outsourced to external accountants
01 Jul 2016	Final advance from JIF to Applicant F (loan approved earlier)
04 Jul 2016	New JIF Executive appointed
21 Jul 2016	Draft Annual Report to Minister for Economic Development, Tourism, Sport and Culture
30 Jul 2016	Mid year report due to Minister for Economic Development, Tourism, Sport and Culture
17 Aug 2016	Firm of accountants engaged by Accounting Officer to review loan to Applicant C at a cost £15k to the Fund
05 Sep 2016	Firm of accountants engaged by Accounting Officer to review loan to Applicant B at a cost of £5k - £7.5k to the Fund
13 Sep 2016	Firm of accountants engaged by Accounting Officer to review loan to Applicant E at a cost of £5k - £7.5k to the Fund
17 Nov 2016	Chief Executive of Chief Minister's Department appointed as Accounting Officer for the Fund in place of Chief Officer for Economic Development, Tourism, Sport and Culture

Summary of terms of loans advanced

Loan	Interest rate	Duration	Repayment holiday	Phased draw-down	Personal guarantees	Royalty agreement
A	4.5%	3 years	12 months	No	Yes	No
B	7.5%	5 years	12 months	No	No	No
C	8.5%	4 years	Nil	No	No	No
D	8.0%	5 years	12 months	No	No	No
E	5.0%	3 years	12 months	No	No	No
F	6.0%	5 years	12 months	Option	Yes	No
G	9.0%	5 years	Nil	Yes	No	No



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