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# *National Museums Scotland*

Annual Report to Those Charged  
with Governance and the Auditor  
General for Scotland

Year ended 31 March 2016

24 August 2016



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PricewaterhouseCoopers  
141 Bothwell Street  
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Audit and Risk Committee,  
National Museums Scotland,  
Chambers Street  
Edinburgh  
EH1 1JF

24 August 2016

Ladies and Gentlemen,

We are pleased to enclose our report to the Audit and Risk Committee in respect of our audit for the year ended 31 March 2016. The primary purpose of this report is to communicate the significant findings arising from our audit that we believe are relevant to those charged with governance.

The scope and proposed focus of our audit work was summarised in our audit plan, which we presented to the Audit and Risk Committee in March 2016. We have subsequently reviewed our audit plan and concluded that our original risk assessment remains appropriate. The procedures we have performed in response to our assessment of significant audit risks are detailed in Section 2.

We have completed the majority of our audit work and expect to be able to issue an unqualified audit opinion on the financial statements at the Board meeting on 21 September 2016. At the time of writing, the key outstanding matters, where our work has commenced but is not yet finalised, are completion of subsequent events review and receipt of the signed letter of representation from Management.

We look forward to discussing our report with you on 24 August 2016. Attending the meeting from PwC will be James Gray.

Yours faithfully

PricewaterhouseCoopers LLP

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# Section 1. Executive summary

## Introduction

We set out in this report our significant findings from our audit of the National Museums of Scotland (“NMS”) for 2015/16, together with those matters which auditing standards require us to report to you as “those charged with governance” of NMS.

We carried out our audit work in line with our 2015/16 audit plan that we presented to you on 29 March 2016. Our audit is not designed to identify all matters that may be relevant to you. Accordingly, the audit does not identify all such matters. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

## Framework for Our Audit

Our audit is conducted in accordance with Auditing Standards (International Standards on Auditing (‘ISAs’) (UK and Ireland)) and the Code of Audit Practice (‘the Code’).

The Code explains how external auditors should carry out their functions under the Public Finance and Accountability (Scotland) Act 2000. The audit of financial statements is covered by engagement and ethical standards issued by the UK Auditing Practices Board (APB), so the Code focuses more on the wider functions of public sector auditors. We have conducted our audit in accordance with the relevant requirements of the Code.

## Respective Responsibilities of Management and Auditors

### *Management*

It is the responsibility of the Board and the Chief Executive, as Accountable Officer, to prepare the financial statements in accordance with directions given by Scottish Ministers in accordance with paragraph 9(3) schedule 7, the National Heritage (Scotland) Act 1985. This means:

- acting within the law and ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements on a timely basis, which give a true and fair view of the financial position of the entity and its expenditure and income for the year ended 31 March 2016; and
- preparing a Directors’ Report and a Governance Statement.

### *Auditors’ responsibilities*

Our responsibilities in accordance with the Code of Audit Practice are to provide you with an audit report on the financial statements stating:

- whether they give a true and fair view of the financial position of the entity and its expenditure and income for the year;
- whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
- whether the information which comprises the annual report included with the financial statements is consistent with the financial statements; and
- whether expenditure and receipts have been incurred and applied in accordance with guidance from Scottish Ministers (the regularity opinion).

We are also required to review and report as necessary on other information published with the financial statements, including the directors' report, annual governance statement, statement on internal control or statement on internal financial control.

## Financial Statements

We received draft financial statements at the start of our fieldwork and they were of a good quality. We proposed a small number of financial and disclosure audit adjustments to the draft financial statements. There are no material unadjusted misstatements at the conclusion of our audit.

We have completed the majority of our audit work and expect to be able to issue an unqualified audit opinion at the Board meeting in September 2016.

## Financial performance

NMS's key financial performance for the period is as follows:

- The final outturn for NMS was £20.547m against an operating resource limit of £20.547m, resulting in a balanced position of no under- or over-spend.
- The capital grant of £1.85m and purchase grant of £0.200m were fully utilised in the year.
- The total incoming resources for 2015/16 were £27.543m a decrease of £5.019m on the prior year balance of £32.562m. This is predominantly due to a decrease in the income generated from government grants.
- As a result of decreased income in the year, NMS had to decrease its charitable expenditure. Expenditure decreased from prior year by £1.051m (£25.740m 2015/16, £26.791m 2014/15) with decreased expenditure on public displays/events and conservation and collections.

NMS have a balanced budget for 2016/17 which has been presented to and approved by the Board of Trustees. This budget shows income for 2016/17 of £23.657m which includes grant in aid funding of £20.317, a decrease of £2.505m on 2015/16 (£22.822m). In addition to the grant in aid funding NMS have been awarded £1.350m for capital expenditure. We have not identified any key indicators or been made aware of any factors that would suggest that NMS will fail to meet its financial targets in 2016/17.

## Additional insight – journals

A key focus in our audit is sharing insight. During our audit procedures for testing journals, we have interrogated the data from which we performed our journals testing to identify observations for your consideration. These are included within Appendix 1.

Please note that copies of this report will be sent to the Audit Scotland in accordance with their requirements.

We would like to thank the management and staff of NMS for their co-operation and assistance during the course of our work.

## Section 2: Significant audit and accounting matters

We have set out in this section the significant matters arising from our audit.

### Matters identified in our audit plan

Set out below is a summary of our response to matters identified in our audit plan:

Significant Risk	Audit response
<p><b><i>Risk of management override of controls</i></b> ISA (UK&amp;I) 240 requires that we plan our audit work to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk that management may override controls in order to manipulate the financial statements.</p>	<p>We performed procedures to test the appropriateness of journal entries using Computer Assisted Audit Techniques, we have provided an analysis of the type of journals posted, see appendix 1 for more details.</p> <p>We reviewed accounting estimates, such as depreciation and indexation, for bias and evaluated whether circumstances producing any bias, represent a risk of material misstatement due to fraud.</p> <p>We evaluated the business rationale underlying significant transactions within the year and adjustments made under FRS 102.</p> <p>We performed ‘unpredictable’ testing procedures, specifically relating to heritable assets.</p> <p><b>We did not identify any issues to report to you as a result of our work.</b></p>
<p><b><i>Risks of fraud in revenue recognition and expenditure recognition</i></b> Underlying ISA (UK&amp;I) 240 there is a (rebuttable) presumption that there are risks of fraud in revenue recognition. There is a risk that NMS could adopt accounting policies or treat income transactions in such a way as to lead to material misstatement in the reported revenue position.</p> <p>We extend this presumption to the recognition of expenditure in the public sector, as there is arguably a greater risk associated with the recognition of expenditure in NMS, owing to the fact that it is largely funded on the basis of its ongoing resource</p>	<p>We obtained an understanding of key income and expenditure controls in place.</p> <p>We evaluated and tested the accounting policy for income and expenditure recognition to ensure that this is consistent with the requirements of the Financial Reporting Manual (FRM).</p> <p>We performed detailed testing of income and expenditure transactions, focussing on the areas we consider to be of greatest risk.</p> <p>We performed a search for unrecorded liabilities to ensure that the liabilities which ought to be included at the year-end had been included correctly.</p> <p><b>We did not identify any issues to report to you as a result of our work.</b></p>

Elevated risk	Audit response
<p><b>Adoption of FRS 102/Charities SoRP</b>                      NMS have prepared financial statements under FRS 102 and the Charities SoRP 2015 for the year ending 31 March 2016. This has resulted in presentational changes to the primary financial statements, a more detailed Trustees’ report and review of prior year figures to determine if restatement is required.</p>	<p>We reviewed management’s assessment of the impact of FRS 102 and the Charities SoRP on the financial statements. We reviewed the Trustee’s reports to ensure it is compliant with the Charities SoRP.</p> <p>Some adjustments were made to the financial statements as a result of the transition to FRS 102. We reviewed these adjustments and noted no issues. No material adjustments were made.</p> <p><b>We did not identify any issues to report to you as a result of our work.</b></p>
<p><b>Wider scope audit risk – financial sustainability</b>                      There is unprecedented financial pressure on the public sector as a result of ever increasing demand during a period of financial austerity in UK public services.</p> <p>This is leading to public sector bodies across the country finding it increasingly difficult to fill budget gaps through the identification of efficiency savings. As a result there is an increasing audit risk that entities do not have detailed plans to show financial sustainability over the next 3-5 years.</p>	<p>We obtained an understanding of processes in place around budgetary controls and forecasting.</p> <p>We performed the following substantive procedures:</p> <ul style="list-style-type: none"> <li>• Reviewed financial performance forecasts and budgets for 2016/17 and beyond, and assessed these for accuracy against known budget cuts. Assumptions used were assessed for reasonableness.</li> <li>• Reviewed evidence of Board approval of budgets; and</li> <li>• Reviewed evidence of cost saving measures being implemented.</li> </ul> <p><b>We found that financial plans for 2016/17 – 2018-19 were in place and approved by the Board. However, detailed measures to reduce the forecast deficit for 2017-18 and 2018-19 had not been prepared and presented to the Board for approval at the time of this report.</b></p> <p><b>See details of the findings in this area in Section 3.</b></p>

## Materiality

We have conducted our work in accordance with the materiality levels detailed below. Our materiality levels are shown below. As noted in the audit plan agreed with the Audit and Risk Committee, overall materiality was based on 2% of total assets for the year ending 31 March 2016. Final materiality figures were updated from the planning stage and set based on the final financial statements. This resulted in an increase in materiality, and an increase in the de-minimis posting level of £15,809.

We have conducted our work in accordance with the materiality levels detailed below.

	£
<b>Overall materiality</b> – This is the amount we have applied in assessing the overall impact on the group financial statements of potential adjustments	<b>£3,598,920</b>
<b>Performance materiality</b> - We have applied this to direct the amount of work performed over each financial statement line item – for example in calculating sample sizes	<b>£2,699,190</b>
<b>De-minimis posting level</b> - Under ISA (UK & I) 450, we are required to report to the Audit and Risk Committee on all unadjusted misstatements in excess of a ‘de-minimis’ or ‘clearly trifling’ amount	<b>£179,946</b>

## Misstatements and significant audit adjustments

Per above we are required to report to you any identified uncorrected misstatements which exceed our de-minimis posting level. We identified one misstatement which is detailed below:

### **Fixed Assets - Indexation Gain**

The indexation gain recognised in the financial statements against fixed assets had been over stated by £3.08m, and as a result the revaluation reserve was also overstated by the same value. The indexation applied each year is an accounting estimate applied between full valuations. The incorrect BCIS All-in TP rate was used when calculating the indexation gain, which resulted in the overstatement.

The above misstatement was above performance materiality of £2,699,190. However, management have corrected the error which led to the overstatement, and as a result the financial statements are not materially misstated.

We have no other uncorrected misstatements arising from our audit to report to you.

## Qualitative aspects of accounting practices

### **Financial statement disclosures**

We have also reviewed, and tested, the material disclosures in the financial statements. We identified some errors within the disclosures of the financial statements and these were addressed by Management. We identified no significant issues as part of this work.

NMS have adopted the Charities SoRP 2015 and FRS 102 when prepared their financial statements for the year ending 31 March 2016. This has resulted in some presentational changes to the primary financial statements and a more detailed Trustees’ report. There have been some prior year restatements in the financial statements as a result of the transition to FRS 102.

We have reviewed the adjustments processed by NMS in relation to the above. These adjustments are detailed in note 27 in the financial statements and are all individually and in aggregate below performance materiality.

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### ***Governance Statement***

The Financial Reporting Manual requires the Chief Executive to sign a Governance Statement which covers all controls including financial, operational, compliance and the management of risk.

We reviewed the governance statement and considered the following:

- Compliance with the required elements as published by the Scottish Public Finance Manual; and
- Consistency with the remainder of information presented within the annual accounts and our overarching understanding of the entity.

Based on our normal audit procedures, **we do not disagree** with the disclosures contained in the Statement.

## Section 3. Financial performance

### Financial targets

**Table 1: Financial targets summary 2015/16**

The below table shows the outturn for the year against the Scottish Government resource limits.

	<b>Outturn £ 000</b>	<b>Budget £ 000</b>	<b>Underspend/ (Overspend) £ 000</b>
Total Capital Resource	2,275	2,275	0
Operating Expenditure (Cash)	20,547	20,547	0
Depreciation / Resource Budget (Non-cash)	3,248	4,192	944
Purchase Grant	200	200	0
<b>Total Operating Resource</b>	<b>29,583</b>	<b>27,214</b>	<b>944</b>

### Financial sustainability

Per Audit Scotland guidance, Financial Sustainability has been added as an elevated risk in addition to those risks identified in our audit plan. Financial sustainability has become a key matter for consideration by all public sector entities and given the grant in aid cuts and cost pressures mentioned above it is vital that consideration of longer term financial plans has taken place.

The Financial Plan for 2016/17 identifies the following key areas of income and expenditure and was presented to and approved by the Board on 23 March 2016:

**Table 5: 2016/17 budget**

	<b>2016/17 Planned Budget £ 000</b>
Grant in Aid – Revenue	21,667
Self-Generated Income	9,471
<b>Total income</b>	<b>31,138</b>
<b>Expenditure</b>	<b>31,138</b>
<b>Surplus / (Deficit)</b>	<b>-</b>

Expenditure includes budgeted costs including salaries, utilities and capital spend.

## 2017/18 and beyond

### *Cost pressures and efficiencies*

In March 2016, a report was presented to the Board detailing the 2016/17 budget and the financial plan for 2017/18 and 2018/19. This plan projects a growing deficit for each year, being £442,000 in 2017/18 growing to £1,120,000 in 2018/19.

The financial plans forecast a flat cash grant in aid allocation year on year. They also forecast a year on year increase in salaries of around 5%. The increase in salary costs and decrease in income is partly offset by a decrease in other costs from 2016/17 to 2017/18 of circa £500,000, however, as noted above, NMS are still forecasting a deficit each year after 2016/17.

The paper presented to the Board states that focus will be on increasing self-generated income in order to reduce the forecast deficit. However, it does highlight to the Board that this would not replace the reduction in grant in aid and that the management of the associated expenditure would be need to be changed in order to receive the greatest benefit.

As noted above, NMS have prepared financial plans and do acknowledge the forecast deficit for 2017/18 and 2018/19. Whilst they have considered the potential ways to reduce the forecast deficit, at the time of presenting this paper, plans have not yet been presented to the Board which detail the specific measures that will be put in place to reduce the deficit along with the associated financial impact of each measure.

NMS should continue to review the measures it could implement to reduce the forecast deficit, and as noted in the recommendation below, a detailed plan should be presented to the Board for approval.

<b>Deficiency</b>	<b>Recommendation</b>	<b>Management Response</b>
<p>NMS have a financial plan in place which has been presented to and approved by the Board in March 2016.</p> <p>This plan notes a balanced budget for 2016/17 and a deficit for 2017/18 and 2018/19, growing to £1.1m. The financial plan acknowledges the deficit and sets out high level possibilities to increase income and decrease expenditure.</p> <p>However, no detailed savings plan is in place to identify the measures to reduce the deficit and set out how they might be delivered.</p>	<p>Management should undertake an exercise to identify potential savings areas, and develop costed savings proposals to take to the Board for approval.</p> <p>Detailed plans should then be developed to set out how the changes will be implemented to realise the savings.</p>	<p>Our main source of funding is Government Grant in Aid. We have received no information on the level of grant funding that we should plan for in 2017/18 or subsequent years. Without any indication of the scale of financial challenge that we may face, it is not appropriate to prepare detailed plans.</p> <p>The Board have received and considered information on a series of options that could be adopted in a scaled response tailored to the size of any challenge that materialises.</p> <p>This information will be updated as part of the 2017/18 budget preparation process.</p> <p>Detailed implementation plans will be quickly put in</p>

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		place when we know what we are planning for.
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# Section 4. Governance and internal control

## Governance structure

NMS is governed by a Board of Trustees (Board) that is appointed by the Scottish Government. The Board is responsible for ensuring that NMS fulfils the aims and objectives set by Scottish Ministers. The role of the Board includes establishing the overall strategic direction, monitoring performance against agreed objectives and ensuring that statutory requirements for the use of public funds are complied with.

The Board is supported by an Executive Team, the Audit and Risk Committee, which has responsibility for monitoring risk and internal control, the Finance Committee, the Nominations and Governance Committee and the Personnel and Remuneration Committee.

We consider that the governance arrangements in place are appropriate.

## System of internal control

The Director in conjunction with management and the Audit and Risk Committee is responsible for developing and implementing systems of internal financial control and having in place proper arrangements to monitor their adequacy and effectiveness in practice.

We review these arrangements for the purposes of our audit of the financial statements and for our review of the annual governance statement and report to you any significant deficiencies in internal control that we find during our audit.

No significant matters were identified in the prior year which required follow up in the current year. We have not raised any significant deficiencies in the current year, however, we have noted one area for improvement as detailed below:

Deficiency	Recommendation	Management Response
<p>During our review of the key financial systems in place, we noted that the Finance Manager has full access to the finance systems in place.</p> <p>Allowing full access to the systems by one individual can increase the risk of fraud.</p> <p>However, we do note that our testing of journals in the year noted no issues of unapproved or fraudulent journals.</p>	<p>In line with best practice, full access to systems should only be provided to a limited number of Superusers. These staff members would usually be within the IT department and should not be members of the Finance team, who may have incentive to manipulate results.</p>	<p>We note this comment and will consider further whether an alternative segregation of duties could be feasible.</p> <p>We currently operate a devolved approach to business systems administration across the organisation, and the Finance Manager role re financial systems is consistent with this.</p> <p>The small number of staff in specialised teams represents a significant constraint on our ability to change the segregation of duties whilst</p>

		delivering an efficient and effective service.

Based on our work performed we consider the systems of internal control to be appropriate.

## Risk management

NMS has an established risk management strategy within the organisation. NMS has a published Risk Policy and maintains a Risk Register. The Board identify key risks each year, and puts in place processes to manage these risks.

The risk register is monitored by the Audit and Risk Committee.

## Internal Audit

As described in our Annual Plan, International Standard on Auditing (UK and Ireland) 610: “Using the work of internal auditors” requires us to:

- Consider the activities of Internal Audit and the extent that their work can be relied upon for external audit procedures;
- Obtain sufficient understanding of internal audit activities and the effectiveness of the function to enable us to identify areas of risk and develop an effective and targeted audit approach; and
- Evaluate and test the quality and timeliness of internal audit work, where we seek to rely on the findings, in order to confirm its adequacy for our purposes.

The internal auditors are KPMG. They have completed the internal audit plan for 2016/17. PwC staff attended Audit and Risk Committee meetings where internal audit reviews were presented. We assessed the internal audit reports issued during the year and considered any potential impact on our audit. As in prior years, we have taken no reliance on the work performed by internal audit.

Based on audit work performed we consider the Internal Audit function to be appropriate for the needs of the Board.

## Other matters

### ***Compensation and Confidentiality Agreements***

During the year there were no staff redundancies and 15 staff left voluntarily. All voluntary departure payments have been made in accordance with the provisions of the Civil Service Compensation Scheme (CSCS), a statutory scheme made under the Superannuation Act 1972.

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## ***Section 5. Fraud***

International Standards on Auditing (UK&I) state that we, as auditors, are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The respective responsibilities of auditors and management are summarised below:

### **Auditors' responsibility**

Our objectives are:

- to identify and assess the risks of material misstatement of the financial statements due to fraud;
- to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- to respond appropriately to fraud or suspected fraud identified during the audit.

### **Management's responsibility**

Management's responsibilities in relation to fraud are:

- to design and implement programmes and controls to prevent, deter and detect fraud;
- to ensure that the entity's culture and environment promote ethical behaviour; and
- to perform a risk assessment that specifically includes the risk of fraud addressing incentives and pressures, opportunities, and attitudes and rationalisation.

### **Prevention and detection of fraud and corruption**

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. As part of our external audit, we have reviewed NMS's high level arrangements for preventing and detecting instances of fraud and corruption. There are no matters we wish to bring to your attention concerning fraud.

NMS's internal control environment is designed to prevent and detect instances of fraud, specifically through published anti-fraud policies and procedures, segregation of duties and authorisation processes. All suspected fraud should be brought to the attention of the Director of Finance and Planning in the first instance. Should the matter merit further investigation, a nominated senior member of staff will be assigned as an independent investigator by either the Director of Finance and Planning or Director. There is a whistleblowing policy in place, which was developed in line with the Bribery Act (2010). No instances of fraud/corruption were reported during the year through the whistleblowing policy.

Based on audit work performed we consider that the controls in place to prevent and detect fraud or corruption to be suitable for the operations of the Board.

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## ***Section 6. Independence***

### **Independence and objectivity**

We have made enquiries of all PricewaterhouseCoopers' teams providing services to you and of those responsible in the UK Firm for compliance matters.

There are no matters which we perceive may impact our independence and objectivity of the audit team.

### **Independence conclusion**

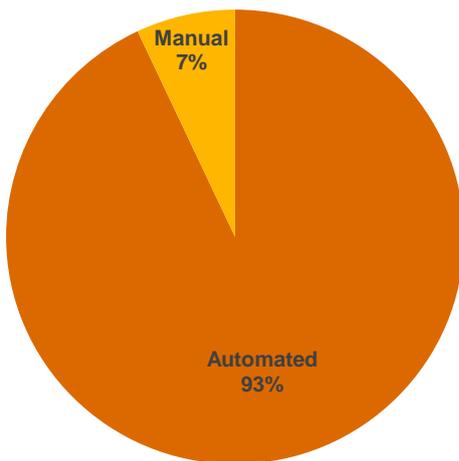
At the date of this plan we confirm that in our professional judgement, we are independent accountants with respect to NMS, within the meaning of UK regulatory and professional requirements and that the objectivity of the audit team is not impaired.

# Appendix 1: Journals insight

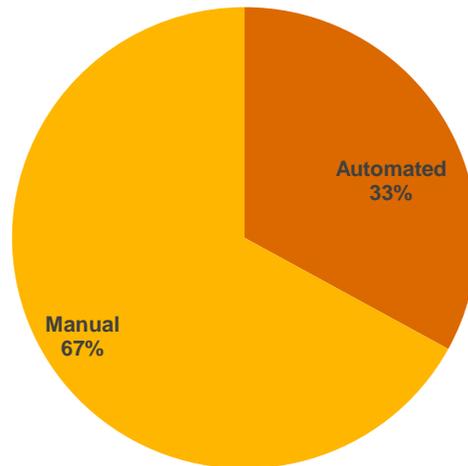
## Automated vs Manual

Summary Profile		
	Quantity	Value (GBP)
<b>Total journals</b>	<b>20,006</b>	<b>£269,405,596</b>
<b>Total manual journals</b>	<b>1,503</b>	<b>£180,673,176</b>
Average no. of lines per manual journal	6.2	

**Volume**

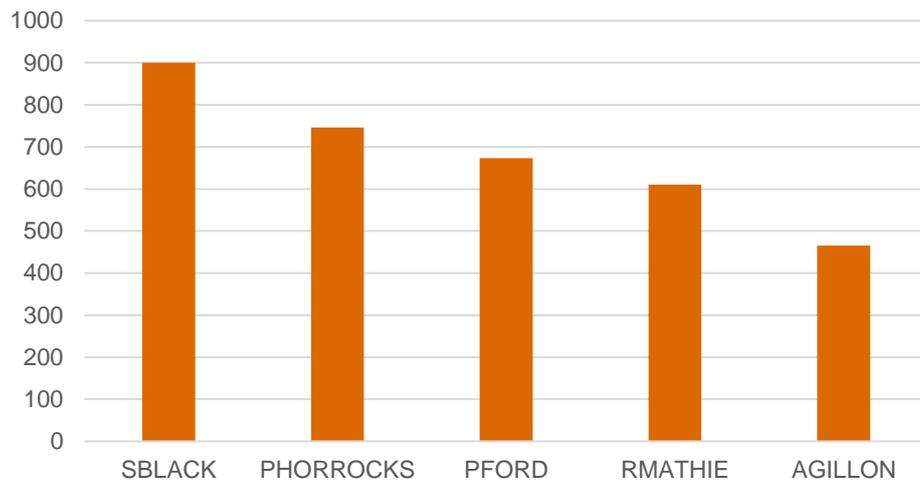


**Value**



*Observation: 93% of journals posted during 2015/16 were posted automatically, with the remaining 7% of journals being posted manually; however we note that 67% of the total journals value for 2015/16 was as a result of the 7% of manual journals posted in the year. We ask management to consider whether this appears reasonable.*

**Top 5 users posting manual journals**



*Observation: the top five manual journal users have been portrayed in the graph above, which is in line with our understanding of the entity as they are all members of the NMS finance team and it is reasonable to assume they post manual journals as part of their role.*



*In the event that, pursuant to a request which NMS has received under the Freedom of Information Scotland Act 2002, it is required to disclose any information contained in this report, it will notify PwC promptly and consult with PwC prior to disclosing such report. NMS agrees to pay due regard to any representations which PwC may make in connection with such disclosure and NMS shall apply any relevant exemptions which may exist under the Act to such report. If, following consultation with PwC, NMS discloses this report or any part thereof, it shall ensure that any disclaimer which PwC has included or may subsequently wish to include in the information is reproduced in full in any copies disclosed.*

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