



# **Historic Environment Scotland**

Planning report to the Audit and Risk Committee  
on the 2016/17 audit

26 January 2017

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# Director introduction

## The key messages in this report

I have pleasure in presenting our planning report to the Audit and Risk Committee for the 2016/17 audit. I would like to draw your attention to the key messages of this paper:

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with those charged with governance.

### Financial challenges

- As with all public sector bodies, Historic Environment Scotland (“HES”) continues to face significant financial challenges. The overall 2016/17 forecast position as at 31 October 2016 is projecting a surplus of £1.709m, with commercial income increasing much more than had been anticipated in the budget. This brings with it a risk that the Scottish Government will reduce the Grant in Aid, while simultaneously HES will have to manage an ever increasing number of visitors to attractions and properties throughout Scotland. HES is dependent on grant funded activities to operate, therefore financial sustainability remains a risk and will be a key area of audit focus in our audit dimensions work discussed further below.
- In the Scottish Government’s draft budget for 2017/18, a significant increase in capital grant funding was announced. HES will need to ensure that plans are developed and put in place, with appropriate lead in times, to ensure that this funding is invested effectively. We will consider these plans as part of our work on the financial sustainability audit dimension discussed below.

### Significant risks

- We have identified the following financial statement significant risks:
- completeness and accuracy of commercial income;
  - categorisation and application of funds;
  - investment grants;
  - valuation of property assets; and
  - management override of controls.

### Audit Dimensions

- The 2016 Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. Our audit work will consider how HES is addressing these and we will report our conclusions in our annual report to the Audit and Risk Committee in October 2017. In particular, our work will focus on:
  - **Financial sustainability** – we will monitor The Board of Trustees’ (“The Board”) actions in respect of its short, medium and longer term financial plan to assess whether short term financial balance can be achieved, whether there is a long-term financial strategy and if investment is effective.
  - **Financial management** – we will review the budget and monitoring reports to the Board during the year and liaise with internal audit in relation to their work on the key financial controls to assess whether financial management and budget setting is effective. We will also consider the capacity of the finance team in view of the prior year audit recommendations.

# Director introduction (continued)

## The key messages in this report

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with those charged with governance.

### **Audit Dimensions (continued)**

- **Governance and transparency** – from our review of Board papers and attendance at Audit and Risk Committees we will assess the effectiveness of governance arrangements. We will also share best practice from elsewhere from our dedicated governance team.
- **Value for money** – we will gain an understanding of The Board’s self-evaluation arrangements to assess how it demonstrated value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered. We will also follow-up on progress with the arrangements for the collection of gift aid at historic sites.

### **Other wider scope work**

- We will monitor The Board’s participation and progress with the National Fraud Initiative (NFI) during 2016/17 and complete an Audit Scotland audit questionnaire by 30 June 2017.
- In accordance with Audit Scotland guidance, we will be requested to provide information to support national performance audits and to inform wider analysis on the following subjects:
  - European Funding
  - Follow-up of Role of Boards report

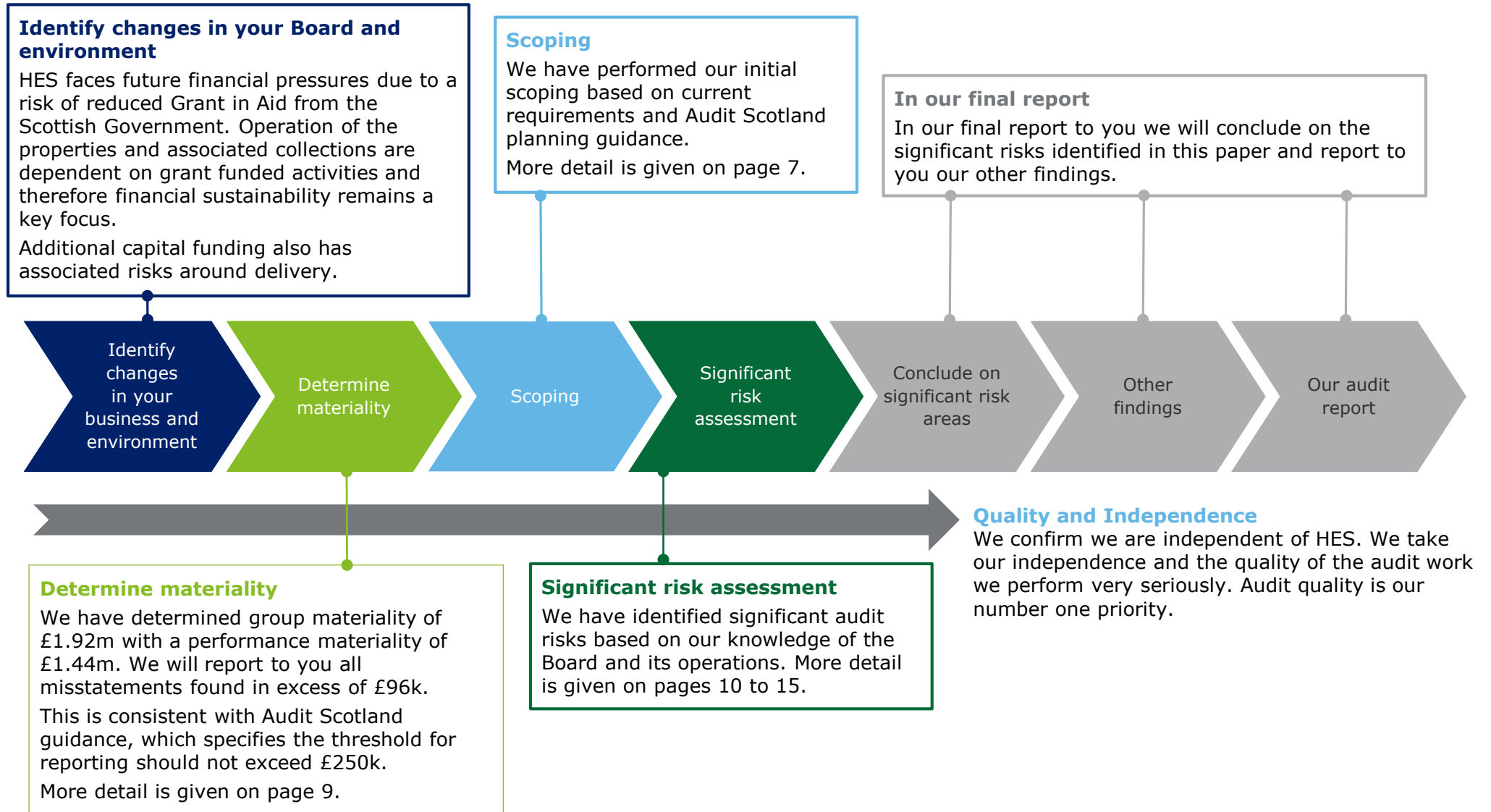
### **Our commitment to quality**

- We are committed to providing the highest quality audit, with input from our market leading specialists, sophisticated data analytics and our wealth of experience. Further information is presented on page 27.

**Pat Kenny**  
**Audit Director**

# Our audit explained

We tailor our audit to your business and your strategy



# An audit tailored to you

## Focusing on your business and strategy

### Impact on our audit

#### Future financial sustainability



HES continues to face significant financial challenges. The overall 2016/17 forecast position as at 31 October 2016 is projecting a surplus of £1.709m, with commercial income increasing much more than had been anticipated in the budget. This brings with it a risk that the Scottish Government will reduce the Grant in Aid, while simultaneously HES will have to manage an ever increasing number of visitors to attractions and properties throughout Scotland.

In the Scottish Government's draft budget for 2017/18, a significant increase in capital grant funding was announced. HES will need to ensure that plans are developed and put in place, with appropriate lead in times, to ensure that this funding is invested effectively.

We will monitor the Board's plans to achieve long term financial sustainability. We will also consider the effectiveness of the transformational change and benefits realisation approach adopted by HES.

#### Risk Management Policy and Strategy



HES is currently embedding a new approach to risk management based on good practice in operation in the public and charities sector. A new Risk Management Policy and Strategy are currently being developed. As part of our wider scope audit work, we will review the current draft documents and provide feedback based on our knowledge and experience from the wider sector.

#### Review of gift aid arrangements



In the 2015/16 annual audit report, it was noted that the collection of gift aid from visitors to historic sites was not yet set up, which represents lost income to HES and is considered a risk to achieving value for money. We will follow up progress with this during 2016/17.

#### Internal Audit Arrangements



The Internal Audit service is carried out by the Scottish Government Internal Audit team, with the current appointment extended to 31 March 2017. Management are in the process of reviewing the options available for the future delivery of the internal audit function. We will provide management with input to any reviews and share benchmarking information from similar organisations. Over the course of our appointment, we will continue to monitor the effectiveness of the service on an ongoing basis.



Significant risk



Normal risk



Considered as part of wider scope audit requirements

# Scoping

## Our key areas of responsibility under the Code of Audit Practice



### Core audit

Our core audit work as defined by Audit Scotland comprises:

- providing the **Independent Auditor's Report** on the annual accounts (and any assurance statement on consolidation packs);
- providing the **annual report** on the audit addressed to the Board and the Auditor General for Scotland;
- communicating **audit plans** to those charged with governance;
- providing **reports to management**, as appropriate, in respect of the auditor's corporate governance responsibilities in the Code (including auditors' involvement in the NFI exercise);
- Preparing and submitting **fraud returns**, including nil returns, to Audit Scotland where appropriate;
- Identifying significant matters arising from the audit, alert the Auditor General for Scotland and support Audit Scotland in producing statutory reports as required; and
- undertaking work requested by Audit Scotland or local performance audit work.

### Wider scope requirements

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland:

- **Financial sustainability** – looking forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.
- **Financial management** – financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.
- **Governance and transparency** – the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.
- **Value for money** - using resources effectively and continually improving services.

# Scoping (continued)

## Our approach



### Liaison with internal audit

The Auditing Standards Board's version of ISA (UK and Ireland) 610 "Using the work of internal auditors" prohibits use of internal audit to provide "direct assistance" to the audit. Our approach to the use of the work of Internal Audit has been designed to be compatible with these requirements.

We will review reports prepared by Internal audit and meet with them to discuss their work. We will also discuss the work where they have identified specific material deficiencies in the control environment and we will consider adjusting our testing so that the audit risk is covered by our work.

Using these discussions to inform our risk assessment, we will work together with internal audit to develop an approach that avoids inefficiencies and overlaps, therefore avoiding any unnecessary duplication of audit requirements on the Board's staff. We do not plan to place any specific reliance on the work of internal audit.

Obtain an understanding of the Board and its environment including the identification of relevant controls.

Identify risks and controls that address those risks.

Carry out "design and implementation" work on relevant controls.

If considered necessary, test the operating effectiveness of selected controls

Design and perform a combination of substantive analytical procedures and tests of details that are most responsive to the assessed risks.

### Approach to controls testing

Our risk assessment procedures will include obtaining an understanding of controls considered to be 'relevant to the audit'. This involves evaluating the design of the controls and determining whether they have been implemented ("D&I").

The results of our work in obtaining an understanding of controls and any subsequent testing of the operational effectiveness of controls will be collated and the impact on the extent of substantive audit testing required will be considered.

### Promoting high quality reporting to stakeholders

We view the audit role as going beyond reactively checking compliance with requirements: we seek to provide advice on evolving good practice to promote high quality reporting.

Audit Scotland has published good practice guides in relation to the Annual Report and the Governance Statement to support the Board in preparing high quality drafts of the Annual Report and financial statements, which we would recommend the Board consider during drafting.

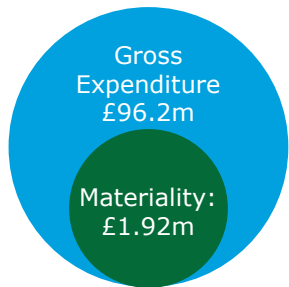


# Materiality

## Approach to materiality



### Basis of materiality – benchmark



- HES wholly owns two subsidiaries: Scran Ltd and Historic Environment Scotland Enterprises Limited, which are consolidated within HES financial statements.
- The audit director has determined group materiality as £1.92m and a performance materiality of £1.44m, based on professional judgement, the requirements of auditing standards and the financial measures most relevant to users of the financial statements.
- We have used 2% of forecast gross expenditure as the benchmark for determining materiality.
- Our approach to determining the materiality benchmark is consistent with Audit Scotland guidance which states that the threshold for clearly trivial above which we should accumulate misstatements for reporting and correction to audit and risk committees must not exceed £250k.
- We will audit the two subsidiaries of HES to local statutory materiality thresholds.

### Reporting to those charged with governance

Under the current materiality level based on gross expenditure, we will report to you all misstatements found in excess of £96k.

We will report to you misstatements below this threshold if we consider them to be material by nature.

### Our audit report

- We will:
- Report the materiality benchmark applied in the audit of the Board;
  - Provide comparative data and explain any changes in materiality, compared to prior year, if appropriate; and
  - Explain any normalised or adjusted benchmarks we use, if appropriate.

Although materiality is the judgement of the audit director, the Audit and Risk Committee must satisfy themselves that the level of materiality chosen is appropriate for the scope of the audit.

# Significant risks

# Income recognition

## Completeness and accuracy of commercial income

### Nature of risk

ISA 240 states that when identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

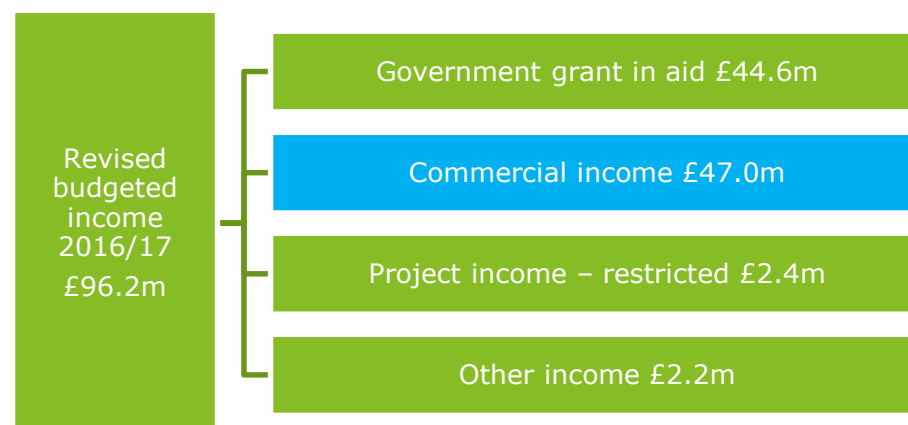
The main components of income for HES, as summarised below, are government grant in aid and commercial income. Grant in aid is directed by the Scottish Government and not considered a significant risk as the process for receipt of this income is not complex and can be verified 100%. The significant risk is pinpointed to completeness and accuracy of commercial income, being income from admissions and retail income from properties in care.

### The key judgement areas, its potential impact on the financial statements and our planned audit challenge

As commercial income comprises low value, high volume cash transactions across multiple locations there is an inherent risk of fraud in respect of these balances.

We will perform the following:

- obtain an understanding of the design and implementation of the key controls in place in relation to recording commercial income;
- assess whether the income streams are recognised in line with the Charities SORP;
- perform analytical procedures over commercial income reported, based on visitor numbers and price changes;
- sample testing of income, tracing till receipts to the ledger, to confirm completeness;
- sample testing of income recorded during the year to confirm accuracy; and
- cut-off procedures to test the accurate recognition of income at the year-end.



### Deloitte comment

We are not aware of any issues arising which would impact on the treatment or recoverability of income during the year.

# Categorisation and application of funds

## Restricted and unrestricted income and expenditure

### Nature of risk

Practice Note 11 *The Audit of Charities in the United Kingdom (revised)* issued by the Auditing Practices Board states that restricted funds should be a presumed significant risk for all charities. As a result, we are required to examine the movement in the restricted funds from the Charity to ensure that the restricted funds have been accounted for correctly.

### The key judgement areas, its potential impact on the financial statements and our planned audit challenge

The Charity must ensure that income is recorded correctly between restricted and unrestricted funds and expenditure is incurred in accordance with relevant charities legislation, the objects of the Charity and the specific fund balances.

We will perform the following:

- obtain an understanding of the design and implementation of the key controls in place around the application of funds, specifically the recognition of income and the utilisation of restricted funds;
- test a sample of income receipts to ensure initial classification is in accordance with the donor wishes;
- test a sample of expenditure from restricted funds in the year to ensure the expense is in line with the donor wishes; and
- review any other movements to/ from restricted funds (e.g. transfers) and obtain supporting documentation to confirm the validity of the movement.

### Deloitte comment

In 2015/16 restricted funds largely related to income received from the European Regional Development Fund (ERDF) and the Heritage Lottery Fund in relation to the Engine Shed Project.

# Investment grants

## Accounting treatment under Charities SORP

### Nature of risk

When HES was formed on 1 October 2015, the organisation assumed the statutory responsibility from Historic Scotland (HS) to deliver grants, mainly to charitable trusts, as well as local authorities and individuals. As this is a material expenditure stream for HES, there is a significant risk associated with the accurate recording and cut off of these grants.

### The key judgement areas, its potential impact on the financial statements and our planned audit challenge

Under the Charities SORP (FRS102) the award of a grant is recognised as a liability when the criteria for a constructive obligation are met, payment is probable, it can be measured reliably, and there are no conditions attaching to its payment that limit its recognition. This resulted in a significant change in 2015/16 with grants being recognised earlier than had been the case under FReM reporting, where grants were recognised at the point of commencement of the funded projects and has resulted in £13.5 million negative unrestricted reserves on the Balance Sheet.

We will perform the following:

- obtain an understanding of the design and implementation of the key controls in place in relation to awarding and recognition of investment grants; and
- test a sample of investment expenditure during the year, accruals at the year-end and commitments disclosed to assess whether they have been accounted for in accordance with the Charities SORP.

### Deloitte comment

No testing has been performed to date as we will complete the above as part of our year-end visit.

# Valuation of property assets

The valuation of £25 million of property assets (as at 31 March 2016) is inherently judgemental

## Nature of risk

HES is required to hold all non-monument property at a modern equivalent use valuation. The valuations are by nature significant estimates which are based on specialist and management assumptions and which can be subject to material changes in value.

## The key judgement areas, its potential impact on the financial statements and our planned audit challenge

HES held £25 million of property assets at 31 March 2016. The financial year to 31 March 2017 will represent 1 of a 5 year rolling programme in which 20% of the portfolio will be revalued. This will be the first full financial year during which HES began delivering activity following the merger of HS and Royal Commission on the Ancient and Historical Monuments of Scotland (RCAHMS).

We will perform the following:

- review any external revaluations performed in the year, assessing whether they have been performed in a reasonable manner, on a timely basis and by suitably qualified individuals;
- test a sample of revalued assets and re-perform the calculation assessing whether the movement has been recorded through the correct line of the accounts;
- consider material changes of assets not subject to full revaluation during the year;
- consider assets classified as surplus or held for sale to assess whether these have been valued and disclosed in line with the SORP and FReM; and
- involve the use of our internal property specialists to review and challenge the assumptions and methodology adopted by the Valuation Office Agency (VOA), including sample testing of inputs to the valuations.

## Deloitte comment

We note that regular discussion takes place between HES and the VOA during the year and a yearly meeting takes place to discuss the revaluation programme.

# Management override of controls

We will use computer assisted audit techniques, including Spotlight, to support our work on the risk of management override

## Nature of risk

International Standards on Auditing requires auditors to identify a presumed risk of management override of control. This presumed risk cannot be rebutted by the auditor. This recognises that management may be able to override controls that are in place to present inaccurate or even fraudulent financial reports.

## The key judgement areas, its potential impact on the financial statements and our planned audit challenge

Our work will focus on:

- the testing of journals, using data analytics to focus our testing on higher risk journals, including unexpected weekend/ bank holiday postings, journals containing suspicious words, round values and journals posted to seldom used accounts;
- significant accounting estimates. In addition to the estimates discussed above in respect of property valuations and investment grants, we will also consider any other provisions and accruals; and
- any unusual transactions or one-off transactions, including those with related parties.

Our wider response to the risk of fraud is set out in the Appendix on pages 22 and 23 of this report.

In considering the risk of management override, we will:

- assess the overall position taken in respect of key judgements and estimates;
- consider the sensitivity of the financial statements with respect to the achieving financial performance targets;
- consider remuneration plans and linkage with key management judgements; and
- consider our view on the overall control environment and 'tone at the top'.

## Deloitte comment

No testing has been performed to date as we will complete the above as part of our year-end visit.

# Wider scope requirements

## Audit dimensions

The Code of Audit Practice sets our four audit dimensions which set a common framework for all public sector audits in Scotland. We will consider how Historic Environment Scotland addresses these areas, including any risks to their achievement, as part of our audit work as follows:

Audit dimension	Areas to be considered	Impact on the 2017 Audit
<p><b>Financial sustainability</b> looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.</p>	<ul style="list-style-type: none"> <li>• The financial planning systems in place across the shorter and longer terms</li> <li>• The arrangements to address any identified funding gaps</li> <li>• The affordability and effectiveness of funding and investment decisions made</li> </ul>	<p>We will monitor HES's actions in respect of its short, medium and longer term financial plans to assess whether short term financial balance can be achieved, whether there is a long-term (5-10 years) financial strategy and if investment is effective. We will also assess the effectiveness of the HES approach to transformational change and benefits realisation.</p>
<p><b>Financial management</b> is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively</p>	<ul style="list-style-type: none"> <li>• Systems of internal control</li> <li>• Budgetary control system</li> <li>• Financial capacity and skills</li> <li>• Arrangements for the prevention and detection of fraud</li> </ul>	<p>As noted on page 7, we will liaise with internal audit in relation to their work on the key financial controls. We will also provide management with feedback on their review of the internal audit function and share benchmarking information from similar organisations.</p> <p>We will review the budget and monitoring reporting to the Board during the year to assess whether financial management and budget setting is effective.</p> <p>We will invite HES to take part in the Deloitte benchmarking survey to assess the level of financial capacity and skills within the board. Our fraud responsibilities and representations are detailed on pages 22 and 23.</p>
<p><b>Governance and transparency</b> is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.</p>	<ul style="list-style-type: none"> <li>• Governance arrangements</li> <li>• Scrutiny, challenge and transparency on decision making and financial and performance reports</li> <li>• Quality and timeliness of financial and performance reporting</li> </ul>	<p>We will review how the governance arrangements are developing following the significant period of change in 2015/16.</p> <p>We will review the financial and performance reporting to the Board during the year as well as minutes of all Board meetings to assess the effectiveness of the governance arrangements. Our attending at Audit and Risk Committees will also inform our work in this area.</p> <p>We will also review the current draft Risk Management Policy and Strategy documents and provide feedback based on our knowledge and experience from the wider sector.</p>
<p><b>Value for money</b> is concerned with using resources effectively and continually improving services.</p>	<ul style="list-style-type: none"> <li>• Value for money in the use of resources</li> <li>• Link between money spent and outputs and the outcomes delivered</li> <li>• Improvement of outcomes</li> <li>• Focus on and pace of improvement.</li> </ul>	<p>We will gain an understanding of HES's self-evaluation arrangements to assess how it demonstrates value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered. We will also follow up progress with implementing the gift aid arrangements.</p>



# Wider scope requirements (continued)

## NFI and Performance audits

### National Fraud Initiative (NFI)

The NFI is a data matching exercise which matches electronic data within and between participating bodies to prevent and detect fraud and is run every two years. All data was submitted in October 2016 and boards will receive matches for investigation in January 2017.

In the HES 2015/16 annual report, KPMG concluded that HES actively investigated NFI matches and that there were no issues of concern regarding the 2014/15 exercise.

In accordance with Audit Scotland planning guidance, we are required to monitor the Board's participation and progress during 2016/17 and complete an NFI audit questionnaire by 30 June 2017. The information contained in this questionnaire will be used for Audit Scotland's NFI report to be published in June 2018.

### Performance audits

In accordance with Audit Scotland planning guidance, we will be requested to provide information to support performance audits and to inform wider analysis on the following subjects during the year:

Purpose	Date
Contribute to informed analysis of European Funding	Spring 2017
Contribute to follow up Role of Boards	30 June 2017

# Audit quality

## Our commitment to audit quality

Our objective is to deliver a distinctive, quality audit to you. Every member of the engagement team will contribute, to achieve the highest standard of professional excellence.

In particular, for your audit, we consider that the following steps will contribute to the overall quality:

- We will apply professional scepticism on the material issues and significant judgements identified, by using our expertise in the sector and elsewhere to provide robust challenge to management;
- We will obtain a deep understanding of your organisation, its environment and of your processes in key areas – such as income recognition, payroll expenditure, and capital expenditure - enabling us to develop a risk-focused approach tailored to the Board;
- Our engagement team is selected to ensure that we have the right subject matter expertise and industry knowledge. We will involve IT and Estates specialists to support the audit team in our work, leading to high quality understanding and challenge; and
- In order to deliver a quality audit to you, each member of the core audit team has received tailored training to develop their expertise in audit skills which includes local Engagement Team Based Learning. This is a partner led programme encouraging teams from across our practice to engage and discuss current sector and audit issues, sharing best practice and expertise. This is in addition to a practice wide health training day held prior to the end of the financial year to share key issues from across the country, to update on regulatory changes and provide early warning of issues other teams may have faced at the interim testing phase.

### Engagement Quality Control Review

We have developed a tailored Engagement Quality Control approach. Our dedicated Professional Standards Review (PSR) function will provide a 'hot' review before any audit or other opinion is signed. PSR is operationally independent of the audit team, and supports our high standards of professional scepticism and audit quality by providing a rigorous independent challenge.

# Purpose of our report and responsibility statement

## Our report is designed to help you meet your governance duties

### What we report

Our report is designed to establish our respective responsibilities in relation to the financial statements audit, to agree our audit plan and to take the opportunity to ask you questions at the planning stage of our audit. Our report includes:

- Our audit plan, including key audit judgements and the planned scope;
- Key regulatory and corporate governance updates, relevant to you.

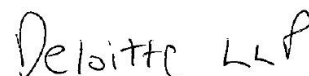
### What we don't report

- As you will be aware, our audit is not designed to identify all matters that may be relevant to the Audit and Risk Committee.
- Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.
- Finally, the views on internal controls and business risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

### Other relevant communications

- This report should be read alongside the supplementary "Briefing on audit matters" circulated separately on 18 January 2017
- We will update you if there are any significant changes to the audit plan.

We welcome the opportunity to discuss our report with you and receive your feedback.



**Deloitte LLP**

Chartered Accountants

Glasgow

18 January 2017

This report has been prepared for the Audit and Risk Committee, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose.

# Appendices

# Prior year uncorrected misstatements and disclosure deficiencies

## Uncorrected misstatements



The following uncorrected misstatements were identified during the course of the prior year audit:

Account	Balance Sheet		Statement of Financial Activities	
	Debit £'000	Credit £'000	Debit £'000	Credit £'000
Opening Reserves	123	-	-	-
Government grant in aid	-	-	-	123
Charitable income - restricted	-	-	70	-
Charitable income - unrestricted	-	-	-	70

There were no disclosure deficiencies noted during the prior year audit.

# Fraud responsibilities and representations

## Responsibilities explained



### Your responsibilities

- The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

### Our responsibilities

- We are required to obtain representations from your management regarding internal controls, assessment of risk and any known or suspected fraud or misstatement.
- As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.
- As set out in the significant risks section of this document, we have identified the risk of fraud in income recognition and management override of controls as a key audit risk for your organisation.

### Fraud characteristics

- Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- Two types of intentional misstatements are relevant to us as auditors – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

## We will request the following to be stated in the representation letter signed on behalf of the Board of Trustees:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We are not aware of any fraud or suspected fraud / We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity or group and involves:
  - (i) management; (ii) employees who have significant roles in internal control; or (iii) others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

# Fraud responsibilities and representations (continued)



We will make the following inquiries regarding fraud:

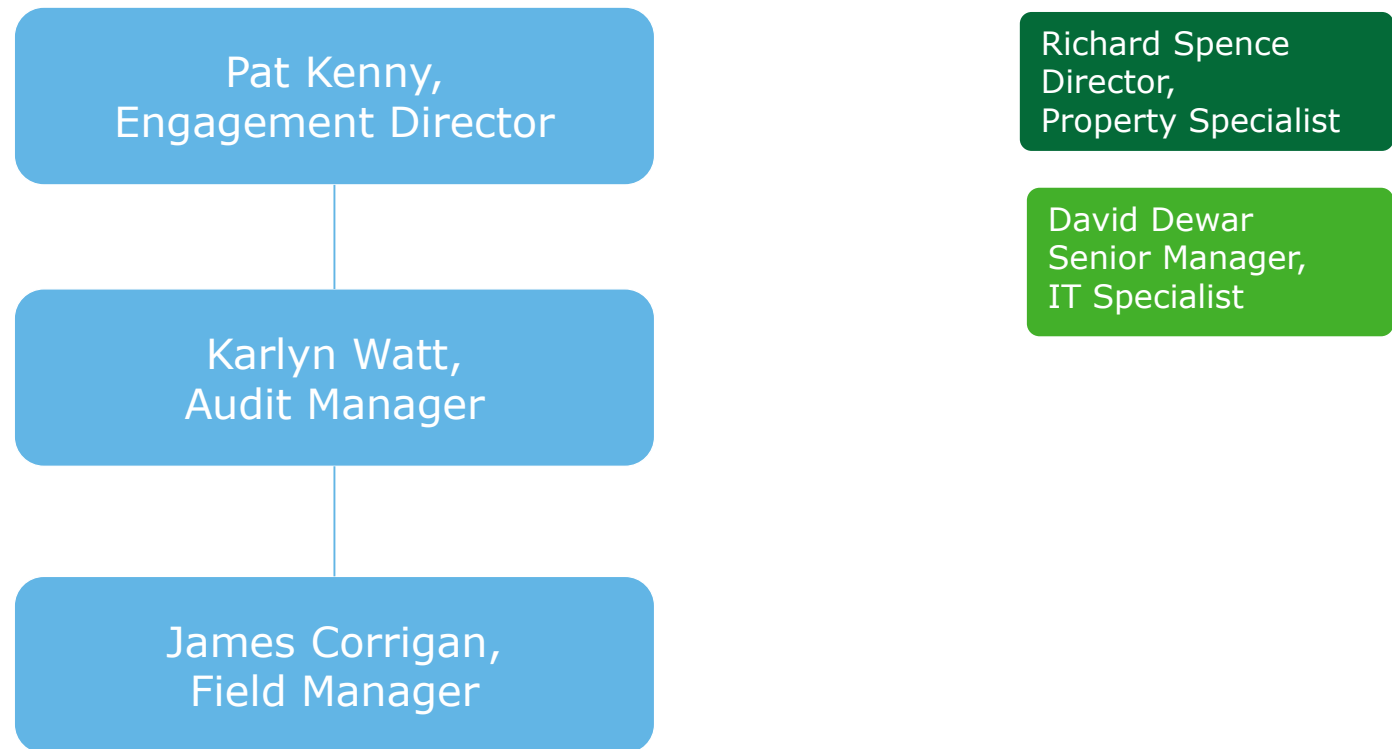
Management	Internal Audit & Local Counter Fraud Specialist	Those charged with governance
<p>Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.</p> <p>Management's process for identifying and responding to the risks of fraud in the entity.</p> <p>Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity.</p> <p>Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.</p> <p>Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.</p> <p>We plan to involve management from outside the finance function in our inquiries.</p>	<p>Whether internal audit and the Local Counter Fraud Specialist has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.</p>	<p>How those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.</p> <p>Whether those charged with governance have knowledge of any actual, suspected or alleged fraud affecting the entity.</p> <p>The views of those charged with governance on the most significant fraud risk factors affecting the entity.</p>

We will also perform procedures in relation to the National Fraud Initiative as set out on page 17.

# Your audit team and timetable

## We have a highly experienced audit team

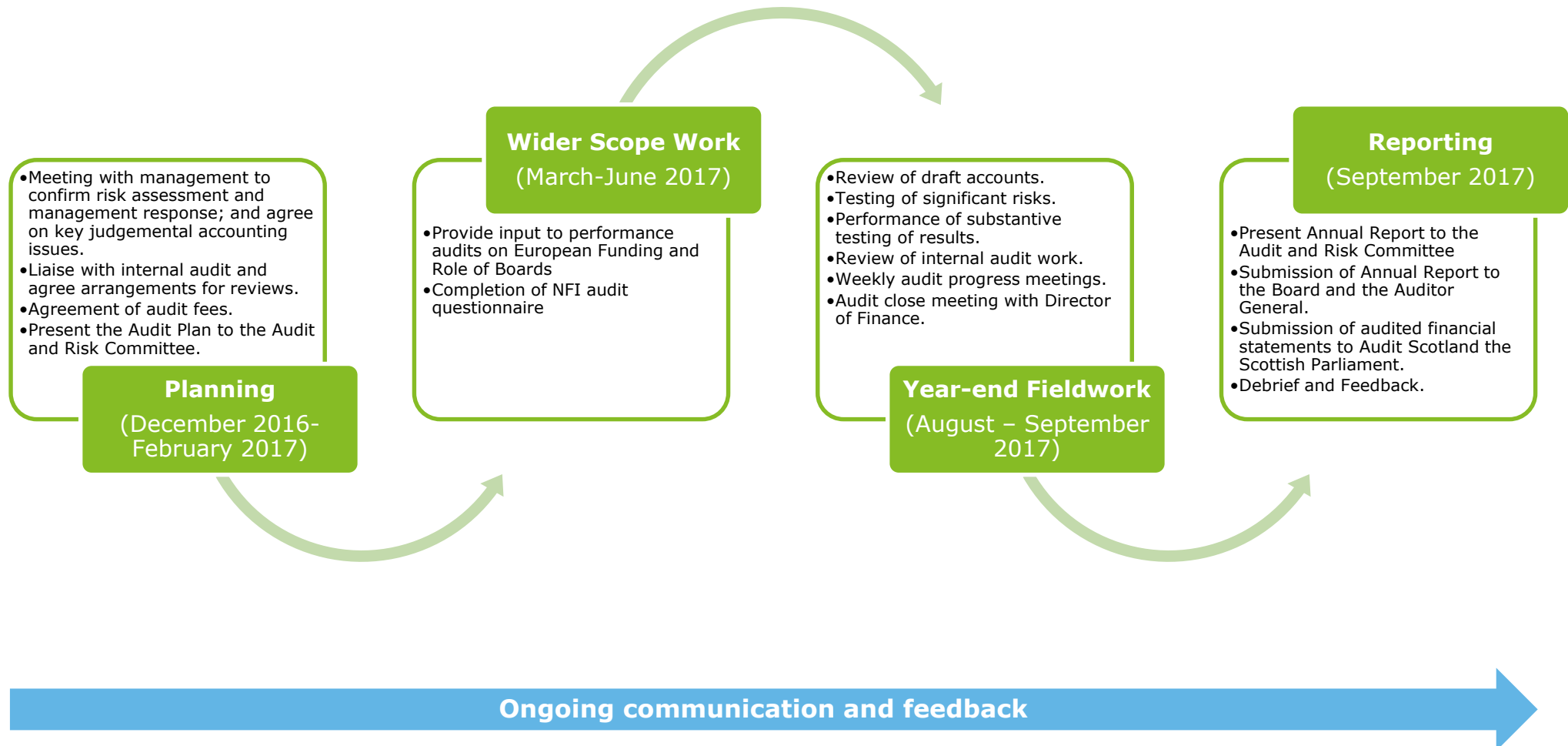
We set out below our audit engagement team. We manage our audit on a basis that it draws on the expertise of our public sector group.





# Your audit team and timetable (continued)

Set out below is the approximate expected timing of our reporting and communication with Historic Environment Scotland and Audit Scotland.



# Independence and fees



As part of our obligations under International Standards on Auditing (UK and Ireland), we are required to report to you on the matters listed below:

## Independence confirmation

We confirm we are independent of the Board and will reconfirm our independence and objectivity to the Audit and Risk Committee for the year ending 31 March 2017 in our final report to the Audit and Risk Committee.

## Fees

A fee range for the 2016/17 audit was provided by Audit Scotland in late December 2016. Our proposed fee for HES, subject to Committee approval, is £74,639 (inclusive of Audit Scotland fixed charges) analysed below. This reflects a maximum 10% uplift on the expected fee to reflect the higher input required in year 1 of our appointment and also to reflect the fact that HES is still a relatively new entity, with associated increased risks:

	£
Auditor remuneration	58,729
Audit Scotland fixed charges:	
Pooled costs	13,120
Audit support costs	2,790
<b>Total proposed fee</b>	<b>74,639</b>

Our proposed audit fees for the two subsidiaries are as followings:

- HESe Limited - £10,000 plus VAT
- Scran Limited - £2,000 plus VAT

Details of all non-audit services fees for the period will be presented in our final report.

## Non-audit services

In our opinion there are no inconsistencies between APB Ethical Standards for Auditors and the Board's policy for the supply of non-audit services or any apparent breach of that policy. We continue to review our independence and ensure that appropriate safeguards are in place including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary.

# Technical developments

## Sector developments



We welcome the opportunity to provide the Board of Trustees with an update on governance and financial reporting.

### Take early steps to manage financial difficulties

In September 2016, the Charity Commission published two reports looking into charities with financial difficulties. The first report was a review of 94 sets of accounts submitted in the year to 31 October 2015 where the charity had income of over £1m and an 'emphasis of matter' paragraph about 'going concern' in the audit report. The second was a more detailed review of 10 charities.

Of the 94, 57 charities have filed more recent accounts, of those 14 no longer have an emphasis of matter paragraph surrounding going concern, 5 consider themselves no longer a going concern and 9 have ceased to operate. 84% of accounts gave more detail about the concerns raised. The concerns raised by auditors were split into two main groups, those drawing attention to current indicators, for example net current liabilities, pension deficits (47%) and matters affecting the charity's future financial situation (53%), for example uncertainty over future funding, dependency on creditors and contingent liabilities. The key findings of the report were around trustees being prepared to address financial difficulties and trustees taking concerns raised by auditors seriously.

Of the 10 charities that were subject to closer scrutiny, the Charity Commission found that, on the whole, trustees were alert to changes in their charity's financial stability and had taken relevant actions. Two of the charities had already failed before the Commission engaged with them and the report highlighted lack of financial planning, lack of management information, infrequent meetings and a failure to critically review income generation methods as specific factors contributing to the financial issues.

The Charity Commission issued updated guidance to support charity trustees in January 2016 -CC12: Managing a charity's finances: planning, managing difficulties and insolvency. The guidance focuses on four main issues:

- What trustees should do to comply with their duties to manage and safeguard their charity's assets
- How trustees can ensure they are fully aware of the financial health of their charity
- Rescue mechanism and alternatives for a charity facing financial difficulties
- What insolvency means for a charity and its trustees

### Charities and litigation: a guide for trustees (CC38)

In August 2016, the Charity Commission published Charities and litigation: a guide for trustees. This is new guidance reiterates the importance of trustees acting in the best interests of their charity and fully documenting all decisions made with regard to general litigation. It also offers more detail on the role of the charity commission in 'charity proceedings', cases where the internal administration of the charity is challenged.

### Consultation on independent examination (CC32)

In June 2016 the Charity Commission published its consultation on Directions for Independent Examination. The updated guidance takes into account the raising of the income threshold for audit, from £500,000 to £1 million and the raising of the threshold for the preparation of consolidated accounts to £1 million, both for year ends ending on or after 31 March 2015. The guidance uses the word 'should' to define expected practice rather than simply recommended practice. The directions also place emphasis on reporting to regulators, both matters of material significance and 'relevant matters' for which there is now a separate section and guidance on reporting. The consultation closed on 30 September 2016.

# Technical developments

## Sector developments (continued)



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### Consultation on Reporting matters of material significance to a UK charity regulator

In May 2016 the Charity Commission published its consultation on reporting matters of material significant to a UK charity regulator – Revised guidance for auditors and independent examiners. These are joint proposals, from England and Wales, Scottish and Northern Ireland regulators which replace the previous list agreed by the Charity Commission and OSCR. The proposals increase the number of matters from eight to ten and refine the wording of the existing matters. The matter referring to matters reported on resignation is removed and the additional matters relate to the requirement for the auditor to report:

- separately to the regulator when issuing a modified report
- when action is not taken by trustees, without reasonable cause, on recommendations made
- when there is evidence that conflicts have not been managed or related party transactions fully disclosed

The consultation closed on 11 September 2016

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### Consultation on power to disqualify from acting as a trustee

The Charity Commission published a consultation in May 2016 seeking views on its proposed approach to using its new power given under The Charities (Protection and Social Investment) Act 2016 to disqualify individuals from acting as trustees. The Charity Commission has published a policy paper which sets out the three tests in the Act that have to be met before the commission can make a disqualification order, the factors that the commission will take into account and the commission's approach to deciding on the length of the disqualification (up to a maximum of 15 years). The power will be implemented in July 2016.

The consultation closed on 22 August 2016.

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### Joseph Rowntree Charitable Trust Case Report

The Charity Commission issued the Joseph Rowntree Charitable Trust case report on the 6 May. The focus of the report was the potential reputational damage from association through funding non-charitable organisations and the risk that grants are provided for non-charitable purposes. The concluding statement regarding the impact of the Commission's involvement highlights the potential for Charity Commission intervention:

"It is clear to other charities and the public that the commission, as regulator, will probe robustly how charities spend charitable funds in order to ensure accountability and transparency and to preserve public trust and confidence in charities." Trustees need to ensure that they understand their due diligence and reporting processes around grant giving and are satisfied that their charitable expenditure is appropriate.

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# Technical developments

## Sector developments (continued)



### Gender pay gap information

Employers with 250 or more relevant employees will be asked to publish the following information on their website for each financial year:

- the percentage difference in mean pay between male and female employees;
- the percentage difference in median pay between male and female employees;
- the percentage difference in the average bonuses received by male and female employees;
- the proportion of men and women who receive bonuses; and
- the number of men and women in each quartile of pay within the workforce.

The first suggested data point will be 30 April 2017 with twelve months to publish information on the charity's website.

Before this we would recommend that trustees' and management consider whether their systems are able to generate the required information and whether there is an issue to be addressed with the gender pay gap with the organisation in terms of policy or implementation

### Modern Slavery Act 2015

The Modern Slavery Act 2015 applies to:

- a commercial organisation (that is a body corporate which would include a CIO, company limited by guarantee, or a corporation established by royal charter or statute);
- which supplies goods or services;
- which carries on a business or part of a business in any part of the UK; and
- which has a turnover (including that of any subsidiaries) of more than £36 million.

The Home Office have published guidance: Transparency in Supply Chains etc. A practical guide to support organisations in considering the impact of the legislation.

If the provisions apply the Act requires the supply chain transparency requirements be disclosed: This means an annual slavery and human trafficking statement. The statement should set out what activity the organisation is undertaking to eliminate slavery and human trafficking from their supply chains and from their own business, or a statement that the organisation has taken no such steps.

Such statements are likely to include information about the organisation's structure, business and supply chains, information on due diligence processes in relation to slavery and human trafficking in its business and supply chains and about the training about slavery and human trafficking available to its staff. Organisations falling within would need to give careful thought to the statement and how they would research its accuracy. The statement would need to be published on the organisation's website and would need to be signed off by a Trustee (or equivalent) and applies for financial years ending on or after 31 March 2016. There is an expectation that it would be published at the same time as the charity's annual report.

Areas to consider include:

- Adding the requirements to the risk register to ensure ownership and oversight
- Critically examining supply chains to identify potential risk areas
- Focussing on other areas of operations for example investments and grants
- Reviewing internal policies and procedures for procuring new suppliers or commencing any new activity
- Reviewing internal training and HR procedures in respect of modern slavery to ensure all staff have had appropriate training, are aware of company policies and that there is an effective whistleblowing policy if modern slavery is found.

# Technical developments

## Sector developments (continued)



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### Issue of parliamentary report on the failure of Kids Company

The Charity Commission has recently been called to provide evidence to the Public Administration and Constitutional Affairs Select Committee on its actions as regulators of Kids Company and how it dealt with prior complaints. The final report was issued on the 1 February and highlights the lessons to be learned by trustees, auditors, Charity Commission and Whitehall. Key recommendations for Trustees include: monitoring reserves; having appropriate experience on the board of trustees; considering trustees length of tenure; understanding the business model and cash flow.

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### SORP Update Bulletin 1

An update Bulletin detailing amendments to SORP for charities applying FRS 102 was published on the 2 February 2016 and has not changed substantively from the draft. The bulletin covers changes to the SORP to bring it into line with changes in FRS 102 and is effective for periods beginning on or after 1 January 2016. It can be early adopted for periods beginning on or after 1 January 2015. The most significant changes include:

- The bulletin confirms the definition of larger charities as charities with an income of over £500,000, a fixed level rather than reflecting the increased audit threshold and confirms that all larger charities will be required to prepare a statement of cash flows.
- The bulletin notes the withdrawal of the FRSE but does not state explicitly that charities that are within the limits of the small companies regime are not allowed to use the section 1A disclosure exemptions in FRS 102 as was proposed. However, these disclosures would provide little value to small charities as the SORP requirements have force of law and specifically require the disclosures that would be exempted.

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### Charity reserves: building resilience

In January 2016, the Charity Commission published CC19 *Charity Reserves: Building resilience*. The key message to trustees is that they must develop a reserves policy that fully justifies and clearly explains keeping or not keeping reserves. The policy must identify and plan for the maintenance of essential services for beneficiaries; reflect the risk of unplanned closure associated with the business model, spending commitments, potential liabilities and financial forecasts; help address the risks of unplanned closure on their beneficiaries, staff and volunteers. The reserves policy must be put in place, operated and the effectiveness regularly reviewed in the light of the changing funding and financial climate and other risks.

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### Freedom of information (public Interest and transparency) private members bill

A private members bill was introduced in parliament on the 19 January that among other measures would extend the Freedom of Information Act 2000 to cover private companies, social enterprises and charities contracted to carry out work for public authorities; and the Royal Household; and for connected purposes. The second reading of the bill will take place in March 2016.

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# Technical developments

## Sector developments (continued)



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<b>Temporary staff</b>	<p>Since the withdrawal of the Staff Hire Concession, charities will have incurred VAT on supplies of temporary workers from employment agencies. Deloitte is working with an employment agency, Adecco, to challenge this position, and is also working with charity clients to support them in making claims for overcharged VAT to protect their position whilst litigation takes place. The First Tier Tribunal heard the case in May/June 2015, and the decision was released in late 2015. The First Tier Tribunal found against the taxpayer, but Adecco has appealed and the case is listed for a hearing by the Upper Tribunal in December 2016.</p>
<b>Irrecoverable VAT in relation to outside the scope supplies</b>	<p>Vehicle Control Services (VCS) operated a car park and received 8% of its income from parking permits - subject to VAT - and 92% of its income from parking charge notices ('PCNs') which it issued to motorists who were in breach of the parking rules. The Court of Appeal had previously decided in 2013 that the PCN income represented damages for trespass or breach of contract and was therefore outside the scope of VAT.</p> <p>Following the Court of Appeal decision there was a disagreement between VCS and HMRC in respect of the extent to which VCS was entitled to recover VAT incurred on costs. Both parties agreed that VCS could not recover VAT incurred on costs that wholly related to PCN income and that VCS was entitled to fully recover VAT that wholly related to parking permit income. The Upper Tribunal (UT) was asked to decide whether VCS was fully entitled to recover VAT incurred on overhead costs (as VCS argued) or whether an apportionment was necessary (as HMRC argued).</p> <p>The UT decided that it was necessary to apportion VAT and that HMRC's proposed income based apportionment was acceptable (resulting in only 8% VAT recovery on overhead costs). The UT decided that that the PCN income was generated from a 'business' activity, but that an apportionment was still necessary because VAT can only be recovered to the extent it relates to taxable business supplies.</p> <p>We await confirmation from VCS as to whether it will appeal the decision.</p>
<b>Below cost supplies still an 'economic activity'</b>	<p>The Court of Appeal has allowed HMRC's appeal in the case of Longridge on the Thames. The Court held that Longridge conducted an economic activity for VAT purposes and, accordingly, could not obtain zero-rating on the construction costs of its new building.</p> <p>The First Tier Tribunal (FTT) and Upper Tribunal both found for Longridge, accepting that the 'predominant concern' of Longridge's activities as a whole is not to make supplies for a consideration, but to carry out activities in a manner which furthers its charitable objectives. The FTT noted that there are features which are not consistent with sound business principles (most obviously the charity's use of volunteers and reliance on donations to meet its costs). This was all consistent with previous case law in this area.</p> <p>However, the Court of Appeal has now allowed HMRC's appeal, finding that there is a direct and immediate link between the payment received and the services provided and therefore there is an economic activity. Mr Justice Morgan stated "I consider that it should now be recognised that the test of 'predominant concern' is unhelpful and may be misleading."</p> <p>This case could be appealed further but, in the meantime, this decision calls into question the historical case law in this area.</p>

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# Technical developments

## Sector developments (continued)



### **Pension schemes**

HMRC have issued Revenue & Customs Brief 14 2016: VAT, Deduction of VAT on pension fund management costs following the Court of Justice of the European Union decision in PPG confirming that the end of the transitional period has been extended, this time until 31 December 2017. This means that taxpayers may continue to use the VAT treatment outlined in VAT Notice 700/17: Funded Pension Schemes until 31 December 2017.

The main points resulting in the extension to the transitional period are not VAT points, but regulatory and accounting/corporation tax issues.

### **Gift aid declaration wording**

The example Gift Aid declarations provided by HMRC were updated in September 2015 to use clearer and simpler language. From 6 April 2016 the updated wording should be used and the template wording for: one-off donations, multiple donations and sponsored events can be found at <https://www.gov.uk/guidance/gift-aid-declarations-claiming-tax-back-on-donations>. Gift Aid declarations made before 6 April 2016 using the old wording do not need to be changed or updated. However, all donations from 6 April 2016 should use the new wording drafted by HMRC unless the declarations were printed prior to 21 October 2015. Charities and CASCs holding stocks of printed materials that were ordered and printed before the new declaration was amended, can use up their current stock before using the new declaration.

As before, charities are not obliged to use the HMRC suggested wording and may adapt the declarations to meet their own needs. Although it is strongly recommended where charities do use different wording, the declarations made still meet the valid Gift Aid declaration requirements.

Charities may wish to review samples of declarations used from 6 April 2016 to confirm, where appropriate, that the revised wording is now being adopted.

### **Charity fundraising review**

Charities should ensure tax compliance processes are robust and managed effectively to maintain public trust and a positive relationship with HMRC.

### **Gift Aid Small Donations Scheme ("GASDS")**

Following the GASDS consultation in early 2016, The House of Commons has updated the briefing paper on the GASDS which discusses in more detail the background to the measure and provides the latest draft of the Bill. The Bill has had its first reading in Parliament with the second reading expected on 11 October 2016.

The maximum annual donation amount that can be claimed under GASDS has been increased from £5,000 to £8,000 with effect from 6 April 2016 and the other revisions aim to make GASDS operate more effectively and flexibly for the greatest number of charities.

### **Retail gift aid guidance**

Retail Gift Aid guidance has been updated and HMRC indicates clearly that the charity will no longer be automatically liable for repayments of tax for reliefs claimed incorrectly. In situations where an amount of tax has been claimed by the charity in excess of amounts of tax paid by the donor, the responsibility to make repayment will pass to the donor.

In practice charities may offer to remedy the error or settle the liability for the donor to maintain goodwill and trust with their supporters.



# Our approach to quality

## AQR team report and findings

### Audit quality and regulation

We pride ourselves on our commitment to quality and our quality control procedures. We have an unyielding pursuit of quality in order to deliver consistent, objective and insightful assurance.

In May 2016 the Financial Reporting Council ("FRC") issued individual reports on each of the six largest firms, including Deloitte, on Audit Quality Inspections which provides a summary of the findings of its Audit Quality Review ("AQR") team for the year ended 31 March 2016. We adopt an open and communicative approach with the regulator and their report is an accurate reflection of our efforts to improve audit quality across our practice over a number of years.

The review performed by the AQR forms an important part of our overall inspection process. We perform causal factor analysis on each significant finding arising from both our own internal quality review and those of our regulators to identify the underlying cause. This then drives our careful consideration of each of the FRC's comments and recommendations, as well as findings arising from our own reviews to provide further impetus to our quality agenda.

18 of the audits reviewed by the AQR were performed to a good standard with limited improvements required and four audits required improvements. No audits were assessed as requiring significant improvements. We have already taken action to respond to the key themes of the report and will continue to undertake further inputs to our audit quality improvement programmes to embed the changes into our practice.

### The AQR's conclusion on Deloitte

"We reviewed selected aspects of 22 individual audits in 2015/16. In selecting which aspects of an audit to inspect, we take account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements.

In response to our last inspection report, the firm has made a number of improvements to its policies and procedures:

- The firm's guidance regarding the testing of journals has been enhanced.
- Additional sector-specific training was provided for individuals involved in financial services audits, together with additional training on internal controls for all audit staff.
- The firm has made a number of improvements to its internal monitoring process, including the development of a moderation process in order to increase consistency.

Our key findings in the current year requiring action by the firm are that the firm should:

- Improve the extent of challenge of management in relation to areas of judgment, in particular for impairment reviews and judgmental valuations.
- Improve aspects of its audit approach in the areas of revenue and inventory.
- Ensure high quality reporting to Audit Committees is achieved on a consistent basis.
- Strengthen its audit approach in relation to defined benefit pension scheme balances and disclosures.
- Strengthen its policies and procedures regarding the engagement quality control review process."

### 2015/16 Audit Quality Inspection Report on Deloitte LLP

# Our approach to quality (continued)

## AQR team report and findings (continued)

### Review of individual audits

The following chart provides a summary of the AQR's assessment of the quality of our individual audits inspected in 2015/16, with comparatives for the previous 4 years. The chart also shows the 5 year average of Deloitte and the 5 year average of the 6 largest firms inspected by the AQR (which comprises Deloitte LLP, Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP, BDO LLP and Grant Thornton UK LLP).

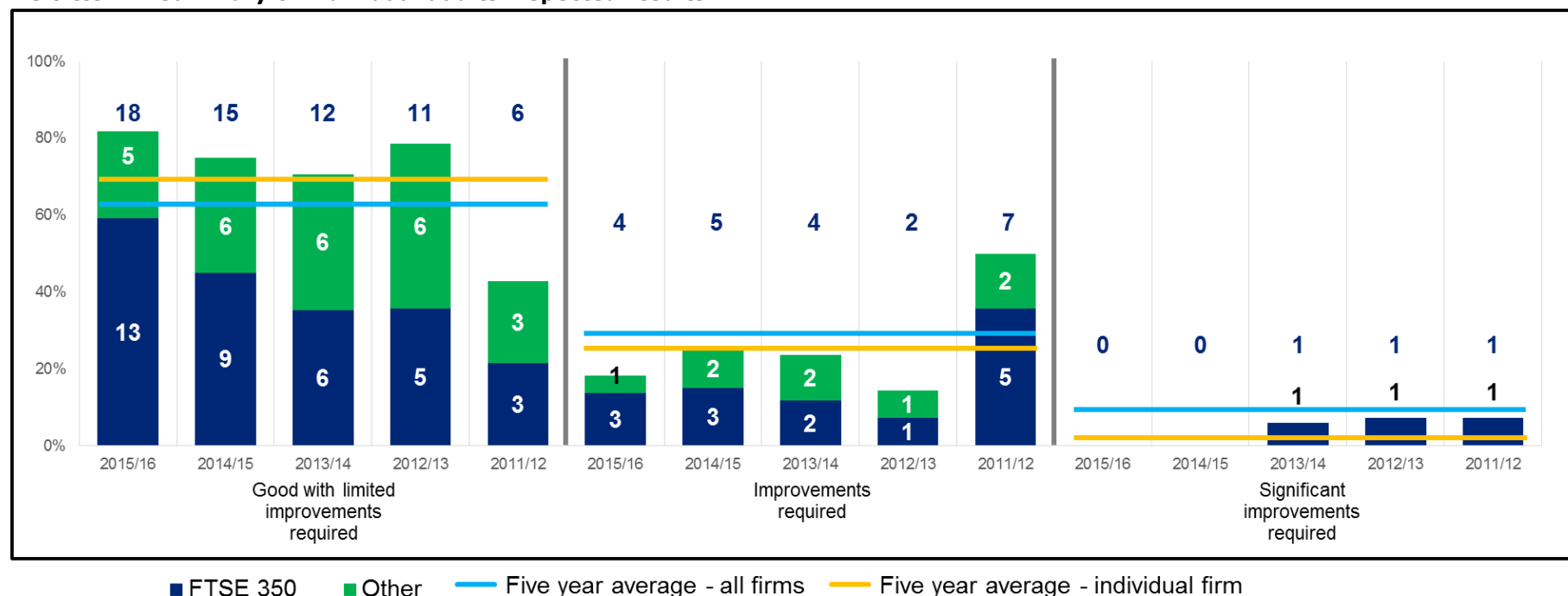
The AQR categorises audits as either:

- Good with limited improvements required
- Improvements required
- Significant improvements required

Changes to the proportion of audits reviewed falling within each grade from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

All the AQR public reports on individual firms are available on its website <https://www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review/Audit-firm-specific-reports.aspx>

### Deloitte LLP summary of individual audits inspected results





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