

Government and Public Sector

September 2006

National Museums of Scotland

Annual Report to Board Members

2005/06 Audit

The Members of the Board
National Museums of Scotland
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15 September 2006

Our ref: LP/SD/CB

Ladies and Gentlemen

Annual Report to Board Members 2005/06

We have completed our audit of the National Museums of Scotland (“NMS”) and its financial statements for the year ended 31 March 2006.

The Annual Report which follows is primarily designed to direct your attention to the key matters that have arisen out of the 2005/06 audit process and to confirm what action is planned by management to address the more significant matters identified for improvement.

We would like to take this opportunity to offer our thanks to those members of management and staff who have assisted us during the course of the audit.

Yours faithfully

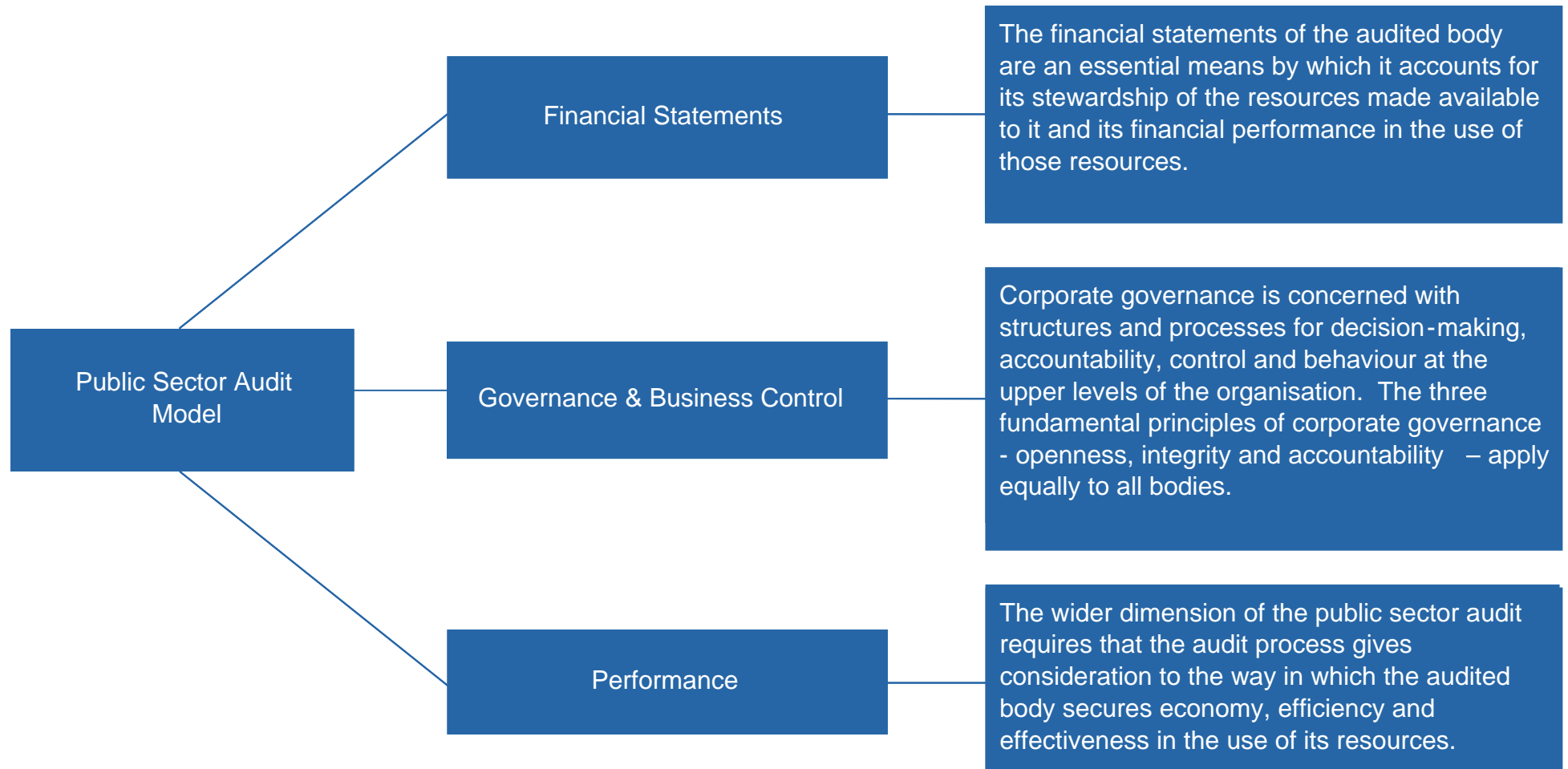
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1. Audit Opinions and Financial Targets

Our Audit Opinion

- 1.1 Our audit opinion concerns both the true and fair statement of NMS's financial results for the year ended 31 March 2006 (2005/06) and the regularity of its income and expenditure in the year.
- 1.2 Our true and fair opinion on the financial statements is unqualified.
- 1.3 Our regularity opinion on income and expenditure is unqualified.
- 1.4 Our opinion is set out in full in **Appendix 3**

Financial Targets

- 1.5 NMS's key financial target is to manage expenditure within income on a year by year basis. In 2005/06, this target was achieved. NMS has no other financial targets set for it by the Scottish Executive or other bodies, though it is expected that Value for Money is achieved. A summary of the financial performance of NMS during 2005/06 is given in Section 2 of this report.

2. Financial Performance and Position

Overall Consolidated Financial Performance for 2005/06

	Actual 2006 (£'000)	Actual 2005 (£'000)
Income		
Grant - in - aid received for running costs	18,193	17,433
Gross Income from grant-aided activities	14	50
Net income from Revenue Earning activities	0	6
Release from Capital Reserve	3,156	3,830
Other Income	1,481	1,027
Bank Interest	98	103
Income received by subsidiaries	2,261	1,822
Gain on sale of land	176	0
Transfer to capital reserve	(176)	0
Total income	25,203	24,271
Expenditure		
Staff costs	12,741	11,465
Depreciation and permanent diminution in value	4,964	4,423
Other operating charges	9,044	9,040
Total operating expenditure	26,749	24,928
Operating surplus / deficit	(1,546)	(657)
Notional cost of capital	(4,789)	(4,441)
Deficit for the financial year (after notional cost)	(6,335)	(5,098)
Reversal of notional cost of capital	4,789	4,441
Release from General Fund Revaluation Reserve	1,838	558
Surplus for financial year transferred to reserves	292	(99)

Financial Out-turn 2005/06 - Commentary

- 2.1 As can be seen from the figures above, NMS achieved an overall surplus of £292,000 against a projected breakeven position. The main reasons for this surplus have been:
- strong income receipts from exhibitions, particularly for the 'Nicholas and Alexandra' exhibition and Concorde at the Museum of Flight;
 - the strong financial performance of NMSE which contributed £467,000 Gift in Aid to NMS during the year; and
 - incomplete revenue projects of £185,000 funded from 2005/06 budgets being carried forward for completion in 2006/07
- 2.2 However, these increases in income have been offset by cost pressures as follows:
- 2.3 In common with organisations across the public sector NMS salary costs have increased significantly. The additional costs of £1.2 million are mainly due to the impact of the pay award of £350,000 and pension cost increases of £508,000 in the current year. These increases have been funded in the current year by increased SE Grant in Aid. However, SE funding will not be available to cover the extra pension costs in 2006/07, when NMS will have to bear a burden of approximately £100,000.
- 2.4 Rising energy costs mean NMS has had to absorb additional costs of £300,000 in 2005/06, with the full year impact being in excess of £500,000 per annum. NMS has taken steps to assess and reduce its energy usage in order to reduce the impact of these higher prices going forward. The Scottish Executive has advised that additional grant-in-aid will not be available to meet these increased energy costs.
- 2.5 Overall, NMS has performed well financially during the year and is taking action to address future cost pressures.

3. Forecast Financial Position for 2006/07

Projected Position

3.1 We have summarised the projected 2006/07 financial position as given in the Corporate Plan for the National Museums of Scotland in the table below:

Income and Expenditure Summary

	£'000
Grant-in-Aid	19,880
Less: Transfer to Capital	(840)
	19,040
Other Operational Income	2,011
Grant-in-Aid and operational income	21,051
Release from deferred grants and capital donation	5,160
Total Income	26,211
Salary costs	12,583
Operational Costs	8,468
Depreciation	5,160
Total costs	26,211
Surplus / (deficit)	0

3.2 Whilst the above demonstrates a breakeven budget for 2006/07, one-off revenue projects of £185,000 carried forward from 05/06 as stated in 2.1 above give a revised budget of a deficit of £185,000.

3.3 As highlighted earlier, NMS is aware of a number of cost pressures it faces in terms of pensions and energy costs. It is important that these cost pressures continue to be the subject of management review to ensure the normal breakeven budget is achieved.

Ongoing Capital Projects

3.4 Each year, the budget highlights a transfer from Grant in Aid to capital. This transfer goes towards funding ongoing capital expenditure and minor refurbishment of the NMS estate. The two major capital projects (the redevelopment of the Royal Museum and the Museum of Flight) are funded separately.

4. The Audit Process and Accounting Issues

Audit Process

- 4.1 The draft financial statements were audited by us during June and July 2006. We are pleased to report a significant improvement in the quality of the audit working papers and in the completeness and timeliness of the financial statements presented to us for audit. We would like to thank the Director of Finance and Resources, the new Head of Finance and the rest of the finance team for their assistance throughout the audit process.

Preparation of Financial Statements

- 4.2 The financial statements were prepared in accordance with the accounting requirements contained in the Charities SORP 2005 and supplementary guidance as issued by the Scottish Executive Education Department (SEED) and approved by the Scottish Ministers.

Accounts Approval

- 4.3 The Annual Accounts were noted by the Audit Committee on the 28 July 2006, and will be recommended in due course to the 15 September Board for adoption and approval.

Audit Adjustments

- 4.4 Management has been informed of audit adjustments required to the format of our figures within the financial statements presented to us for audit. These have been accepted by management and changes made as advised.

5. Systems of Internal Control

Statement of Internal Control

- 5.1 We do not disagree with NMS's disclosures contained in the Statement on Internal Control. NMS has used the format prescribed in the Scottish Public Finance Manual and has outlined its processes to identify and evaluate risks. In addition, key elements of NMS's control framework have been highlighted including risk management and internal audit.

Follow Up Report on previous control matters

- 5.2 Our follow up report on our 2004/05 control recommendations was issued in March 2006. Of the 31 agreed recommendations made in our 2004/05 reports, 7 were classed as not yet implemented, with 12 recommendations being partially implemented.
- 5.3 Following a request from the Audit Committee we also performed a review of the further progress since our March 2006 visit. The review took place on 24 August 2006 and of the nineteen recommendations that were still outstanding in March 2006, eighteen had been fully implemented and one, in relation to the Collect aged debtors system, was partly implemented.
- 5.4 Our Follow-Up report will be provided to next year's external auditors, Audit Scotland, in order that ongoing progress can be monitored.

Action Point 1

Financial Systems and our 2005/06 Internal Controls Report

5.6 At our interim visit, we reviewed the following areas, relying on the work of internal audit where appropriate:

- internal audit;
- financial management and budgetary control;
- prevention and detection of fraud and corruption;
- the legality of financial transactions; and
- rotational review of key systems of financial control, specifically the payroll and purchasing cycles.

5.7 A total of three control issues were reported to management in our Interim Management Letter in March 2006. The key issue identified related to weaknesses in the payroll system which have been identified by internal audit. We are pleased to report that during the course of the final audit only one additional control weakness was identified in respect of capitalisation of expenditure whereby we identified that a number of items which were below NMS's stated capitalisation policy had in fact been capitalised. These relate to minor costs within capitalised projects which on review should have been expensed, albeit the amounts involved were not material.

Action Point 2

Finance Management and Budgetary Control

5.8 During the year, the finance department has suffered from management shortages following the departure of the Head of Finance. However, despite this we are pleased to report identified improvements in the system of budgetary control. In particular, a system of formal meetings between finance and budget holders to discuss variances has been established and are viewed by both sides as in a positive manner.

Internal Audit's Report on NMS's Internal Controls

5.9 The extract of the Internal Auditor's opinion for 2005/06 is reproduced below:

In our opinion, subject to the detailed observations and findings in our reports and the recommendations made being implemented, NMS has a framework of control which provides moderate assurance regarding the effective and efficient achievement of NMS objectives. Reports in previous years had identified weaknesses in the IT control regime. We are unable to give an opinion about progress in this area because [our follow up review was postponed at the request of the Director of Finance due to the fact that an IT consultancy is currently assisting with the improvement of the IT environment].

6. Governance Arrangements

Governance Arrangements at National Museums of Scotland

- 6.1 As part of the requirements of the Code of Audit Practice we undertook a review of the arrangements in place within NMS for ensuring appropriate financial governance arrangements. Our findings and recommendations from this review were included in our Interim Management Letter. No significant issues relating to governance were identified.
- 6.2 In addition to that review we followed-up on prior year recommendations (refer also to Section 5), including the recommendations made in prior years in relation to the arrangements for securing appropriate governance. The key governance matter which remained outstanding was in relation to the need to develop a more formal link between risk management and the corporate planning process. This has now been actioned as noted in paragraph 6.4 below.

Risk Management

- 6.3 Risk management is defined as “a systematic process for identifying, assessing, controlling, monitoring, reviewing and auditing risk.” Effective risk management is of importance to NMS as adverse consequences of risk could place limitations on service delivery and put a strain on staff and financial resources. To fulfil this requirement the Trustees are required to implement a robust and effective framework for the management and understanding of risk. The framework should be developed by building on existing good practice and should be used to facilitate the organisation’s planning and decision making process.
- 6.4 Our review indicated that, overall, the risk management arrangements appear to be operating as intended. We did, however, note that the formal updating of the risk register is only performed on an annual basis and that, as in previous years, the link between the corporate planning and the risk management processes had not yet been formalised. As a result it is difficult for NMS to demonstrate effective ongoing management of risk. This was highlighted in our Interim Management Letter issued in March and we are happy to report has since been actioned.

7. Prevention and Detection of Fraud and Irregularities

Fraud and Corruption Reviews

- 7.1 As part of our rotational plan to review the key systems and methods for the prevention and detection of fraud and corruption we have conducted a review of the overall policies and arrangements at NMS, together with key controls surrounding payroll. Our findings in this regard were included in our Interim Management Letter. Areas highlighted for attention were as follows:
- the need to ensure that all payroll system improvements agreed with internal audit are implemented and are in operation as soon as is practicable; and
 - the need for staff to comply with existing control procedures by ensuring that the existence of all new suppliers is confirmed using two separate sources of validation. Alternatively, management should review procedures and consider whether two forms of confirmation should still be required.
- 7.2 We are pleased to report that we are aware of progress in implementing these recommendations.

Fraud and Irregularities Guidance

- 7.3 We have reviewed the fraud and irregularities guidance issued by Audit Scotland during 2005/06 and undertaken work accordingly. There were no matters for reporting here from this work.

Fraud Submission

- 7.4 A return is submitted to Audit Scotland of all reported frauds during the year. NMS submitted a nil return for the year.

Termination Packages

- 7.5 Stephen Elson's employment contract with NMS was terminated on the 31 December 2005 due to incapacity. A compensation payment was made under the Civil Service Compensation Scheme. A compromise agreement was signed as part of the termination.
- 7.6 This package was subject to appropriate authorisation and approval.

8. Best Value Follow Up

- 8.1 As part of the 2004/05 audit process, we undertook a Best Value review. This review was in the form of a self-assessment based upon initial guidance provided by the Scottish Executive.
- 8.2 An action plan was agreed with management and we are aware that action is ongoing in a number of the areas highlighted for review.

Action Point 1

Appendix 1: Action Plan

	Report Reference	Issue	Risk	Recommendation	Management Response	Responsible Officer/Due Date
1	5.4 8.2	<p>Recommendations remain outstanding from the following reports:</p> <ul style="list-style-type: none"> • Updated 2005/06 Follow Up Report (September 2006), which now includes recommendations from our Interim Management Letter 2005/06; and • Best Value Report 2004/05. 	Identified weaknesses in NMS systems may not have been corrected.	Management should ensure that agreed recommendations are implemented with agreed timescales.	Management to review outstanding issues and ensure implemented within agreed timescales.	<p>Director of Finance & Resources</p> <p>31 December 2006</p>
2	5.7	During the course of the audit, it was identified that a number of items below the stated de minimis level of £2,000 had in fact been capitalised.	The fixed assets balance may be overstated.	<p>Management should review its capitalisation policy and ensure that relevant staff are aware of both that and the requirements of FRS 15.</p> <p>(Note – this recommendation has also been included in our Updated 2005/06 Follow Up Report (September 2006).)</p>	Management has reviewed its capitalisation policy, increasing it to £5,000 for 2006/07. Relevant staff are aware of the change and the requirements of FRS 15.	<p>Director of Finance & Resources</p> <p>In place</p>

Appendix 2: Responsibilities of External Audit and the National Museums of Scotland and its Management

The matters dealt with in this report came to our notice during the conduct of our normal audit procedures which we carried out in accordance with the framework and principles contained within the Audit Scotland's Code of Audit Practice.

As a result, we may not have identified all the issues and matters that may exist. It is the responsibility of the National Museums of Scotland and its management to maintain adequate and effective financial systems and to arrange for a system of internal controls. To discharge our audit responsibility we evaluate significant financial systems and associated internal controls and where appropriate, report to management any weaknesses identified. In practice, we do not examine every financial activity and accounting procedure and we cannot substitute for management's responsibility to maintain adequate systems of internal control.

This report is intended to assist the National Museums of Scotland regarding its arrangements to implement appropriate controls surrounding the production of certain management information and processing systems. The report does not purport to provide information or advice to any person not associated with the National Museums of Scotland and we accept no responsibility to such persons. Specifically, the report should not be interpreted as providing legal advice to the National Museums of Scotland or any other party.

The prime responsibility for the prevention and detection of fraud and irregularities rests with the National Museums of Scotland. It also has a duty to take reasonable steps to limit the opportunity for corrupt practices. As part of our approach we consider these arrangements, but our work does not remove the possibility that fraud, corruption or irregularity has occurred and remained undetected.

It is the responsibility of the National Museums of Scotland and its officers to prepare the Accounts in compliance with statutory and other relevant requirements. We are responsible for providing an opinion on the Accounts.

It is the responsibility of the National Museums of Scotland to put in place proper arrangements to ensure the proper conduct of its financial affairs, and to monitor their adequacy and effectiveness in practice. We have a responsibility to review and, where appropriate, report on the financial aspects of the audited body's corporate governance arrangements, as they relate to:

- The legality of transactions that might have significant financial consequences;
- The financial standing of the audited body;
- Systems of internal financial control; and
- Standards of financial conduct, and the prevention and detection of fraud and corruption.

It is the responsibility of the National Museums of Scotland to put in place proper arrangements to manage its performance, to secure economy, efficiency and effectiveness in its use of resources. We have a responsibility to review and, where appropriate, report on the arrangements that the National Museums of Scotland has put in place to secure economy, efficiency and effectiveness in its use of resources.

We also have a responsibility to undertake reviews arising from national studies commissioned by Audit Scotland where these have been designated as mandatory studies.

For more details on any of the issues raised in this document reference should be made to those detailed reports issued by us to the National Museums of Scotland during the year and as listed at **Appendix 4**.

Appendix 3: Audit Opinion

Independent auditor's report to the members of National Museums of Scotland, the Auditor General for Scotland and the Scottish Parliament

We have audited the financial statements of the National Museums of Scotland for the year ended 31 March 2006 under the National Heritage (Scotland) Act 1985. These comprise the Income and Expenditure Account, the Balance Sheet, the Cash Flow Statement and Statement of Total Recognised Gains and Losses and the related notes. These financial statements have been prepared under the accounting policies set out within them.

This report is made solely to the parties to whom it is addressed in accordance with the Public Finance and Accountability (Scotland) Act 2000 and the Code of Audit Practice approved by the Auditor General for Scotland and for no other purpose as set out in paragraph 43 of the Statement of Responsibilities of Auditors and of Audited Bodies prepared by Audit Scotland, dated July 2001.

We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Respective responsibilities of the board, Accountable Officer and auditor

The board and Accountable Officer are responsible for preparing the annual report and the financial statements in accordance with the National Heritage (Scotland) Act 1985 and directions made thereunder by the Scottish Ministers. The Accountable Officer is also responsible for ensuring the regularity of expenditure and receipts. These responsibilities are set out in the Statement of Accountable Officer's Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and with International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Auditor General for Scotland.

We report our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the National Heritage (Scotland) Act 1985 and directions made thereunder by the Scottish Ministers. We also report whether in all material respects the expenditure and receipts shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. We also report if, in our opinion, the Foreword is not consistent with the financial statements, if the body has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by relevant authorities regarding remuneration and other transactions is not disclosed.

We review whether the Statement on Internal Control reflects the body's compliance with the Scottish Executive's guidance. We report if, in our opinion, it does not comply with the guidance or if it is misleading or inconsistent with other information we are aware of from our audit of the financial statements. We are not required to consider, nor have we considered, whether the statement covers all risks and controls. Neither are we required to form an opinion on the effectiveness of the body's corporate governance procedures or its risk and control procedures.

We read the other information contained in the annual report and consider whether it is consistent with the audited financial statements. This other information comprises only the Report of the Board of Trustees. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with the Public Finance and Accountability (Scotland) Act 2000 and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board as required by the Code of Audit Practice approved by the Auditor General for Scotland. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of expenditure and receipts included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the board and Accountable Officer in the preparation of the financial statements, and of whether the accounting policies are appropriate to the body's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Remuneration Report to be audited are free from material misstatement, whether caused by fraud or error, and that in all material respects the expenditure and receipts shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Remuneration Report to be audited.

Opinion

Financial statements

In our opinion

- the financial statements give a true and fair view, in accordance with the National Heritage (Scotland) Act 1985 and directions made thereunder by the Scottish Ministers, of the state of affairs of the body as at 31 March 2006 and of its surplus, total recognised gains and losses and cash flows for the year then ended; and
- the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the National Heritage (Scotland) Act 1985 and directions made thereunder by the Scottish Ministers.

Regularity

In our opinion in all material respects the expenditure and receipts shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

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September 2006

Appendix 4: Other formal reports submitted during the 2005/06 process

	Financial Statements	Governance & Business Control	Performance
• Annual Service Plan 2005/06	-	-	-
• Follow Up of 2004/05 Audit Recommendations	✓	✓	✓
• 2005/06 Interim Management Letter	✓	✓	-

This report is intended solely for the information of the National Museums of Scotland. In the event that, pursuant to a request which the National Museums of Scotland received under the Freedom of Information (Scotland) Act 2002, it is required to disclose any information contained in this External Audit Report, it will notify PwC promptly and consult with PwC prior to disclosing such External Audit Report. National Museums of Scotland agrees to pay due regard to any representations which PwC may make in connection with such disclosure and the National Museums of Scotland shall apply any relevant exemptions which may exist under the Act to such External Audit Report. If, following consultation with PwC, National Museums of Scotland discloses this External Audit 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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