

Scottish Natural Heritage

Report on the 2006/07 Audit



November 2007



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Executive Summary

Introduction

In 2006/07 we audited the financial statements of Scottish Natural Heritage (SNH) and looked at aspects of performance management and governance. This report sets out our key findings.

Financial position

We have given a qualified opinion on the financial statements of SNH for 2006/07. The qualification relates to the ongoing limitation in scope of audit work arising from uncertainty over the regularity of payments under management agreements entered into prior to 1 January 2000 (see paragraph 15 for more details).

For 2006/07 the accounting treatment of grant-in aid changed in accordance with the Financial Reporting Manual (FRoM). This resulted in the income and expenditure account being replaced by an operating cost statement, with the grant-in-aid received from the Scottish Government being accounted for through reserves.

As a result of these changes the operating cost statement shows an excess of expenditure over income of £67.751m in 2006/07 (2005/06 £64.455m). This expenditure was funded by grant-in-aid of £66.865 million received from the Scottish Government (2005/06 £58.451 million). SNH managed its finances within capital and operating budgets and cash funding limits approved by its sponsoring department, Scottish Executive Environment and Rural Affairs Department (SEERAD), now Scottish Government Rural Directorate (SGRD).

Net operating costs increased by £3.021 million in 2006/07 primarily as a result of impairment charges for Great Glen House, which accounts for £2.924 million (97%) of this increase. The inclusion of Great Glen House on the asset register is the primary reason for net assets increasing to £26.866 million in 2006/07 from £5.233 million in 2005/06.

Performance

SNH performed well against its key targets agreed with the Scottish Government, with nine fully achieved and two partially achieved. Achievements have been made in promoting shared services and efficient government, and SNH has introduced a revised management structure to support service delivery.

Although not fully implemented, plans are in place to develop workforce planning, corporate and business planning and risk management.



Governance

Corporate governance is concerned with the structures and process for decision making, accountability, control and behaviour at the upper levels of an organisation. Overall the corporate governance and control arrangements for SNH operated satisfactorily during the year, as reflected in the Statement on Internal Control.

Looking forward

In 2007/08, we intend to continue our audit work on internal control systems and the financial statements, as well as continuing to monitor progress with the development of the single environment and rural service (SEARS) and the implementation of new accounting arrangements as a result of International Financial Reporting Standards and the Accounting Standards Boards intentions for heritage assets. We also intend to review the progress SNH has made in strengthening Best Value arrangements since our baseline review of this area in 2005/06.

Audit Scotland
November 2007



Introduction

1. This report summarises the findings from our 2006/07 audit of SNH. The scope of the audit was set out in our Audit Plan, which was presented to the Audit Committee on 1st February 2007. This plan described the work we planned to carry out on financial statements, performance and governance.
2. Appendix A of this report sets out the key risks highlighted in this report and the action planned by management to address them.
3. This is the first year of a five year audit appointment. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officers and members of SNH during the course of our audit. This report will be submitted to the Auditor General for Scotland and will be published on our website www.audit-scotland.gov.uk.



Financial Statements

4. In this section we summarise key outcomes from our audit of SNH's financial statements for 2006/07, and comment on the key financial management and accounting issues faced.

Our responsibilities

5. We audit the financial statements and give an opinion on:
 - whether they give a true and fair view of the financial position of SNH and its expenditure and income for the period in question
 - whether they have been prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements
 - the regularity of the expenditure and receipts.
6. We also review the statement on internal control by:
 - considering the adequacy of the process put in place by the Chief Executive as accountable officer to obtain assurances on systems of internal control
 - assessing whether disclosures in the statement are consistent with our knowledge of SNH.

Overall conclusion

7. We have given a qualified opinion on the financial statements of SNH for 2006/07. The qualified opinion relates to the ongoing limitation in scope of the audit work arising from uncertainty over the regularity of payments under management agreements entered into prior to 1 January 2000.

2006/07 Outturn

8. For 2006/07 the accounting treatment of grant-in aid changed in accordance with the Financial Reporting Manual (FReM). In previous years, grants and grant-in-aid received for revenue purposes from the Scottish Government was shown as a receipt through the income and expenditure account. Following the changes, grant-in-aid is now disclosed as a credit to reserve balances.
9. In addition, the income and expenditure account has been replaced with an operating cost statement, recognising that SNH are primarily government funded, rather than a commercial trading organisation.



10. As a result of these changes the operating cost statement shows an excess of expenditure over income of £67.751m in 2006/07 (2005/06 £64.455m). This expenditure was funded by grant-in-aid of £66.865 million received from the Scottish Government (2005/06 £58.451 million). SNH managed its finances within capital and operating budgets and cash funding limits approved by its sponsoring department, Scottish Executive Environment and Rural Affairs Department (SEERAD), now Scottish Government Rural Directorate (SGRD).
11. Net operating costs increased by £3.021 million in 2006/07 primarily as a result of impairment charges for Great Glen House which accounts for £2.924 million (97%) of this increase. This is not anticipated to recur in future years.
12. Net assets have increased to £26.866 million in 2006/07 from £5.233 million in 2005/06. The increase is primarily due to an increase in tangible fixed assets for the purchase and fit out costs for Great Glen House and reductions in provisions for liabilities and charges for employees leaving the organisation under early retirement or early severance terms.

2007/08 Budget

13. SNH has been allocated grant in aid of £66.250 million for running costs in 2007/08 (2006/07: £66.865 million), and a further £1.930 million for capital expenditure (2006/07: £19.680 million).

Issues arising from the audit

14. We reported the following issues to the Audit and Risk Management Committee on 26 September 2007:
15. **Regularity qualification on audit opinion** - In 2001, the European Commission confirmed that UK nature conservation management agreements entered into after 1 January 2000 were allowable as state aid. However no ruling has been made regarding retrospective approval of management agreements entered into prior to 1 January 2000. During 2006/07 SNH spent approximately £1.1 million under pre-January 2000 agreements which, in the absence of European sanction, must be deemed irregular. The audit opinion includes a regularity qualification in relation to this management agreement expenditure incurred during the financial year. Audit Scotland will continue to review the level of this expenditure and any recurring need for the qualification annually.
16. **Preparation and submission of the accounts for audit** – The key stages in the audit process which need to be completed before the Audit and Risk Management Committee can approve the accounts include on-site audit work, formal clearance of issues with officers, and communication of key issues and the proposed audit opinion to the Committee. Following a review of the final accounts project plan prepared by the finance team, a revised timetable was prepared for



submission of draft accounts for audit. Accounts were provided on 17 August, in line with this timetable, to facilitate formal approval by the end of September.

17. There are a number of procedures that feature as year end tasks in the preparation of the accounts. Some of these tasks, including identification of assets, review of provisions, consideration of new or changed disclosure requirements, and preparation of some disclosure notes can be addressed early in the closure process. This would facilitate the completion of some audit review prior to receipt of the draft accounts, and support earlier closure in future years. An early review meeting is planned between the finance team and external audit to consider the 2006/07 accounts process and identify areas for continuous improvement to the accounts preparation and audit process for 2007/08. This will support the development of an advanced timetable for the 2007/08 financial statements.

Action Point 1

Statement on internal control

18. The Statement on Internal Control provided by SNH's Accountable Officer reflected the main findings from both external and internal audit work. In May 2007, Internal Audit undertook a review of SNH's risk management system in place during 2006/07. Internal Audit highlighted some weaknesses in the risk management system with regard to linking risk management with corporate planning and limited contingency plans being in place. Amendments were made to the Statement on Internal Control to reflect these issues, and work is continuing on the development of these links within the new corporate and business planning approach.

Regularity assertion

19. The Public Finance and Accountability (Scotland) Act 2000 imposes a responsibility on auditors that requires us to certify that, in all material respects, the expenditure and receipts shown in the accounts was incurred or applied in accordance with applicable enactments and guidance issued by the Scottish Ministers. We have been able to address the requirements of the regularity assertion through a range of procedures, including written assurances from the Accountable Officer as to his view on adherence to enactments and guidance. No specific issues were identified by the Accountable Officer.



Performance

20. Public audit is more wide-ranging than in the private sector and covers the examination of, and reporting on, performance and value for money issues. As part of our audit we are required to plan reviews of aspects of the arrangements to manage performance, as they relate to economy, efficiency and effectiveness in the use of resources.
21. Accountable officers also have a duty to ensure the resources of their organisation are used economically, efficiently and effectively. These arrangements were extended in April 2002 to include a duty to ensure 'best value' in the use of resources.

Key targets

22. SNH has agreed 11 key targets with the Scottish Government which are drawn from SNH's Corporate Plan covering the four main themes:
 - Caring for the natural world
 - Enriching people's lives
 - Promoting sustainable use
 - Delivering the strategy.
23. SNH performed well against its key targets agreed with the Scottish Government with nine fully achieved and two partially achieved.
24. Key target 2 was to bring 80% of the special features on Scotland's nationally important nature sites into favourable condition by March 2008. This target was partially achieved, with 75% of features classed as in 'favourable' or 'favourable recovering' condition at 31st March 2007.
25. Key target 4 relates to the implementation of a new approach to nature conservation using the provision of the Nature Conservation (Scotland) Act 2004. Although achievement of the planned milestones has slipped, substantial progress had been made in implementing the new approach with procedures and guidance being introduced. Measures to improve performance are being prepared for 2007/08.
26. Key target 10 relates to supporting the Scottish Government's Efficient Government Initiative by seeking Best Value in all SNH operations. The target of £1 million efficiency savings has been exceeded, with monies reinvested to achieve improvements in baseline information for the Species Action Framework and funding a number of other projects.



Organisational and corporate planning

27. Members of the Scottish Government Rural Directorate (SGRD), including SNH, participate in the “on the ground” project aimed at promoting joint working between public bodies involved in rural issues. Following occupancy of Great Glen House in June 2006, the property is now being shared with a number of partner organisations. Approval has also been given for a major project involving a number of partner organisations sharing property at Golspie in East Sutherland. SNH has actively reviewed its support services for opportunities for sharing services and currently provides information technology support to a number of partner organisations.
28. In response to SNH’s Strategic Review, published in 2005, SNH introduced a revised management structure to provide more clarity to customers over service responsibility and reduce service overlap. The revised management structure has been in place since April 2007. Wider workforce planning has still to be developed and a major project to support this will be undertaken in 2008/09, taking into account skills gap analysis, succession planning and career management. We will continue to monitor these developments over the coming years.

Action Point 2

29. SNH is due to update its 5 year Corporate Plan for the period 2008 to 2011. Work is currently underway to more closely align the corporate planning process and business planning process, including linking the high level corporate strategy objectives with the strategy and priorities in the corporate plan in preparation for the work to be completed for the 2008/11 corporate plan. Stakeholder consultation is a key element of the development of the corporate plan and the 2008/11 plan will be subject to a strategic environmental assessment which includes consultation on the draft plan.

Efficient Government

30. As part of the Scottish Government’s Efficient Government Initiative, SNH has been set a target to achieve, by 2008, recurrent savings of £2 million per annum. The projected outturn for EGI savings at the end of 2008 is currently £2.486 million of time and cash releasing savings. The savings generated are directed into front-line initiatives to deliver natural heritage benefit.
31. Internal Audit review the EGI project on an ongoing basis through its consultancy service, an interim report for the period 2006/07 provided management with satisfactory assurance over the management controls over the project. The Scottish Government also carried out a review of SNH’s EGI project in October 2006 and SNH were awarded a green rating across all seven criteria.
32. SNH is demonstrating that it is on track to achieve the EGI target savings. We will continue to monitor progress throughout 2007/08.



Governance

Overview of arrangements

33. This section sets out our main findings arising from our review of the SNH's governance arrangements. This year we reviewed:
- key systems of internal control
 - the internal audit function
 - aspects of information and communications technology (ICT).
34. We also discharged our responsibilities as they relate to the prevention and detection of fraud and irregularity; standards of conduct; and the organisation's financial position. Our overall conclusion is that governance arrangements within the SNH are sound and have operated throughout 2006/07.

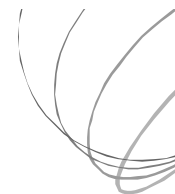
Systems of internal control

35. Key controls within systems should operate effectively and efficiently to accurately record financial transactions and prevent and detect fraud or error. This supports a robust internal control environment and the effective production of financial statements. In their annual report for 2006/07 internal audit provided their opinion that SNH continues to have a broadly sound framework of risk management, internal control and corporate governance ensuring the effective and efficient achievement of SNH's objectives.
36. As part of our audit we reviewed the high level controls in a number of the SNH's systems that impact on the financial statements. Our overall conclusion was that key controls were operating effectively, although some instances of non-compliance with internal control procedures were highlighted relating to the frequency of control account reconciliations and the use of assets disposal authorisation forms.

Action Point 3

Risk management

37. Internal Audit reviewed the risk management arrangements in place during 2006/07 and provided satisfactory assurance that the risk management system met the vast majority of current Government requirements and helps to ensure that risks are identified, evaluated, monitored and managed. However, a number of weaknesses were identified during the review, including:



- the risk register is not linked to SNH's Corporate Plan or Corporate Strategy
 - there are limited contingency plans in place to mitigate the impact of high risks if they do materialise
 - risk management updates were not always provided to the Audit and Risk Management Committee (ARMC) during 2006/07. This has since been implemented in 2007/08.
38. SNH's ARMC endorsed the decision to delay introducing a revised risk management system until 2008/09, so that the risk management system can be integrated with the new corporate planning system and associated database as a single project and allow for the opportunity to pilot the new system with selected Units in the later part of 2007/08.

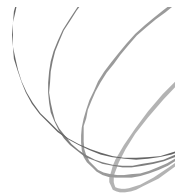
Action Point 4

Internal audit

39. The establishment and operation of an effective internal audit function forms a key element of effective governance and stewardship. We therefore seek to rely on the work of internal audit wherever possible and as part of our risk assessment and planning process for the 2006/07 audit we assessed whether we could place reliance on the SNH's internal audit function. We concluded that the internal audit service operates in accordance with the Government Internal Audit Manual and therefore placed reliance on a number of internal audit reviews.

Information and communication technology

40. We undertook a Computer Service Review providing a high-level risk based assessment of ICT services within SNH.
41. A number of areas of good practice within SNH were identified during our review, in particular:
- implementing an information and IS strategies project board with responsibility for strategy
 - completing an annual learning and development plan for all staff
 - installing good access and environmental controls in key computer rooms
 - monitoring contracts and Service Level Agreements with key service providers
 - undertaking regular network penetration tests and ensuring key vulnerabilities are addressed.
42. The review also highlighted some areas where improvements can be incorporated into current operational practice, including:



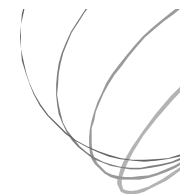
- implementing the outstanding BS7799 compliance action plan
 - driving Business Continuity Management throughout SNH
 - removing backups off-site on a daily basis
 - minimising the use of test and live data on the same server.
43. SNH has considered the findings of the computer services review and recorded their planned action or acceptance of risks, including responsibilities and timescales for implementation. We will continue to monitor progress throughout 2007/08.



Looking Forward

44. SNH faces a number of challenges in 2007/08, which include:

- **Best Value** – As part of the 2007/08 audit we will be reviewing the progress that the SNH has made in strengthening their arrangements for securing Best Value since our baseline review work in 2005/06. Over the next year we will also be developing and refining our approach to the audit of public bodies' arrangements to secure economy, efficiency and effectiveness in the use of resources, as this is one of our key objectives as auditors, set out within the new Code of Audit Practice approved by the Auditor General. This will inform our ongoing work to develop an approach to the audit of Best Value across the Scottish public sector. We intend to consult with both clients and stakeholders at key stages of these initiatives.
- **International Financial Reporting Standards** – The introduction of IFRS's from 2008/09 is likely to significantly change some accounting policies. SNH will need to review their accounting policies to ensure that appropriate disclosures are made in the financial statements.
- **Single environment and rural service (SEARS)** – The minister has asked the 'On the Ground' family which comprises the Forestry commission, SEPA, Scottish National Heritage, national Parks, Deer Commission, Crofters Commission, Scottish Government Rural Payments and Inspections Directorate and the Animal Health Agency to develop a proposal for closer, more efficient, "joined-up" working within existing legal and organisational frameworks. The proposal must be ready for implementation by June 2008. SNH will play a key role in developing the service.
- **Heritage Assets** - The Accounting Standards Board has issued Financial Reporting Exposure Draft (FRED) 40 on Accounting for Heritage Assets. It is expected that the FReM for 2008/09 will be updated with the new requirements when the outcome is known of the Accounting Standards Board's deliberations on the reaction to FRED 40. SNH has responded to the consultation on the exposure draft, highlighting that including heritage assets on the balance sheet will impact on their non-cash costs which could rise year on year due to depreciation and capital charges increasing. This could result in a possible adverse impact on SNH's natural heritage objectives. The response also identified that there could be high cost and time implications of valuing heritage assets. SNH will need to give consideration to the impact on the financial statements regarding comparatives and restatement of the asset valuations.



Appendix A: Action plan

Key Issues and Planned Management Action

Action Point	Issue Identified	Planned Action	Responsible Officer	Target Date
1	SNH fail to undertake key tasks in the accounts preparation process for 2007/08, to support its planned earlier closure and audit review timetable.	<p>A review of the processes involved in completing the financial accounts to identify key tasks to identify those that can be completed early.</p> <p>An early review meeting between the accounts preparation team and the external auditor.</p> <p>A timetable will be submitted to the Audit Committee for approval.</p>	Director of Corporate Services.	January 2008
2	Workforce planning may not identify weaknesses in the ability of SNH's staff to deliver the organisations strategic objectives.	<p>Major workforce planning project is to be undertaken during 2008/09.</p> <p>Development of the i-people HR database including consideration of modules to assist workforce planning.</p>	Head of Human Resources	March 2009
3	<p>Failure to adhere to defined internal control procedures around reconciliations could lead to</p> <ul style="list-style-type: none"> errors in the general ledger going undetected and resulting in excessive year-end adjustments to the ledger balances fixed assets being disposed of without proper authority. 	<p>Control account reconciliations are being included on the routine task list for identified officers with completion on a monthly basis.</p> <p>Finance Services will monitor the completion of all control account reconciliations.</p> <p>Finance Services have been working with Procurement and Internal Audit to develop and agree a revised disposal process. This will ensure that all asset additions and disposals are supported by properly authorised documentation and will strengthen the control process.</p>	Head of Finance	<p>Control accounts - November 2007</p> <p>Fixed assets – December 2007</p>
4	Risk management processes fail to prioritise strategic risks facing the business.	<p>Integrated project to align the risk management system with the new corporate planning system and associated database.</p> <p>Detailed proposals for linking risk management to the business planning process.</p> <p>Revised approach to guidance and training to give greater focus on prioritisation of strategic risks.</p>	Strategy and Communications Manager	June 2008