

National Galleries of Scotland

Report on the 2007/08 Audit



October 2008



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Executive Summary

Introduction

In 2007/08 we looked at the key strategic and financial risks being faced by National Galleries of Scotland (NGS). We audited the financial statements and we also reviewed aspects of performance management and governance. This report sets out our key findings.

Financial Position

NGS operated within the budget limits set by the Scottish Government for capital spending and operating expenditure. NGS' net asset position increased to £159.038 million (2006/07: £139.134 million) mainly due to inclusion of a grant towards acquisition of the d'Offay collection and revaluation of a building.

Scottish Ministers have set a financial allocation for NGS of £17.715 million for 2008/09. This comprises £12.213 million grant-in-aid for running costs including £0.175 million for running costs of the d'Offay collection, capital grants of £2.488 million including £1.228 million for Portrait Gallery refurbishment; and £3.014 million to cover non-cash costs.

Financial Statements

We have given an unqualified opinion on the financial statements of NGS for 2007/08.

We have also concluded that in all material respects, the expenditure and receipts shown in the financial statements were incurred or applied in accordance with applicable enactments and relevant guidance, issued by Scottish Ministers.

Performance

In 2007/08 NGS was required by the Scottish Government to deliver cash releasing efficiencies of £0.2 million over the three year period ending 31 March 2008. NGS has reported to the Scottish Government that this target has been met. Future efficiency savings are set at 0% per annum for 2008/09, and 3% for each of 2009/10 and 2010/11. This represents £0.7 million by 2010/11 which is a considerable sum in proportion to NGS' non-salary cost base. This is a significant challenge.

In 2007/08 NGS was set a number of key performance indicator targets by the Scottish Government including increasing visitor numbers by 3% and reducing the grant-in-aid per visitor by 5% over the three year period ending 31 March 2008. NGS has reported to the Scottish Government that most targets were achieved including the cash releasing target referred to above.



Best Value

We reported on progress made by NGS in implementing the agreed recommendations from the review of best value carried out by PWC in 2005/06. The main recommendation not yet fully implemented was the demonstration of a clear link between the risk management process and corporate planning. NGS has agreed to consider risk management as part of 2009/10 corporate planning.

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 NGS operated satisfactorily during the year, as reflected in the Statement on Internal Control.

We examined the key financial systems which underpin the organisation's control environment. We concluded that financial systems and procedures operated sufficiently well to enable us to place reliance on them.

The Management Statement /Financial Memorandum issued by the Scottish Government has not been updated since 1993. The Scottish Government has confirmed that the Management Statement /Financial Memorandum will be reviewed shortly.

Looking forward

The final part of our report notes some key risk areas and issues for NGS going forward.

We highlighted a number of national issues which affect all public sector bodies including NGS, such as the National Performance Framework and the introduction of Scotland Performs; the impact of international financial reporting standards; and the review of data handling arrangements in public bodies across Scotland. NGS also faces financial pressure over the next three years against a background of tighter funding constraints. Other specific risks affecting NGS include managing the £17.6 million Portrait Gallery redevelopment project.

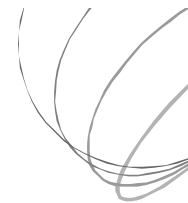
The assistance and co-operation given to us by staff and Trustees during our audit is gratefully acknowledged.

Audit Scotland
October 2008



Introduction

1. This report summarises the findings from our 2007/08 audit of NGS. The scope of the audit was set out in our Audit Plan, which was presented to the Audit Committee on 25 February 2008. This plan set out our views on the key business risks facing the organisation and described the work we planned to carry out on financial statements, performance and governance.
2. We have issued a range of reports this year, and we briefly touch on the key issues we raised in this report. Each report set out our detailed findings and recommendations and NGS' agreed response.
3. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by staff and Trustees of NGS 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 Position

4. In this section we summarise key outcomes from our audit of NGS financial statements for 2007/08, and comment on the key financial management and accounting issues faced. The financial statements are an essential means by which the organisation accounts for its stewardship of the resources available to it and its financial performance in the use of those resources.

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 NGS and its expenditure and income for the period in question;
 - whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
 - the consistency of the information which comprises the Report of the Board of Trustees included in the Annual Report with the financial statements, and
 - 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 Director General as accountable officer to obtain assurances on systems of internal control, and
 - assessing whether disclosures in the statement are consistent with our knowledge of NGS.

Overall conclusion

7. We have given an unqualified opinion on the financial statements of NGS for 2007/08.
8. The date agreed in the audit plan for submission of the unaudited accounts was 23 June 2008. There were two subsequent revisions to the timetable and the unaudited accounts were provided to us on 11 August. The good standard of the supporting papers which was an improvement on the prior year position and the timely responses from NGS staff allowed us to conclude our audit within the agreed timetable and provide our opinion to the audit committee on 2 October 2008.



Financial Position

Outturn 2007/08

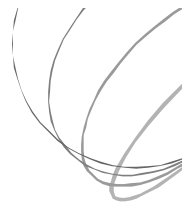
9. NGS is required to work within the budget limits set by the Scottish Government. The final grant in aid set by the Scottish Government for NGS for 2007/08 was £15.739 million. This figure comprises an operating budget of £11.465 million, a capital budget of £1.26 million to fund procurement of additions to NGS collections, and non-cash items of £3.014 million. The Scottish Government also provided £10 million towards the acquisition with the Tate Gallery of the d'Offay collection. The acquisition was completed in June 2008. NGS operated within the budget limits set by the Scottish Government for capital and operating expenditure and drew down its full cash grant in aid entitlement.
10. The FReM requirement to account for grant-in-aid as a credit to reserves has resulted in an excess of expenditure over income of £10.337 million for 2007/08 (2006/07: £9.847 million). The grant-in-aid credited to reserves for 2007/08 was £11.465 million (2006/07: £11.165 million).
11. NGS' net asset position increased to £159.038 million (2006/07: £139.134 million). The increase of £19.904 million over the previous year arose mainly from the inclusion of the grant towards acquisition of the d'Offay collection and the revaluation of a building.

2008/09 Budget

12. Scottish Ministers have set an initial financial allocation for NGS of £17.715 million for 2008/09. This comprises:
 - £12.213 million grant in aid for running costs including £0.175 million for running costs of the d'Offay collection. Total grant in aid is 6.5% more than in 2007/08;
 - capital grants of £2.488 million including £1.228 million for Portrait Gallery refurbishment. The purchase grant for artworks is the same amount as 2007/08, and
 - £3.014 million to cover non-cash costs.
13. NGS recognises that an increase in planned commitments for 2008/09 will create pressure on the budget. NGS will need to make savings in order to match budgets to the available resources.

Issues arising from the audit

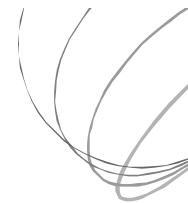
14. As required by auditing standards we reported to the audit committee on 2 October 2008 the main issues arising from our audit of the financial statements. The key issues reported were:



- **Artworks acquisitions accruals policy** - we were not able to identify clear guidance for artworks acquisitions accruals to assess whether it had been consistently applied or conformed to accounting standards. NGS Finance investigations resulted in a net adjustment of £100,000 to artwork acquisitions and accruals in the balance sheet. There was no effect on the excess of expenditure over income. Final accounts were amended and NGS have undertaken to prepare guidance on the financial treatment of these acquisitions.
- **Portrait Gallery refurbishment** – professional fees of approximately £300,000 relating to the refurbishment of the Portrait Gallery which is estimated to total £17.6 million and continue until 2011 had been treated as prepayments resulting in an understatement of fixed assets and an overstatement of prepayments with no effect on the excess of expenditure over income. These costs should have been treated as assets under construction. There was no specific guidance for identifying Portrait Gallery refurbishment project costs which should be capitalised or treated as revenue expenditure. Final accounts were amended and NGS have undertaken to prepare guidance on the financial treatment of capital and revenue items relating to capital projects. Consideration will also be given to budget and cash flow control and potential asset impairment related to this project.

Regularity Assertion

15. 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 were 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 significant issues were identified for disclosure.



Governance

Overview of arrangements

16. This section sets out our main findings arising from our review of NGS governance arrangements. This year we reviewed:
 - key systems of internal control; and
 - internal audit.

17. We also discharged our responsibilities as they relate to prevention and detection of fraud and irregularity; standards of conduct; and the organisation's financial position (see paragraphs 9 - 11). Our overall conclusion is that arrangements within NGS are sound and have operated throughout 2007/08.

Strategic aims

18. The NGS Corporate Plan 2007/10 sets out the vision for the future of NGS and establishes key priorities as well as the aims and objectives guiding activities over the coming years.

19. The nine priorities are:
 - To enhance NGS' national and international reputation for the high quality of the collection, displays and exhibitions;
 - To develop NGS' reputation for academic excellence and to make research and expertise available to the widest possible public;
 - to place people – enjoyment, inspiration and education – at the heart of what NGS does as an organisation
 - to reinvent the Scottish National Portrait Gallery with a new vision, concept and facilities;
 - to improve and upgrade the existing possibilities for presenting modern and contemporary art in Scotland;
 - to make the best use of the NGS estate;
 - to continue to build on the financial stability, efficiency and sustainability of the NGS on the existing plural funding model;
 - to ensure that the organisation is in keeping with NGS' aims and values; and



- to ensure the best possible protection for NGS' collection, public and staff while maintaining high level services for visitors.
20. The delivery of the corporate plan objectives will be particularly challenging given the tight financial constraints over the same period. This is an area we will keep under review during our appointment.

Systems of internal control

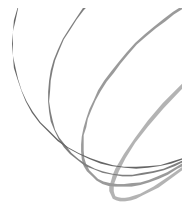
21. Key controls within systems should operate effectively and efficiently to accurately record financial transactions and prevent and detect fraud or error. This supports a robust internal control environment and the effective production of financial statements. In their annual report for 2007/08 Baker Tilly provided their opinion that, based on the internal audit work undertaken during the year to 31 March 2008, NGS had, in their opinion, an adequate framework of control over the systems they examined. The level of assurance reflected weaknesses in ICT business continuity and disaster recovery planning which are being addressed by NGS in 2008/09.
22. As part of our audit we reviewed the high level controls in a number of NGS systems that impact on the financial statements. Our overall conclusion was that key controls were operating effectively.
23. Departmental Accountable Officers are responsible for putting in place an appropriate framework for sponsored bodies consistent with the model Management Statement/Financial Memorandum (MS/FM) set out in the Scottish Public Finance Manual (SPFM). The SPFM requires that the MS/FM is reviewed and updated periodically by the Sponsor Directorate within the Scottish Government, normally at least every 2-3 years. The MS/FM for NGS has not been updated since 1993 and includes a number of outdated provisions, including many references that have been overtaken by the introduction of resource accounting and the impact of devolution. The Scottish Government has confirmed that the MS/FM will be reviewed shortly but that NGS should be guided by the latest model MS/FM in the SPFM.

Prevention and detection of fraud and irregularities

24. NGS has appropriate arrangements in place to prevent and detect fraud, inappropriate conduct and corruption, including policies and codes of conduct for staff and Board members.

Internal Audit

25. 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 2007/08



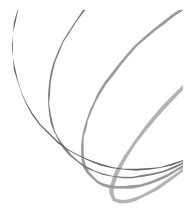
audit we assessed whether we could place reliance on NGS internal audit function provided by Baker Tilly. We concluded that Baker Tilly operates in accordance with the Government Internal Audit Manual and therefore placed reliance on their work in number of areas during 2007/08, as we anticipated in our annual audit plan.

Statement on Internal Control

26. The Statement on Internal Control provided by the NGS Accountable Officer reflected the main findings from both external and internal audit work. This recorded management's responsibility for maintaining a sound system of internal control and set out NGS' approach to this.

Information and Communication Technology

27. During 2007/08, Baker Tilly undertook a review of ICT services and concluded that in general, the ICT function appears to be operating well with the exception of weaknesses in business continuity and disaster recovery planning. We have taken assurance from the internal audit work in this area.



Performance Management

28. 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.
29. 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.

Best Value developments

30. The positive impact of the Best Value concept in local government led Scottish Ministers to introduce a non-statutory Best Value duty on all public sector accountable officers (i.e. across health and central government) in 2002. This was reinforced by refreshed Ministerial guidance in 2006, highlighting the importance that the Scottish Government places on Best Value as a means of supporting public service reform.
31. That position was again re-iterated in the Scottish Government's recent response to the Crerar scrutiny review which credited the Best Value regime as a key driver of modernisation and improvement in public services. Audit Scotland is committed to extending the Best Value audit regime across the whole public sector and significant development work has taken place over the last year.
32. The framework for our proposed Best Value audit approach was agreed by Audit Scotland's Corporate Management Team in September 2007. It is based on the key principles of flexibility and proportionality; alignment and integration with our existing activities; being delivered within our existing resources, and with an evolutionary implementation.
33. Using the Scottish Government's nine best value principles as the basis for our audit activity, we have identified five priority development areas (Use of Resources, Governance and Risk Management, Accountability, Review and Option Appraisal, and Joint Working) for our initial development work.
34. Currently we are concentrating on the development of Use of Resources audit toolkits, focusing initially on Financial Management, Efficiency, and Information Management. These toolkits are being piloted in a sample of NHS and central government clients during 2007/08 and 2008/09. Developed toolkits will also be made available to public bodies to consider for self assessment.



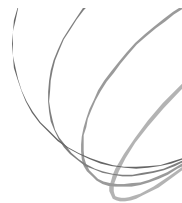
35. We reported on progress made by NGS in implementing the agreed recommendations from the review of best value carried out by PWC in 2005/06. The main recommendation not yet fully implemented was the demonstration of a clear link between the risk management process and corporate planning. NGS have agreed to consider risk management as part of 2009/10 corporate planning.

Efficiency

36. In 2007/08 NGS was required by the Scottish Government to deliver cash releasing efficiencies of £0.2 million over the three year period ending 31 March 2008.
37. NGS has reported to the Scottish Government that this target has been met. Efficiencies were a combination of one-off savings and recurring efficiencies such as staffing reductions and shared services. Savings have been reinvested in projects that will enable NGS to flex and scale up activities without proportionate increases in headcount numbers or maintenance costs.
38. In the next three year budget settlement NGS is required to make efficiency savings of 0% per annum for 2008/09, and 3% for each of 2009/10 and 2010/11. This represents £0.7 million by 2010/11 which is a considerable sum in proportion to NGS' non-salary cost base. This is a significant challenge.

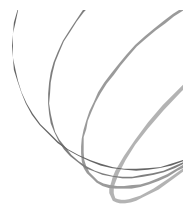
Performance Management

39. In 2007/08 NGS was required to report quarterly to the Scottish Government progress in achieving a number of key performance indicators covering increasing visitor numbers by 3%, measuring, reporting and maintaining the balance of participation among relevant under-represented groups, raising at least £1.474 million self-generated income, numbers of long and short loans out of artworks, reducing grant-in-aid per visitor by 5%, and delivering cash releasing efficiency savings of £0.2 million, all over the three year period ending 31 March 2008. NGS has reported that most targets have been met though there were difficulties with maintaining the balance of participation and defining the measurement criteria for long loans out. Achievements included increasing visitor numbers by 17.5%, exceeding the target amount of self-generated income and reducing grant-in-aid per visitor by more than 8%.
40. Discussions are continuing with the Scottish Government in relation to improvements in the ways that the performance of NGS can be assessed for 2008/09.



National Studies

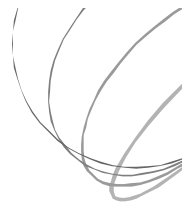
41. Audit Scotland published a national study, relevant to NGS, on *Review of major capital projects in Scotland*. The report considered major public sector projects in Scotland which cost £811 million completed in the five years between April 2002 and March 2007. It examined progress against cost and time estimates, quality specifications and project management in general.
42. The NGS Playfair project completed in 2004 to refurbish the Royal Scottish Academy and provide a new underground link to the National Gallery of Scotland was included as a case study. The Playfair project was assessed as being on or close to target for time, quality and project management. The £32 million final cost was £6 million (26%) higher than the initial estimate and £5 million (21%) higher than the contract cost estimate partly due to changing the scope of the project and the increased cost was met by raising additional funding from the private sector.
43. The report also contains wider findings and recommendations that NGS may find useful for its management of the Portrait Gallery refurbishment.



Looking Forward

44. NGS faces a number of challenges in 2008/09, which include:

- **Portrait Gallery redevelopment** – This £17.6 million project will require sound project management arrangements. Funding of £5.1 million has been secured from the Scottish Government and positive support has been received from the Heritage Lottery Fund. It will be challenging to raise the balance of funding required from private sources.
- **Bank accounts** - The SPFM now requires all bodies to which the SPFM is directly applicable, including bodies sponsored by the Scottish Government, to have their core bank accounts with HM Paymaster General, except where Scottish Government's Financial Management Branch can be persuaded that the holding of such an account would not be cost effective. NGS banks with Bank of Scotland. NGS have been advised of a Scottish Government tendering exercise for provision of a cost-effective banking alternative to HM Paymaster General. A new contract is expected to be operational from November 2008. NGS will need to review their banking operations to assess the suitability of the Scottish Government contract.
- **Scotland Performs** – The Scottish Government is continuing to develop its approach to performance management based on a National Performance Framework and outcome agreements. The National Performance Framework is based on the outcome based 'Virginia-style' model of performance measurement and reporting. In support of this the Scottish Government has developed a new electronic tool and website to communicate to the public on Scotland's progress. This will include progress on overall delivery of the administration's purpose for Government, the five strategic objectives for Scotland and other aspects of the outcomes based National Performance Framework. We will consider how NGS is addressing this developing area as part of the 2008/09 audit.
- **Efficiency and future funding** – Budgets for 2008/09 and the immediate future will need to be managed within a tighter funding regime. This includes significantly less scope for the application of end of year flexibility for the Government with HM Treasury until the next Spending Review; no option to transfer funds from capital to revenue; and the impact of the introduction of International Financial Reporting Standards (IFRS), particularly on PFI, leases and infrastructure accounting. The challenge for NGS is to prioritise spending, identify efficiencies and review future commitments to ensure delivery of key targets and objectives.
- **Data handling** – The Scottish Government carried out a review of data handling arrangements in Scotland, in response to failures in UK government bodies' procedures and practices during 2007. The review considered current policies and procedures on data protection, consistency with government standards and local arrangements for implementation of procedures. An interim report published in April 2008 made some initial recommendations and a final report is



expected soon. We will monitor NGS' response to the review and action taken as part of our 2008/09 audit.

- **International Financial Reporting Standards (IFRS)** – As part of the UK Budget 2007 the Chancellor announced that the timetable for IFRS implementation was to be extended by a year with central government accounts in Scotland to become IFRS compliant with effect from the 2009/10 financial year. However, this timetable does not apply to registered charities, such as NGS, which will be required to follow a slower timetable for convergence agreed by the UK Accounting Standards Board. A detailed timetable and list of requirements for all central government bodies in Scotland has been issued by the Scottish Government. Notwithstanding the slower timetable applying to NGS, the convergence process may require significant resource to complete and it is important that NGS properly plan to manage the transition over the next few years.