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# *National Galleries of Scotland*

## Annual Report to the Audit Committee and the Auditor General for Scotland

Year ended 31 March 2012

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The matters raised in this and other reports that flow from the audit are only those which have come to our attention arising from or relevant to our audit that we believe need to be brought to your attention. They are not a comprehensive record of all matters arising and in particular we cannot be held responsible for reporting all risks in your business. This report has been prepared for and only for *National Galleries of Scotland* in accordance with the terms of our engagement letter and for no other purpose. We do not accept or assume any liability or duty of care 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.

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# 1 Introduction

We have pleasure in presenting this report relating to our audit of the financial statements of National Galleries of Scotland for the year ended 31 March 2012.

We have discussed this report with the Head of Finance and IT as part of our audit process. The purpose of this report is to update the Committee on the progress of the audit and of any significant matters that have arisen during the course of our work.

## 1.1 Audit status

Our audit work on the draft financial statements for the year ended 31 March 2012 was carried out from the week commencing 25 June 2012. The audit is now complete.

## 1.2 Audit overview and conclusions

Subject to the satisfactory resolution of the matters set out above, finalisation of the financial statements and their approval by the Audit Committee, we expect to issue an unqualified audit opinion for National Galleries of Scotland.

## 1.3 Findings arising from the audit

Section 2 of this report summarises the findings arising from our audit.

## 1.4 Misstatements and significant deficiencies in internal control

A summary of corrected and uncorrected misstatements is included in Appendix 1. A summary of the areas identified for improvement in relation to control deficiencies identified is included in Appendix 2.

## 1.5 Other areas of feedback

Section 4 contains other matters for the attention of those charged with governance, including elements of communication required under International Standard on Auditing (ISA) 260 (revised and re-drafted) "Communication with those charged with governance". We identified one misstatement, which is uncorrected, that we believe should be brought to your attention. This relates to the application of an indexation factor to the value of land and buildings. The misstatement was not of a material nature. Further details are outlined in Section 4 and Appendix 1.

We look forward to the opportunity to discuss the points raised in the report with you at the Audit Committee meeting on 14 September 2012.

We would also like to take this opportunity to express our thanks for the co-operation and assistance we have received from the management and staff of National Galleries of Scotland throughout our work.

## 2 Audit Findings

Our understanding of the organisation developed further in the course of our planning and interim audit work, and updates to our original Audit Plan were presented to the Audit Committee in the Interim Management Letter on 22 May 2012. In this section of the report we outline the significant audit risks as identified in the updated plan and highlight the work performed around them.

Areas of audit risk	Audit approach
<b>Consideration of fraud risk</b>	
<p>All organisations are at risk of fraud, with specific fraud risks being:</p> <ul style="list-style-type: none"><li>• the potential for intentional misstatement of the financial statements;</li><li>• the misappropriation of assets; and</li><li>• management override of controls.</li></ul>	<p>We will undertake a review of management's overall fraud arrangements and fraud policies such as whistle blowing policies.</p> <p>Our assessment of controls will consider their effectiveness for preventing and identifying fraud, with any weaknesses highlighted to management.</p> <p>We will perform audit testing of journals to ensure their legitimacy, and will incorporate unpredictability into our testing of income and expenditure.</p>
<b>Recognition of operating expenditure</b>	
<p>There is a general rebuttable presumption within our audit approach that there is a risk of material misstatement due to fraud relating to revenue recognition.</p> <p>For the purposes of National Galleries of Scotland this risk is more sensibly inverted to reflect the risk around overstatement of expenditure.</p>	<p>We will review the current treatment of income and expenditure to ensure that it is in accordance with the requirements of accounting standards focusing on higher risk areas such as accruals and credit notes.</p> <p>Our cut-off testing will be planned to ensure that there is no overstatement of expenditure in 2011/12 and/or understatement of income.</p>

Please note that we had initially identified an elevated audit risk regarding changes to the Government Financial Reporting Manual (FReM) that would require the majority of grants and donated assets to be recognised as income immediately rather than credited to reserves. However, following confirmation that the changes would not apply to National Galleries of Scotland the risk was removed.

We have included a summary of our findings below:

## Our response to the areas of audit focus identified in the audit plan:

Risk identified/area of audit focus	Audit response
Consideration of fraud risk <b>Significant risk</b>	In accordance with our audit plan, we tested significant journals and a sample of lower value journals to ensure unpredictability, and examined management's accounting estimates for bias.  We can confirm that our work in this area did not identify any errors that required adjustment to the financial statements.
Recognition of operating expenditure <b>Significant risk</b>	We evaluated and tested the key controls over the expenditure cycle.  We reviewed and tested a sample of operating expenditure transactions, with a particular focus on the risk of cut-off errors in transactions around the year-end.  We can confirm that our work in this area did not identify any errors that required adjustment to the financial statements.

Our work in relation to our significant risks has resulted in no errors being identified that require an adjustment to be made to the financial statements.

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# ***3 Financial Performance***

## **3.1 Financial performance – 2011/12**

NGS is facing an increasingly challenging financial environment. Although total in-year income increased by £1.561 million to £38.581 million (2010/11 £38.020 million), there was a significant reduction in Grant in Aid of £10.004 million to £14.179 million. However, it should be highlighted that the majority of this was as a consequence of non-recurring capital funding ending with the completion of works at the Scottish Portrait Gallery (£9.610 million in 2010/11). The Scottish Government has confirmed that Grant in Aid will continue with similar reductions in future years.

## **3.2 Financial outlook – 2012/13 and beyond**

The NGS Board approved a balanced budget for 2012/13 in February 2012 and Corporate Plan for 2012-2014 in June 2012. The 2012/13 budget estimates includes a reduction in Grant in aid (excluding Annually Managed Expenditure) from £15.879 million to £14.545 million in 2012/13 (including £0.050 million that is National Library of Scotland's share of capital grant for shared services), with £1.065 million being as a result of a reduction to the capital grant.

NGS faces a number of cost pressures arising from the buildings and plant. In particular, the next priority for NGS is to refurbish the Scottish National Gallery. However, with a reduced capital budget NGS will face a challenge just to continue to manage their capital budget effectively to maintain the quality of the existing estate.

## **3.3 Financial Management and Leadership**

It is commendable to note that the organisation has done well to achieve the financial efficiencies in previous years, as well as increasing self-generated income.

Management should continue to demonstrate strong leadership and the promotion of an efficiency and savings culture. This leadership will include robust monitoring and reporting on progress against any savings plans, and taking early action to avoid slippage within any savings schemes identified.

# 4 Communications required under ISA 260

The following table contains communication required under ISA 260 (revised and re-drafted) “Communication with those charged with governance”.

Requirement	Delivery of requirement
Uncorrected and corrected misstatements	We identified one misstatement, which is uncorrected, that we believe should be brought to your attention. This immaterial misstatement related to the application of an indexation factor to the value of land and buildings. Further details are included below.
Significant accounting principles and policies	Significant accounting principles and policies are disclosed in the notes to the financial statements. Board members will represent to us that they have considered the accounting policies and that there have not been any material changes in the accounting principles and policies used during the year.
Significant qualitative aspects of the organisation’s accounting practices and financial reporting , management’s judgments and accounting estimates	<p>The only significant accounting estimate that was required in the preparation of the financial statements was the selection of an appropriate index for the valuation of property.</p> <p>Over several years management employed the Office for National Statistics’ Retail Prices Index excluding mortgage interest payments (RPIX). This index is not suited to the valuation of buildings as it is based on the consumer prices inflation rather than the value of similar property. PricewaterhouseCoopers LLP recommends the Building Cost Information Service All in Tender Price Index (BCIS), which is also used by the District Valuer to inform their quinquennial valuations.</p> <p>There is an immaterial difference of £2.405 million between the net book value (NBV) of fixed assets indexed using RPIX as at 31 March 2012 and the same assets indexed using BCIS. This consists of an overstatement of £0.005 million in the depreciation charged to the Income and Expenditure account, and an overstatement of £2.400 million in the cumulative revaluation gains processed through reserves since the last formal revaluation. We have proposed adjustments in respect of this which are detailed in Appendix 1.</p> <p>Further, we strongly recommend that NGS adopts the BCIS index for 2012/13 onwards, which will have the dual advantages of ensuring material differences do not develop, and of minimising future gains and losses on formal revaluations. The information is available from the District Valuer.</p>
Deficiencies in the internal control environment	<p>The purpose of the audit was to express an opinion on the financial statements. The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters being reported are limited to those deficiencies that we have identified during the audit and that we have concluded are of sufficient importance to merit being reported to you.</p> <p>Such deficiencies in internal controls are included in Appendix 2.</p>

Details of material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern	We have not encountered any material uncertainties which cast doubt upon the ability of National Galleries of Scotland to continue as a going concern.
Disagreements with management	We have not disagreed with management on any matters which, individually or in aggregate, could be significant to the financial statements that have not been adjusted as summarised in Appendix 1.
Confirmation of audit independence	We confirm that, in our professional judgment, as at the date of this document, we are independent auditors with respect to the entity and its related entities, within the meaning of UK regulatory and professional requirements and that the objectivity of the audit engagement leader and the audit staff is not impaired.

## Governance and Performance

National Galleries of Scotland has a well-developed approach to risk management and performance monitoring involving the Board and the Audit Committee to ensure that organisational goals remain on track. This process has continued to be refined on an ongoing basis.

## Civil Service Pension Scheme

The majority of National Galleries of Scotland staff are eligible to join the Civil Service Pension Scheme. The latest actuarial valuation of the scheme was performed in 2007, and valuations are currently suspended. Management has disclosed the situation appropriately in the accounts. However, National Galleries of Scotland should be aware that contribution rates may increase significantly once an up-to-date valuation is performed.



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# *Appendices*

# Appendix 1 – Summary of corrected and uncorrected misstatements

The tables below set out details of the misstatements identified in the course of our substantive year-end audit work. The misstatement is uncorrected (i.e management has chosen not to process it through the final accounts) and is not of a material nature.

No	Description of misstatement	Income and Expenditure Account		Balance Sheet	
		Dr	Cr	Dr	Cr
1	DR Revaluation Reserve CR Land and Buildings Cost DR Accumulated Depreciation CR Depreciation Charge DR Release from revaluation reserve CR Revaluation reserve  <i>Being the impact of applying the BCIS All in Tender Price Index to revalue property on the depreciation charge in the year and the net book value at year end.</i>	£5,314	£5,314	£2,405,146  £5,314	£2,405,146   £5,314
<b>Total corrected misstatements</b>		<b>£5,314</b>	<b>£5,314</b>	<b>£2,410,460</b>	<b>£2,410,460</b>

# Appendix 2 – Deficiencies in internal control

The following points detail our internal control recommendations based on the results of our current year audit. We have graded our recommendations according to their possible impact.

**(H) High** Serious matters which should be addressed as a matter of urgency

**(M) Medium** Areas where attention is required

**(L) Low** Best practice recommendations

## Depreciation – Low

Finding	Recommendation
When recalculating depreciation, we noted that one asset within the Computers and Office Equipment category was being depreciated over six years instead of four years, as per NGS policy.	All assets should be depreciated according to NGS's accounting policies.
<b>Management response</b>	
This refers to the BEMS Building management packages that was moved from Fixtures and Fittings (6 years depreciation) to Office Equipment (4 years depreciation) and the depreciation rate was not updated when the move was made. We will write off the asset completely in 2012/13 to correct this error.	

## Review of manual journals – Low

Finding	Recommendation
Manual journals are not reviewed by a second member of staff.	Management should ensure that there is a formal threshold above which journals require review and authorisation. All journals meeting these requirements should be reviewed and authorised by an appropriate second member of staff.
<b>Management response</b>	
We will carry out a review on the practicalities of implementing this. We may be able to identify a report from Microsoft Great Plains that will enable us to carry out this review in an efficient manner. We will review this during 2012/13.	

## Employee numbers report – Low

Finding	Recommendation
<p>From our testing of payroll, payroll reports could not be re-run to allow us to recalculate NGS's full time equivalent (FTE) number due to the configuration of the payroll system. Although an alternative report was provided to give comfort over FTE calculation, recalculating the FTE is an important input for the purposes of our audit procedures.</p>	<p>Management should investigate whether it is possible to re-run the reports used in the calculation of the FTE number for year end purposes. If it is not possible, original reports should be retained as audit evidence.</p>
<b>Management response</b>	
<p>We will retain the original reports in 2012/13.</p>	

## Donated assets capitalisation – Medium

Finding	Recommendation
<p>From our testing of heritage assets additions, we noted that 49 out of 85 donated assets had not been recognised in the accounts and we were unable to quantify the value of the assets not being capitalised – therefore no financial adjustment was proposed.</p>	<p>NGS should capitalise all future donated assets.</p>
<p>FRS 30 highlights the impracticality of valuing gifted items, allowing an exception for recognition of assets where the cost information for donated assets:</p> <ul style="list-style-type: none"><li>- may present measurement difficulties;</li><li>- will only be obtained at significant costs; or</li><li>- the process of obtaining such information is onerous compared to the additional benefit that the users will receive by knowing this information</li></ul>	<p>The values being capitalised should be formally documented, and be signed off by an internal or external expert.</p>
<p>Internal experts at NGS or, in certain circumstances (e.g. significant value items), external experts would be well placed to assign best estimate values to all donated assets.</p>	
<b>Management response</b>	
<p>We are carrying out a review on the practicalities of valuing these assets, as there may be an issue if we have to incur a cost to get assets valued. We will review the system of valuing donated assets during 2012/13.</p>	

## Standing data amendments report for creditors – Low

Finding	Recommendation
As part of our work on creditors, we were unable to obtain a report of changes to creditors' bank details as the audit report had inadvertently been disabled by a system administrator.	Management should ensure that the audit report is re-enabled.
<b>Management response</b> We have re enabled the report.	

## Indexation of buildings – Medium

Finding	Recommendation
Management employed the Office for National Statistics' Retail Prices Index excluding mortgage interest payments (RPIX). This index is not suited to the valuation of land buildings as it is based on the consumer prices inflation rather than the value of similar property.	The Building Cost Information Service All in Tender Price Index (BCIS), which is also used by the District Valuer to inform their quinquennial valuations, should be used going forward. The data for the indexation is obtainable from the District Valuer.
<b>Management response</b> If we are able to obtain the BCIS index at no cost we will use this for the 2012/13 accounts. If this is not possible we will use a suitable, free index.	

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