www.pwc.co.uk

National Museums Scotland

Annual Report to the Board of Trustees of National Museums Scotland and the Auditor General for Scotland - FINAL

Year ended 31 March 2012

pwc

Contents

1 Introduction

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

We have discussed this report with the Director of Finance and Resources and the Head of Finance 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 complete, subject to the following outstanding matters:

- receipt and review of the service auditor's report covering the payroll services provided by Equiniti ICS.
- approval of the financial statements and letter of representation; and
- completion procedures, including subsequent events review.

1.2 Audit Opinions

Our audit opinion concerns both the true and fair statement of National Museum Scotland's financial statements and results for the year ended 31 March 2012 and the regularity of its income and expenditure in the year.

Subject to the satisfactory resolution of the matters set out above, our true and fair opinion on the financial statements is unqualified.

Our regularity opinion on income and expenditure draws attention to the integrity of certain cash withdrawals.

After the year-end, the Internal Auditors were engaged to review the integrity of certain cash withdrawals following discrepancies which came to light during July 2012. The initial findings of the review indicate the sums involved are not material to the presentation of the financial statements, nor imply a fundamental weakness in the system of internal controls. The Board of Trustees has outlined the matter within the Governance Statement.

In our opinion and taking account of the above noted matter, in all material respects, the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

1.3 Financial statements responsibilities

It is the responsibility of NMS management to prepare the financial statements in compliance with statutory and other relevant requirements. We are responsible for providing a true and fair opinion on the financial statements.

1.4 Findings arising from the audit

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

1.5 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 controls is identified is included in Appendix 2.

1.6 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 three misstatements in total (detailed in Appendix 1), two of which concerned the depreciation charge and the third the indexation of buildings. These errors were immaterial individually and in aggregate.

We look forward to the opportunity to discuss the points raised in the report with you at the Audit Committee meeting on 14 August 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 Museums 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 30 March 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
Consideration of fraud risk	
All organisations are at risk of fraud, with specific fraud risks being: • the potential for intentional misstatement of the financial statements; • the misappropriation of assets; and • management override of controls.	We reviewed management's overall fraud arrangements and fraud policies during our planning work. Our assessment of controls will consider their effectiveness for preventing and identifying fraud, with any weaknesses highlighted to management. We will perform audit testing of journals to ensure their legitimacy, and will incorporate unpredictability into our testing of income and expenditure.
Recognition of operating expenditure	
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. For the purposes of National Museums Scotland this risk is more sensibly inverted to reflect the risk around overstatement of expenditure.	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. We tested key controls over expenditure and reviewed a sample of transactions for legitimacy during our interim audit visit. Cut-off and accruals testing will be performed as part of our post-year end audit work.
Capitalisation of the Royal Museum Project	
National Museums Scotland has recently completed a £47 million major renovation of the former Royal Museum to transform the building and integrate it with the National Museum. There is a risk that concurrent work to maintain the existing estate has been capitalised rather than expended in the period.	We considered National Museums Scotland's processes for ensuring expenditure is correctly classified as capital or as repairs and maintenance and tested key controls over expenditure during our interim audit visit. In addition, we will review the fixed asset additions and repairs and maintenance accounts to ensure that the correct items have been capitalised in accordance with accounting standards in our post-year end work.

Cost Pressures	
National Museums Scotland continues to face significant cost pressures, (a reduction of approximately 4.16% in the revenue budget) particularly with regard to capital maintenance programmes. Ongoing budget restraint will make it more challenging to preserve the quality of the estate, while this is essential to maintain the condition and value of the collection.	The challenge for National Museums Scotland is to prioritise spending, identify efficiencies and review future commitments to ensure minimum standards are maintained and to avoid damage to the collection. We will focus on priority areas and take account of the status of key projects. Our Annual Report will comment on these areas and the key drivers for the year-end position. We will assess management's approach to identifying and quantifying impairments in our post-year end audit work. Where possible, we will rely on independent valuations of the estate, taking into account the condition of buildings as at 31 March 2012.
Restructuring	
In response to the continuing financial challenges facing the organisation, a Voluntary Severance/Exit Scheme may be considered by National Museums Scotland.	We will discuss and consider the accounting treatment, the structure, timing and the funding of any scheme with management. We will also assess any scheme's alignment to the overall strategy of the organisation, and any potential impact on staff morale and the achievement of longer term goals.

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 Museums Scotland the risk was removed. This was communicated to the Audit Committee in our Interim Management Letter.

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 **Significant risk**	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 did not identify any indications of fraud or errors that required adjustment to the financial statements, and that all the manual journals we reviewed were supported by appropriate rationale and documentary evidence. However we did identify two aspects in which the controls could be strengthened. Manual journals posted by the Head of Finance are not reviewed by a second member of staff, and not all journals are clearly documented on a manual journal form. Our recommendations are detailed in Appendix 2.
Recognition of operating expenditure **Significant risk**	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.
Capitalisation of the Royal Museum Project **Elevated risk**	We examined and tested the processes through which costs were allocated to capital project codes, and thereby capitalised on the balance sheet. We reviewed and tested a sample of fixed asset additions to ensure that they had been capitalised in accordance with accounting standards and NMS' accounting policy. We also tested a sample of transactions in repairs and maintenance accounts to ensure that they did not meet the criteria for capitalisation. We can confirm that our work in this area did not identify any errors that required adjustment to the financial statements. However we did identify an immaterial understatement of £479,641 in the depreciation charged in the year on the Royal Museum. Depreciation of the Royal Museum for the period from April 2011 to August 2011 had not been charged, resulting in understatement of the depreciation charge and overstatement of the revaluation loss. There is no impact on the Net Book Value (NBV) of the Royal Museum as a result of this. The breakdown of this is detailed in Appendix 1.

Cost Pressures **Elevated Risk**	We reviewed the condition of the estate, focusing on compliance reports of work that is necessary to ensure legislative and regulatory requirements are met. Although we recognise that NMS has a severe backlog of maintenance work, we are satisfied that the buildings are not materially impaired as at the year end. We can confirm that our work in this area did not identify any errors that required adjustment to the financial statements.
Restructuring **Elevated Risk**	We reviewed the purpose and terms of the voluntary exit scheme. We also tested the calculation of a sample of exit payments and reviewed management's accounting treatment. The current Director of Finance and Resources and the Head of Finance will both leave under the scheme in 2012. Arrangements are underway to recruit a new member of staff for a combined role, and we encourage management to ensure the successful candidate is in place in time for a sufficient handover period. We can confirm that our work in this area did not identify any errors that required adjustment to the financial statements.

We are pleased to report that our audit work in response to the significant and elevated risks did not identify any errors that required adjustment to the financial statements. We identified three misstatements in total (detailed in Appendix 1), two of which concerned the depreciation charge and the third the indexation of buildings. These errors were immaterial individually and in aggregate.

3 Financial Performance

3.1 Financial performance – 2011/12

NMS is facing an increasingly challenging financial environment with total in-year savings of £1.100 million having been required, mainly due to Grant in aid being reduced by £0.885 million to £20.425m.

To effectively manage within its reduced funding NMS reviewed its income and cost base and budgeted additional income of £0.100 million; made staff savings of approximately £0.500million through deleting vacant posts, restructuring, a voluntary exit program and other staff changes; and reduced its operational costs by over £0.500 million through reductions in utility costs, training and development and other savings across a number of departments.

Overall in 2011/12 the NMS result was a deficit of £0.200 million, this was mainly as a result of project timing as the net value of projects carried forward into 2012/13 reduced from the previous year leaving a high project spend in the 2011/12 year.

3.2 Financial outlook – 2012/13 and beyond

The NMS Board approved a breakeven position for 2012/13, but recognised that a number of projects funded in 2011/12 would require to be carried forward in to 2012/13. The Scottish Government has confirmed that running cost Grant in aid will remain static for 2012/13 but has indicated reductions of £0.101 milion in 2013/14 and a further £0.102 million in 2014/15 although these will need to be confirmed in due course.

The organisation operated a voluntary exit scheme in 2011/12 with the objective of reducing permanent salary costs in 2012/13. The cost in the year was £0.572 million, and the scheme was supported by an additional £0.350 million grant from the Scottish Government. The majority of staff whose exit under the programme was agreed in 2011/12 will leave in 2012/13. The resulting savings will have an ongoing impact from 2012/13.

NMS faces a number of cost pressures arising from the buildings and plant, including a major backlog of estates maintenance; with an estimated cost of £13.300 million remaining after the current planned work has been completed. However with a reduced capital budget NMS will need 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 recurring financial efficiencies in previous years. Service reduction is beginning to impact on some areas of work with management taking action to minimise the degree to which this will impact on the level of service delivery.

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 three uncorrected misstatements, that are not material to the financial statements individually or in aggregate, that we believe should be brought to your attention. Details of these can be found in Appendix 1. Further detail related to largest of the misstatements (misstatement 3) is included below.
Significant accounting principles and policies	Significant accounting principles and policies are disclosed in the notes to the financial statements. Trustees have provided us with representations that they have considered the accounting policies and that here 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	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. Over several years, management employed the Office for National Statistics’ Output Price Index for Public Works (OPI) in agreement with previous auditors. This index is not well suited to the valuation of buildings as it is based on the cost of materials used for new build construction rather than the value of similar property. PwC strongly 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. There is an immaterial difference of £1,847,104 between the NBV of fixed assets indexed using OPI as at 31 March 2012 and the same assets indexed using BCIS. This consists of an overstatement of £110,177 in the depreciation charged to the Income and Expenditure account, and an understatement of £1,736,927 in the cumulative revaluation gains processed through reserves since the last formal revaluation. We have proposed adjustments for these amounts, which are detailed in Appendix 1. As the variances are immaterial, management does not propose to adopt the BCIS index for 2011/12 and we agree that this is acceptable. However we strongly recommend that NMS 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 as included in Appendix 2.

Deficiencies in the internal control environment	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. At the time of signing the Financial Statements, Internal Audit were engaged to review the integrity of certain cash withdrawals following discrepancies which came to light during July 2012. The initial findings of the review indicate the sums involved are not material to the presentation of the financial statements, nor imply a fundamental weakness in the system of internal controls. However, management have undertaken to implement any recommendations arising from the review upon finalisation of the report. Such deficiencies in internal controls are included in Appendix 2.
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 Museums 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.
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

NMS 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 NMS 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, NMS should be aware that contribution rates may increase significantly once an up-to-date valuation is performed.

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. All are uncorrected, and are immaterial both individually and in aggregate.

No	**Description of misstatement**	**Income and Expenditure Account**		**Balance Sheet**	
		Dr	**Cr**	**Dr**	**Cr**
1	DR Depreciation Charge CR Accumulated Depreciation CR Revaluation Reserve *Being an adjustment to charge depreciation on the Royal Museum to the general ledger for the period April to August 2011*	£479,641			 £142,712 £336,929
2	DR Accumulated Depreciation CR Depreciation Charge *Being the correction of excess depreciation charged on an asset in the Galleries category, as a result of mis-keying when entering it into the Britannia fixed asset register.*		 £326,449	£326,449	
3	DR Fixed Assets NBV DR Release from Revaluation Reserve CR Depreciation Charge CR Revaluation Reserve *Being the impact of applying the BCIS All in Tender Price Index rather than the OPI index to revalue property on the depreciation charge in the year and the net book value at year end.*	 £110,177	 £110,177	£1,847,104	 £1,847,104
Total uncorrected misstatements		**£589,818**	**£436,626**	**£2,173,553**	**£2,326,745**

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

Manual journal records – Low

Finding	Recommendation
Although records are filed for all manual journals, staff do not routinely use the journals form. We acknowledge that the retained paperwork contains the crucial information. However, this information is not clearly presented.	When a manual journal is posted, the journal should be printed from the system and the print attached to and filed with the supporting paperwork.
Management response Accepted recommendation. From 1st April 2012 a print of the journal is being attached to supporting paperwork already with the implementation of the new PSF Finance System	

Review of manual journals – Low

Finding	Recommendation
Manual journals posted by the Head of Finance are not reviewed by a second member of staff, unless there is an impact on the cash balances.	Management should ensure that there is a formal threshold above which journals posted by the Head of Finance and his successor require authorisation. All journals meeting these requirements should be reviewed and authorised by an appropriate second member of staff.
Management response Management will update procedures to reflect the current management structure. This will be reviewed following the appointment of the new Director of Planning later in 2012.	

Heritage asset disposals – Low

Finding	Recommendation
Objects that are purchased for the collections using National Museums' purchase grant are capitalised as heritage assets on the balance sheet each year. We acknowledge that disposals from the collections are rare and tightly controlled, but noted that were no mechanisms to ensure any disposals were reflected in the financial statements.	As part of the accounts preparation process each year, management should obtain a report of heritage assets purchased since 1 April 2001 that have been disposed of, drawn from the Ad Lib collections management system. Any such disposals should be reflected in the financial statements.

Management response

Accepted recommendation. There were no disposals for the year ended 31 March 2012. A report will be obtained as part of the year end process for the year ended 31 March 2013 from Ad Lib to reflect any disposals of heritage assets purchased since 1 April 2001 in the accounts.

Indexation of property– Medium

Finding	Recommendation
Over several years, management employed the Office for National Statistics' Output Price Index for Public Works (OPI). This index is not suited to the valuation of buildings as it is based on the cost of materials used for new build construction rather than the value of similar property.	PwC 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. Using this index will have the dual advantages of ensuring material differences do not develop, and of minimising future gains and losses on formal revaluations.

Management response

Accept recommendation. Management will adopt the BCIS index in the preparation of its accounts for the year ending 31 March 2013.