KPMG

cutting through complexity

Historic Scotland

Annual audit report

Audit: year ended 31 March 2013

9 September 2013

Contents

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About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

This report is for the benefit of Historic Scotland ("the Agency") and is made available to Audit Scotland (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes, but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

Headlines

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practise* ("the *Code*"). This specifies a number of objectives for the audit.

In accordance with ISA (UK and Ireland) 260: *Communication with those charged with governance*, this report also summarises our work in relation to the financial statements for the year ended 31 March 2013.

We wish to record our appreciation of the continued co-operation and assistance extended to us by your staff during the course of our work.

Area	Summary observations	Analysis
Service overview		
Business issues and financial position	A revised framework document with the Scottish Government was agreed in March 2012 and will next be reviewed in 2015. Duff House and Bute House were transferred to Historic Scotland in 2012-13. The contribution from Aberdeenshire Council in respect of Duff House costs was paid in June 2013. Historic Scotland outturn for the year ended 31 March 2013 is an overspend of £135,000. The main areas of cash overspend relate to grants and the voluntary early exit scheme. Authorisation for the overspend was obtained from the Scottish Government. A balanced budget as been set for 2013-14.	Page 4
Performance Management		
Performance management	We tested a sample of the key performance indicators included in the annual report and found these to have been calculated correctly. We completed our work on the follow up of Audit Scotland's report *Scotland's public finances: Addressing the challenges.* Overall, there is a rigorous budget setting process.	Page 10
Governance and narrative reporting		
Governance	Our review of governance arrangement did not identify any issues, however we have raised a number of recommendations related to the authorisation of the IT contract, signed March 2012, where there were significant weaknesses in the business planning stages, authorisation and project management.	Pages 5-6, 13-14 Appendix five
Control observations	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are in the main designed appropriately and operating effectively. We reported on control weaknesses in our interim management report	
Financial statements and accounting		
Accounting policies	There have been no changes to accounting policies in 2012-13. No newly effective accounting standards are expected to have a material impact on next year's financial statements.	Page 16
Audit conclusions	We have issued unqualified audit opinions on the 2012-13 financial statements.	Page 17
Year-end process	The financial statements, management commentary, governance statement and remuneration report were received by the agreed date and were well supported by high quality working papers.	Page 17

Service overview

Our perspective on key business issues and the financial position of the Agency

Key business issues

In 2012-13, a focus on efficiency has continued and performance against most of the key performance targets agreed with Scottish Ministers was positive, despite challenges associated with poor weather and difficult trading conditions in the summer impacting all tourism operators across the UK.

Visitor numbers were 3.2 million, slightly below the 3.3 million target and income from commercial activities, while increased by 2.5% compared with the prior year to £32.2 million, was £1 million below budget.

Development on a number of significant projects, including Bannockburn and the Scottish Ten project continued in 2012-13 and a project at Iona Abbey will be undertaken in 2013-14.

Framework document

As an executive agency of the Scottish Government, all functions are carried out on behalf of Scottish Ministers. The chief executive is responsible to the Scottish Ministers, within the terms of the framework document, for Historic Scotland's management, performance and future development.

In March 2012 a revised framework document was agreed. There are no significant changes arising from the revised framework document, other than clarification of the responsibilities of the chief executive, as accountable officer and the role of senior management and non-executive directors.

The framework document includes financial delegations. It is recommended that management review the categorisation of delegations with the Scottish Ministers as a number of current expenditure (revenue) delegations appear to be incorrectly classified as capital expenditure delegations

Recommendation one

Royal Commission on the Ancient and Historical Monuments of Scotland ("RCAHMS")

An option appraisal on securing the long terms future of RCAHMS functions led to the development of a business case, in July 2012, to merge the Agency with RCAHMS. The aim of the merger is to ensure the long term sustainability of both organisations and draw on their respective strengths.

It emerged from a review of the existing historic environment policy, led by the Agency on behalf of the Cabinet Secretary for Culture and External Affairs, that an overarching historic environment strategy is needed. The aim of the strategy being to ensure the historic environment is managed and protected, but also promoted to deliver cultural, social and economic benefits. A joint consultation on a Historic Environment Strategy for Scotland and the merger of Historic Scotland and RCAHMS was issued on 8 May 2013.

Legislation will be required to facilitate the merger and allow creation of the new body from 1 April 2015. During the period leading up to the merger, management of both organisations will need to ensure a transition plan is developed and that the existing control environment is not weakened as a result of significant organisational changes.

Bute House and Duff House

In 2012-13 operational responsibility for Bute House and Duff House was transferred to Historic Scotland.

In relation to Duff House, Historic Scotland has recently finalised a management agreement with Aberdeenshire Council who will make annual contributions of £160,000 towards associated costs. After contributions, which were not received until June 2013, annual operating expenditure is increased by approximately £330,000 (until the termination of the agreement with Aberdeenshire Council in 2016) but opportunities for growing associated income are being pursued by management.

Key business issues (continued)

IT strategy and network contract

Prior to 2012, there was no formal IT strategy at Historic Scotland and a consultant was initially recruited on a three month basis to support its development, before being appointed on a fixed term basis as the head of IT. Internal audit have reported that there was no defined framework in place over development of the IT strategy, which was presented to the senior management team on a number of occasions during its development.

On 28 March 2012, the then director of finance at Historic Scotland signed an IT contract with ATOS IT Services UK Limited for three years committing Historic Scotland to approximately £2.6 million of expenditure over the contract term.

The purpose of the contract is primarily to support the development of a corporate network to replace the SCOTS system which Historic Scotland felt was not meeting organisational needs, as well as providing an IT helpdesk, network and desktop support and infrastructure service.

By June 2012, it became apparent to senior management that the contract did not fully meet the Agency's requirements and a number of actions have subsequently been taken forward, under the direction of the director of human resources (who has taken over responsibility for IT as part of a planned transition), to modify the services provided by the supplier. Project governance arrangements have been significantly improved since the contract was signed.

Internal audit findings

The Scottish Government internal audit service conducted a review of the associated implementation of the Agency IT strategy which considered:

- IT governance: arrangements and rationale in place over the development and management of the IT strategy;
- IT investment / development: management procedures over critical IT infrastructure systems which underpin the implementation of the strategy, including development of the specifications and procurement processes;
- project management: review of the implementation of projects; and
- the IT strategy.

Based on the work undertaken, internal audit provided 'reasonable assurance' on the risk management, control and governance arrangements in place related to the IT strategy. However, it found controls at the start of the contract to be poor including sign-off and authorisation, change control and contract development.

Internal audit raised a number of recommendations and in particular noted that the Agency processes did not include:

- a framework to assist with development of the IT strategy;
- a business case or plan underpinning the rationale for the corporate network IT contract;
- formal sign-off of the strategy or contract by the senior management team and confusion by both the former head of IT and former director of finance with regards to committing the organisation to significant expenditure.

Authorisation

We have been informed by senior management that there was limited awareness that the contract had been agreed until it was announced by the provider. This indicates a significant weakness in the the business planning stages, authorisation and project management.

The permanent secretary designates the chief executive as Accountable Officer, under section 15 of the Public Finance and Accountability (Scotland) Act 2000, and the chief executive is personally responsible for the propriety and regularity of finances.

Key business issues (continued)

Relevant delegated authority limits are set out below:

Financial delegations per framework documents		
Nature of expenditure	**2008**	**2012**
Capital – 'To incur expenditure on information technology systems and related equipment.'	£1 million for any single project	£1 million for any single project
Recurring expenditure – 'to incur expenditure on staff remuneration, administrative expenses and any other necessary operating expenses including equipment, vehicles, plant and machinery, consultancies, publicity and accommodation.'	Unlimited	Unlimited

The chief executive subsequently delegates authority to directors through financial responsibility statements. These were issued by the former chief executive in 2010 and updated in early 2013 by the current chief executive. In both cases, financial delegation to directors is effectively any amount up to the directors' budget responsibility.

At its meeting in March 2012, shortly before the contract was signed, the senior management team approved the objectives of the IT strategy. The minute does not make clear whether the strategy itself was approved.

Since costs incurred under the contract are within officers' budget responsibility and costs incurred are revenue costs, not related to purchase of IT systems or equipment which are capitalised, the then director of finance appears to have had appropriate authority to enter the contract on behalf of Historic Scotland. However, in our opinion, there is a lack of clarity over authority to enter into financial commitments, compared with annual expenditure which could be clarified in the framework documents, following discussion with Scottish Government.

Recommendation two

The principles of IT strategy were endorsed by the senior management team in March 2012 although we understand that the senior management team had previously considered and approved the strategy, the approval is not clearly documented. Therefore, while that may have led to some confusion over approval of the strategy or its objectives compared with the contract, the strategy should have been formally finalised prior to development of the contract scope as part of tender procedures.

We would have expected documented approval of the contract by the senior management team (through minutes) and then chief executive.

Current financial delegations within Historic Scotland are largely unchanged from those which applied at the time the contract was signed and should be enhanced to ensure appropriate oversight and approval of significant expenditure and contracts by the senior management team and chief executive, in line with their, appropriate, expectations.

Recommendation three

Financial position

The outturn as at 31 March 2013 was an overspend of £135,000 against the budget of £77.2 million.

The year end overspend comprised a non-cash variance of £1.182 million underspend and cash variance of £1.318 million overspend.

Financial performance

Expenditure for the year to 31 March 2013 is £135,000 over budget, which has reduced from a forecast over spend of £780,000 as at December 2012.

When allocating initial expenditure budgets, 5% to 10% of operational capacity was withheld centrally until the progress in respect of commercial income targets was known. This allowed some additional control over expenditure to mitigate the risk of a significant over spend.

Performance against the original budget is summarised below.

	Revised budget £'000	Actual £'000	Variance £'000
Gross commercial and tourism income	32,158	32,265	107
Other income	1,435	1,481	46
Scottish Government budget	47,346	47,346	
Cost of goods sold	(4,150)	(4,245)	(95)
Total income	**76,789**	**76,847**	**58**
Policy	850	834	16
Heritage	3,836	3,823	13
Conservation	25,103	25,122	(18)
Commercial and Tourism	16,728	16,753	(25)
Corporate services	27,310	27,994	(684)
Centrally managed budgets	3,410	2,457	953
Total expenditure	**77,237**	**76,982**	**255**
Surplus/(deficit)		**(135)**	

Source: SMT finance report 2012-13 (21 May 2013)

Income from commercial and tourism

Although income has increased from the previous year the income figure is still £1.0 million below that originally budgeted for at the start of the year. Due to poor weather and difficult trading conditions in the summer impacting all tourism operators across the UK. The increase in income is due to an increase in admission prices and other charges. In the current economic climate there may be limited scope to generate additional income through further price increases and so any further increases will require consideration of any adverse affects this could have on visitor numbers and consequently on commercial income and the achievement of the business plan.

Other variances

The year end deficit consists of two main elements:

- non- cash variance of £1.182 million under spend; and
- cash variance of £1.318 million overspend

The non-cash variance relates to lower than anticipated capital charges.

The cash variance comprises expenditure in respect of:

- additional grant commitments, £469,000;
- voluntary early exit scheme, £463,000; and
- other overspends, £386,000.

The most significant other overspend is the increase in compensation payments to visitors and staff who have been injured or made claims against the Agency during the year.

Historic Scotland has obtained authorisation for the above overspend from the Scottish Government and the actual cash overspends are within the limits of this authorisation.

Financial position (continued)

Scottish Government grant funding will reduce by £3.7 million in 2013-14 and a further £4.6 million in 2014-15.

The 2013-14 plan forecasts a breakeven position, achievement of which is partially dependent on delivering £1.5 million reduction in payroll costs.

£0.4 million reduction in payroll costs will be achieved as a result of the voluntary exit scheme which occurred in 2012-13.

Financial plans 2013-14

The Scottish Government set out its spending plan for the next three years. This will mean a drop in direct government funding from £44.0 million in 2012-13 to £40.3 million in 2013-14 and £35.7 million in 2014-15 for Historic Scotland.

Management has budgeted a breakeven position for 2013-14, based on anticipated grant-in-aid of £45.8 million, which includes an additional £5 million in capital and 'shovel ready' funding.

The 2013-14 budget is summarised below:

	2013-14 £'000
Scottish Government grant income	45,791
Commercial income	33,448
Other income	1,252
Total income	**80,491**
Direct allocations	51,456
Investment commitment	14,590
Capital and shovel ready funding	4,990
Cost of goods sold	4,100
Non-cash capital charges	3,311
Corporate projects and contingency	2,000
Sundry adjustments net	44
Total expenditure	**80,491**

Source: SMT budget report 7 May 2013

The budgeted commercial income represents an increase of £1.1 million compared with 2012-13. This is a challenging target and will require regular monitoring through out the year so that any necessary remedial action can be taken promptly such as activities to encourage visitor spend or to consider the impact on expenditure which may need to be reduced if income levels are not achieved. The figure used in the above budget is £1.4 million less than the figure predicted by the commercial and tourism directorate. It is management's intention to use any income above budget to fund additional projects.

Scottish Government capital and 'shovel ready' funding includes:

- Bannockburn and Lews Castle, £1.4 million;
- Edinburgh Castle rock fall containment , £1.1 million; and
- other projects approved by the senior management team, £1.7 million.

£0.8 million of this funding has been retained and not yet allocated.

The balanced budget assumes that sustainable savings of £1.5 million in respect of payroll costs will be achieved in 2013-14. The required savings is comprised of a number of aspects including reduced overtime, vacancy management, flexible working and savings arising from flexible working arrangements.

Work is still ongoing to identify how the savings in relation to the vacancy position and flexible working arrangements will be achieved during 2013-14.

Performance management

Our perspective on the performance management arrangements, including follow up work on Audit Scotland reports

Performance management

Our testing of KPT's did not identify any issues.

Management have responded to the Director General, Governance and Communities letter on corporate expectations.

Best Value	In April 2002 the Scottish Ministers introduced a non-statutory duty on accountable officers to ensure there are arrangements designed to secure Best Value. Audit Scotland is committed to extending the Best Value audit regime across the whole public sector. Using the Scottish Executive's nine Best Value principles as a basis for audit activity, Audit Scotland previously selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). Management have not utilised the Best Value toolkits, but a number of aspects of arrangements to deliver Best Value are effectively embedded into policies and practices. For example, management participate in the procurement capability assessment exercise and have previously improved their rating under this assessment. The procurement policy has a number of stated objectives and performance indicators associated with delivering Best Value. In 2012-13, procurement have run a number of sessions looking at how contracts are managed with the intention of identifying the best way that procurement can support operational staff. There may be further opportunities for Historic Scotland to improve its practices by adopting other principles from Best Value toolkits and so we would encourage use of the toolkits to be made where appropriate, for example in respect of community engagement, partnership working and community engagement or customer focus and responsiveness. In 2012-13, Historic Scotland had a 3% efficiency saving target, equating to £1.4 million compared with 2011-12. This target was achieved in the year. In respect of 2013-14 a 3% efficiency target has again been set and management intend to achieve efficiency savings in 2013-14 through payroll reductions as outlined on page eight.
Performance management	Historic Scotland's annual report includes a summary of performance against a number of Key Performance Targets ("KPT's") which, in our opinion, represented challenging targets that were well aligned with strategic objectives of Historic Scotland. In 2012-13, the Agency failed to achieve six of the 14 targets. Two of the targets which were not achieved relate to commercial income and the remaining targets not achieved relate to non financial information and, where appropriate, context has been included in the annual report on why those targets were not achieved. We have reviewed this information for consistency with the financial statements and tested a sample of KPT's to consider the extent to which they are supported by evidence. The KPT's are consistent with the financial statements and supported by our sample testing. Internal audit is currently carrying out a bi-annual review of KPT's which will be reported in autumn 2013.
Corporate expectations	The Director General, Governance and Communities wrote to public bodies on corporate expectations in July 2012 asking for a preliminary assessment of progress. In response, Historic Scotland has completed a preliminary assessment of progress towards meeting the delivery areas identified, including how each of the areas aligns with the key commitments identified in the corporate plan. Historic Scotland is taking appropriate action in response to the Scottish Government's letter.

Performance management (continued)

During 2012-13 we have performed follow-up work in relation to the Audit Scotland national report: *Scotland's public finances: Addressing the challenges* as well as preparing returns on national studies. In our opinion, Historic Scotland has a sound budget setting and review process and performance in respect of efficiency saving targets is regularly monitored.

Scotland's public finances: addressing the challenges	As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified the *Scotland's public finances: Addressing the challenges for* follow-up by local auditors in 2012-13. The aim of the follow-up work is to assess how public bodies are responding to the challenges of public sector budget constraints and their efforts to achieve financial stability. In our opinion, Historic Scotland has a sound budget setting and review processes which is evidenced through senior management team involvement and challenge throughout the process. The 2013-14 budget has been prepared taking into account lessons learned from the previous year (i.e. in respect of the assumptions for commercial income). Variances and delivery against budget are closely monitored and discussed by the senior management team. The 2013-14 budget has been set incorporating savings required to respond to the reduction in Scottish Government grant funding and the 3% efficiency target. Finance is discussed each month at senior management team meetings together with performance against the 3% efficiency savings target reported against on a quarterly basis. Detailed findings are given in appendix three.

Governance and narrative reporting

Our overall perspective on your narrative reporting, including the remuneration report and annual governance statement

Update on controls findings from our audit

Corporate governance arrangements

We updated our understanding of the governance framework and did not identify any issues in relation to governance.

Annual governance statement and governance arrangements	The statement for 2012-13 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on the governance framework, the system of internal control, internal audit, internal financial controls and risk management arrangements and analyses the effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. The statement, which is made by the Accounting Officer, considers the effectiveness of the system of internal control based on information provided by the audit and risk committee and internal audit. The statement identifies that there have been no significant risk-related matters and no significant lapses of data security. Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls are designed appropriately and operating effectively. As part of our interim audit we updated our understanding of the governance framework as part of our overall assessment of Historic Scotland's risk and control environment. We did not identified any issues during our interim review. We also considered this area as part of our work on the annual governance statement and again did not identify any issues.
Annual report, including the management commentary	The financial statements form part of the annual report of Historic Scotland for the year ended 31 March 2013. We are required to consider the management commentary and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the management commentary is consistent with the financial statements. Changes to the UK Corporate Governance Code, which will be applicable for year ending 31 March 2014, will require that the \`front end' narrative reporting is \`fair, balanced and understandable.' Audit committees will be expected to consider this as part of their consideration of the annual report and financial statements. In our view, the annual report already complies well with this requirement, although we recommend early consideration of the requirements of the revised Code against Historic Scotland's reporting format.

Corporate governance arrangements (continued)

Remuneration report	The remuneration report was provided in advance of the commencement of the audit, and supported by good quality information to support the disclosures provided. The pensions figures were not made available until 18 June 2013. This was due to sector wide delays in receiving the information from the actuary and not within Historic Scotland's control.
Internal audit	We have considered the findings form internal audit reports finalised during 2012-13 to inform our assessment of risks that need to be considered and addressed during the audit. Our review of internal audit reports also helps ensure that any duplication of work is avoided. With the exception of the report relating to the IT contract, there were no significant issues that have arisen as a result of these reviews. The Scottish Government internal audit department will present their annual report to the audit and risk committee on the 24 June 2013.
Prevention and detection of fraud	Procedures related to fraud are designed and implemented effectively. The audit and compliance team complete random checks at sites through out the year which enhance the control environment, particularly with respect to stock and cash balances. There is a whistle blowing policy that can be found on the Historic Scotland intranet. No significant fraud or irregularity has been identified during the year.
National Fraud Initiative ("NFI")	The National Fraud Initiative ("NFI") is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use for uploading data and monitoring matches. Historic Scotland have received the data matches back and have made progress in commencing investigations . Based on progress made to date. Historic Scotland's arrangements for the investigation of NFI matches appear sufficient. We will complete an NFI questionnaire which will be reported to Audit Scotland by 31 January 2014. This will be completed in liaison with management. At this stage, we are satisfied with the progress that has been made.

Financial statements and accounting

Our perspective on the preparation of the financial statements and key accounting judgements made by management

Accounting policies

There have been no changes to accounting policies in 2012-13. All accounting policies have been applied consistently.

There have been no substantive changes to the financial reporting framework as set out in HM Treasury's *Financial Reporting Manual* ("FReM").

The financial statements have been prepared on a going concern basis

Accounting framework and application of accounting policies	
Area	**KPMG comment**
Financial reporting framework	■ Historic Scotland prepared the financial statements in accordance with HM Treasury's Financial Reporting Manual 2012-13 ("FReM"). ■ During the year there have been no substantive changes in financial reporting requirements, and consequently there are no material changes to the Historic Scotland's accounting policies. ■ We are satisfied that the accounting policies adopted remain appropriate to Historic Scotland.
Impact of revised accounting standards	■ No newly effective accounting standards are considered to have a material impact on the Historic Scotland's financial statements.
Going concern	■ The financial statements have been prepared under the assumption that the organisation is a going concern. Given the nature of Historic Scotland this is a reasonable assumption and a balanced budget has been set for 2013-14 which indicates that the organisation will continue to operate. ■ A joint consultation on a Historic Environment Strategy for Scotland and the merger of Historic Scotland and RCAHMS was issued on 8 May 2013. During 2015-16 it is intended that, subject to approvals, Historic Scotland and RCAHMS will merge. This is not considered to have a material impact on the net assets of Historic Scotland.

Audit conclusions

We have issued an unqualified audit opinion on the financial statements and the regularity of transactions reflected in those financial statements.

The financial statements were made available on a timely basis and were accompanied by high quality working papers.

Audit conclusions

We have issued an unqualified opinion on the truth and fairness of the state of Historic Scotland's affairs as at 31 March 2013, and of Historic Scotland's financial statements for the year then ended. We also provide our unqualified opinion on the regularity of transactions within the year. There are no matters identified on which we are required to report by exception.

In gathering the evidence for our opinion we have:

- performed a mixture of substantive and controls testing to ensure an efficient approach that covers all the key risks;
- liaised with internal audit and reviewed their reports to ensure all key risk areas having a potential financial statements impact have been considered;
- reviewed assumptions and judgements made by management and considered these for appropriateness;
- considered if the financial statements may be affected by fraud through discussions with senior management and internal audit to gain a better understanding of their work in relation to prevention and detection of fraud with the potential to impact on the financial statements; and
- attended the audit committee to communicate our findings to those charged with governance, but also to update our understanding of the key governance processes and obtain key stakeholder insights.

Financial statements preparation

Preparation of the financial statements

- High quality working papers and substantially complete draft financial statements were provided at the start of the audit fieldwork in May 2013. This included the management commentary and remuneration report.
- In advance of our audit fieldwork, we issued a 'prepared by client' request setting out a list of required analyses and supporting documentation. The standard of documentation was good and there was evidence of accountability and ownership of working papers across the finance department.
- Throughout the course of the year we have had regular correspondence with the Historic Scotland's finance team to ensure that disclosure within the financial statements was consistent with the requirements of the FReM. We provided feedback to management on the content of the financial statements, annual report and remuneration report, and we are pleased to report that these were consequently prepared appropriately.
- There are no significant matters in respect of (i) audit differences; (ii) auditor independence and non-audit fees; and (iii) management representation letter content.

Overview assessment

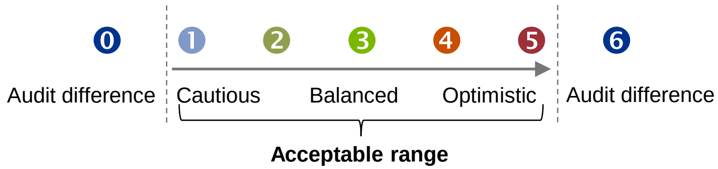
Overall, in respect of the key judgements made in the preparation of the financial statements, we are satisfied that management's judgements are generally balanced, and do not represent either an overly optimistic, or overly cautious, position.

In respect of accruals and deferred income, we identified two errors in a sample of three. The statistically extrapolated most likely difference in the population is £215,000. This is not material and we have agreed with management that no adjustment is necessary.

Assessment of subjective areas

Asset/liability class	Current year	Prior year	Balance (£m)	KPMG comment
Accruals and deferred income	3	3	(13.7)	Based on the results of our testing, we are satisfied that the accruals balance is not materially misstated. We tested three accruals relating to "Goods Received Not Invoiced " and identified two instances where the actual amount that was invoiced was different to the amount accrued. To select our sample we used a statistical sampling technique and therefore we are required to extrapolate our testing results to arrive at an extrapolated, most likely different in the population. The extrapolated, most likely difference, identified as a result of our testing is not material and is reported as an unadjusted, most likely difference of £215,000, in appendix two.

Level of prudence



Cautious means a smaller asset or bigger liability; Optimistic is the reverse

Appendices

Mandatory communications

There were no changes to the core financial statements and one unadjusted difference, the most likely difference in the financial statements.

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft financial statements which impacted on the net assets or the net expenditure for the year. A small number of minor numerical and presentational adjustments were required to some of the financial statements notes.	-
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There is an unadjusted difference relating to accruals. Details of this are at appendix two.	Appendix two
Confirmation of Independence Letter issued by KPMG to the Audit Committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of our Audit Director and audit staff.	Appendix three
Schedule of Fees Fees charged by KPMG for audit and non-audit services	There were no non-audit services in 2012-13.	-
Draft management representation letter Proposed draft of letter to be issued by Historic Scotland to KPMG prior to audit sign-off	There are no significant changes to the standard representations required for our audit from last year.	-

Audit differences

There is an unadjusted audit difference relating to accruals.

This difference is not material.

Unadjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you.

There is an unadjusted audit difference relating to accruals. Details of this unadjusted, most likely audit difference are shown below.

Adjusted caption	Nature of difference	Statement of Financial Position	Statement of Comprehensive Net Expenditure
Changes to the prime financial statements		**£'000**	**£'000**
Trade and other payables	Testing identified differences between the accrued amount and the amount which was subsequently invoiced. The actual differences identified where below £10,000, however, based on our sample size, and statistical extrapolation, we estimate the most likely difference in the population of accruals is £215,000 overstated. Controls relating to expenditure were tested during interim and we did not identify any issues.	(215)	-
Net operating cost before Scottish Government funding	The double entry of the above.	-	215
Net impact		**215**	**215**

Auditor independence and non-audit fees

Auditing Standards require us to consider and confirm formally our independence and related matters in our dealings with the Agency.

We have appropriate procedures and safeguards in place to enable us to make the formal confirmation in our letter included opposite.

Auditor independence

Professional ethical standards require us to provide to you at the conclusion of an audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed. This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence.

We have considered the fees paid to us by the Company and its related entities for professional services provided by us during the reporting period. We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Directors and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Regular communications
- Internal accountability
- Risk management
- Independent reviews

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the Chief Executive.

Confirmation of audit independence

We confirm that as of 20 June 2013, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This report is intended solely for the information of the Audit Committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

Scotland's public finances: addressing the challenges follow up

As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified Scotland's public finances: Addressing the challenges for follow-up in 2012-13.

We carried out follow-up work to consider the Agency's response to the report.

1. Do public bodies have sustainable financial plans which reflect a strategic approach to cost reduction?	
Does the organisation have a balanced financial plan for 2012-13 which sets out: ■ Assumptions about sources of income and cost pressures? ■ What cost reductions and other efficiency savings will need to be made, and how they are to be delivered? ■ Risks to service delivery as a consequence of the need to reduce costs and deliver identified efficiency savings?	The question relates to 2012-13 but as this return is been completed in 2013-14 and answers primarily relate to 2013-14 onwards. Historic Scotland has produced a balanced budget for 2013-14 which has been approved by the senior management team. The figure for commercial income is underpinned by a forecast from the commercial and tourism directorate, adjusted based on experience in the current year. A 3% efficiency target has been set by the Scottish Government. Management expect to deliver this through tight control over recruitment to maximise vacancies savings, procurement and changes to contracts for income generation. A baseline reduction of 8% in Scottish Government funding is implicit in the budget in line with the 23% reduction over the three year period 2012-13 to 2014-15. Directorates where they were required to set out the risks and potential impacts of reduced budget allocations as part of the budget setting process.
Does the organisation have a clear budget-setting process which: ■ Demonstrates a clear understanding of its costs and how costs vary with activity? ■ Takes into account previous years' service delivery performance and where improvements need to be made? ■ Takes into account the body's track record on delivering against budgets and analysis of the reasons for previous years' under/over spends? ■ Allocates resources according to a clear understanding of its priorities, including which services or activities are expected to contribute most and least to the achievement of the organisation's outcomes?	Historic Scotland has a clear budget setting process led by the finance directorate. The senior management team receive regular updates on the process and budget pressures that might impact on service delivery and impact of budget reductions . The Agency has moved from incremental budgeting to a form of zero based budgeting since 2010-11. There is some evidence in the 2013-14 budget setting process that lessons have been learned from the 2012-13 budget. For example, in the 2013-14 budget the commercial income figure used is £1.4 million less than the figure that was predicted by the commercial and tourism directorate, reflecting experience gained in 2012-13. In setting the 2013-14 budget, all directorates were initially required to set a budget based on 85% of the previous years allocation. Some directorates (e.g. commercial and tourism) received a smaller reduction, as an example of allocating resources based on outcomes.

Scotland's public finances: addressing the challenges follow up (continued)

Is there a clear evidence base to cost reduction plans? If yes: ■ Does the organisation undertake a programme of service reviews designed to identify the scope to reduce costs? ■ Do cost reduction plans provide adequate detail on how savings are to be made and over what timeframe? ■ Do cost reduction plans state who within the organisation is accountable for their delivery? ■ Do cost reduction plans give adequate consideration to the impact of reduced expenditure/ changes to service delivery arrangements on service performance and outcomes? ■ Are clear baselines established against which efficiency savings can be measured?	In setting the 2013-14 budget, directorates were informed their budget was to be 85% of the allocation in 2012-13 and then the directorates were required to establish how they could deliver against this budget. In 2012-13, the directorates were required to review costs and identify where savings could be made. Finance assisted in this exercise. Performance against budget (and hence in achieving cost reductions / efficiency savings) is reported monthly to the senior management team – holding directorates accountable. The financial responsibility statements, issued by the chief executive to directors, delegates budget responsibility, including contribution to value for money, achievement of outcomes and monitoring arrangements. Efficiency savings are reported quarterly to the senior management team and the audit and risk committee.
Does the organisation regularly use benchmarking to compare its costs and performance with other organisations, including public bodies in other sectors and other non-public sector bodies? Can the organisation demonstrate real and measurable benefits from its benchmarking activities in terms of cost and/or quality improvements?	Historic Scotland engages each year in the Scottish Government corporate services benchmarking exercise. This allows the organisation to compare their costs and performance to other public sector bodies. Historic Scotland also participates in informal benchmarking against other bodies with significant commercial income such as the National Trust for Scotland and English Heritage. Historic Scotland are not able to demonstrates specific benefits from benchmarking but is currently in the process of trying to explore why other bodies in the sector receive more membership income per member than Historic Scotland.

Scotland's public finances: addressing the challenges follow up (continued)

Does the organisation have a longer term financial strategy which: ■ Takes into account planned changes to service delivery arrangements and anticipated changes in demand for services? ■ Sets out how financial resources will be matched to strategic goals? ■ Demonstrates that current cost reductions and efficiency savings are in line with longer term strategic objectives?	Historic Scotland has budget plans for 2013-14 and is shortly commencing preparing the budget for 2014-15. The corporate plan covers the period up to 2015 and sets out the organisations strategic priorities. There is no long term financial strategy document and management propose that one will be developed jointly with RCAHMS as both organisations move towards the new body from April 2015.
2. Do senior officials, elected members and non-executive directors demonstrate ownership of financial plans and are they subject to sufficient scrutiny before approval?	
Do senior officials, elected members and non-executive directors demonstrate ownership of financial plans: ■ Are high level financial targets and the overall financial position of the organisation discussed regularly at board level meetings? ■ In setting financial plans, do members adequately consider the impact of budget reductions on service quality and outcomes?	Performance against budget is discussed at senior management team meetings. Performance against Key Performance Targets ("KPT's") are reported quarterly to the senior management team and audit and risk committee. From our review of the minutes of each of these committees, in our opinion, effective scrutiny of these areas is delivered by these committees.
Do senior officials, elected members and non-executive directors provide: ■ Sufficient focus on strategy and performance? ■ Adequate challenge on longer-term financial plans? ■ Regular consideration of financial risks? ■ Adequate monitoring of the achievement of efficiency targets?	The senior management team regularly reviews performance against targets that focus on strategy and performance. There is no long term financial plan but the senior management team do provide challenge in the annual budget setting process. Financial risks are considered by the senior management team in the form of the monthly report against budget. Achievement of the 3% efficiency saving is reported quarterly to both the senior management team and audit and risk committee.

Scotland's public finances: addressing the challenges follow up (continued)

Is there appropriate transparency and accountability of decisions about cost reduction measures and future organisational plans: ■ Is there appropriate consultation with the public and other stakeholders over cost reduction plans which identify various options and their impact on service delivery and outcomes? ■ Do financial and corporate plans adequately spell out the consequences of reduced budgets on the organisation's ability to deliver services and outcomes?	Historic Scotland has not consulted with the public and other stakeholders over cost reduction plans although there was a consultation with stakeholders in respect of the corporate plan delivery process. The corporate plan contains a section on the downward trend of budgets and the organisation's ability to deliver services and outcomes in that context.
Do finance/resource committees and other scrutiny committees play a suitably prominent role in the consideration of budget plans and risks to service delivery: ■ Are finance/resource and other scrutiny committees sufficiently involved in the consideration of budget plans, including: ■ the impact of budget reductions on service delivery ■ the organisation's track record of delivering against budgets? ■ reasons for previous years' under/over spends against budget? ■ Do finance/resource and other scrutiny committees undertake a regular programme of reviews of business areas to examine issues such as the achievement of value for money and service delivery? ■ Do finance/resource and other scrutiny committees regularly assess areas such as financial risks and efficiency savings? Are reports from finance/resource and other scrutiny committees on budget plans and risks to service delivery given proper consideration by officials, with recommendations being promptly acted upon? ■ Do finance/resource and other scrutiny committees receive reports on the extent to which cost reductions and efficiency savings have impacted on service delivery?	The committees that play a significant role in considering the Agency's budget plans are the senior management team and audit and risk committee. The senior management team is involved in the setting of the budgets and this includes impact of budget reductions, delivery against budgets and explanations of variances against previous years. The senior management team and audit and risk committee have not carried out any reviews of business areas to examine issues such as the achievement of value for money and service delivery. On a monthly basis the senior management team assesses financial risks via the monthly budget monitoring report. Based on our review of minutes of the committees, reports from on budget plans and risks to service delivery are given proper consideration by officials, with recommendations being promptly acted upon.

Action plan

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses.

Priority rating for recommendations		
Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the organisation or systems under consideration. The weaknesses may therefore give rise to loss or error.	**Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.	**Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
1 Framework document – financial delegations		**Grade two**
The framework document includes financial delegations. A number of current expenditure (revenue) delegations appear to be incorrectly classified as capital expenditure delegations.	It is recommended that management review the categorisation of delegations with the Scottish Ministers.	We are reviewing the framework during Summer 2013 to bring it into line with Scottish Government structures (not least the move of Policy to the Scottish Government) so there will be an opportunity at that point to revise the annex on delegated authority. **Responsible officer:** Corporate analysis and performance manager **Implementation date:** 31 August 2013

Action plan

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
2 **Framework document – authorisation**		**Grade two**
There is some lack of clarity over authority to enter into financial commitments, compared with authority to incur expenditure and how this authority applies over a number of financial years. There is a risk that this lack of clarity will lead to financial commitments been entered into without appropriate authorisation.	It is recommended that authority to enter into financial commitments should be clarified based on discussion with Scottish Ministers and subsequently clarified in the financial delegations issued by the chief executive to directors.	We will revisit the authority to enter into financial commitments in consultation with Scottish Government finance colleagues and seek to clarify, as necessary, any amendments to the financial delegations already in place **Responsible officer:** Corporate analysis and performance manager**,** strategic management accountant**,** head of procurement **Implementation date:** 30 September 2013

Action plan

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
3 Authorisation limits		**Grade one**
There is no evidence that the senior management team or former chief executive played a significant role in consideration and approval of the IT contract scope, following approval of the IT strategy. The principles of IT strategy were endorsed by the senior management team in March 2012 although we understand that the senior management team had previously considered and approved the strategy, the approval is not clearly document. Therefore, while that may have led to some confusion over approval of the strategy or its objectives compared with the contract, the strategy should have been formally finalised prior to development of the contract scope as part of tender procedures. Financial delegations made by the chief executive to directors provides high limits (up to directorate budgets) and therefore there is a risk that expenditure could be incurred without appropriate review by the chief executive as accountable officer. In some cases, such as in respect of capital grants made by Historic Scotland, high authorisation limits are appropriate. However, the risk is that without appropriate oversight by the senior management team and chief executive, other types of expenditure will be incurred without sufficient review.	It is recommended that the financial delegations made by the chief executive to directors, and by directors to other staff are reviewed to ensure that limits are appropriate and applied consistently which ensure significant expenditure is subject to approval by the senior management team or chief executive. A single set of thresholds should be applied across the organisation on an individual invoice, commitment and cumulative basis (by supplier) to ensure appropriate oversight of expenditure. .	Financial delegation limits have been reviewed to ensure they are appropriate to the Agency. Regular reporting to the senior management team on projects addresses the issue of cumulative project expenditure and ensures there is appropriate oversight. Funding for new projects is approved subject to business cases which detail costs, benefits, risks and opportunities over the life of the project. The Agency examines and reports expenditure through a range of mechanisms including purchasing authority limits and procurement approvals and will refine existing reports on expenditure by supplier which will be reviewed regularly. Staff with delegated purchasing or financial authority will be reminded that they must operate within their authorised delegation limit and must not agree any arrangements with suppliers or contractors that could potentially breach these limits. This will also apply to staff using a government procurement card. The notice issued to staff will outline the potential management actions in respect of non-compliance. **Responsible officer:** Strategic management accountant**,** financial operations manager, head of procurement. **Implementation date:** 30 September 2013, quarterly thereafter

cutting through complexity