



cutting through complexity

Historic Scotland

Annual audit report to the Audit and Risk Committee and the Auditor
General for Scotland

Audit: year ended 31 March 2015

3 August 2015

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in connection with this
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About this report

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

This report is for the benefit of Historic Scotland and is made available to Audit Scotland and the Auditor General for 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 circumstances set out in the executive summary: scope and responsibilities.

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.



Executive summary Headlines

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("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 summarises our work in relation to the financial statements for the year ended 31 March 2015.

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

Area	Summary observations	Analysis
Strategic overview		
Key issues and update	<p>Historic Environment Scotland was legally established in April 2015 and the Board formed in advance, in January 2015. HES is a Non Departmental Public Body with charitable status, and will also operate a trading subsidiary. Historic Environment Scotland will assume the activities of Historic Scotland, Royal Commission on the Ancient and Historical Monuments of Scotland ('RCAHMS') and Scran on 1 October 2015.</p> <p>The joint business plan for Historic Scotland and RCAHMS set out 14 Key Performance Targets ('KPTs') for 2014-15. All but two KPTs agreed with the Scottish Ministers for the year were met.</p>	Page 6
Financial position	<p>The outturn for the year ended 31 March 2015 reflects an underspend of £0.3 million. This includes £0.4 million of capital charge allocation not utilised, resulting in an operational overspend of £0.1 million. The year saw an increase in commercial income of £1.8 million compared to 2013-14, owing to greater visitor numbers. Expenditure was significantly lower than the prior year (by £4 million), as a result of the decreased budget available to Historic Scotland.</p>	Page 8
Financial statements and accounting		
Audit conclusions	<p>We have issued an unqualified audit opinion on the 2014-15 financial statements, following their approval by the accountable officer.</p> <p>The financial statements, excluding the remuneration report pensions information, were received by the start of audit fieldwork and were supported by high quality working papers.</p>	Page 13
Significant risks and audit focus areas	<p>The areas highlighted below are the specific audit focus areas identified within our audit strategy:</p> <ul style="list-style-type: none"> ■ fraudulent revenue recognition risk in relation to the income from commercial and tourism ; ■ recognition of grants to charitable trusts, local authorities and individuals; and ■ accuracy of cash and fraud risk in relation to cash handling in the Agency's multiple sites. <p>The audit strategy for 2014-15 also identified the preparations for the establishment of Historic Environment Scotland as an audit focus area.</p> <p>Audit work was completed to satisfy the requirements of ISA 330 'The auditor's responses to assessed risks', including tests of key financial controls. In respect of each matter, we are content with management's judgements and the accounting treatment.</p>	Pages 14, 15 and 16

Area	Summary observations	Analysis
Financial statements and accounting (continued)		
Going concern	Historic Scotland's financial statements have been prepared on a going concern basis, despite the upcoming combination with RCAHMS on 1 October 2015. This is because on 1 October 2015, Historic Environment Scotland will assume the activities and responsibilities of Historic Scotland, and they will therefore continue.	Page 16
Accounting policies	There have been no changes to accounting policies applied by Historic Scotland in 2014-15. No newly effective accounting standards are expected to have a material impact on the 2015-16 financial statements of Historic Environment Scotland.	Page 16
Governance and narrative reporting		
Governance	Over-arching and supporting corporate governance arrangements at Historic Scotland remained primarily unchanged in 2014-15. Actions are required to ensure appropriate governance arrangements are in place for Historic Environment Scotland, in advance of 1 October 2015.	Page 20
Internal controls	Testing of the design and operation of financial controls over significant risk points was undertaken as part of interim and final audit testing. Our work concluded that that controls relating to financial systems and procedures are designed appropriately and operating effectively.	Page 21
Performance management		
Performance management	Our review of Historic Scotland's performance management arrangements in the year to 31 March 2015 indicates that these continue to be appropriate. Internal audit reviews, conducted as part of the 2014-15 internal audit plan, provided assurance over recruitment and workforce planning, information and data handling and IT general controls and IT security in the year to 31 March 2015. These reviews did not identify significant weaknesses.	Pages 24 and 25

Purpose of this report

The Auditor General for Scotland (“the Auditor General”) has appointed KPMG LLP as auditor of Historic Scotland under the Public Finance and Accountability (Scotland) Act 2000 (the “Act”). The period of appointment is 2011-12 to 2015-16, inclusive. The 2015-16 appointment is in respect of Historic Environment Scotland.

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at Historic Scotland and the Auditor General. The scope and nature of our audit were set out in the audit strategy document which was presented to the audit and risk committee at the outset of our audit.

The Code sets out the wider dimensions of public sector audit which involves not only the audit of the financial statements but also consideration of areas such as financial performance and corporate governance.

Accountable officer responsibilities

Audit Scotland’s *Code of Audit Practice* (the “Code”) sets out Historic Scotland’s responsibilities in respect:

- preparation of financial statements that show a true and fair view;
- systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- financial position; and
- Best Value.

Auditor responsibilities

This report reflects our overall responsibility to carry out an audit in accordance with our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the Code.

Scope

An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance.

Weaknesses or risks identified are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist.

Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) (“ISA”) 260 *Communication with those charged with governance*, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity.

This annual audit report to members and our presentation to the audit and risk committee, together with previous reports to the committee throughout the year, discharges the requirements of ISA 260.

Strategic overview

Our perspective on key business issues and financial position

Historic Environment Scotland ('HES') was legally established on 1 April 2015 and will assume full responsibility on 1 October 2015.

Historic Scotland and RCAHMS considered the operational and legal structure of HES in conjunction with Scottish Government. HES is a NDPB with charitable status and with a trading subsidiary.

Transitioning to Historic Environment Scotland

Historic Environment Scotland ('HES') was legally established on 1 April 2015. The HES Board was appointed in January 2015 and began work upon establishment in April 2015. A chief executive has yet to be announced.

Historic Scotland and The Royal Commission on the Ancient and Historic Monuments of Scotland ('RCAHMS') formed a joint senior management team ('joint SMT'). A joint business plan and joint risk register have been formed and the joint SMT conducted financial planning for the full year of 2015-16. A business model for HES was proposed and approved by the HES Board on 27 May 2015 and the accounting system (FMIS) was redesigned with the business model in mind.

The joint SMT has been chaired by both the Historic Scotland and the RCAHMS chief executives since 2013-14. Historic Scotland and RCAHMS will remain separate until HES assumes full responsibility on 1 October 2015. Accordingly, the chief executive of Historic Scotland will continue to be directly accountable to the Scottish Government until 30 September 2015.

Structure of Historic Environment Scotland

Scottish Government indicated that the legal structure of HES should be a Non Departmental Public Body with charitable status alongside a trading subsidiary, Historic Environment Scotland Enterprise ("HESE"). Historic Scotland and RCAHMS considered the benefits compared to other legal structures, and confirmed that this is the optimum option. It offers the benefits of charity rates relief and gift aid claims, access to funding and potentially reducing the corporation tax payable on HES profits to £nil, as income would be covered by a charitable exemption. OSCR has informally confirmed that the application for charitable status will be successful. A draft application has been considered by OSCR who have offered advice on minor amendments. The official application will be submitted in early August 2015.

As part of the combination, the two subsidiaries of RCAHMS, Scran Trust and Scran Limited (together "Scran") will also join HES. This was confirmed in March 2015, after some of the preparation work for the combination had been completed.

We set out the proposed structure of the HES group on the following page.

Scran Trust, through its wholly owned trading arm Scran Limited, provides educational online services for cultural and historical material. Scran's income comes from subscriptions and sales of services. In addition to its trading activity Scran's income comes from two grants; from Education Scotland and the Culture and Heritage Division. Both of these funds will cease after October 2015 and it is expected that there will be a budgetary deficit of £0.2 million in 2015-16 and £0.4 million in 2016-17 that will require mitigation.

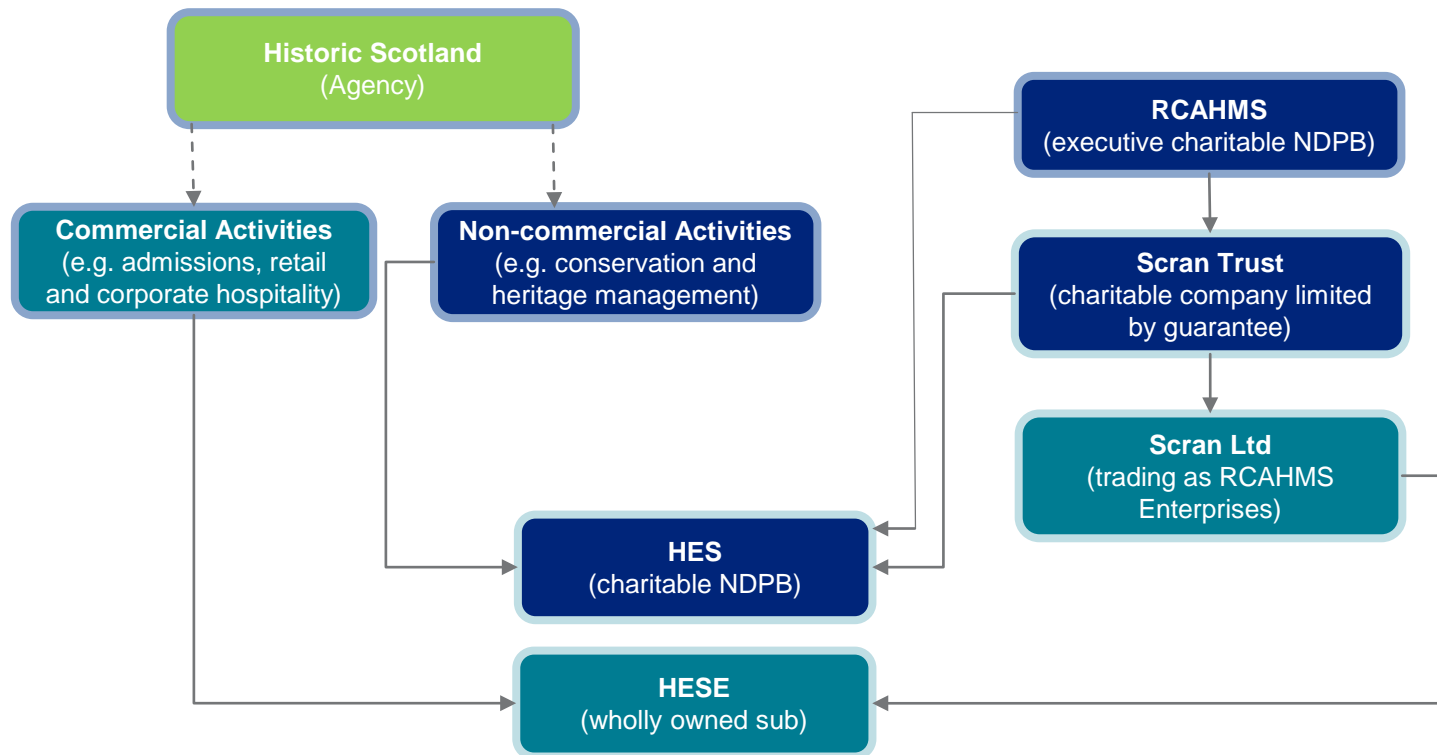
The Historic Scotland Foundation ("HSF") will remain a separate entity, however a member of the HES board will be asked to join the HSF Board. Scran Trust transferred £1.1 million of its reserves to HS to fund the development of Scran in the future.

There are many considerations and actions required to establish the HES group effectively; given complexities of business combinations, corporation tax obligations, VAT obligations and OSCR requirements. Without an established HES audit and risk committee, important scrutiny of arrangements is compromised.

Key performance targets ("KPTs")

The joint business plan set out 14 KPTs for Historic Scotland for the financial year. Based on quarter four performance, all but two of the KPTs have been met or exceeded. The KPTs that did not meet the target were the improvement of organisational resilience through a reduction in average working days lost to 4.84 (average working days in 2014-15 were 6.54), and the increase of staff engagement from 64% (staff engagement has dropped to 61%).

The diagram below shows the formation of the HES Group, as explained in the previous page.



2014-15 income increased compared to prior year while total expenditure reduced. An underspend of £0.3 million was reported in 2014-15, in comparison to £3.1 million in 2013-14.

Income primarily increased as a result of greater visitor numbers. Commercial income in 2014-15 surpassed forecasts and prior year performance.

Historic Scotland continues to face budget pressures due to reduced direct funding from Scottish Government.

Financial position

The initial Scottish Government funding allocated to Historic Scotland for the year 2014-15 was £37.737 million. This included £0.7 million of funding for the Policy Directorate which did not belong to the Agency and was subsequently deducted during the Autumn Budget Review. The initial budget was further tightened at the the Spring Budget review by £1.7 million, requiring efficiencies and delays of projects. Historic Scotland's management undertook a reprioritisation exercise to manage the revised budget expenditure of £35.4 million.

With a net operating cost of £35.05 million, actual underspend was £0.3 million. The equivalent prior year underspend was £3.1 million. A comparison to 2013-14 is provided in the opposite table.

Key differences in actual income and expenditure from the prior year are:

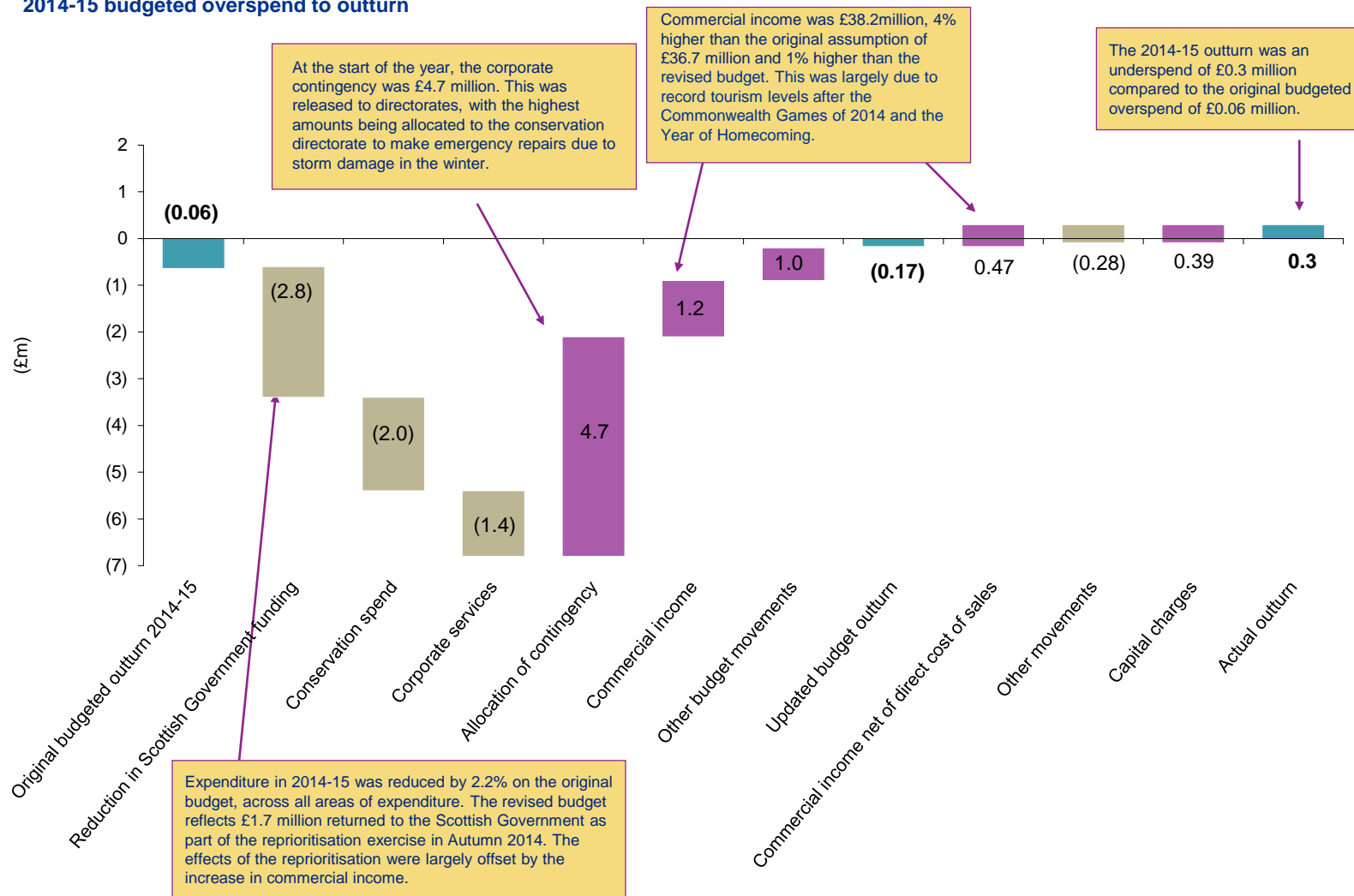
- Significantly lower Scottish Government funding of £35.4 million (£32.8 million cash funding and £2.6 million in capital charges) in comparison to 2013-14 funding of £45.3 million. The effects of the reprioritisation exercise were largely offset by the increase in commercial income.
- A 5% increase in commercial income from £36.7 million in 2013-14 to £38.2 million in 2014-15. It was a successful trading year with record visitor numbers, largely due to record tourism levels after the Commonwealth Games of 2014 and the Year of Homecoming.
- A reduction in expenditure in 2014-15 of 6.3%, due to decreased budgets over all areas of expenditure. In particular, investments were £2.9 million lower than in 2013-14 with specific projects, such as Bannockburn 2014 being completed and funding being £1.4 million lower on the project.

A summary of key movements between the original budget and the actual outturn is presented on the next page.

	2014-15 £000	2013-14 £000	Variance
Total commercial and other income	39,815	38,194	1,621
Total expenditure	(74,127)	(79,080)	4,953
Net operating cost	(34,312)	(40,886)	6,574
PPE additions	(931)	(1,503)	572
Notional charges	187	197	(10)
Total net non-cash charges	(744)	(1,306)	562
Adjusted net operating cost	(35,056)	(42,192)	7,136
Budgeted Scottish Government funding	35,373	45,304	(9,931)
(Under)/over spend	(317)	(3,112)	(2,795)
<i>Original budget (under)/over spend</i>	64	(550)	486

The original 2014-15 budgeted outturn was an overspend of £0.06 million. We provide an analysis of the movements from the original budget to the updates forecast undertaken by management in February 2015. The movements between this budget outturn and the actual outturn are also shown opposite.

2014-15 budgeted overspend to outturn



Net assets as at 31 March 2015 were £20.3 million, representing an increase of £0.7 million from 31 March 2014.

The increase is a result of the £0.3 million surplus and revaluation of non-current assets of £0.4 million.

Statement of financial position

Historic Scotland had net assets at 31 March 2015 of £20.3 million (2013-14: net assets of £19.6 million). The key elements of the movement is set out below.

Assets

Non-current assets reduced by £0.9 million; representing £2.2 million depreciation and amortisation, net of £0.9 million additions and a £0.4 million property revaluation. Properties are revalued every five years, on a rolling basis.

Current assets decreased by £2.9 million. The majority of the movement is explained by lower trade and other receivables (decrease of £0.9 million) and a decrease in cash of £1.7 million. The movements are explained as follows:

- commercial income continuing to increase, in line with prior year trends of commercial;
- receivables included large one-off prepayments (such as £0.3 million for water charges) in 2013-14 which are not replicated this year due to timing differences;
- one of the Heritage Lottery Fund (“HLF”) projects is winding down and therefore accrued income is £0.1 million less than the prior year; and
- the reduction in cash is attributed to timing differences, and in particular the timing of when BACS payments were made at the year end.

Liabilities

The £4.5 million decrease in total liabilities to £14.3 million as at 31 March 2015 is due to:

- the impact of lower expenditure arising from the reduced budget; and
- efforts made to reduce outstanding liabilities to prepare for the implementation of the new FMIS system and the transition to HES, which links to the lower cash position as at 31 March 2015.

Consolidated statement of financial position	2015 £'000	2014 £'000
Total non-current assets	30,500	31,377
Inventories	1,497	1,806
Trade and other receivables	1,907	2,822
Cash and cash equivalents	730	2,400
Total current assets	4,134	7,028
Total assets	34,634	38,405
Current liabilities		
Trade and other payables	13,767	18,052
Provisions	174	399
Total current liabilities	13,941	18,451
Non current liabilities	399	393
Total liabilities	14,340	18,844
Net assets	20,294	19,561

Funding pressures are anticipated to continue in 2015-16, with increased specific project costs and the assumption that commercial income cannot sustain current growth levels.

The initial 2015-16 joint budget shows a balanced budget of £89 million. This includes indicative funding of £44.4 million. The budget may be subject to revision by HES management and following the Spending Review.

Financial plans 2015-16

Historic Scotland (and Historic Environment Scotland from 1 October 2015) will continue to face pressures arising from reduced government funding. A number of factors are expected to contribute to pressures, such as the required £1.5 million IT spend in order to move to SWAN by September 2015 and £3.2 million necessary conservation investment. Management does not expect income to continue at its current growth rate, however it is anticipated that with two Easter periods in 2015-16 there will be a positive impact on turnover.

The joint 12 month budget for Historic Scotland and RCAHMS is a balanced budget of £89 million. The budget includes a number of assumptions:

- commercial income continuing to increase, in line with prior year trends of commercial income exceeding budgeted expectations;
- staff costs representing 40% of expenditure. Staff costs are budgeted to increase by £1.9 million because of the annual pay increase, increased employer pension contributions and increased staffing related transition costs;
- one-off transitional expenditure amounting to £2.1 million, in relation to projects, such as the investment in Information Systems and the development of a corporate website;
- the Scottish Government granting HES an additional £3 million grant in aid in 2015-16, for use by both bodies. The additional funding will fund the one-off transitional costs, as well as the increase in staff costs in both bodies; and
- Scottish Government providing £2 million funding for the rock-fall project and Engine Shed.

The budget will be subject to revision by HES management and pending the Spending Review. Whilst £40.1 million of Scottish Government funding is confirmed, other funding may change.

The budget does not take account of all financial effects of HES's potential charitable status, such as the receipt of gift aid from HESE and charity rates relief to supplement the income of HES. The benefits have been monetised by professional advisor to be approximately £2 million. The VAT cost on losing section 41 status has been incorporated into the consolidated budget assumptions, estimated at approximately £1 million.

The consolidated budget is shown in the following table.

Consolidated budget 2015-16	£m
SG grant/core funding	44.4
Commercial income	39.5
Non-commercial and project income	2.0
RCHAMS enterprise	0.9
Capital funding	2.2
Total income	89.0
Staff costs	38.3
Investments commitment	14.5
Operational costs/program budgets	20.7
Cost of retail goods and Travel Trade commission	4.8
Capital expenditure	2.2
SG capital charges-non cash	3.6
Contingency	4.9
Total expenditure	89.0

Financial statements and accounting

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

We have issued an unqualified audit opinion on the financial statements and on 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

Following approval of the financial statements by the Historic Scotland's accountable officer we have issued an unqualified opinion on the truth and fairness of the state of Historic Scotland's affairs as at 31 March 2015, and of its net operating cost for the year then ended. We have also issued an 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 controls testing and substantive procedures to ensure that key risks to the financial statements have been covered;
- communicated with internal audit and reviewed its reports as issued to the audit and risk committee to ensure all key risk areas which may be viewed to have an impact on the financial statements have been considered;
- reviewed assumptions and accounting judgements made by management and considered these for appropriateness;
- considered the potential effect of fraud on the financial statements through discussions with senior management and internal audit; and
- attended audit and risk committees to communicate our findings to those charged with governance, and to update our understanding of the key governance processes.

Financial statements preparation

- High quality working papers and draft financial statements were provided at the start of the audit fieldwork on 5 May 2015. This included the strategic report, directors' report and part of the governance statement.
- In advance of our audit fieldwork, we issued a 'prepared by client' request setting out a list of required analyses and supporting documentation. Reflective of the long standing working relationship with Historic Scotland, the standard of documentation was good and there was evidence of accountability and ownership of working papers across the finance department. Against the backdrop of the additional workload in preparing for the formation of Historic Environment Scotland alongside the new responsibility for RCAHMS activities, the quality of the workpapers provided and readiness for audit is creditable.
- Throughout the course of the year we had regular communication and discussion with 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, strategic report, directors' report, and governance statement 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, as reported in appendix one.
- We consider that management has maintained a robust control environment in the year to 31 March 2015, with segregation of duties and authorisation controls over sales, purchases, grants and journal posting.

The significant areas of risk identified in our audit strategy were in respect of:

- **management override of controls; and**
- **revenue recognition fraud risk;**

and other focus areas of:

- **investments;**
- **cash and cash equivalents; and**
- **transition to Historic Environment Scotland.**

We summarise below the risks of material misstatement as reported within the audit strategy document along with additional risks identified during the course of the audit. We set out the key audit procedures to address those risks and our findings from those procedures, in order that the audit and risk committee may understand the process by which we arrived at our audit opinion.

We have no changes to the risk or our approach to addressing the assumed ISA risk of fraud in management override of controls. We do not have findings to bring to your attention in relation to this matter; no control overrides were identified.

Significant risks	Our response	Audit findings
<p>Revenue recognition fraud risk</p> <p>Professional standards require us to make a rebuttable presumption that the fraud risk from income recognition is a significant risk. Historic Scotland's income is primarily comprised of Scottish Government funding and commercial and tourism income. The level of judgement required in recognition of such income sources is minimal and we do not regard the risk of fraud from this revenue recognition as significant. Income from admissions and trading sales is considered to be inherently risky due to the nature of cash handling and the multiple locations managed by Historic Scotland.</p>	<p>We tested the design, implementation and operating effectiveness of the following controls around cash handling:</p> <ul style="list-style-type: none"> ■ bank reconciliations; ■ monthly sites income reconciliations; and ■ journal postings. <p>As part of the final audit procedures we performed the following substantive testing:</p> <ul style="list-style-type: none"> ■ performed corroborating analytical reviews against the prior year and budget; ■ tested journals at the year end and obtained supporting documentation; and ■ enquired of employees in the finance department regarding unusual transactions and obtained third party evidence where relevant. 	<p>We are satisfied that income from admissions and trading sales is correctly stated in the financial statements. We did not identify instances of fraudulent revenue recognition.</p>

Audit focus areas	Our response	Audit findings
<p>Investments</p> <p>Historic Scotland has a statutory responsibility to deliver grants, mainly to charitable trusts, as well as local authorities and individuals.</p> <p>The main risk is that applicants do not own the property (or hold a lease for more than 25 years) or that the work agreed is not completed.</p>	<p>We tested the design, implementation and operating effectiveness of the investment grant authorisation control to verify that management had an appropriate control framework over investment approval and expenditure.</p> <p>During final audit procedures we performed the following substantive testing:</p> <ul style="list-style-type: none"> ■ vouched a sample of grant expenditure to supporting documentation; ■ tested a sample of capital commitments to 31 March 2015 and agreed to internal documentation and external confirmations; and ■ agreed post year-end payments to bank statements to corroborate and challenge the accrual position as at the year end. 	<p>Controls over the approval of grant expenditure were found to be designed, implemented and operating effectively throughout the financial year.</p> <p>From the procedures performed, we are satisfied that investments and capital commitments presented as at 31 March 2015 are correctly stated in the financial statements.</p>
<p>Cash and cash equivalents</p> <p>A significant amount of retail income from sites is received in cash on a daily basis. The cash is recorded on the site tills that link to the finance system. It is collected by a security company to be banked.</p> <p>Cash handling is linked to the significant risk of fraudulent income recognition. Issues relating to cash handling in sites were noted a previous year.</p> <p>Management identified that Historic Scotland drew down £3.3 million cash from Scottish Government in March 2015, being excess of the allocated budget. The cash was not expended and was held in the bank account at the year end.</p>	<p>We set out our response to the related fraudulent revenue recognition risk on page 14, also being relevant in our audit of cash balances.</p> <p>In addition we performed substantive procedures over the cash balances in light of the excess drawdown:</p> <ul style="list-style-type: none"> ■ agreed the year end cash balance to third party confirmations; ■ agreed reconciling items within the bank reconciliations to post year end bank statements; and ■ challenged and discussed management's presentation and disclosure of the excess cash drawdown within the financial statements. 	<p>The financial statements show a cash balance as at 31 March 2015 of £0.7 million, a reduction of £1.7 million from the prior year.</p> <p>From the procedures performed, we are satisfied that cash balances presented as at 31 March 2015 are correctly stated in the financial statements.</p> <p>The excess drawdown of £3.3 million is not included within the cash balance, with the agreement of Scottish Government. We concur with this approach as the cash is not the property of Historic Scotland and is included within Scottish Government's cash balance.</p>

Audit focus areas	Our response	Audit findings
<p>Historic Environment Scotland</p> <p>In readiness for the creation of Historic Environment Scotland ('HES') in October 2015, Historic Scotland is required to make disclosures in the financial statements for the year ended 31 March 2015. These include the basis for the going concern assumption, expenditure incurred on behalf of RCAHMS analysis and future developments narrative.</p> <p>In 2014-15 Historic Scotland incurred £0.1 million expenditure on behalf of RCAHMS, mostly in relation to staff costs. Similarly, Historic Scotland incurred £1,000 expenditure on behalf of HES, in salary and travel and subsistence for the HES Board.</p>	<p>In respect of the transactions on behalf of RCAHMS and HES we agreed a sample of the expenditure to third party evidence. Due to the low value of expenditure, we agreed with management that no disclosure of these transactions is required within the financial statements.</p> <p>We agreed amounts presented in the related party disclosure to third party evidence for transactions between RCAHMS and Historic Scotland.</p> <p>We considered progress against the transition plan, by reading progress reports, assessing entity level controls (such as the development of a joint risk register) and through discussions with management. The latest progress report, as at 28 May 2015, identifies that almost 80% of program deliverables has been achieved. We considered the ongoing work to form appropriate governance arrangements and provide further narrative on page 20.</p> <p>We considered the disclosure of future developments disclosed within the strategic report and considered this against our understanding of the combination, and agreed for consistency with other information provided within the financial statements.</p> <p>We considered the going concern disclosure in the financial statements and discussed with management the appropriate wording to be used to better reflect the rationale supporting the assumption.</p>	<p>We consider the disclosure of the following items in relation to the combination to be appropriate in the financial statements:</p> <ul style="list-style-type: none"> ■ expenditure incurred by Historic Scotland on behalf of RCAHMS and HES; ■ related party transaction disclosure notes for transactions between RCAHMS and Historic Scotland; ■ future developments narrative within the strategic report; and ■ the going concern assumption. <p>Throughout 2015-16 we will continue to discuss the the appropriate accounting treatment for the combination of organisations to form HES.</p> <p>Whilst the integration plan appears to be on track, we identified that there are areas of governance which require to be addressed promptly. Specifically an audit and risk committee should be appointed to ensure that scrutiny arrangements are in place and to support management in the decisions surrounding the combination and the establishment of HES.</p> <p style="text-align: right;">Recommendation one</p>

There have been no changes to accounting policies during 2014-15.

The financial statements have been appropriately prepared on a going concern basis.

Accounting framework and application of accounting policies		
Area	Summary observations	Audit findings
Accounting policies	<ul style="list-style-type: none"> There were no changes to adopted accounting policies in the year. There were no critical judgement areas, with stability in activities compared to the prior year. 	We are satisfied that accounting policies and judgments made in the preparation of the financial statements remain appropriate.
Financial reporting framework	<ul style="list-style-type: none"> Historic Scotland prepares financial statements in accordance with HM Treasury's Financial Reporting Manual 2014-15 ("FReM"). There have been no relevant changes to the financial reporting framework in the year, other than minor changes to the disclosure of compensation payments within the remuneration report, however these have had no impact for Historic Scotland. 	We are satisfied that the accounting policies adopted remain appropriate to Historic Scotland and have been correctly applied.
Going concern	<ul style="list-style-type: none"> The financial statements have been prepared under the assumption that the organisation is a going concern. We reviewed, and discussed with management, the decision to prepare the financial statements under the going concern assumption in light of the transfer of activities to Historic Environment Scotland on 1 October 2015. Although RCAHMS and Historic Scotland will combine to create Historic Environment Scotland on 1 October 2015, we are satisfied with the going concern assumption. This is on the basis that the new body will assume the functions of Historic Scotland. All Historic Scotland assets and liabilities will be transferred to the new body. Grant in aid funding of £44.4 million has been confirmed by Scottish Government for 2015-16, of which £40.1 million relates to Historic Scotland activities. Whilst the funding has been confirmed, the government Spending Review may result in changes to the funding. Management considers the grant in aid to be sufficient to ensure that Historic Scotland and Historic Environment Scotland are able to meet debts as they fall due in the year to 31 March 2016. We reviewed the forecasts for 2015-16, considered management's budgeting performance against the outturn for 2014-15. 	<p>We concur with management's view that the going concern assumption and disclosure are appropriate.</p> <p>Historic Scotland's operations are viewed as continuing in business.</p> <p>The confirmed grant in aid is considered to be sufficient, alongside other income generated, to ensure debts are settled as they fall due.</p>

Our testing of the annual report and remuneration report confirms that these are consistent with the financial statements and with required disclosures per the FReM.

Area	Summary observations	Audit findings
<p>Annual report, including the strategic and directors' reports</p>	<p>The financial statements form part of the annual report of Historic Scotland for the year ended 31 March 2015. We reviewed the contents of the strategic and directors' report against the disclosure requirements and are content with the proposed reports. We provided management with minor suggestions relating to how the reports could be enhanced, ensuring that the financial commentary is reflective of the annual results.</p>	<p>We are required to consider the strategic and directors' reports, and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the strategic and directors' report is consistent with the financial statements.</p>
<p>Remuneration report</p>	<p>The remuneration report was provided during the onsite audit and was supported by good quality information and working papers,</p> <p>Management has received the pensions information from the Department for Work and Pensions and completed the remuneration report, which was provided to us on 26 June.</p> <p>There was a change to the composition of the senior management team in the year, as the Director of Finance left the organisation in October 2014. We discussed the presentation of the above matter with management and confirmed that the disclosures made are in accordance with the requirements of the FReM.</p>	<p>We are satisfied that the information contained within the remuneration report is consistent with the underlying records, the financial statements and the structure of the senior management team.</p> <p>The change to the senior management team composition during the year is appropriately explained.</p>

Governance and narrative reporting

Our overall perspective on the narrative reporting and annual governance statement

Update on controls findings from our audit

Governance arrangements are appropriate for Historic Scotland in 2014-15.

Going forward, an audit and risk committee for Historic Environment Scotland will be required to ensure good governance of the new body.

Area	Our response	Audit findings
<p>Annual governance statement and governance arrangements</p>	<p>The statement for 2014-15 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on Historic Scotland’s governance framework, operated internal controls, the work of internal audit, and risk management arrangements and analyses the efficiency and effectiveness of these elements of the framework. The Historic Scotland audit and risk committee met three times during 2014-15 to discuss and scrutinise risk, control and governance.</p> <p>Historic Scotland formed a joint senior management team (‘SMT’) with RCAHMS, which meets at least fortnightly. The joint SMT leads Historic Scotland as the collective decision making body for the agency. It is chaired by the joint chief executives of Historic Scotland and RCAHMS and is responsible for the day-to-day running of the organisation. To support the effective transition to Historic Environment Scotland, the transition programme is overseen by a programme board, chaired by the joint chief executives as SROs.</p> <p>The Historic Environment Scotland Board was formed in January 2015, although no audit and risk committee has been formed. There is a risk that decisions in relation to the formation of Historic Environment Scotland are not being taken at the appropriate level as noted in the action plan in appendix three.</p> <p>The Agency transferred £0.35 million to the Historic Scotland Foundation (‘HSF’) in 2014-15. HSF provided grants worth £0.50 million to Historic Scotland. We remain content with the separation of HSF from the governance arrangements of Historic Scotland. No changes are expected on the formation of HES.</p> <p>Historic Scotland operates a risk management framework to monitor and reports on risk on a regular basis to all levels of management and those charged with governance. Risk registers are operated for the organisation as a whole and for individual directorates and are also regularly reviewed. Actions within registers are assigned owners to ensure the accountability of actions to reduce and mitigate risk.</p> <p>Historic Scotland’s system of internal control is designed to manage risk and is based on a framework of financial regulations, accountability and regular review of financial management information. Internal audit provides assurance over the effective management of the internal control framework. Internal audit completed three reviews in the year to 31 March 2015, none of which identified significant weaknesses in controls. The fourth and final review of the internal audit plan covering the combination is expected to be completed in June.</p>	<p>We have updated our understanding of the governance framework and documented this though our overall assessment of Historic Scotland’s risk and control environment. We consider the governance framework and annual governance statement to be appropriate for Historic Scotland and that the governance statement is in accordance with guidance and reflects our understanding of the organisation.</p> <p>The prompt creation of an audit and risk committee for Historic Environment Scotland is required to ensure there are appropriate governance arrangements at the inception of the new body.</p>

Our testing of the design and operation of financial controls over significant risk points identified no exceptions.

Area	Our response	Audit findings
Internal controls	<p>Management is responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the financial statements. 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 designed appropriately and operating effectively.</p> <p>The findings of our controls testing relate only to those matters identified during our normal audit work, in accordance with the Code, and there may still be weaknesses or risks within the control environment which have not been identified through this work. KPMG's identification of weaknesses, when applicable, does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.</p> <p>We have not raised findings to management in relation to the operation of the control framework and the operating effectiveness of individual controls.</p>	<p>Our work concluded that controls relating to financial systems and procedures are designed appropriately and operating effectively.</p>
Prevention and detection of fraud	<p>No material fraud or other irregularities were identified during the year and we consider that Historic Scotland has appropriate arrangements to prevent and detect fraud, on a reasonable assurance basis. Inevitably for a multi-site organisation which engages with the public, there are fraud risks of low monetary value and minor frauds are identified.</p> <p>The arrangements for preventing and detecting fraud include policies and codes of conduct for staff, supported by a fraud policy and response plan and a fraud response group.</p>	<p>We consider that Historic Scotland has appropriate arrangements to prevent and detect fraud.</p>
Maintaining standards of conduct and the prevention and detection of corruption	<p>Historic Scotland has arrangements including policies and codes of conduct for staff and senior management, supported by a whistleblowing policy. Senior management is responsible for setting the 'tone at the top' and is responsible for abiding by the code of conduct and disclosing interests which may be of importance, material or otherwise, to its work at Historic Scotland.</p>	<p>We consider that Historic Scotland has appropriate arrangements to prevent and detect inappropriate conduct and corruption.</p>

Area	Our response	Audit findings
<p>Internal audit</p>	<p>The internal auditor of Historic Scotland is the Scottish Government Internal Audit Department. An annual audit plan was approved by the audit and risk committee and progress against the plan reported throughout the year. Internal audit takes a risk based approach to its work and supports management in maintaining sound corporate governance and internal controls through the independent examination and evaluation of control systems and the reporting of any weaknesses to management for action.</p> <p>Audit Scotland's Code of Audit Practice sets out the wider dimension of public sector audit. It requires external auditors to perform an annual assessment of the adequacy of the internal audit function. We considered the activities of internal audit against the requirements of Public Sector Internal Audit Standards ('PSIAS'), focusing our review on the public sector requirements of the attribute and performance standards contained within PSIAS. This included a review of the internal audit charter, reporting lines, independence, objectivity and proficiency and the range of work carried out by internal audit.</p> <p>From this assessment, and considering the requirements of International Standard on Auditing 610 (<i>Using the Work of Internal Audit</i>), we can apply the internal auditor's work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there is no impact on our planned substantive testing.</p> <p>Internal audit has completed its agreed plan for the year ended 31 March 2015; the annual report states that risk, governance and control procedures are effective in supporting the delivery of objectives and exposure to potential weaknesses is low. On this basis, internal audit provided substantial assurance in respect of Historic Scotland's governance, risk management and internal control arrangements.</p>	<p>We have concluded that the internal audit service operates in accordance with Public Sector Internal Audit Standards.</p> <p>The Internal Auditor has completed all scheduled main and follow up reviews as per the annual audit plan.</p> <p>The annual audit report provides "substantial assurance".</p>
<p>National Fraud Initiative ("NFI")</p>	<p>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. Our review of Historic Scotland's NFI participation resulted in a satisfactory grading and our findings have been separately reported to Audit Scotland, in accordance with issued guidance.</p>	<p>We consider that Historic Scotland has participated appropriately in the NFI process and that all recommended matches have been appropriately investigated in a timely manner.</p>

Performance management

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

Our work has identified that Historic Scotland's Best Value and performance management arrangements are generally robust.

Area	Our response	Audit findings
<p>Performance management and best value</p>	<p>Scottish Government guidance for Accountable Officers on Best Value in public services requires a systematic approach to self-evaluation and continuous improvement. The guidance identifies the themes an organisation needs to focus on in order to deliver the duty of Best Value, but notes that implementation should be appropriate and proportionate to the priorities, operating environment, scale and nature of the body's business.</p> <p>Reports on progress against key performance targets are discussed at the joint senior management team meetings on a quarterly basis. This ensures appropriate governance over performance and facilitates the identification of mitigating actions in a timely manner for underperforming areas. In addition, the audit and risk committee received quarterly updates from management during the year to facilitate scrutiny and challenge of key management decisions.</p> <p>Management remains committed to leveraging resources in the best possible way and doing more within decreasing resource settlements. The Agency was able to manage the reduced government funding and revised expenditure budget in the year and there is no indication that arrangements to manage performance have deteriorated.</p> <p>The Agency had an efficiency saving target of £1.4 million for the year 2014-15. The target was surpassed and efficiencies achieved reported as £2.9 million. This mainly comprised of:</p> <ul style="list-style-type: none"> ■ £1.1 million in holding vacancies and reducing payroll costs (including overtime); ■ £0.80 million from the Conservation Directorate; £0.40 million in Holyrood Palace savings, £0.12 million in utilities, £0.18 million in income generated for services already provided and £0.10 million collective effect of other minor areas of efficiency; ■ £0.60 million from procurement efficiency in collaborative contracts; and ■ £0.20 million from services provided in house, e.g. training, changing to better value for money suppliers, introducing multi-functional device printers. <p>In respect of 2015-16, an efficiency target of 3% of the joint SG funding has been set, equating to £1.3 million. As in previous years, the focus is to drive efficiencies from effective workforce planning and efficient procurement. There may be greater challenges in 2015-16 due to the negative effect on efficiency of temporary contracts for facilitation of the merger and one off costs associated with that.</p> <p>To consider the controls and processes to support Best Value aims, internal audit performed reviews in the year to 31 March 2015 over recruitment and workforce planning. Our consideration of the work of internal audit did not identify high risk findings within these areas.</p>	<p>We consider that Historic Scotland has appropriate arrangements to effectively manage performance and achieve Best Value in processes.</p>

Area	Our response	Audit findings
<p>Local response to national studies</p>	<p>Audit Scotland periodically undertakes national studies on topics relevant to the performance of central government bodies. To ensure that added value is secured through the role of Audit Scotland and its appointed auditors, auditors will continue to ensure that audited bodies respond appropriately to reports from Audit Scotland's programme of national performance audits.</p> <p>Audit Scotland reports are collated by the head of management accounts, who is responsible for identifying the relevant Directorate and sharing the report with the Director. The responsibility for taking action in response to the report output lies with the Directors.</p>	<p>We consider that Historic Scotland has appropriate arrangements to effectively respond to national studies.</p>
<p>Financial capacity in public bodies</p>	<p>Through the process of feedback through annual audit reports, current issues reports and sector meetings, Audit Scotland has identified that overall reductions in staff numbers in public bodies may be affecting the capacity of back-office functions and specifically finance.</p> <p>Audit Scotland requested the collation of baseline data across the public sector to inform sector specific overview reports and may inform a follow-up to the joint report on the public sector workforce which was published in November 2013 or support the development of the future performance audit programme.</p> <p>We completed a return to Audit Scotland in respect of our findings. Our review in response to the request for data collection identified that there is appropriate financial capacity within the organisation to ensure effective management, however strategic financial management could be enhanced. We note that in the absence of a director of finance, all preparatory work relating to the combination has been undertaken by the head of finance, in addition to normal responsibilities. Furthermore, an audit and risk committee has not yet been formed for Historic Environment Scotland and the Historic Environment Scotland CEO has yet to be announced.</p>	<p>We consider that Historic Scotland has appropriate financial capacity to effectively manage the organisation.</p> <p>Strategic financial management could be enhanced and there is a requirement for the prompt creation of an audit and risk committee for Historic Environment Scotland.</p>

Appendices

There were no changes to the core financial statements and there are no unadjusted audit differences

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 net operating cost for the year.	-
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 are no unadjusted audit differences.	-
Confirmation of Independence Letter issued to the audit and risk 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 two
Schedule of Fees Fees charged by KPMG for non-audit services	We have not charged any non-audit fees for the year.	Appendix two
Draft management representation letter Proposed draft of letter to be issued by Historic Scotland to KPMG	There are no changes to the standard representations required for our audit from last year, except for specific narrative in respect of going concern and Historic Environment Scotland.	-
Materiality The materiality applied to audit testing.	We assessed materiality based on our knowledge and understanding of Historic Scotland's risk profile and financial statements balances. Materiality was determined at £1.5 million - approximately 2% of total expenditure and consistent with the materiality identified in our audit strategy document. We designed our audit procedures to detect errors at a lower level of precision, i.e. £1.12 million. We report identified errors greater than £75,000 to the audit and risk committee.	

Auditing standards require us to consider and confirm formally our independence and related matters in our dealings with Historic Scotland.

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 Historic Scotland 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 board of directors.

Confirmation of audit independence

We confirm that as of 3 August 2015, in our professional judgement, 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 letter is intended solely for the information of the audit and risk committee and should not be used for any other purpose.

Yours faithfully
KPMG LLP

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

We present the identified findings across four risk dimensions:

- financial statements;
- business risks;
- governance risks; and
- performance reporting.

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 and risk	Recommendation(s)	Agreed management actions
<p>1 Creation of a Historic Environment Scotland Audit and Risk Committee (page 16)</p> <p><i>Risk dimension: Governance</i></p> <p>We noted that the majority of preparatory work relating to the combination to form Historic Environment Scotland has been undertaken by the head of finance at Historic Scotland. This is in addition to normal responsibilities. At present, there is no Director of Finance at Historic Scotland to share that responsibility.</p> <p>There is a risk arising from the fact that an audit and risk committee has not yet been formed for Historic Environment Scotland and the Historic Environment Scotland CEO has yet to be announced. This introduces the risk that reporting in relation to the combination and the new Body, and hence monitoring of the progress, is inadequate.</p>	<p>We recommend that an audit and risk committee for Historic Environment Scotland is formed promptly. The audit and risk committee should ensure that governance arrangements at Historic Environment Scotland are appropriate, that there is organisational accountability, performance and risk management and that structures and roles are properly defined to support effective discharge of responsibilities.</p> <p>Scrutiny of the decisions taken so far, and future actions, in the establishment of the Historic Environment Scotland group should be the responsibility of the audit and risk committee on behalf of the Board.</p>	<p>Grade one</p>
		<p>Agreed. A paper was sent to the HES board for consideration on 30 July 2015. It is foreseen that the ARC will be set up in August.</p> <p>Responsible officer: Historic Environment Scotland Board</p> <p>Implementation date: August 2015</p>



cutting through complexity

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