
National Galleries of Scotland

Annual Report to Those Charged
with Governance and the Auditor
General for Scotland

Year ended 31 March 2015

19 August 2015

PricewaterhouseCoopers
141 Bothwell Street
Glasgow
G2 7EQ

Audit and Risk Committee,
National Galleries of Scotland,
73 Belford Road,
Edinburgh
EH4 3DS

19 August 2015

Ladies and Gentleman,

We are pleased to enclose our report to the Audit Committee in respect of our audit for the year ended 31 March 2015. The primary purpose of this report is to communicate the significant findings arising from our audit that we believe are relevant to those charged with governance.

The scope and proposed focus of our audit work was summarised in our audit plan, which we presented to the Audit Committee in February 2015. We have subsequently reviewed our audit plan and concluded that our original risk assessment remains appropriate. The procedures we have performed in response to our assessment of significant audit risks are detailed in Section 2.

We have completed the majority of our audit work and expect to be able to issue an unqualified audit opinion on the financial statements at the Board meeting in September 2015. At the time of writing, the key outstanding matters, where our work has commenced but is not yet finalised, are review and disclosure check of final draft accounts, completion of subsequent events review and receipt of the signed letter of representation from Management. We will provide an oral update on these matters at the meeting on 19 August 2015.

We look forward to discussing our report with you on 19 August 2015. Attending the meeting from PwC will be James Gray and Jennifer Bell.

Yours faithfully

PricewaterhouseCoopers LLP

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Section 1. Executive summary

Introduction

We set out in this report our significant findings from our audit of the National Galleries of Scotland (“NGS”) for 2014/15, together with those matters which auditing standards require us to report to you as “those charged with governance” of NGS.

We carried out our audit work in line with our 2014/15 audit plan that we presented to you on 24 February 2015. Our audit is not designed to identify all matters that may be relevant to you. Accordingly, the audit does not identify all such matters. 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.

Framework for Our Audit

Our audit is conducted in accordance with Auditing Standards (International Standards on Auditing (‘ISAs’) (UK and Ireland)) and the Code of Audit Practice (‘the Code’).

The Code explains how external auditors should carry out their functions under the Public Finance and Accountability (Scotland) Act 2000. The audit of financial statements is covered by engagement and ethical standards issued by the UK Auditing Practices Board (APB), so the Code focuses more on the wider functions of public sector auditors. We have conducted our audit in accordance with the relevant requirements of the Code.

Respective Responsibilities of Management and Auditors

Management

It is the responsibility of the Board and the Chief Executive, as Accountable Officer, to prepare the financial statements in accordance with the Paragraph 8 (3) of the Schedule to the National Galleries of Scotland Act 1906 as amended by Section 17 of the National Heritage (Scotland) Act 1985, and directions made there under. This means:

- acting within the law and ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements on a timely basis, which give a true and fair view of the financial position of the entity and its expenditure and income for the year ended 31 March 2015; and
- preparing a Directors’ Report, a Governance Statement and a Remuneration Report.

Auditors’ responsibilities

Our responsibilities in accordance with the Code of Audit Practice are to provide you with an audit report stating whether, in our opinion the financial statements and the part of the Remuneration Report to be audited and give an opinion on:

- whether they give a true and fair view of the financial position of the entity and its expenditure and income for the year;
- whether they were prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements;
- whether the information which comprises the annual report included with the financial statements is consistent with the financial statements; and

- whether expenditure and receipts have been incurred and applied in accordance with guidance from Scottish Ministers (the regularity opinion).

We are also required to review and report as necessary on other information published with the financial statements, including the directors' report, annual governance statement, statement on internal control or statement on internal financial control and the remuneration report.

Financial Statements

Due to a number of changes of staff within the finance department, the preparation of the financial statements was a challenging process this year for the NGS finance team. The audit fieldwork dates were altered to accommodate this. The full set of draft accounts were received later than had been planned, however, when a full set was received they were of good quality. We proposed only minor disclosure audit adjustments to the draft financial statements. There are no unadjusted misstatements at the conclusion of our audit, as these have been resolved and accepted by management.

We have completed the majority of our audit work and expect to be able to issue an unqualified audit opinion at the Board meeting in September 2015.

Financial performance

NGS's key financial performance for the period is as follows:

- The final outturn for NGS was £14.119m against an operating resource limit of £ 14.825m, resulting in an £0.706m underspend. It should be noted that this was a notional underspend as the variance is in relation to depreciation
- The total consolidated incoming resources for 2014/15 decreased by £3.798m, a total decrease of 16.2%. This is predominantly due to a decrease in voluntary income, specifically gifts and donations. NGS is currently reviewing methods of increasing its voluntary income, including increasing its 'friends' memberships from 8,000 (2014/15) to 15,500 by 2020.
- As a result of a decrease in voluntary income, NGS was under pressure to reduce its expenditure in 2014/15. Expenditure decreased from prior year by £3.57m partly due to less being spent on repairs on property and due to a decrease in utility costs. However, due to part of the reduction being on repairs and maintenance the full saving made this year is not sustainable, so longer term solutions will be required should funding remain lower than in previous years.

NGS has a 2015/16 budget which was presented to and approved by the Audit Committee and SMT. The budgeted income for 2015/16 is £16.235m which include grant in aid funding of £15.825, which is an increase of £1.00m on 14/15 (£14.825m). The grant in aid funding for 2015/16 also includes £1.700m of ring fenced funding and £1.100m of capital funding. We have not identified any key indicators or been made aware of any factors that would suggest that NGS will fail to meet its financial targets.

Additional insight – journals

A key focus in our audit is sharing insight. During our audit procedures for testing journals, we have interrogated the data from which we performed our journals testing to identify observations for your consideration. These are included within Appendix 1.

Please note that copies of this report will be sent to the Audit Scotland in accordance with their requirements.

We would like to thank the management and staff of NGS for their co-operation and assistance during the course of our work.

Section 2: Significant audit and accounting matters

We have set out in this section the significant matters arising from our audit.

Matters identified in our audit plan

Set out below is a summary of our response to matters identified in our audit plan:

Matter arising	Audit response
<p><i>Fraud and management override of controls</i> ISA (UK&I) 240 requires that we plan our audit work to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk that management may override controls in order to manipulate the financial statements.</p>	<p>We performed procedures to:</p> <ul style="list-style-type: none"> • Test the appropriateness of journal entries using Computer Assisted Audit Techniques, we have provided an analysis of the type of journals posted, see appendix 1 for more details; • Review accounting estimates for bias and evaluate whether circumstances producing any bias, represent a risk of material misstatement due to fraud; • Evaluate the business rationale underlying significant transactions; and • Identify any areas of fraud or management override by performing ‘unpredictable’ procedures <p>We did not identify any issues to report to you as a result of our work.</p>
<p><i>Recognition of expenditure</i> Under ISA (UK&I) 240 there is a (rebuttable) presumption that there are risks of fraud in revenue recognition. There is a risk that NGS could adopt accounting policies or treat income transactions (specifically charging scheme income) in such a way as to lead to material misstatement in the reported revenue position.</p> <p>We have rebutted the risk of fraud in revenue recognition and have extended this presumption to the recognition of expenditure in the public sector, as there is arguably greater risk associated with the recognition of expenditure in NGS due to the nature of its funding.</p>	<p>We obtained an understanding of the key controls relating to the expenditure process.</p> <p>We evaluated and tested the accounting policy for expenditure recognition to ensure that this is consistent with the requirements of the Financial Reporting Manual (FRoM).</p> <p>We performed detailed testing of expenditure transactions, focussing on the areas we consider to be of greatest risk.</p> <p>We performed a search for unrecorded liabilities to ensure that the liabilities which ought to be included at the year-end had been included correctly.</p> <p>We did not identify any issues to report to you as a result of our work.</p>

Materiality

We have conducted our work in accordance with the materiality levels detailed below. As noted in the audit plan, which was agreed with the Audit Committee, overall materiality was based on 2% of total assets for the year ending 31 March 2015.

	£
Overall materiality – This is the amount we have applied in assessing the overall impact on the group financial statements of potential adjustments	£5,762,668
Performance materiality - We have applied this to direct the amount of work performed over each financial statement line item – for example in calculating sample sizes	£4,322,001
De-minimis posting level - Under ISA (UK & I) 450, we are required to report to the Audit Committee on all unadjusted misstatements in excess of a ‘de-minimis’ or ‘clearly trifling’ amount	£250,000

Misstatements and significant audit adjustments

There are no uncorrected misstatements arising from our audit to report to you.

Qualitative aspects of accounting practices

Financial statement disclosures

We have also reviewed, and tested, the material disclosures in the financial statements. We identified some errors within the disclosures of the financial statements and these were addressed by Management. We identified no significant issues as part of this work.

Governance Statement

The Financial Reporting Manual requires the Chief Executive to sign a Governance Statement which covers all controls including financial, operational, compliance and the management of risk.

We reviewed the governance statement and considered the following:

- Compliance with the required elements as published by the Scottish Public Finance Manual; and
- Consistency with the remainder of information presented within the annual accounts and our overarching understanding of the entity.

Based on our normal audit procedures, **we do not disagree** with the disclosures contained in the Statement.

Section 3. Financial performance

Financial targets

Table 1: Financial targets summary 2014/15

The below table shows the outturn for the year against the Scottish Government resource limits.

	Outturn £ 000	Budget £ 000	Underspend/ (Overspend) £ 000
Total Capital Resource	0	0	0
Operating Expenditure (Cash)	12,025	12,025	0
Depreciation / Resource Budget (Non-cash)	2,094	2,800	706
Total Operating Resource	14,119	14,825	706

NGS had minor variances to budgeted resource limits during the year. Key areas of expenditure include:

- Staff costs (48% of total operating expenditure) – Staff costs increased by £0.465m in the year, an increase of 5% on the prior year, mainly due to an increase in staff numbers (FY 14 – 258 permanent and 31 temporary staff, FY 15 – 260 permanent and 43 temporary staff). The increase in staff numbers is due to additional funded posts for a variety of project activities.
- Other operating charges (37.5% of total operating expenditure) – Other operating charges have decreased by £0.34m from the prior year. This decrease is due to several factors, including, but not limited to, a decrease in operating lease rentals, contracted staff costs and IT and communications costs.

Financial sustainability

Financial sustainability has become a key matter for consideration by all public sector entities and it is vital that consideration of longer term financial plans has taken place.

The budget for 2015/16 identifies the following key areas of income and expenditure:

Table 5: 2015/16 budget

NGS	2015/16 Planned Budget £ 000
Grant in Aid – Revenue	13,025
Grant in Aid – Non Cash	1,700
Grant in Aid - Capital	200
Total Grant in Aid	14,925
Other Income	3,210
Total income	18,135
Expenditure	18,118
Surplus / (Deficit)	17

Expenditure includes budgeted costs including salaries, departmental spend, estates and exhibition costs of £16.218m, depreciation of £1.7m and capital spend of £0.2m.

2016/17 and beyond

Cost pressures and efficiencies

NGS's Corporate Plan 2015-2018 provides context regarding the economic situation which presents challenges and adds pressures to the running of NGS, in particular highlighting the competition for funding both in the public sector but also from private resources.

The key aims of NGS from 2015-2018 are identified as

- Improving the quality of and care for the collections
- Developing skills, knowledge and research
- Delivering an innovative and inspiring public programme
- Building a relationship with their audiences
- Developing a sustainable and efficient business model
- Developing the partnership programme

The Scottish Government has set an overall expectation of 3% efficiency savings for public sector bodies. During 2015/16 NGS plans raise extra income to fund this, focussing on increasing the self-generated income within the business, whilst ensuring that NGS continues to be accessible to the wider public. Currently, savings from salaries and reducing core costs have reduced expenditure by £0.8m per annum.

NGS are currently in the process of developing a plan detailing the income required to be generated in order to meet the savings required. The draft document details the potential income that could be generated over the

coming 5 years. NGS should ensure the savings are realistic and this plan should be presented to the audit committee and approved by the SMT.

Section 4. Governance and internal control

Governance structure

NGS is governed by a Board of Trustees (Board) that is appointed by the Scottish Government. The Board is responsible for ensuring that NGS fulfils the aims and objectives set by Scottish Ministers. The role of the Board includes establishing the overall strategic direction, monitoring performance against agreed objectives and ensuring that statutory requirements for the use of public funds are complied with.

The Board is supported by a Senior Management Team, the Audit Committee, which has responsibility for monitoring risk and internal control, the Governance Committee and the Staffing & Remuneration Committee.

We consider that the governance arrangements in place are appropriate.

System of internal control

The Director General in conjunction with management and the Audit Committee is responsible for developing and implementing systems of internal financial control and having in place proper arrangements to monitor their adequacy and effectiveness in practice.

We review these arrangements for the purposes of our audit of the financial statements and for our review of the annual governance statement and report to you any significant deficiencies in internal control that we find during our audit.

The significant matters that, in our professional judgement, we believe we should bring to your attention are set out in the table below. No significant matters were identified in the prior year which required follow up in the current year.

Deficiency	Recommendation	Management Response
<p>Recording of Restricted and Unrestricted Expenditure/Income</p> <p>It was noted that the current process for recording expenditure and income does not easily allow it to be recorded as restricted and unrestricted within the finance ledger. The process of identifying restricted and unrestricted expenditure/income is performed at year end.</p> <p>Our testing over expenditure and income is designed to identify any material misstatement within presentation of restricted and unrestricted. Our testing has not identified any misstatements</p>	<p>A control should be implemented going forward to ensure that all expenditure and income is recorded as restricted or unrestricted within the finance ledger, as it is received.</p>	<p>Restricted income is to be tracked in the general ledger and management reports going forward.</p>

<p>relating this, however in order to accurately record the split between restricted and unrestricted, a control should be put in place, to allow this to be input to the finance ledger.</p>		
<p>Disclosure of Related Parties</p> <p>All related parties of both the Trustees and Senior Management should be disclosed on their Declaration of Interest forms, to ensure that accurate reporting of related parties can occur.</p> <p>It was found during testing that some Trustees had not accurately disclosed all related parties on their declarations.</p> <p>Although there were no material related party transactions noted, there is a risk that if trustees and senior management do not declare all related parties, transactions may occur which are not recognised and therefore not appropriately disclosed in the financial statements.</p>	<p>Trustees should be reminded to report all related parties, including their employer, in their annual declaration forms. The definition of a related party per NGS policies should be circulated to all Trustees.</p>	<p>A code of conduct exists for all trustees outlining their responsibilities for disclosing related parties. This was updated in May 2015 and circulated to and approved by all trustees.</p>
<p>Review and Authorisation of Journals</p> <p>As noted in appendix one, 17 individuals had access to post journals in the year. This is a high number in relation to the size of the finance department, however, we note that this is due to high staff turnover. At present, manual journals are not formally reviewed or approved once posted.</p> <p>Through our testing we did not identify any incidences of fraud in relation to manual journals. However, there is a risk that a fraudulent or incorrect journal could be posted which would not be identified due to the lack of review and approval of manual journals. This risk is increased when there is a high staff turnover, and as such this is an area where controls should be improved.</p>	<p>A control should be put in place whereby manual journals are reviewed and approved by a Senior member of the Finance team to reduce the risk of error or fraud.</p>	<p>It may not be practical nor necessary for all manual journals to be reviewed, however as part of a general control review on key processes this will be assessed and a recommendation presented to Audit & Risk in respect of control over manual journal entry.</p>

<p>Efficiency Savings</p> <p>A draft document is in place which details the self-generated income required over the coming years to close the funding gap. The draft plan notes additional income required of £1.0m in 2015/15 to £3.9m in 2019/20.</p> <p>Given the increasing funding gap it is essential that a detailed plan is in place and approved by Management. We acknowledge that NGS are in the process of identifying how it will deliver these savings for the coming five years.</p>	<p>Management should ensure they progress the exercise being undertaken to identify potential ways to generate income over the coming years.</p> <p>Detailed plans should then be developed to set out how the changes will be implemented and this should be presented to the Audit and Risk Committee for their review.</p>	<p>The Business Planning exercise is an ongoing process and the Management Team are focussed on delivering the proposed changes. The plan is reviewed and discussed at SMT and Audit and Risk and Board level on a regular basis.</p>
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Based on our work performed we consider the systems of internal control to be appropriate.

Risk management

NGS has an established risk management strategy within the organisation. NGS has a published Risk Policy and maintains a Risk Register. The Board identify key risks each year, and puts in place processes to manage these risks.

The risk register is monitored by the Audit and Risk Committee.

Internal Audit

As described in our Annual Plan, International Standard on Auditing (UK and Ireland) 610: “Using the work of internal auditors” requires us to:

- Consider the activities of Internal Audit and the extent that their work can be relied upon for external audit procedures;
- Obtain sufficient understanding of internal audit activities and the effectiveness of the function to enable us to identify areas of risk and develop an effective and targeted audit approach; and
- Evaluate and test the quality and timeliness of internal audit work, where we seek to rely on the findings, in order to confirm its adequacy for our purposes.

The internal auditors are Chiene & Tait. They have completed the internal audit plan for 2014/15. PwC staff attended Audit Committee meetings where internal audit reviews were presented. We assessed the internal audit reports issued during the year and considered any potential impact on our audit. As in prior years, due to our audit approach, we have taken no reliance on the work performed by internal audit.

Based on audit work performed we consider the Internal Audit function to be appropriate for the needs of the Board.

Other matters

Compensation and Confidentiality Agreements

NGS have not had any voluntary redundancy agreements during the 2014/15 year.

Section 5. Fraud

International Standards on Auditing (UK&I) state that we, as auditors, are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The respective responsibilities of auditors and management are summarised below:

Auditors' responsibility

Our objectives are:

- to identify and assess the risks of material misstatement of the financial statements due to fraud;
- to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- to respond appropriately to fraud or suspected fraud identified during the audit.

Management's responsibility

Management's responsibilities in relation to fraud are:

- to design and implement programmes and controls to prevent, deter and detect fraud;
- to ensure that the entity's culture and environment promote ethical behaviour; and
- to perform a risk assessment that specifically includes the risk of fraud addressing incentives and pressures, opportunities, and attitudes and rationalisation.

National Fraud Initiative (NFI)

NGS participates in the National Fraud Initiative (NFI). They have identified 55 recommended matches for the 2014/15 year and management have investigated and uploaded results on to the national NFI system. In accordance with our responsibilities as your appointed auditor, we have completed the NFI questionnaire, and have made the following observations:

- of the 55 recommended matches, 2 have been investigated (4%) and the remaining 53 are under investigation; and
- no frauds or overpayments have been identified through investigations made.

Management have confirmed that a preliminary review has been performed on all matches and no issues have been identified. Action should be taken by Management to ensure all recommended matches are formally investigated and reported on the NFI system.

Prevention and detection of fraud and corruption

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. As part of our external audit, we have reviewed NGS's high level arrangements for preventing and detecting instances of fraud and corruption. There are no matters we wish to bring to your attention concerning fraud.

NGS's internal control environment is designed to prevent and detect instances of fraud, specifically through published anti-fraud policies and procedures, segregation of duties and authorisation processes. All fraud is investigated by either the Head of HR, Head of Operations or Chief Operating Officer in the first instance, with an independent investigator appointed by the Chief Operating Officer where required. There is a whistleblowing policy in place, which was developed in line with the Bribery Act (2010). The only instances of fraud communicated to external audit in the year are those noted within the governance statement of the financial statements. These are not deemed to have a material financial impact on the financial statements.

Based on audit work performed we consider that the controls in place to prevent and detect fraud or corruption to be suitable for the operations of the Board.

Section 6. Independence

Independence and objectivity

We have made enquiries of all PricewaterhouseCoopers' teams providing services to you and of those responsible in the UK Firm for compliance matters.

There are no matters which we perceive may impact our independence and objectivity of the audit team.

Independence conclusion

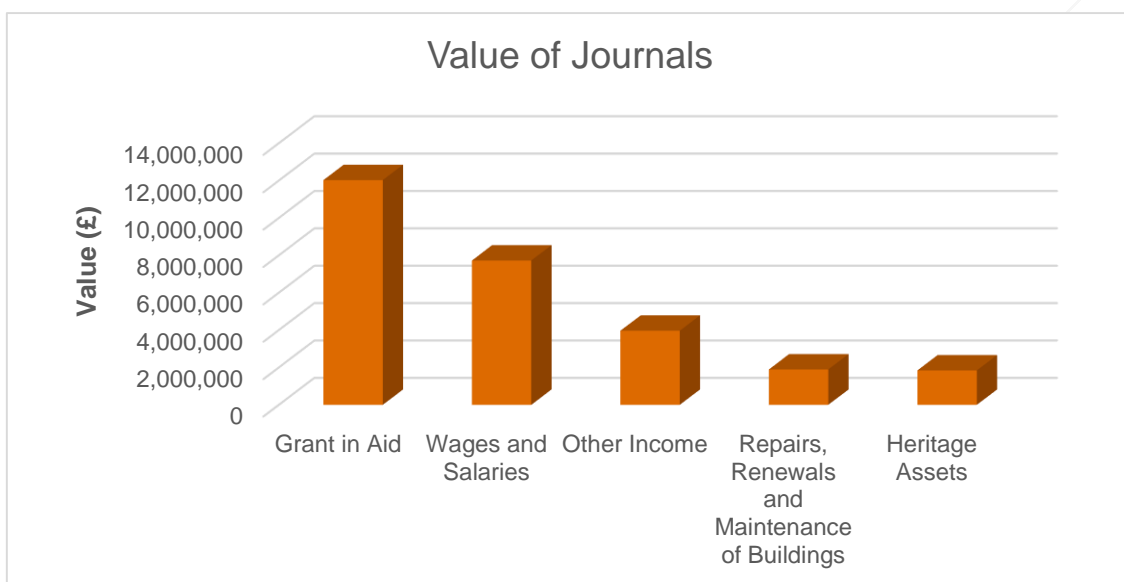
At the date of this plan we confirm that in our professional judgement, we are independent accountants with respect to NGS, within the meaning of UK regulatory and professional requirements and that the objectivity of the audit team is not impaired.

Appendix 1: Journals insight

Summary		
	Quantity	Value (GBP)
Total journals	26,063	£182,110,322.62

The data above shows the total number and value of journals, both manual and automated, posted in the financial year 2014/15.

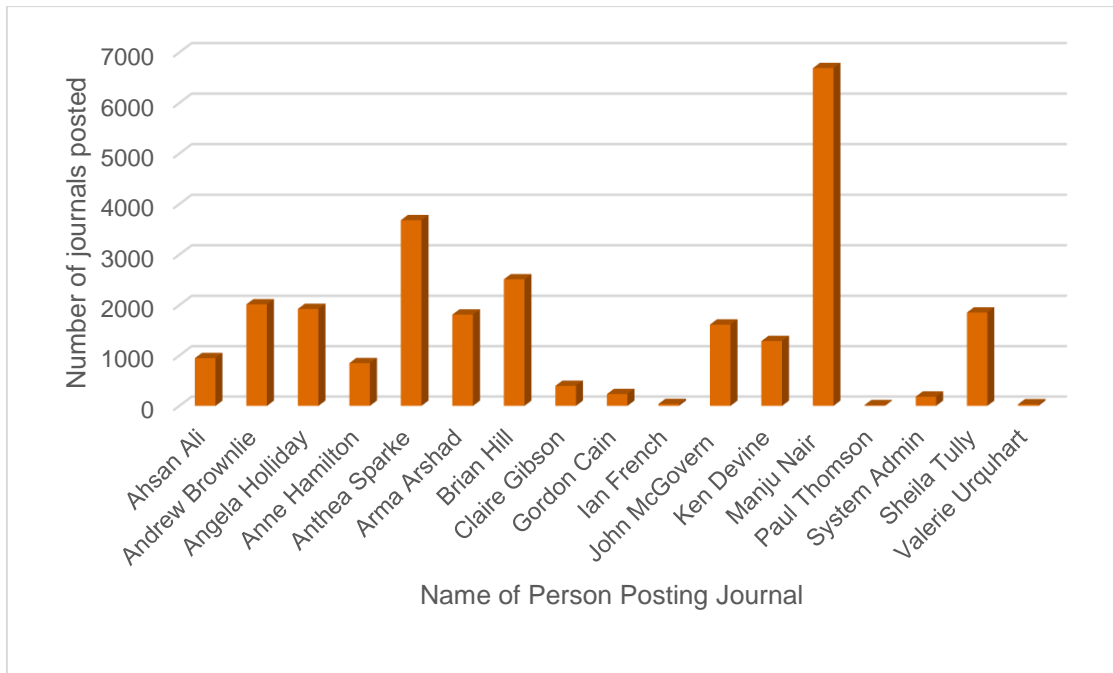
Top 5 Financial Statement Line Items, by Value



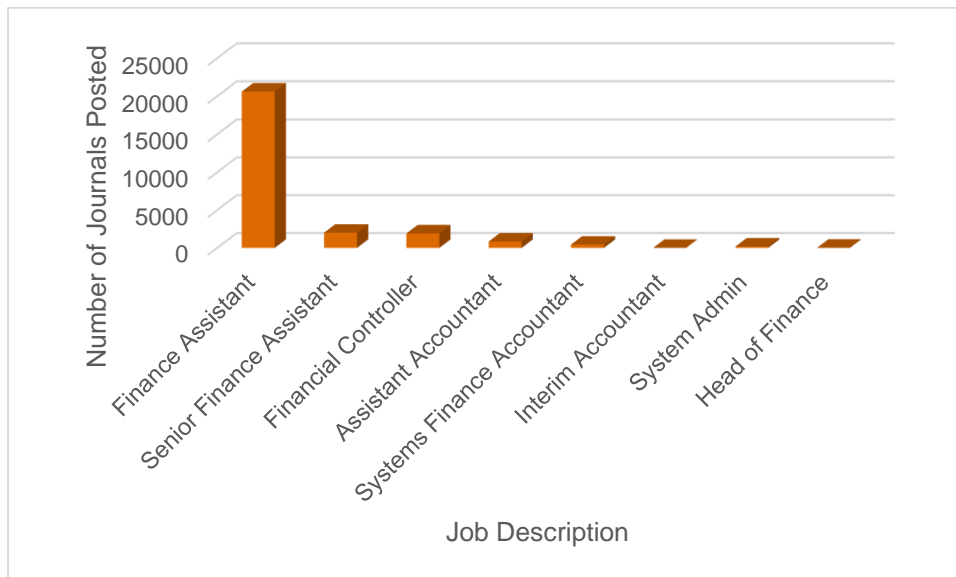
The above graph shows the value of manual and automated journals posted to the top five Financial Statement Line Items. It can be seen that the highest value relates to the grant in aid received from the Scottish Government, followed by Wages and Salaries, these are in line with our expectations.

The following two graphs show the number of users with access to post journals to the system, the number of journals posted by each, and the number of journals posted by job title. It can be seen from the graphs that there were 17 separate users who posted journals during 2014/15. This number of users having access to post journals is considered to be high relative to the size of NGS finance team. As shown within the graph below ‘number of journals posted by each user’ the number of journals posted, varied significantly by user, from 14 to 6,689. NGS finance team experienced a high level of staff turnover in the year, in particular within the Finance Assistants post. Of the 26,063 journals posted, 20,619 were posted by finance assistants which is shown within the second graph below. This would be in line with our expectations, given the role of the Finance Assistants. The second graph shows that despite a high volume of individuals having access to post journals, all were in posts that would be expected to have this access.

Number of Journals posted by each user



Number of Journals Posted by Job Title



In the event that, pursuant to a request which NGS has received under the Freedom of Information Scotland Act 2002, it is required to disclose any information contained in this report, it will notify PwC promptly and consult with PwC prior to disclosing such report. NGS agrees to pay due regard to any representations which PwC may make in connection with such disclosure and NGS shall apply any relevant exemptions which may exist under the Act to such report. If, following consultation with PwC, NGS discloses this report or any part thereof, it shall ensure that any disclaimer which PwC has included or may subsequently wish to include in the information is reproduced in full in any copies disclosed.

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