Historic Environment Scotland

Annual audit report to the Audit and Risk Committee, the Trustees of Historic Environment Scotland and the Auditor General for Scotland

For the year ended 31 March 2016

1 December 2016

Contents

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 Environment Scotland ("HES") and is made available to Audit Scotland and the Auditor General (together "the Beneficiaries"). This report has not been designed to be of benefit to anyone except the Beneficiaries. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

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 introduction and responsibilities 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 (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) 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.

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Andy Shaw, who is the engagement leader for our services to Historic Environment Scotland, telephone 0131 527 6673 email: andrew.shaw@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN.

Executive summary

Executive summary

Audit conclusions

- We have issued an unqualified audit opinion on the financial statements of Historic Environment Scotland ("HES"). We note that the financial statements preparation process and the audit fieldwork were extended in length and identified several matters to be resolved. This arose from the complexity of the formation of HES combined with Charities SORP (FRS 102) adoption.

Financial position

- Net income of £15 million is reported in the financial statements to 31 March 2016 representing six months of activity in HES. This is offset by net liabilities of £10.4 million absorbed from Historic Scotland ("HS") and The Royal Commission on the Ancient and Historic Monuments of Scotland ("RCAHMS") on 1 October 2015. This compares to a breakeven budget, however is the result of differences arising on reporting under the Charities SORP (FRS 102). Closing net assets are £5 million, although there is £13.5 million of negative unrestricted reserves, due to grant commitments being recognised on confirmation of the award to the grantee instead of commencement of the project. Page 6

- The 2016-17 budget shows a break-even position, with grant in aid of £45 million supplemented by £40 million other income to cover budgeted expenditure of £85 million. We reiterate the recommendation from our interim management report that management accounts are reconciled to a forecast statutory position through the year. Page 6

Financial statements and related reports

- We concluded satisfactorily in respect of each of the significant risks and audit focus areas identified in the audit strategy document. We identified a number of audit adjustments and presentational adjustments to the draft financial statements as detailed at appendix one. The accounting issues are complicated and management worked methodically and thoroughly through each matter. We have no matters to highlight in respect of independence. Written representations are based on standard required representations, in addition to specific representations relating to the value of the stock provision. Pages 8 – 20

Wider scope

- We considered the wider scope audit dimensions and note risks in relation to: Pages 22 - 31
  - Financial sustainability: uncertainty over future funding, negative unrestricted reserves and long term forecasting.
  - Financial management: finance team capacity, financial monitoring of the statutory position, use of standing financial instructions and controls over debt collection and reconciliation of the stock system to the general ledger.
  - Governance and transparency: key governance arrangements being finalised, transfer of Scran operations and chief executive changes.
  - Value for money: readiness for gift aid collection, HESE non-operational in 2015-16 and cost of administrative and IT issues on transition.

Scope and responsibilities

Purpose of this report

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

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 Environment Scotland and the Auditor General. The scope and nature of our audit were set out in our 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

The Code sets out Historic Environment Scotland’s responsibilities in respect of:

- 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. Appendix six sets out how we have met each of the responsibilities set out in 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. Management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems.

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

Financial position

Financial position

Overview

The financial statements of HES are prepared for the full year to 31 March 2016, however they include only activity for the six months from 1 October 2015; from when HS and RCAHMS were absorbed. There was no activity in the period 1 April to 30 September 2015. Consolidated financial statements include the activity of Scran Limited from 22 February 2016 when this entity was acquired. The balance sheet also contains the acquisition of the assets and liabilities of Scran Trust, which also took place on 22 February 2016.

Financial position

The consolidated statement of financial activity ('SOFA') reports net income of £15.0 million. This reflects strong performance on commercial income in the year, as well as the effects of reporting investment grants in line with Charities SORP (FRS 102) requirements as detailed at appendix five.

The transfer of HS and RCAHMS net liabilities of £10.4 million into HES also reflects the impact of recognising additional commitments on investment grants of £32.6 million at 1 October 2015, compared to those recognised in HS to 30 September 2015.

Reserves

As a result of the above adjustments, as at 31 March 2016 HES had closing funds of £5 million; comprising £17.5 million revaluation reserves and £0.9 million restricted reserves, offset by £13.5 million negative unrestricted reserves. This negative unrestricted reserve position is due to additional commitments at 31 March 2016 of £22.4 million recognised as a result of applying the Charities SORP (FRS 102) to investment grants as noted above and detailed at appendix five.

Financial plans 2016-17 and beyond

The 2016-17 approved budget for HES includes total expenditure of £85 million, funded by Scottish Government grant in aid of £45 million and self-generated income of £40 million. This appears achievable when compared to self generated income of £47.7 million for the full 12 month period 2015-16 (split across HS, RCHAMS and HES). Management intends to carry out longer term financial forecasting following the next government spending review.

Consolidated statement of financial activity

Six months activity to 31 March 2016	**2015-16 £'000**
Government grant in aid	36,019
Self-generated income	17,612
Total income	**53,631**
Total expenditure	**(38,675)**
Net income	**14,956**
Net transfer in	(10,358)
Gain on revaluation of fixed assets	414
Net movement in funds	**5,012**

Source: KPMG analysis of Historic Environment Scotland's draft financial statements 2015-16

Consolidated balance sheet

	31 March 2016 £'000
Fixed assets	36,479
Current assets	12,286
Current liabilities	(31,571)
Net current liabilities	**(19,285)**
Total assets less current liabilities	**17,194**
Non-current liabilities	(11,264)
Provisions for liabilities	(918)
Total net assets	**5,012**
Unrestricted reserves	(13,470)
Restricted reserves	944
Revaluation reserves	17,538
Total funds	**5,012**

Source: KPMG analysis of Historic Environment Scotland's draft financial statements 2015-16

Conclusion

HES generated significant commercial income during 2015-16 to supplement the government grant in aid allocation.

Adjustments to the financial statements to recognise investment grant commitments at the point of award, rather than project commencement, resulted in significant net liabilities transferred into HES from HS and at 31 March 2016 and contributes to the high net income recognised in the six months to 31 March 2016.

Financial statements and related reports

Audit conclusions

Audit opinion

We have concluded satisfactorily on the significant risk areas and other audit focus areas and have issued an unqualified audit opinion on the truth and fairness of the state of HES's affairs as at 31 March 2016 and of HES's incoming resources and application of resources for the year then ended.

Financial reporting framework, legislation and other reporting requirements

As a charitable non-departmental public body, HES is required to prepare its financial statements in accordance with Financial Reporting Standard ('FRS') 102, the Charities Statement of Recommended Practice FRS 102 ('Charities SORP (FRS 102)') and the Financial Reporting Manual ('FReM'). The Trustees report replaces the performance report. The Charities SORP (FRS 102) takes precedence where there is a conflict. Our audit confirms that the financial statements after adjustment are appropriately prepared.

Regularity

Our audit work, as outlined on the following pages, concluded that in all material respects the expenditure and income in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.

Statutory reports

We have not identified any circumstances to notify the Auditor General that indicate a statutory report may be required.

Other communications

The financial statement preparation and audit were impacted by a number of factors outwith the finance team's control, resulting in delays in the financial statements being prepared and the audit work carried out. This is detailed further on page nine. There were no other significant matters arising from the audit that were discussed, or subject to correspondence with management that have not been included within this report. There are no other matters arising from the audit, that, in our professional judgement, are significant to the oversight of the financial reporting process.

Audit misstatements

There were five audit adjustments required to the draft financial statements which impacted on the net assets and income and expenditure for the year. There are two unadjusted audit differences. Further details of these audit misstatements are provided in appendix one.

Written representations

Written representations are based on our standard required representations, in addition to specific representation required by management relating to the value of the stock provision.

Context of our audit

Materiality

We summarised our approach to materiality in our audit strategy. On receipt of the financial statements and during our audit testing we reviewed our materiality levels. Whilst total expenditure per the financial statements was lower than that used to calculate our planning materiality (£38.7 million per financial statements; £44.3 million budgeted), we concluded that our planning materiality for 2015-16 of £880,000 (2.2% of expenditure; 2% of budgeted expenditure) remains appropriate. We based this judgement on the key difference between budgeted and actual expenditure being the £10.2 million reduction in investment grant expenditure, which was audited substantively (reported in appendix one and five). We report all misstatements greater than £44,000.

Forming our opinions and conclusions

In gathering the evidence for the above opinions and conclusions we:

- performed controls testing and substantive procedures to ensure that key risks to the annual accounts have been covered and that the regularity of income and expenditure was in accordance with regulations;
- 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 annual accounts have been considered;
- reviewed estimates and accounting judgements made by management and considered these for appropriateness;
- considered the potential effect of fraud on the annual accounts through discussions with senior management to gain a better understanding of the work performed in relation to prevention and detection of fraud; 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

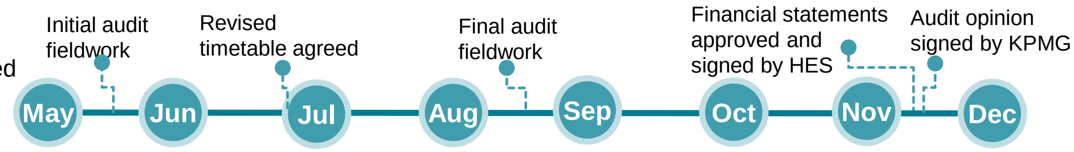
Preparation of financial statements was not straightforward. Management managed admirably with many accounting complexities, including fundamental matters requiring resolution with Scottish Government. The complexities included:

operational impacts of the formation of HES, including senior personnel changes	acquisition of Scran Trust and Scran Limited in February 2016	challenges with IT server transfers and issues with system reporting
agreement with Scottish Government relating to the transfer of fixed assets	new accounting requirements from the Charities SORP (FRS 102)	limited finance team capacity and reliance on key individuals

Our audit commenced in May 2016, however the financial statements were not complete without a clear audit trail. We revisited the audit in June 2016. At this stage, financial statements were progressing but not complete. A revised timetable was agreed and the final audit visit planned for August 2016. On commencing our final fieldwork in August, a clear audit trail supported the draft financial statements and the majority of our audit work was carried out. Complexities associated with the transition to applying the Charities SORP (FRS 102) resulted in audit work continuing into September and October 2016.

Throughout the process, we noted significant reliance on key individuals within the finance team and we reiterate the recommendation raised in our interim management report with respect to the need to increase finance team capacity. We also raised a recommendation relating to audit preparedness for 2016-17 financial statements.

Recommendation one



Significant risks and other focus areas in relation to the audit of the financial statements

We summarise below the risks of material misstatement as reported within the audit strategy and new risks identified as the audit progressed. 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 better understand the process by which we arrived at our audit opinion.

Significant risks as per audit planning:

- management override of controls fraud risk;
- income and expenditure recognition fraud and error risk; and
- transition to HES from HS and RCAHMS.

Other focus areas as per audit planning:

- investment grants; and
- new reporting frameworks – FRS 102 and Charities SORP 2014.

Additional risks identified as the audit progressed:

- transfer of assets into HES; and
- transfer of Scran Trust assets and acquisition of Scran Limited.

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 RISK	OUR RESPONSE	AUDIT CONCLUSION
Transition to HES from HS and RCAHMS HES assumed the activities and responsibilities of HS and RCAHMS from 1 October 2015. The agreement to transfer Scran assets and liabilities into HES was effective from 22 February 2016. A new finance system for HES was developed and implemented on 20 October 2015. We identified a risk that the operating effectiveness of controls may be disrupted. The opening balance sheet of HES was required to be accurately prepared from the closing balance sheets of HS and RCAHMS at 30 September 2015 and accurately transferred onto the new finance system.	As reported in the interim management report, for the six months to 30 September 2015 we tested key financial controls within HS and RCAHMS, performed substantive testing of balances within these entities and held discussions with the finance team to review transition arrangements. Additional work carried out during our year end audit included: ▪ Agreeing the transfer of draft closing balances of HS and RCAHMS to the HES ledger as at 1 October 2015 to closing trial balances previously audited. ▪ Substantive tests of detail over adjustments made to the draft balances at 1 October 2015 transferred into the HES ledger, confirming them to be in line with relevant financial reporting frameworks and underlying records. ▪ Considering the operating effectiveness of controls throughout the year. ▪ Reviewing changes to governance and IT arrangements since our interim audit visit. We have considered these as part of our narrative in relation to wider scope areas in section four. ▪ Substantive testing over the acquisition of Scran Trust assets and liabilities and Scran Limited into HES on 22 February 2016, including verification of the completeness and accuracy of material balances. Further narrative on this acquisition is provided on page 15.	The key findings from our audit work are: ▪ HS and RCAHMS closing balances at 30 September 2015 were accurately transferred into the HES general ledger. ▪ We identified an audit adjustment to capital additions reported in HES, which incorrectly included additions from the period 1 April 2015 to 30 September 2016 (appendix one). ▪ Governance arrangements are in the process of being finalised. We consider these further on page 28. ▪ Two control recommendations were identified through substantive audit testing of HES account balances, relating to the reconciliation of the stock system to the general ledger and the timely collection of trade receivables; our recommendations are set out in appendix three.

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
Income and expenditure recognition fraud and error risk Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk. Given the operation of HES, we considered that the risk of fraudulent expenditure recognition was linked. There is a risk that income and expenditure relating to 2015-16 was incorrectly accrued or deferred, both at 31 March 2016 period end and at the transition date of 1 October 2015. The timing of providing services across the period start and end involved management judgements on what to accrue or defer.	We performed testing over income and expenditure recognition during our work over HS, RCAHMS and HES balances. Our work over HS and RCAHMS balances and HES interim controls was reported in the interim management report. Our work over income and expenditure recognised within HES financial statements included: - Substantive tests of detail of Scottish Government grant income received in the period 1 October 2015 to 31 March 2016, including reconciling these to full year budget allocations. - Analytical procedures over commercial and trading income reported, based on visitor numbers and price changes. - Substantive test of details of other grant funding received, in particular funding for the Engine Shed project and consideration of the recognition of such grants in line with Charities SORP (FRS102). - Cut-off procedures performed to test the accurate recognition of self-generated income and other expenditure over the year end. - Testing to confirm the accuracy of classification of income and expenditure as restricted or unrestricted, in line with Charities SORP (FRS 102) requirements. - Sample testing expenditure reported in the period, confirming accurate recognition and regularity. - Consideration of the appropriateness of bases of income and expenditure recognition under FRS 102, FReM and Charities SORP (FRS 102) reporting requirements. Appendix five sets out key considerations of specific technical areas considered in our work over income and expenditure.	The key findings from our audit work are: - We did not identify instances of fraudulent revenue or expenditure recognition. - We identified three instances of error in income and expenditure recognition as described below. Further detail of the value of adjustments identified is included in appendix one and detail on the accounting treatment of each area for completeness is included in appendix five. - Following these adjustments, we are satisfied that income and expenditure is recognised appropriately within the financial statements. Scottish Government grant funding An adjustment was identified to recognise grant funding for the full amount awarded by the Scottish Government in HES, rather than recognising cash held as a liability at the period end as was previously presented in HS. Engine Shed grant funding An adjustment was identified to classify an element of the grant funded Engine Shed asset as restricted, to reflect the ongoing restrictions applied by Heritage Lottery Funding over the use of the asset once complete. Investment grant commitments An adjustment was identified to recognise grants provided by HES at the point of the firm offer of award, rather than commencement of the project, in line with Charities SORP (FRS 102) requirements.

Significant risks (continued)

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
Fraud risk from management override of controls Professional standards require us to communicate the fraud risk from management override of controls as a significant risk; as management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.	As reported in the interim management report, we performed controls testing over journal entries, bank reconciliations, budget monitoring, investment grants approval, BACS payment authorisation, reconciliation of monthly sales income and sales invoice authorisation during our interim audit visit. Our additional substantive procedures performed during the year end audit included: ▪ Substantive testing of journal entries throughout the year, confirming a sample of journals had been appropriate raised, approved and agreed to relevant supporting documentation. ▪ Assessment of accounting estimates, including the valuation of heritage assets and provisions for liabilities. ▪ Assessment of significant transactions that are outside the organisation's normal course of business, or are otherwise unusual, including the acquisition of Scran Limited through the transfer of Scran Trust assets into HES in February 2016.	We did not identify instances where management override of controls had occurred.

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
Transfer of assets into HES HES was established by the Historic Environment Scotland Act 2014, which sets out the legal basis for the transfer of functions and assets into HES, from HS and RCAHMS. This is supported by the HES Property Transfer Scheme 2015, which provides detail of the assets and liabilities transferred under the Act. Review of this by management raised concerns around the accounting treatment of the following assets: ▪ *properties in care*, held within HS as heritage assets at £nil value: these were excluded from transfer by the Property Transfer Scheme. ▪ *other assets owned by HS*: these are transferred to HES under the Property Transfer Scheme. ▪ *operational assets within the boundaries of properties in care*: the Property Transfer Scheme does not specify whether these assets transfer. ▪ *RCAHMS assets*: these are transferred to HES under the Property Transfer Scheme. The principles of FRS 102 as applied by the Charities SORP (FRS 102) must be applied to the recognition of assets in HES, primarily the requirement to account for transactions and events in accordance with their substance and not merely their legal form.	We held several discussions with management to consider the required accounting treatment of the transfer of assets into HES. HES's proposed approach was initially to account for properties according to the substance over legal form principles embedded in FRS 102 and the Charities SORP (FRS 102) by removing those assets from the balance sheet that were not transferred by the Act and for which there were no committed ongoing rights to the assets. This would have resulted in the removal of properties in care and operational assets within the boundaries of properties in care from their balance sheet. HES consulted the Scottish Government, which advised in a letter dated 9 September 2016 that HES should retain the accounting treatment for fixed assets that Historic Scotland adopted, despite Historic Environment Scotland not being an agency and despite the wording of the Act. Whilst the letter provided by Scottish Government is not a legally binding document, it does state that Scottish Government considers that HES should continue the treatment. It applied accounting in its own financial statements that reflects HES recognising the assets. As Scottish Government (Scottish Ministers) is the effective owners of HES and has requested this accounting treatment, we are content for HES to apply it, despite not being an agency of government. The Act allows for activities to be transferred to another body (theoretically compromising recognition on HES's balance sheet), however the letter confirms that it is not the intention and therefore appropriate to continue recognising the operational heritage assets as HES has the benefit of the income for the foreseeable future. Other assets owned by HS and all assets owned by RCAHMS are considered as transferred into HES through both legal rights and the substance of the rights over the assets.	The key findings from our audit work are: ▪ Following consultation with Scottish Government, we are satisfied that the accounting treatment adopted for the fixed assets adopted by HES is appropriate. ▪ All assets held in HS are transferred into HES, including properties in care and operational assets within properties in care boundaries.

Significant risks (continued)

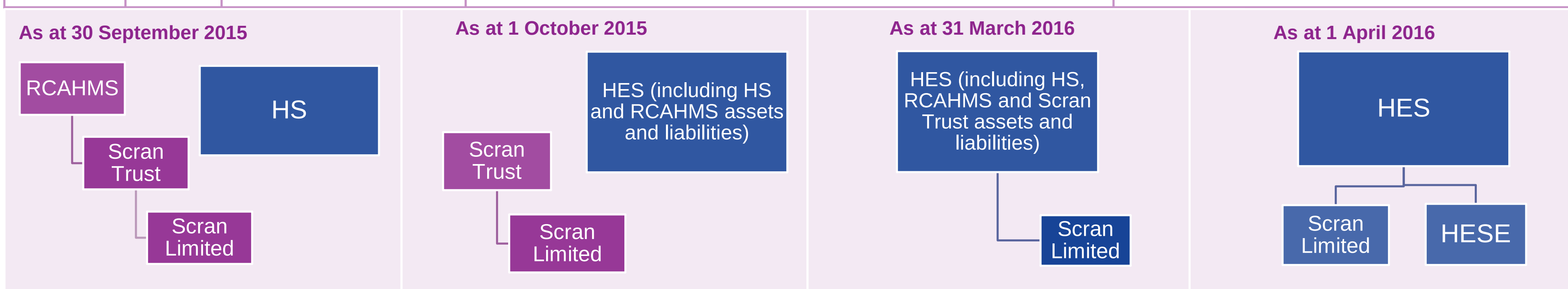
SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
Acquisition of Scran Trust assets and liabilities and Scran Limited Scran Trust assets and liabiltiies were acquired by HES on 22 February 2016, as formalised under a transfer agreement. Scran Trust was then dissolved. Scran Trust owned 100% of the share capital of Scran Limited. As a result, Scran Limited was also acquired by HES. As acquisitions these must be accounted for at fair value in line with the Charities SORP (FRS 102). Specific disclosures are also required for the acquisition. The following risks were identified in relation to these acquisitions: re is a risk that fair values are materially misstated, or that required disclosures are incorrect or omitted. - fair values are materially misstated; - required disclosures are incorrect or omitted; - balances are not accurately consolidated into HES financial statements; and - licences and agreements supporting the underlying arrangements for the recognition of revenue in specific entities are lost (where for example the assets are owned in another).	Our work over the acquisition of Scran Trust assets and liabilities included: ▪ Agreeing the amounts transferred into the HES general ledger on 22 February 2016 to underlying records of Scran Trust and Scran Limited as at this date. ▪ Review of the application of fair value accounting to assets and liabilities acquired, for the group and also for HES “the charity”. ▪ Review of the legal arrangements underlying revenue streams. ▪ A separate statutory audit is being carried out over Scran Limited financial statements to 31 March 2016. Whilst the Scran Limited financial statements have not been signed as at the date of this report, the audit work over the balances included within the HES financial statements is concluded. ▪ Testing of the consolidation for inclusion of accurate Scran Limited balances.	The key findings from our audit work are: ▪ Consolidated balances from Scran Limited have been included accurately on the HES general ledger. ▪ Acquisition accounting and disclosures for Scran Trust and Scran Limited have been applied correctly in the HES financial statements.

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
Investment grants HES assumed the statutory responsibility from Historic Scotland to deliver grants, mainly to charitable trusts, as well as local authorities and individuals. As a material expenditure stream for HES, there is a risk associated with the accurate recording and cut-off over investments granted.	As reported in our interim management report, we performed controls testing over the design, implementation and operating effectiveness of controls over investment grant authorisation during our interim audit visit. Our additional substantive procedures performed during the year end audit included: ▪ Sample testing over investment expenditure during the period, accruals at the period end and commitments disclosed. ▪ Agreement of narrative disclosures within the financial statements for accuracy and agreement to underlying records.	The key findings from our audit work are: ▪ We are satisfied that investment grant approval processes are appropriately designed, implemented and operating effectively. ▪ We identified an error in the recognition of investment grant commitments under the Charities SORP (FRS 102). Detail narrative on the accounting treatment is provided in appendix five. The adjustment recorded is detailed in appendix one. ▪ Following this adjustment, we are satisfied that investment expenditure, accruals and commitments are reported accurately within the financial statements.

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
New reporting frameworks – FRS 102 and Charities SORP 2014 As a charitable NDPB with a reporting period beginning after 1 January 2015, HES must report under FRS 102 in compliance with the Charities Statement of Recommended Practice (FRS 102) and the Government Financial Reporting Manual ("FReM") 2015-16. This was the first time the finance team prepared accounts under these frameworks therefore there was a higher risk of omitted or incorrect disclosures.	Our work consisted of: ▪ Review of the financial statements for compliance with the Charities SORP (FRS 102), FReM 2015-16 and Audit Scotland published guidance relating to charitable NDPBs. ▪ Completion of disclosure checklists over the draft financial statements. ▪ Substantive test of detail over significant or unusual transactions, agreeing such transactions to underlying records to confirm the substance of the transaction is reported accurately and in line with SORP and FReM requirements (including the acquisition of Scran Limited and Scran Trust assets in February 2016). ▪ Review of FRS 102 transition adjustments to HES opening balances for accuracy and completeness. ▪ Review of disclosures made in respect of transition adjustments.	The key findings from our audit work are: ▪ We proposed presentational adjustments review of the draft financial statements to comply with the relevant reporting requirements. ▪ We identified errors in the recognition of Scottish Government grant income, other funding income and investment commitments under new Charities SORP (FRS 102) requirements, as detailed at appendix one and appendix five. Following correction of these points, we are satisfied that ▪ the financial statements are correctly prepared in compliance with the Charities SORP 2014, FReM 2015-16 and Audit Scotland published guidance. ▪ the financial statements include all required disclosures as required by these accounting standards and in respect of transition adjustments; and ▪ transition adjustments to HES opening balances have been appropriately applied.

REPORT	SUMMARY OBSERVATIONS	AUDIT CONCLUSION
Trustees report	As a charitable non-departmental public body, HES is required to prepare a Trustees report in accordance with FRS 102 and the Charities SORP (FRS 102). It must also apply the requirements of the FReM, although it is exempt from the requirement to prepare a remuneration report. The Trustees report includes the following sections as required by the Charities SORP (FRS 102): ▪ objectives and activities; ▪ achievements and performance; ▪ financial review; ▪ structure, governance and management; and ▪ reference and administrative details.	We held discussions with management regarding the Charities SORP (FRS 102) requirements and provided comments relating to how the draft management commentary could be enhanced and where additional information disclosures should be made. We are satisfied that the information contained within the Trustees report is consistent with the financial statements.
Annual governance statement	The statement for 2015-16 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on HES'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.	We note that there have been a number of governance changes during the year. We considered the annual governance statement against these changes and are satisfied with the disclosures.

ENTITY	TYPE	RELATIONSHIP TO HES	SUMMARY OBSERVATIONS	AUDIT CONCLUSION
Scran Limited	Company	Subsidiary from 22 February 2016	The acquisition of Scran Limited is accounted for at fair value, in line with the Charities SORP (FRS 102). On review of the assets and liabilities acquired, we concur with management's assessment that the fair value of these equates to the book value. The acquisition was at £nil consideration.	Acquisition accounting and disclosures for Scran Limited have been applied correctly in the HES financial statements.
Scran Trust	Charity	Assets and liabilities acquired by HES on 22 February 2016	The acquisition of Scran Trust is accounted for at fair value, in line with the Charities SORP (FRS 102). On review of the assets and liabilities acquired, we concur with management's assessment that the fair value of these equates to the book value. The acquisition was at £nil consideration.	Acquisition accounting and disclosures for Scran Trust have been applied correctly in the HES financial statements.
RCAHMS	Charity	Assets and liabilities absorbed into HES on 1 October 2015	We carried out an audit of RCAHMS non-statutory financial statements at 30 September 2015. The balances absorbed into HES on 1 October 2015 were reviewed and confirmed to journal postings for completeness and accuracy.	RCAHMS closing balances were accurately transferred into HES on 1 October.
HESE	Company	Subsidiary, operational from 1 April 2016	HESE was not operational during 2015-16 therefore does not require financial statements or consolidation into HES accounts. We considered the value for money implications of trading activities being processed through HES at page 30.	There are no HESE accounting requirements at 31 March 2016.



Qualitative aspects

ISA 260 requires us to report to those charged with governance our views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

We consider the accounting policies adopted by HES to be appropriate. The accounting framework has changed from policies from those applied in HS, reflecting the application of FRS 102 and the Charities SORP (FRS 102) in HES as compared to IFRS and the FReM applied in HS.

There are no significant accounting practices which depart from what is acceptable under the Charities SORP (FRS 102) and the FReM.

Significant accounting estimates include:

- the present value of fixed assets. These are valued on a five year rolling basis by the Valuation Office Agency, with indexation applied at interim periods. We are satisfied that the valuation basis remains appropriate and that revaluations were applied accurately.
- provisions for liabilities, including a provision for dilapidations at John Sinclair House of £0.48 million. We reviewed the basis of the provision and concluded that the estimate is appropriate.
- a stock obsolescence provision of £0.53 million. We reviewed the basis of this estimate and concluded that the value provided is appropriate.

We did not identify indications of management bias.

Financial statement disclosures were considered against requirements of the Charities SORP (FRS 102) and FReM. No departures from these requirements were identified.

Future accounting and audit developments

There are no changes to the Charities SORP (FRS 102) for 2016-17, and no significant changes to the FReM.

ISA (UK & Ireland) 700 and 720 have been revised for accounting periods beginning on or after 17 June 2016. These revise the requirements for the structure and content of the independent auditor's report. Audit Scotland is considering whether to early adopt the standards for 2016-17.

The 2016-17 audit of HES financial statements will be carried out by Deloitte. In concluding our 2015-16 audit work, we will liaise with the incoming auditor.

Wider scope

Introduction

The Code frames the wider scope of our audit in terms of four audit dimensions; financial management, financial sustainability, governance and transparency and value for money. At the centre of these dimensions is Best Value.

It remains the responsibility of the audited body to ensure that they have proper arrangements in place across each of these audit dimensions. These arrangements should be appropriate to the nature of the audited body and the services and functions that it has been created to deliver. We review and come to a conclusion on these proper arrangements.

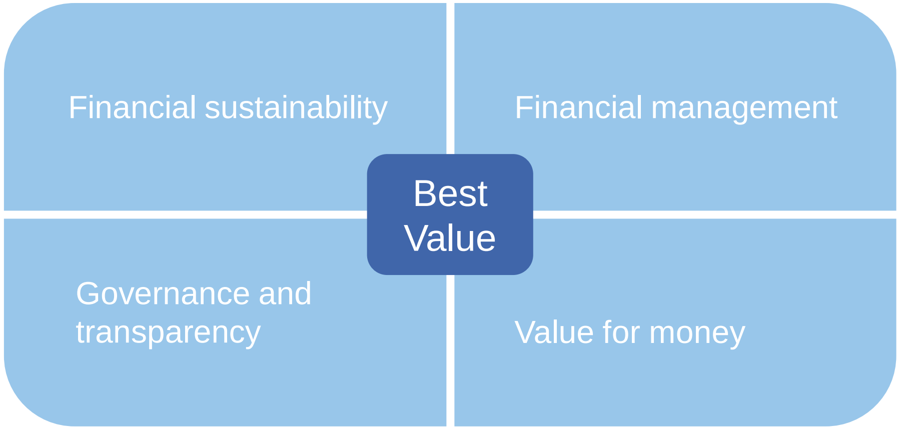
During our work on the audit dimensions we have considered the work carried out by internal audit and other scrutiny bodies to ensure our work meets the proportionate and integrated principles contained within the Code.

Audit work and conclusions

We summarise over the next few pages the work we have undertaken in the year to obtain assurances over the arrangements in place for each audit dimension and our conclusions on the effectiveness and appropriateness of these arrangements.

The next page sets out those risks we identified during our audit planning stage, any emerging risks during the course of audit work and our overall conclusion on each audit dimension.

Where we have found arrangements to not be effective or are absent we have provided further narrative on the following pages and recommendations for improvement. Where we have found the arrangements to be generally effective and operating as expected we have identified this in the conclusions we have formed.



Wider scope

Audit dimensions risk map and conclusions

Financial sustainability (Page 24)

Management continues to monitor financial sustainability risks; funding uncertainty remains the key risk to financial sustainability for HES.

This is partially mitigated by increasing commercial income generated from properties in care and other trading income, which continues to show strong performance year on year. Operation of the properties is dependent on grant funded activities and there remains a risk to financial sustainability from forward funding commitments from the Scottish Government being limited to a year.

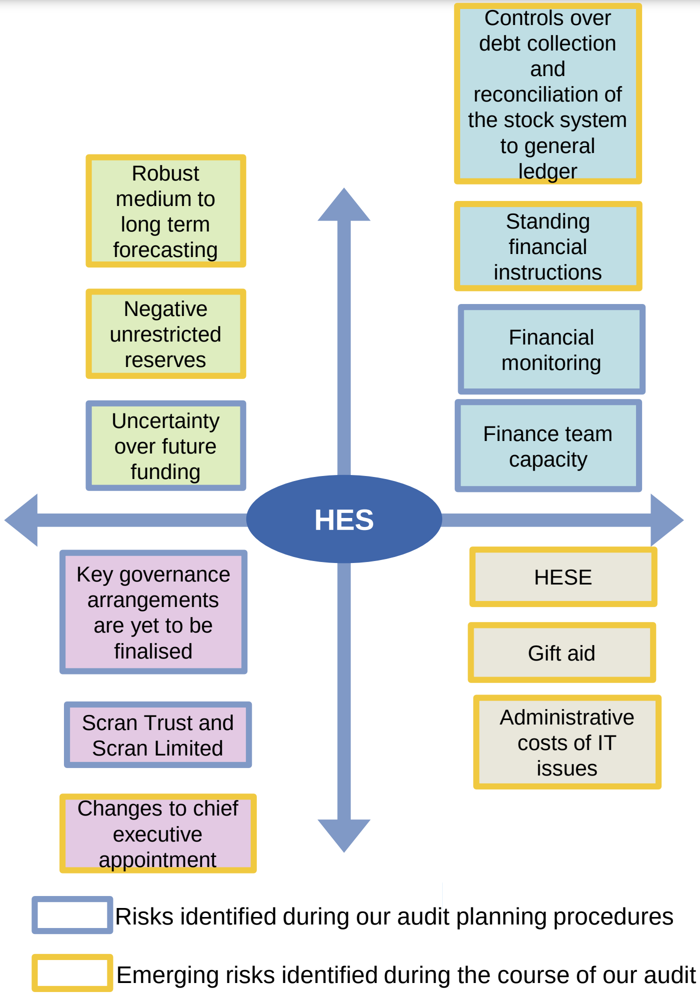
HES shows significant negative unrestricted reserves at year end, due to changes in accounting for investment grants under the Charities SORP (FRS 102).

Governance and transparency (Page 28)

The governance arrangements of HES developed from those in place at HS. A joint Board and audit and risk committee ensured continuity in governance over the transition period, with effective scrutiny, challenge and transparency on decision making.

A permanent chief executive of HES was appointed on 6 September, following changes to the Accountable Officer through the period.

Governance arrangements at related entities were also subject to change in the period. RCHAMS and Scran Trust dissolved following transfer of their operations into HES from 1 October 2015 and 22 February respectively. Scran Limited continued to be managed by its Board following acquisition by HES. HESE had not commenced operations by 31 March 2016 but was managed under HES governance arrangements.



Financial management (Page 25)

In our interim management report, we noted that the finance team capacity is stretched and raised a recommendation for this to be reviewed. We also raised a recommendation in respect of reporting against budget, reconciling Scottish Government and statutory reporting more clearly.

We reiterate these recommendations and note findings from our year end audit work over standing financial instructions and operational controls relating to stock reconciliations and debt collection processes.

Given the significant accounting challenges for the year, we consider that the finance team has coped well. The core operations continue to be robustly managed.

Value for money (Page 30)

Value for money is considered in the delivery of services by HES.

We did not identify any significant risks associated with achieving value for money, however note a number of areas where value for money could be achieved. These include: implementing arrangements for the collection of gift aid at historic sites as soon as possible; ensuring the full operation of HESE as intended through 2016-17 and proactively addressing IT and administrative issues to reduce avoidable costs going forward.

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

In considering the financial sustainability of HES we performed the following work:

- *Reviewing the financial position of HES as at 31 March 2016.* We provide commentary on the financial position on page 6. Changes to the recognition of investment grant liabilities from the application of the Charities SORP (FRS 102) resulted in a significant deterioration of HES's net asset position as reported. Closing funds were reduced to £5 million, comprising revaluation reserves of £17.5 million revaluation reserves and £0.9 million restricted reserves, offset by £13.5 million negative unrestricted reserves. Although these are significant negative unrestricted reserves, they arise due to the accounting treatment of investment grants.
- Management considers that HES will remain a going concern for a year following signing of the financial statements. We concur with management's assessment of going concern for HES given that core grant in aid supplemented by self-generated income is sufficient to ensure HES is able to meet its debts as they fall due.
- *Reviewing financial budgets and forecasting, financial strategies and key risks over financial sustainability.* Funding from the Scottish Government is only confirmed annually. No forward funding commitments are provided to HES which would support the consideration of financial sustainability over a longer period. An annual operating budget is prepared by HES in February for the financial year ahead. Management intends to carry out longer term financial forecasting following the next government spending review.
- *Reviewing self-generated income streams*. Commercial and trading income remains strong and approximately half of expenditure requirements are funded by self-generated income. Our review of commercial income generation in 2016-17 confirms that self-generated income continues to grow. This provides assurance over the financial sustainability of HES, as reduced reliance on government grant in aid provides security over a longer period than the annual funding amounts of grant in aid, however as these are dependent on grant funded activities to operate, there remains some risk to financial sustainability.

Conclusion: Government grant in aid funding uncertainty remains the key risk to financial sustainability for HES. This is partially mitigated by increasing commercial income generated from properties in care and other trading income, which continue to show strong performance year on year. As the properties are dependent on grant funded activities to operate, there remains a risk to financial sustainability in the longer term. Whilst it is recognised that longer term financial planning is difficult when only one year funding commitments are provided, HES would benefit from a more strategic approach to its finances, including scenario planning. This would support management in demonstrating HES's financial sustainability and understanding the profile of investment spend and when such liabilities fall due.

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

We carried out audit tests to determine the effectiveness of the financial management arrangements. This included:

- *Assessing the budget setting and monitoring processes within HES.* The 2016-17 budget for HES was approved in February and based on the confirmed annual government grant-in-aid allocation. In monitoring against budget, we note increasing divergence between statutory reporting and reporting requirements to Scottish Government. We reported within our interim management report a recommendation that management should provide a reconciliation to a forecast statutory position alongside quarterly management accounts presented to the Board. We reiterate this recommendation within the action plan at appendix three.
- *Consideration of the finance function and financial capacity within HES.* Our audit testing found that the financial processes involved in daily transaction processing are effective, however overall finance team capacity is under strain and therefore financial reporting and financial statement preparation has been challenging. We raised a recommendation in our interim management report relating to finance team capacity, which we repeat within the action plan at appendix three.
- *System generated reports.* We reported issues relating to system generated reports within our interim management report, including a discrepancy on the reported trial balance. This was resolved by management prior to final audit fieldwork and financial reports provided during the audit were satisfactory. We note from discussions with management that improvements are planned to system generated reports through additional reports being designed to facilitate easier monitoring and review.
- *Review of standing financial instructions.* Financial processes in HES follow the requirements of the Scottish Public Finance Manual ('SPFM') and limits of delegation agreed with the Scottish Government. HES does not have its own tailored financial regulations. Although the requirements of the SPFM are appropriate to follow, there is a risk that these may be interpreted to HES operations in different ways across the organisation. In addition, the requirements of the Charities and Trustee Investment (Scotland) Act 2005 must be followed, which require specific consideration. We have raised a recommendation in our action plan at appendix three for a tailored set of financial instructions to be developed and communicated.
- *IT transformation.* Our audit approach did not rely on IT controls therefore we did not carry out a general IT controls audit, but considered IT during the course of our substantive testing and made inquiries of management to identify any associated audit risks. We noted challenges associated with the transfer of data onto the new server at Scottish Government and note that previous RCAHMS operations still do not have access to the server so continue to operate paper-based processing prior to entry onto the HES ledger. The overall value of RCAHMS income and expenditure is small to HES as a whole, therefore we do not identify a specific audit risk associated with this.
- *Review of payroll arrangements.* We considered payroll arrangements within our audit testing of staff costs. Staff costs are a significant proportion of total expenditure, therefore it is important that these are managed appropriately. Budget monitoring includes specific consideration of staff costs. The payroll function is outsourced to Northgate. The transition to HES resulted in small discrepancies relating to employment tax paid to HMRC over the transition date. We discussed these with human resources and confirmed that they are actively addressed by Northgate with HMRC. These are low value (less than £10,000 underpayment in total) and no penalties are expected therefore we did not identify an associated audit risk.

We are required to provide specific conclusions on the following areas which relate to financial management and support our overall conclusion on this audit dimension.

Internal controls

Management is responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the financial statements. Details of controls tested were reported to those charged with governance in our interim management report.

We raised two 'grade one' (significant) recommendations in respect of system generated reports and organisational structure and finance team capacity. Two 'grade two' (material) recommendations were also raised in relation to monitoring of financial performance and consolidation of Scran. Our follow up to these recommendations is detailed at appendix three. All recommendations are in progress.

From our substantive audit testing at year end, we raised four further 'grade two' (material) recommendations included in appendix three relating to collection of debtors, reconciliation between the stock system and the general ledger, audit preparedness and the development of tailored standing financial instructions.

We noted during our year end audit work that risk management procedures are in development. Previous risk registers from HS and RCAHMS have been used as a baseline to develop HES specific risk registers. The work being undertaken by management, Trustees and the Audit and Risk Committee demonstrates a commitment to best practice.

A summary of the completion of prior year audit recommendations is provided at appendix four. One 'grade one' (significant) recommendation was raised in 2014-15; this has been implemented by management.

Conclusion: Internal controls we tested over risk management, financial, operational and compliance systems and procedures are designed, implemented and operating effectively, subject to the recommendations raised above.

Standards of conduct and the prevention and detection of corruption

Testing over the processes to prevent and detect corruption included:

- *Review of policies (codes of conduct for staff and trustees, the whistleblowing policy and registers of interests).* HES policies were updated from those applied in HS. We confirmed that these were appropriately developed and reviewed. Our review did not identify any significant omissions or errors in these policies.
- *Consideration of the accessibility of policies to staff and trustees.* The policies and processes tested are readily available to staff via the staff intranet.
- *Testing of completeness of registers of interests of senior staff and trustees.* No errors were identified in this testing. Inspection of the declarations of interest from senior staff and board members showed that these were completed and followed up appropriately, to ensure inclusion in the financial statements where appropriate.
- *Review of reporting arrangements for conflicts of interests and whether these had been followed.* Conflicts of interest are a standing agenda item for committees to ensure appropriate reporting.

Conclusion: HES has appropriate arrangements to prevent and detect inappropriate conduct and corruption. Policies continue to be updated within HES, with the key policies relating to the prevention and detection of corruption complete and available to all staff.

Arrangements for the prevention and detection of fraud and error

Testing over the processes to prevent and detect fraud and error included:

- *Review of policies against best practice guidance and examples.* HES's policies were found to be in line with relevant guidance. There is a fraud policy which details how the organisation will deal with fraud and the steps which should be taken. Details on reporting of fraud and whistle blowing are included within the scheme of internal delegation and purchasing delegations.
- *Consideration of the accessibility of policies to staff and trustees.* The policies and processes tested are readily available to staff through the staff intranet.
- *Consideration of controls which reduce the risk of fraud and error.* All expenditure is required to be reviewed and authorised in line with financial regulations. Management reporting is carried out monthly. Bank and control account reconciliations are performed and reviewed monthly, which should identify any variances.

Conclusion: HES has appropriate arrangements in place to prevent and detect fraud.

National Fraud Initiative

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.

We submitted a return to Audit Scotland summarising our conclusions on HES's participation in NFI. The questionnaire covered reporting of NFI progress and outcomes, recording of results of investigations in the NFI system, action taken for alleged fraud cases and the overall engagement of HES with NFI.

Conclusion: The return concluded that HES discussed and reported relevant feedback and responded effectively and efficiently to outcomes, utilising resources appropriately to respond to the outcomes. No alleged or actual fraud was identified through NFI.

Wider scope

Governance and transparency

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.

In considering governance and transparency we performed the following work:

- *Reviewing the organisational structure, reporting lines and level of scrutiny within HES*. HES demonstrates effective scrutiny, challenge and transparency on decision making through various levels of committee reporting reviewed. Decisions are transparent as actions are documented within detailed board minutes which are available to key stakeholders.
- *Reviewing financial and performance reporting within the organisational structure.* Reporting is prepared regularly, reported appropriately and is of good quality, with narrative supporting key movements and variances to budget, subject to our recommendation at appendix three relating to improving reconciliation to the statutory position. As a charitable NDPB, the divergence from reporting to Scottish Government under cash accounting increases, and we raised a recommendation in our interim management report in respect of reconciling in-year reporting to statutory reporting, which we reiterate at appendix three. Commercial and tourism income is reported monthly, providing detailed analysis of admissions, retail and other trading income from properties in care. Key performance indicators are reported on a regular basis.
- *Reading the annual governance statement;* as discussed on page 18.
- *Consideration of key risks over governance and transparency in relation to Scran Limited, HES's wholly owned subsidiary;* as discussed on page 15.
- *Reviewing internal audit review of corporate governance arrangements*. Internal audit conducted a review into the corporate governance arrangements within HES and concluded with reasonable assurance. We did not identify any additional audit risks from the work reported.
- *Reviewing the changes in senior personnel with HES.* We reviewed changes to senior personnel within HES. This included the changes in the Accountable Officer role between Paul Smart (to November 2015); David Middleton (5 November 2015 to 31 March 2016); David Mitchell (1 April 2016 to 11 September 2016) and Alex Patterson (6 September 2016 onwards). We recognised a potential risk associated with the number of changes to the Accountable Officer role, however we are satisfied that the role has been filled throughout the period of account and to date.
- *Reviewing transition governance arrangements.* The governance arrangements of HES developed from those in place at HS. A joint Board and audit and risk committee ensured continuity in governance over the transition period, with effective scrutiny, challenge and transparency on decision making.
- *Reviewing governance arrangements over related entities.* Governance arrangements at related entities were also subject to change in the period. RCHAMS and Scran Trust dissolved following transfer of their operations into HES from 1 October 2015 and 22 February respectively. Scran Limited continued to be managed by its Board following acquisition by HES on transfer of Scran Trust assets. HESE had not commence operations by 31 March 2016 but was managed under HES governance arrangements.

Conclusion: HES underwent a significant period of change during the financial year. Financial monitoring and scrutiny were found to be effective, subject to our recommendations raised as detailed at appendix three. Internal audit reviewed corporate governance arrangements and concluded with reasonable assurance. Governance arrangements for HES, including Scran Limited and HESE are in their infancy.

We are required to provide specific conclusions on the following areas which relate to governance and transparency and support our overall conclusion on this audit dimension.

Internal audit

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. We also considered the requirements of International Standard on Auditing 610 *(Considering the Work of Internal Audit)*.

We reviewed internal audit reports and conclusions.

Conclusion: We can apply internal audit’s work to inform our procedures, where relevant, however did not identify any areas where this was relevant during our audit. The review of internal audit reports and conclusions did not indicate additional risks and there is no impact on our planned substantive testing.

Corporate governance

We updated our understanding of the governance framework and documented this through our overall assessment of HES’s risk and control environment. This included testing entity wide controls, including risk management, operational and compliance controls, as reported in the interim management report.

In our interim management report, we raised a recommendation relating to organisational structure.

Conclusion: We reiterate recommendations raised in our interim management report relating to organisational structure and the capacity of the finance team. As corporate governance arrangements in HES are in their infancy, we cannot conclude on the effectiveness of the corporate governance framework at this time.

Value for money is concerned with using resources effectively and continually improving services.

We considered value for money and Best Value throughout our testing. Accountable officers have a specific responsibility to ensure that arrangements have been made to secure Best Value. Some of the areas where we had a specific focus on value for money and Best Value are:

- *Performing controls testing over expenditure authorisation.* No exceptions were found through our testing of purchase authorisations or grant approval processes.
- *Review of costs incurred in transition.* We reviewed costs of transition and confirmed that these are separately identified within management accounts, comparing actual to budgeted costs, presented to the Board. Total budgeted transition costs for the full year split across HS, RCAHMS and HES totalled £2.9 million, against which £2.9 million is reported as spent. (As transition cost are not separately identifiable within HES statutory financial statements, this figure was not audited separately).
- *Review of self-generated income.* We reviewed self-generated income through the period and after the period end. Commercial and tourism figures reported internally continue to show performance in excess of budget. Increased income generation from existing assets demonstrates good value for money.
- *Consideration of capital projects.* Our substantive testing of capital projects found that these were monitored and managed appropriately. Delays in the construction of one project (the Engine Shed) resulted in reduced funding being received from the European Regional Development Fund ('ERDF'). Our discussions with management confirmed that this was due to unavoidable construction delays and tight timescales in the funding offer. We do not identify any specific value for money risks associated with this lost funding.
- *Review of tax and gift aid arrangements.* Gift aid arrangements were discussed with management and it was noted that collection of gift aid from visitors to historic sites is not yet set up. This represents lost income to HES and is considered a risk to achieving value for money. The subsidiary intended to hold trading income and expenditure, HESE, was not operational during 2015-16. Although management is comfortable that trading activities within HES made a loss in 2015-16 therefore are not liable to corporation tax, we have not yet received these calculations for review and therefore recognise a risk that tax liabilities may arise through not having a tax efficient organisational structure established.
- *Consideration of costs associated with IT and administrative issues.* The operational IT issues noted in both our interim management report and financial reporting challenges detailed in this report (page 9) are expected to cause additional administrative costs including staff and specialist's time. These include: limitations in system reporting; and manual processing required for RCAHMS operations. We recognise an associated risk to achieving value for money, where these costs may be reduced through increasing capacity to deal with issues prior to these crystallising.
- *Review of severance schemes.* We substantively tested redundancy and other departure costs incurred during 2015-16 and did not identify any exceptions in the approval or accounting for them. All costs of these departures were paid in accordance with the Civil Service Compensation Scheme.

Conclusion: We did not identify any significant risks associated with achieving value for money, however note a number of areas where improved value for money may be achieved. These include: implementing arrangements for the collection of gift aid at historic sites as soon as possible; ensuring the full operation of HESE as intended through 2016-17; and proactively addressing IT and administrative issues to reduce avoidable costs going forward.

Wider scope
Local follow up work

In November 2013 the Accounts Commission and Auditor General for Scotland published a report on Scotland's public sector workforce. The report highlighted a number of key messages on workforce changes across Scotland in the public sector and made a number of recommendations to the Scottish Government a number of recommendations to the Scottish Government, central government bodies, the NHS, COSLA and local authorities.

We have performed follow up work on this report, and submitted a return to Audit Scotland summarising our findings and conclusions. This work covered the following key issues:

- Planning
- Service delivery
- Partnership working
- Challenge and scrutiny
- Reporting

The conclusions submitted to Audit Scotland are summarised below.

Planning

The corporate plan sets out the strategic requirements and this is supported by the annual business plan and directorate plans. These include high level workforce considerations, but there is no separate workforce plan. HES is a newly formed body and the corporate plan includes the intention of undertaking workforce planning and developing effective career and talent management programmes.

Whilst HES does not have a current workforce plan, we do not consider this unreasonable for an organisation created on 1 October 2015. There is a clear commitment in the corporate plan to develop such plans and progress against the corporate plan will need to be closely monitored to ensure appropriate workforce planning is embedded in the organisation.

Service delivery

During the period of merger HES had objectives around recruitment or refilling of posts for efficiencies, based around robust testing of whether the post needs refilled or retained at the same grade with applications then assessed by a staffing committee prior to any resource decisions. As noted above a more proactive and longer term business focus on this work is being developed.

In line with procedures and guidelines and approved by SG and the Cabinet office, HES runs voluntary exit schemes ('VES'). Business cases look at budget and commitments against planned efficiencies. HES run trackers for VES or workforce changes through management information reporting, tracking by human resources and finance reports.

Scenario planning is not used at present due to the merger process, but is in development as part of the work being undertaken by human resources and finance.

Partnership working

In the past, HS was a part of a number of networks, but the focus for the last two years has been around the merger delivery and establishment of the new NDPB. Going forward, the HES corporate plan includes a commitment to partnership working, including actively participating in Community Planning Partnerships.

Challenge and scrutiny

Quarterly reports are provided to the senior management team around workforce management information and data. Human resources also work with the senior management team for approval of the budget and resource plans for the coming year.

Reporting

HES has target efficiencies set by government. For exit schemes, trackers are run to report on the savings. HES runs wellbeing initiatives on a rolling basis, track and monitor absences and reasons for trends and partake in Civil Service surveys that report questions on wellbeing. There is a well-being steering group with representatives across the organisation for a planned and joint approach to initiatives.

Appendices

Adjusted and unadjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all corrected and uncorrected misstatements, other than those which are trivial, to you. There were five audit adjustment required to the draft annual accounts which impacted on the net assets and income and expenditure for the year. There are two unadjusted audit differences.

A number of numerical and presentational adjustments were required to some of the financial statement notes.

Corrected audit differences		BALANCE SHEET		INCOME AND EXPENDITURE	
NATURE OF ADJUSTMENT	CAPTION	£000 DR	£000 CR	£000 DR	£000 CR
Review of investment grant commitments against the requirements of FRS 102 identified balances reported as commitments which meet the criteria for recognition as liabilities within the financial statements. This resulted in a transition adjustment to reserves in HES at 1 October 2016, closing balances at 31 March 2016 and corresponding adjustment to the SOFA in the period.	Investment grant expenditure	-	-	-	(10,152)
	Creditors under one year	-	(11,436)	-	-
	Creditors over one year	-	(10,982)	-	-
	Opening reserves	32,570	-	-	-
Scottish Government grant funding was recognised in HES net of the year end cash balance, which was held as a creditor. The adjustment removed this creditor and recognises the full amount of Scottish Government grant funding over the 12 month period from 1 April 2015 to 31 March 2016, when taken together with that recognised in HS and RCAHMS. The opening creditor brought forward in respect of cash is also removed as a transition adjustment to opening reserves.	Creditors under one year	5,721	-	-	-
	Government grant in aid	-	-	-	(4,728)
	Opening reserves	-	(993)	-	-
Capital additions reported in HES included additions from the period 1 April 2015 to 30 September 2016, incorrectly. These were originally posted to revenue expenditure in Historic Scotland six month balances to 30 September 2015, as capital additions to work in progress are only typically moved from revenue to capital expenditure as part of year end journals.	Opening reserves	1,292	-	-	-
	Work in progress	-	(1,292)	-	-

Appendix one

Audit differences (continued)

Corrected audit differences (continued)		BALANCE SHEET		INCOME AND EXPENDITURE	
NATURE OF ADJUSTMENT	CAPTION	£000 DR	£000 CR	£000 DR	£000 CR
Our review of grant documentation relating to the Engine Shed funding concluded that funds from HLF included ongoing restrictions to the use of the Engine Shed asset. The adjustment will ensure the balance of the asset funded by HLF funds is held as a restricted asset.	Unrestricted funds Restricted funds	977 -	- (977)	- -	- -
A stock obsolescence provision was disclosed within provisions, rather than being disclosed net of stock.	Provisions Stock	526 -	- (526)	- -	- -

Uncorrected audit differences		BALANCE SHEET		INCOME AND EXPENDITURE	
NATURE OF ADJUSTMENT	CAPTION	£000 DR	£000 CR	£000 DR	£000 CR
A retrospective adjustment was made to HS six month income to 30 September 2015, to reflect income earned in the period not recorded. This should also be reflected as an adjustment to the Scottish Government grant income earned in this period, reflected in HES in opening reserves, and a corresponding adjustment to the grant income earned in the six month period to 31 March 2016.	Opening reserves Government grant in aid	123 -	- -	- -	- (123)
Restricted expenditure reported against a specific restricted fund (Scotland's Urban Past) incorrectly omitted some restricted expenditure. The closing fund balance is unchanged as the deficit on the fund is met by a transfer from unrestricted reserves to bring back to £nil at year end.	Charitable income - restricted Charitable income - unrestricted	- -	- -	70 -	- (70)

To the audit and risk committee members

Assessment of our objectivity and independence as auditor of Historic Environment Scotland (the Charity)

Professional ethical standards require us to provide to you at the conclusion of the 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 and addresses:

- General procedures to safeguard independence and objectivity;
- Independence and objectivity considerations relating to the provision of non-audit services; and
- Independence and objectivity considerations relating to other matters.

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 partners, 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
- Communications
- Internal accountability
- Risk management
- Independent reviews.

We are satisfied that our general procedures support our independence and objectivity.

Independence and objectivity considerations relating to the provision of non-audit services

Summary of fees

We have considered the fees charged by us to the charity and its affiliates for professional services provided by us during the reporting period.

We have detailed the fees charged by us to the charity and its related entities for significant professional services provided by us during the reporting period in the attached appendix, as well as the amounts of any future services which have been contracted or where a written proposal has been submitted. Total fees charged by us for the period ended 31 March 2016 are as follows:

	Current year (£000)
Audit of HES and RCAHMS opening balances	96
Audit of Scran Limited	9
Total audit	105
Total non-audit services	-
Total fees	**105**

Fees presented exclude VAT.

The ratio of non-audit fees to audit fees for the year was 0: 1.

Confirmation of audit independence

We confirm that as of the date of this letter, 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 and risk committee of the charity and should not be used for any other purposes.

We would be very happy to discuss the matters identified above (or any other matters relating to our objectivity and independence) should you wish to do so.

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 audit dimensions:

- financial sustainability;
- financial management;
- governance and transparency; and
- value for money.

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 Audit preparedness *Risk dimension: financial management*		**Grade two**
The audit of the financial statements to 31 March 2016 was impacted by several factors including: operational impacts of the transition to HES and incorporation of Scran Trust and Scran Limited; senior personnel changes and limited finance team capacity; issues with system reporting; discussions with Scottish Government relating to key accounting areas including grant in aid and fixed assets and the new requirements of accounting under the Charities SORP (FRS 102). Together with changes in the finance team, this resulted in significant delays in the preparation and subsequent audit of the financial statements for 2015-16.	A timeline for the preparation and review of 2016-17 financial statements should be agreed and resource requirements identified and addressed. Responsibilities for the preparation of discrete areas of the financial statements could be delegated within the finance team, enabling the preparer of the financial statements a greater role in reviewing and challenging these prior to the audit. Audit workpaper expectations should be communicated to the finance team to ensure that clear audit trails are maintained between the general ledger, summary schedules, and financial statements.	Agreed. A timetable for the 2017-18 will be prepared following the planning meeting with the external auditor. In setting this timetable the complexities of the organisation and staff availability will be considered and appropriate time allocated. The timetable will include staff responsibilities and staff will be trained to ensure that lead schedules will be SORP compliant. **Responsible officer:** Financial Operations Manager **Implementation date:** 16 December 2016 for timetable, following planning meeting with the external auditor.
2 Collection of debtors *Risk dimension: financial management, value for money*		**Grade two**
Our audit fieldwork identified a debtor balance of approximately £0.4 million remained uncollected at 31 March 2016 and at the date of audit in August 2016. We brought this to the attention of management. On review, it was noted by management that this debt had not undergone appropriate debt collection processes, attributed to unavoidable staff absence and unclear responsibilities within the finance team. There is a risk of lost income to HES where debts are not appropriately chased for collection.	We recommend that management implements and communicates a clear debt collection procedure, with clearly designated responsibilities.	Agreed. The debt collection procedure will be reviewed and updated as required. The Income Team Manager is monitoring the outstanding debts position closely, especially for large customers with multiple accounts. **Responsible officer:** Income Team Manager **Implementation date:** Procedure to be reviewed and agreed by 31 January 2017. Monitoring and controlling of large customers with multiple accounts is now in place.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
3 Reconciliation between stock system and general ledger *Risk dimension: financial management*		**Grade two**
Our audit fieldwork over the stock balance transferred into HES identified significant discrepancies between the stock system and the general ledger. Management was aware of these and previously presented papers to the Board to detail the proposed actions to correct balances within the general ledger, resulting in a write back of approximately £0.6 million of incorrectly recorded stock sales, having accrued over several years. Although we are satisfied that this corrects the overall total on the general ledger to the stock system, which is supported by stock count records, there remains a risk that the two systems do not reconcile on an individual site basis.	We recommend that a formal stock reconciliation procedure be implemented, where the stock system is compared to the general ledger stock codes on a monthly basis and discrepancies investigated and cleared. Documentation should be retained, showing evidence of preparation and review.	Agreed. Regular stock counts are carried out at sites. The general ledger and stock system are reconciled on a monthly basis, slippage is recorded and monitored. Any unexpected discrepancies arising from the reconciliations will be investigated. **Responsible officer:** Commercial Accountant and Merchandising Manager **Implementation date:** Implemented.
4 Development of standing financial regulations *Risk dimension: financial management*		**Grade two**
Financial processes in HES follow the requirements of the Scottish Public Finance Manual ('SPFM') and limits of delegation agreed with the Scottish Government. There is no interpretation of these for HES in the form of tailored financial regulations. Although the requirements of the SPFM are appropriate to follow, there is a risk that these may be interpreted to HES operations in different ways across the organisation. In addition, the requirements of the Charities and Trustee Investment (Scotland) Act 2005 must be followed, which require specific consideration.	We recommend that a tailored set of financial regulations be developed and communicated to all staff and made available via the intranet. This should reflect the requirements of both the SPFM and the Charities and Investment (Scotland) Act 2005.	Agreed. Staff are aware of the requirements of the SPFM and give assurance that this is followed, however a HES tailored financial regulations would be of benefit and is a priority within the organisation. **Responsible officer:** Head of Finance **Implementation date:** April 2017

Below, we present recommendations raised in our interim management report and audit status summary:

Finding(s), risk(s) and recommendation(s)	Update
1 System generated reports (Grade one); *Risk dimension: financial management*	
The new Integra system reporting functionality is in development and the trial balance reports generated were out of balance by a small amount (£89). There was a risk that information could not be accurately extracted and reviewed. We recommended that: ▪ the development and testing of reports from Integra be progressed as a high priority; ▪ the variance on the trial balance should be investigated and resolved; and ▪ new reports should be thoroughly tested before use in financial reporting to confirm their completeness and accuracy.	The trial balance variance was investigated and resolved in advance of our final audit fieldwork. The development and testing of reports from Integra is in progress. We reiterate the importance of developing and testing these reports.
2 Organisational structure and finance team capacity (Grade one); *Risk dimension: financial management, governance and transparency*	
An organisational structure was not finalised for HES at the time of our interim management report. The core finance team capacity appeared stretched in dealing with both day to day transactional reporting as well as the additional requirements from system changes, new reporting frameworks and organisational change. There was a risk that financial reporting and performance management may be of lower quality, errors made, or deadlines missed due to the pressure on staff time. We recommended that: ▪ the organisational structure for HES should be determined and formalised as soon as possible; and ▪ the capacity of the finance team be reviewed in order to ensure a strong control environment for transactional reporting, performance monitoring and statutory reporting, particularly in light of the need to recruit a permanent finance director.	The organisational structure is being established. An interim finance director was appointed, however the capacity of the finance team remains stretched and we reiterate the recommendation to review and address this, to ensure a strong control environment.

Below, we present recommendations raised in our interim management report and audit status summary:

Finding(s), risk(s) and recommendation(s)	Update
3 Consolidation of Scran (Grade two); *Risk dimension: financial management*	
The agreement to transfer the Scran Trust assets and liabilities to HES was effective from 22 February 2016. There was a risk that without a clear plan for transition, HES may expose itself to operational risk. Where financial reporting requirements are not fully considered early, this may also lead to delays in the financial reporting timetable. Lack of clarity of the regulatory requirements, for example what the requirements are for Scran Trust to report to the Scottish Charity Regulator ("OSCR"), could risk potential breaches of regulatory requirements. We recommended that: ▪ management develops a plan for the transition of Scran operationally and in respect of the required financial accounting treatment; ▪ consideration should be given to how Scran activities will be reported in HES; and ▪ management should review the regulatory requirements of the transition and ensure they are appropriately addressed.	We reiterate our recommendation to fully review the transition of Scran operations into HES and ensure that reporting and regulatory requirements are being met.
4 Monitoring of financial performance (Grade two); *Risk dimension: financial management*	
The reporting requirements of Scottish Government grant income under FRS 102, the Charities SORP (FRS 102) and the FReM show increasing variance. There was a risk of a lack of clarity at board or audit and risk committee level of what the performance reported in HES for the six months of activity to 31 March 2016 would look like, and any impact on the statutory position of ongoing discussions on income recognition. We recommended that: ▪ further detail on the statutory position at the six month period to 30 September 2015 and 31 March 2016 is provided to board and audit and risk committee members, including the impact of ongoing income recognition discussions; and ▪ the management accounts are updated to reflect the actual split between grant in aid and commercial income across the two periods.	Management accounts were updated to reflect the actual split between grant in aid and commercial income across the two six month periods of 2015-16. We reiterate our recommendation to review the in-year reporting of performance and include a reconciliation to the expected year end statutory position.

We follow up prior year audit recommendations to determine whether these have been addressed by management. The table below summarised the recommendations made during the 2014-15 audit and their current status.

Grade	Number recommendations raised	Implemented	In progress	Overdue
One	1	1	-	-
Two	-	-	-	-
Three	-	-	-	-

We have provided a summary of progress against overdue actions below, and their current progress.

Finding and risk	Recommendation	Agreed management actions	Status
Creation of a Historic Environment Scotland Audit and Risk Committee 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. 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.	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. 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.	Agreed. A paper was sent to the HES board for consideration on 30July 2015. It was foreseen that the ARC would be set up in August. **Responsible officer(s):** Historic Environment Scotland Board **Implementation date:** August 2015	Implemented. Audit and Risk Committee meets quarterly and continues to operate within the Historic Environment Scotland Governance Structure.

Appendix five

Accounting areas – Scottish Government Grant income

Introduction

For the financial year from 1 April 2015 to 31 March 2016, HS, RCAHMS and HES were together allocated total Scottish Government grant income (excluding non-cash allowances) of £43.5 million, revised to £43.0 million following the Spring Budget Revision process.

Accounting treatment

For monitoring purposes throughout the year, information of income is managed and monitored under Scottish Government accounting principles. For the financial statements however, government grants must be accounted for under the performance model of FRS 102, in line with the Charities SORP (FRS 102).

As at 30 September 2015

As at 30 September 2015, Scottish Government grant income in HS and RCAHMS was initially recognised in the ledger in line with cash received. It was confirmed with Scottish Government that the grant should be recognised in line with expenditure at 30 September, reflecting the carry-forward of unused grant into HES. Adjustments to Scottish Government grant reported to 30 September 2015 in HS and RCAHMS were reported in our interim management report.

As at 31 March 2016

As at 31 March 2016, Scottish Government grant income was initially recognised for the remaining balance of the full year allocation to HS, HES and RCAHMS, less a creditor equal to the cash held by HES at year end. This was the treatment in HS to reflect the status as an agency, however as a charitable NDPB this treatment is not appropriate and the grant should only be deferred as a creditor where there is uncertainty as to whether it can meet the requirements of entitlement to the grant.

Unspent balances drawn down do not need to be returned to the Scottish Government at the year end, therefore we agreed an audit adjustment to record the full remaining amount of grant in HES in the period to 31 March 2016 (appendix one).

Full year

Following the audit adjustment, the total reported across HS, RCAHMS and HES for the full year equals the grant awarded by the government (table right), with a minor variance due to travel subsidies confirmed after the original budget allocation letter (£52,000).

	2015-16 Budget on HMT database	Budget available to HES
	£000s	£000s
Resource DEL	41,123	41,123
Ring-fenced (or "non cash") DEL	3,541	3,541
Capital DEL	2,410	2,410
Non-cash DEL cover	**300**	**300**
SG In-year Reprioritisation	n/a	-500
Total DEL	**47,374**	**46,874**
Expenditure classed as AME	0	0
Total budget	**47,374**	**46,874**

Recognised under statutory reporting: £43,033

Source: HES - Finance - Budget Allocation Letter - 2015-16 - Revised after SBR#3

	HS 6 month period to 30 Sep 2015 (£000)	RCAHMS 6 month period to 30 Sep 2015 (£000)	HES 6 month period to 31 Mar 2016 (£000)	Full year from 1 Apr 2015 to 31 Mar 2016 (£000)
Total income excluding SG grant	29,240	877	17,612	**47,729**
Total costs	(34,072)	(3,123)	*(38,675)	***(75,870)**
Net expenditure	(4,832)	(2,246)	*(21,063)	***(28,141)**
SG grant recognised	4,955	2,111	*36,019	***43,085**
Outturn	123	-135	*14,956	***14,944**

Source: HS 6 month balances; RCAHMS signed financial statements; HES draft financial statements

* Following audit adjustments as detailed at (appendix one) relating to grant in aid and investments expenditure

Appendix five
Accounting areas – Engine Shed funding

Introduction

A capital development project to create a research and learning hub for building conservation is being undertaken by HES involving the conversion of a former military depot in Stirling, the Engine Shed. The project is jointly funded by the Heritage Lottery Fund ('HLF'), Scottish Government and European Regional Development Fund ('ERDF'). Delays in construction mean completion is due to be spring 2017 rather than 2016 as originally planned.

Accounting treatment – performance conditions

Each of the funding grants is derived from a government source, therefore are considered government grants under the Charities SORP (FRS 102). These must be accounted for under the performance model described in FRS 102. Where there is evidence that grant would either not be paid, or would be reclaimed, in the event of non-delivery of construction, then this constitutes performance conditions which limit recognition of the grant until met. Recognition in this case in line with actual eligible expenditure incurred is appropriate in line with the SORP. Total spend recognised by period is detailed opposite.

Accounting treatment - restrictions on use

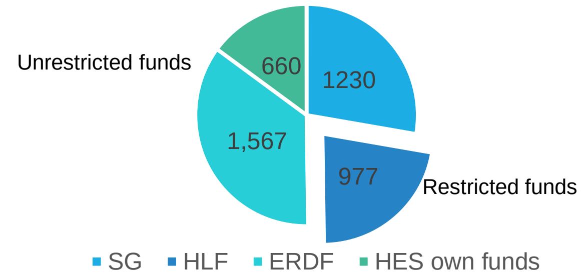
Consideration must also be given to the classification of income and the resulting asset as either restricted, or unrestricted. As the grant funding from HLF and ERDF can only be used for the particular purpose of constructing the Engine Shed building, these income streams are classified as restricted.

In considering whether the resulting asset is restricted or unrestricted going forward, the Charities SORP (FRS 102) provides guidance:

> *Charities SORP (FRS 102) 2.12.* In deciding whether the asset is categorised as restricted or unrestricted, trustees should consider whether the terms of the gift:
> - require the charity to hold the tangible fixed asset acquired on an on-going basis for a specific purpose; or
> - are met once the specified asset is acquired, so allowing the charity to use the asset acquired on an unrestricted basis for any charitable purpose.

Based on these criteria, it is determined that while the ERDF grant does not specify ongoing use requirements, the funds granted from HLF include specific provisions for the use of the Engine Shed building following completion. For this reason, we consider the HLF funded portion of the building to be restricted. We raised an audit adjustment (appendix one) to transfer this amount from unrestricted funds to restricted funds. Once completed, depreciation charged on this portion of the asset will be charged against the restricted fund. The split of restricted and unrestricted expenditure to 31 March 2016 is detailed opposite.

Total spend to 31 March 2016 (£000)



	2014-15 (£000)	1 Apr 2015 to 30 Sep 2015 (£000)	1 Oct 2015 to 31 Mar 2016 (£000)	Estimate for 2016-17 (£000)	Estimate 2017-18 & after (£000)	Total (£000)
SG	30	432	768	1,098	-	**2,328**
HLF	45	-	932	2,675	175	**3,827**
ERDF	-	96	1,471	-	-	**1,567**
HES own funds	1	659	-	60	5	**1,414**
Total	76	1,187	3,171	3,833	180	**8,447**

Source: HS 6 month balances; RCAHMS signed financial statements; HES draft financial statements

Appendix five

Accounting areas – Investment grants

Introduction

HES awards grants for projects relating to building repair, conservation area regeneration, heritage related events and other causes in line with its charitable objectives. The stages of a grant award are shown opposite. A significant change in the surplus and net assets resulted from the change in the point of recognition of grants under the Charities SORP (FRS 102) as described below.

Accounting treatment

Grants are considered non-exchange transactions under the Charities SORP (FRS 102), as the grant-maker awards a grant without receiving equal value in exchange. Grants must be recognised in line with the below requirements:

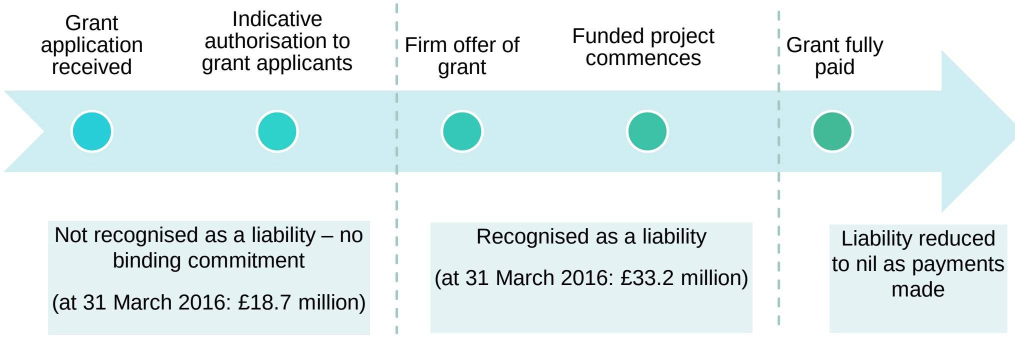
> *Charities SORP (FRS 102) 7.18*. The award of a grant is a non-exchange transaction. A charity awards a grant to further its own charitable purposes but without creating a contractual relationship with the recipient. The award of a grant is recognised as a liability only when the criteria for a constructive obligation are met, payment is probable, it can be measured reliably, and there are no conditions attaching to its payment that limit its recognition.

Change under Charities SORP (FRS 102)

In HS under FReM reporting, grants were recognised at the point of commencement of the funded project. Under the Charities SORP (FRS 102), the point of recognition of grant accruals is once all above criteria are met. We reviewed grant offers and concluded that a binding commitment with probable payment which can be reliably measured exists at the earlier stage of the firm offer of the grant. This results in grants being recognised earlier in HES than was the case in HS.

Audit adjustment

From this change in point of recognition, an audit adjustment was identified (appendix one). This reduces opening net assets at 10 October 2015 in HES by £32.6 million, reduces closing reserves by £22.4 million and increases net income in the year by £10.1 million.



Impact of audit adjustment on SOFA

The resulting SOFA charge in HES is £1.4 million, reduced from the £11.5 million originally reported. This represents all grants for which a firm offer of award was made in the period 1 October 2015 to 31 March 2016. All grants with a firm offer of award prior to 1 October 2015 are adjusted through opening reserves in HES.

The SOFA charge is lower in the period to 31 March 2016, as disproportionately more grants are awarded in the first six months of the year, as can be seen from the movement in firm offers of grants awarded below.

Detail of our audit adjustment is at appendix one.

As at:	Grants with a firm offer of award, recognised under Charities SORP (FRS 102) as a liability (£'000)
31 March 2015	33,613
30 September 2015	38,037
31 March 2016	33,154

Appendix six
Appointed auditors responsibilities

Area	Appointed auditors responsibilities	How we've met our responsibilities
Corporate governance	Review and come to a conclusion on the effectiveness and appropriateness of arrangements to ensure the proper conduct of the bodies affairs including legality of activities and transactions, Conclude on whether the monitoring arrangements are operate and operating in line with recommended best practice.	Page 28 sets out our conclusion on these arrangements.
Financial statements and related reports	Provide an opinion on audited bodies' financial statements on whether financial statements give a true and fair view of the financial position of audited bodies and their expenditure and income Provide an opinion on whether financial statements have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements Provide an opinion on the regularity of the expenditure and income.	Page 8 summarises the opinions we expect to provide.
Financial statements and related reports	Review and report on, as appropriate, other information such as annual governance statements, management commentaries, remuneration reports, grant claims and whole of government returns.	Page 18 reports on the other information contained in the financial statements, covering the annual governance statement, management commentary and remuneration report. There are no grant claims and whole of government returns that we have reviewed and reported on.
Financial statements and related reports	Notify the Auditor General or Controller of Audit when circumstances indicate that a statutory report may be required.	Page 8 sets out any notifications we have made to the Auditor General or Controller of Audit.
Financial statements and related reports	Review and conclude on the effectiveness and appropriateness of arrangements and systems of internal control, including risk management, internal audit, financial, operational and compliance controls.	Page 25 sets out our conclusion on these arrangements.
WGA returns	Examine and report on WGA returns	HES is below the threshold for an audited WGA return.

Appendix six
Appointed auditors responsibilities (continued)

Area	Appointed auditors responsibilities	How we've met our responsibilities
Standards of conduct – prevention and detection of fraud and error	Review and conclude on the effectiveness and appropriateness of arrangements for the prevention and detection of fraud and irregularities, bribery and corruption and arrangements to ensure the bodies affairs are managed in accordance with proper standards of conduct. Review National Fraud Initiative participation and conclude on the effectiveness of bodies engagement.	Page 26 sets out our conclusion on these arrangements. Page 27 concludes on the bodies participation in the National Fraud Initiative.
Financial position	Review and conclude on the effectiveness and appropriateness of arrangements to ensure that the bodies financial position is soundly based.	Page 6 sets out our conclusion on these arrangements.
Financial position	Review performance against targets	Page 6 summarises our review of how the body has performed against it's financial targets.
Financial position	Review and conclude on financial position including reserves balances and strategies and longer term financial sustainability.	Page 6 sets out our conclusion on the bodies financial position including reserves balances. Page 6 sets out our conclusion on the bodies financial strategies and longer term financial sustainability.
Best Value	Review and conclude on the effectiveness and appropriateness of arrangements of accountable officers specific responsibility to ensure that arrangements have been made to secure Best Value.	Page 30 sets out our conclusion of the bodies arrangements.

cutting through complexity

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