



Final report to the Members of the Audit, Risk and Assurance Committee and the Auditor General for Scotland on the 2016/17 audit

25 September 2017

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Director introduction

The key messages in this report

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

- A robust challenge of the key judgements taken in the preparation of the financial statements.
- A strong understanding of your internal control environment.
- A well planned and delivered audit that raises findings early with those charged with governance.

I have pleasure in presenting our final report to the Audit, Risk and Assurance Committee of Historic Environment Scotland (HES) group for the 2017 audit.

As detailed in our plan presented to the Committee on 26 January 2017, the new Code of Audit Practice, which came into force for the 2016/17 audits, sets out our responsibilities under core audit and wider scope requirements. A reminder of the requirements is set out below.

- *Opinion on the financial statements and regularity*
- *National performance audits and Best Value audits*



- *Opinion on management commentaries, remuneration reports and governance statements*

- *Public reporting and audit findings*
- *Wider scope reporting including Best Value*

Director introduction (continued)

The key messages in this report (continued)

I would like to draw your attention to the key messages of this paper:

Statutory audit

- Conclusions from our testing**
- The significant risks, as identified in our audit plan, related to:
- completeness and accuracy of commercial income;
 - categorisation and application of funds;
 - investment grants;
 - valuation of property assets; and
 - management override of controls.

A summary of our work on the significant risks is provided in the dashboard on page 10.

We have identified an uncorrected misstatement from our procedures to date in relation to the recognition of investment grants where a number of grants were found to have been accounted for incorrectly. Management have undertaken a full review of all investment grants to quantify the overall error. As the adjustment is not material, this will not be adjusted in the financial statements. We have reviewed the work performed by management and are satisfied the misstatement is not material.

Based on the current status of our audit work, we envisage issuing an unmodified audit opinion for HES.

Our audit work is also substantially complete for the two subsidiaries, Historic Environment Scotland Enterprises Limited (HESe) and SCRAN Limited, where we envisage issuing an unmodified audit opinion for HESe. As SCRAN Limited has ceased trading and is therefore no longer a going concern, our audit opinion includes an emphasis of matter to confirm that, in forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosure made in the notes to the financial statements, which explains that the financial statements have been prepared on a basis other than that of a going concern.

Director introduction (continued)

The key messages in this report (continued)

I would like to draw your attention to the key messages of this paper:

Statutory audit

Insight

We have utilised Spotlight, Deloitte's patented analytics tool, to perform analytics on the journal entries posted in the year to profile the journal population which has helped us identify journals of audit interest, such as journals posted on non-business days or journals with key words, e.g. fraud. No issues have been identified from our testing.

A high level assessment of all HES journal postings has been performed and a summary of insights for management consideration is noted on page 18.

We have identified a control weakness in the treatment of investment grants which has resulted in an uncorrected misstatement being reported as noted above. We have recommended that the finance team should take primary responsibility for overseeing/performing the reconciliation process for financial statement purposes going forward to ensure year-end liabilities have been recognised in line with the relevant accounting standards.

Status of the audit

We can confirm that all outstanding matters have been completed and the audit is now complete.

Director introduction (continued)

The key messages in this report (continued)

Best Practice

Overall conclusion The Government Financial Reporting Manual (FReM) states that charitable Non Departmental Public Bodies (NDPBs) are not required to comply with the requirements of chapter 5 (in respect of the performance report and accountability report). Instead charitable NDPBs are required to produce:

- A trustees' annual report (as required by the charities SORP and 2006 regulations)
- A governance statement (as required by the Scottish Public Finance Manual (SPFM))
- Remuneration disclosures in the notes (as required by the charities SORP). These disclosures replace the need for a separate remuneration report.

HES has, however, chosen to publish a separate remuneration and staff report in accordance with the requirements of the FReM to aid transparency.

We have reviewed the trustees' annual report with reference to the format and content set out in the Charities Statement of Recommended Practice (SORP) confirming that all material disclosures have been made.

As a new requirement in 2016/17, we are required to provide an opinion on whether:

- the trustees' annual report has been prepared in accordance with the SORP;
- the information given in the governance statement is consistent with the financial statements; and
- the governance statement has been prepared in accordance with the Historic Environment Scotland Act (the Act) and the directions made thereunder by the Scottish Ministers.

From our audit we have identified some disclosure omissions, including details on trustees induction and training. Management have agreed to include these details in the final report. Based on the current status of our audit work, we envisage issuing unmodified opinions on the above.

In addition to the opinion, we have read the trustees' report and governance statement and confirmed that the information contained within both is materially correct and consistent with our knowledge acquired during the course of performing the audit, and is not otherwise misleading.

We have also audited the parts of the remuneration and staff report subject to audit and confirmed that it has been prepared in accordance with the Act and the directions made thereunder by the Scottish Ministers.

Director introduction (continued)

The key messages in this report (continued)

Adds Value

Financial Sustainability

While we are satisfied that annual financial planning and monitoring is applied on a robust basis, with accurate reporting throughout the year, given the significant financial risks identified by the Trustees, it is important that HES progresses medium and longer term financial planning as a matter of urgency. We would expect this to cover:

- A clear understanding of the business model and the costs of individual activities within it.
- Scenario planning.
- Details of assets/liabilities and how they will change over time.
- Details of capital investments needs and how they will be paid for.
- Analysis of demand drivers and projected income.
- Evidence based savings plans and how they will be delivered.
- Funding shortfalls if applicable and relevant mitigating actions.

We understand that work is underway in developing a financial strategy, with a draft expected to be presented to the Board in December 2017. We will monitor progress with this as part of our 2017/18 audit work.

Financial Management

We have reviewed internal audit reports issued in the year. From our testing throughout the audit we are satisfied that HES has adequate systems of internal controls in place.

We are satisfied that HES has strong financial monitoring arrangements and is robust enough to sufficiently capture any changes in the achievement of financial targets.

We have considered the concerns of the previous auditors regarding the capacity within the finance team and note that there has been further recent changes, including a newly appointed Director of Finance and the departure of the Head of Finance. The finance team therefore remains stretched with capacity and continuity still an issue. We also note that significant challenges remain for the new Finance leadership particularly around financial planning and linking spend to the impact delivered on priority outcomes.

We are satisfied HES has appropriate arrangements for the prevention and detection of fraud and corruption.

Director introduction (continued)

The key messages in this report (continued)

Adds Value

Governance and transparency

- We confirm that we have reviewed governance arrangements and have identified no issues in this regard.
- From our review of the internal audit plan for 2016/17 and audit reports, we are satisfied that there are appropriate systems of internal control in place and no significant weaknesses have been identified. Appropriate disclosure has been made in the annual governance statement of issues identified from the work of internal audit and action being taken.
 - We are comfortable with the fraud arrangements in place and confirm we have not been made aware of any financially significant frauds in the year.
 - We have identified no issues with regard to the arrangements for maintaining standards of conduct and the prevention and detection of corruption.
 - We have noted several changes in senior leadership during the year, but do not consider this to be a concern.

Value for money

There is a clear framework in place to ensure that HES performance is monitored and reported. This is based on five key HES themes of lead, understand, protect, value and perform. It is clear that the Board has made substantial progress in its first full year of operation.

Going forward, we would like to see increased visibility of resource and financial planning being based on the evidenced based contribution to key HES priorities and national performance outcomes. This would link resource planning to the outcomes achieved with clear supporting KPI's.

Pat Kenny
Audit Director

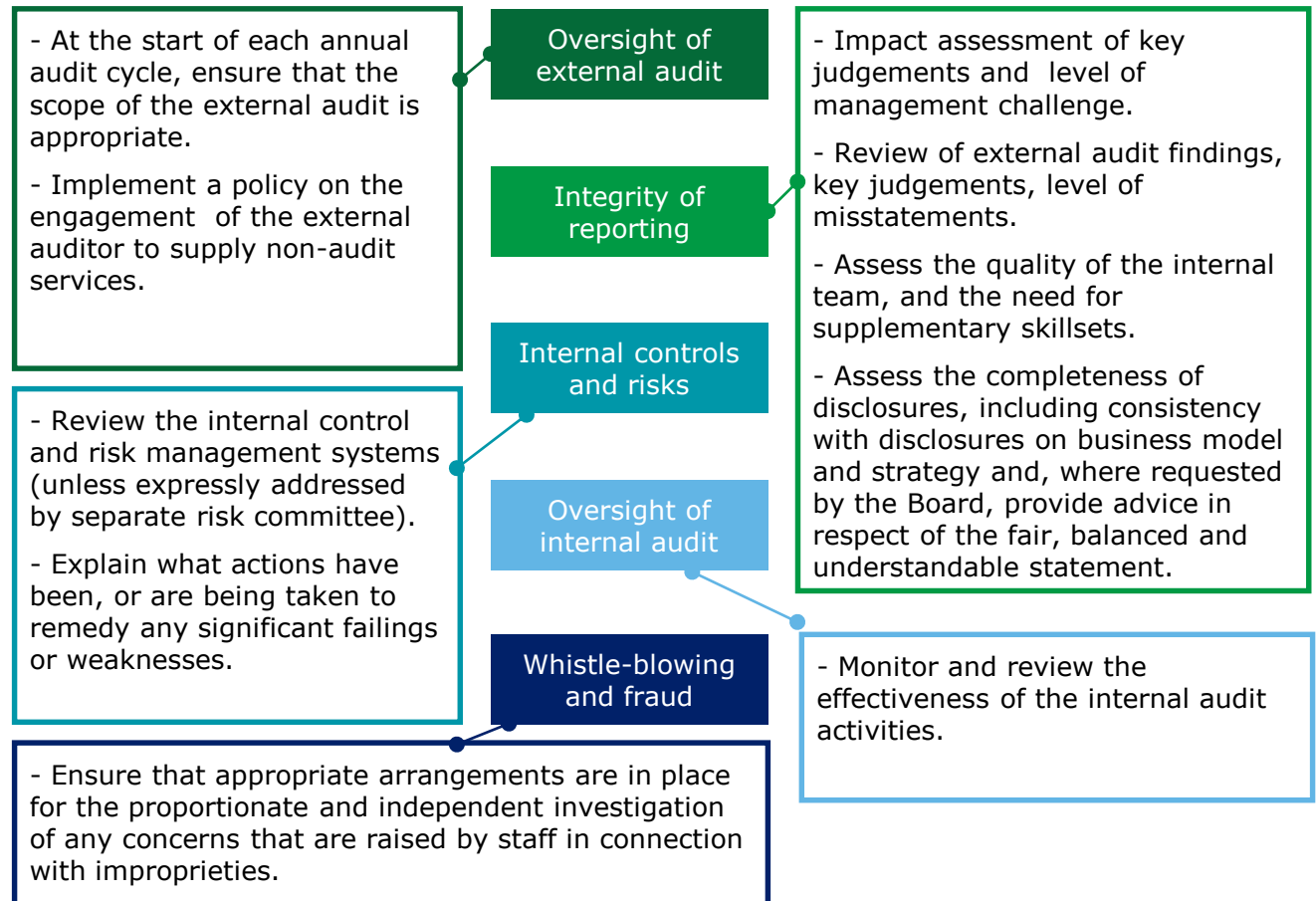
Responsibilities of the Audit, Risk and Assurance Committee

Helping you fulfil your responsibilities

The primary purpose of the Auditor's interaction with the Audit and Risk Committee:

- Clearly communicate the planned scope of the financial statements audit
- Provide timely observations arising from the audit that are significant and relevant to the Audit, Risk and Assurance Committee's responsibility to oversee the financial reporting process
- In addition, we seek to provide the Audit, Risk and Assurance Committee with additional information to help them fulfil their broader responsibilities

As a result of regulatory change in recent years, the role of the Audit, Risk and Assurance Committee has significantly expanded. We set out here a summary of the core areas of Audit, Risk and Assurance Committee responsibility to provide a reference in respect of these broader responsibilities and highlight throughout the document where there is key information which helps the Audit and Risk Committee in fulfilling its remit.



Our audit explained

Area dimensions

In accordance with the 2016 Code of Audit Practice, we have considered how you are addressing the four audit dimensions, being:

- Financial sustainability
- Financial management
- Governance and transparency
- Value for money

Final audit report

In this report we have concluded on the audit risks identified in our planning report and any other key findings from the audit.

Key developments in your business

As noted in our planning report, HES faces future financial pressures due to a risk of reduced Grant in Aid from the Scottish Government. Operation of the properties and associated collections are dependent on grant funded activities and therefore financial sustainability remains a key focus.

Additional capital funding also has associated risks around delivery.

Materiality

The group materiality of £1.702 million and performance materiality of £1.276 million has been based on the benchmark of gross expenditure from the draft accounts.

We have used these as the basis for our scoping exercise and initial risk assessment. We have reported to you all uncorrected misstatements greater than £85k.

A lower materiality for the separate financial statements of the two subsidiaries has been set at £215k (HESe) and £10k (SCRAN).

Significant risks

Our risk assessment process is a continuous cycle throughout the year. Page 10 provides a summary of our risk assessment of your significant risks.

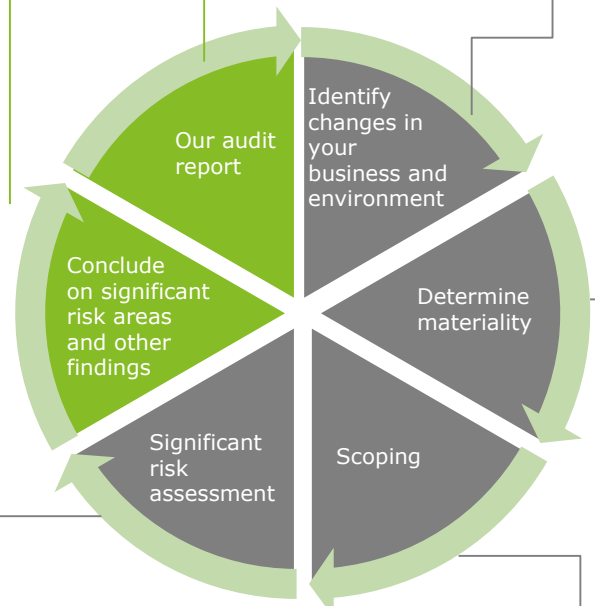
Quality and Independence

We confirm we are independent of Historic Environment Scotland. We take our independence and the quality of the audit work we perform very seriously. Audit quality is our number one priority.

Scope of the audit

We have audited the financial statements for the year ended 31 March 2017 of Historic Environment Scotland group.

We have also audited the separate financial statements of the two subsidiaries, HESe Ltd and SCRAN Ltd.



Timeline 2017

December 2016 – January 2017

Meetings with management and other staff to understand the processes and controls.

26 January 2017
Presented planning paper to the Audit and Risk Committee

August – September 2017

Review of draft accounts, testing of significant risk and performance of substantive testing of results.

31 March 2017
Year end

7 September 2017
Audit close meeting

29 September 2017
Audit, Risk and Assurance Committee meeting

26 October 2017
Accounts sign off

Significant risks Dashboard

Risk	Material	Fraud risk	Planned approach to controls testing	Controls testing conclusion	Consistency of judgements with Deloitte's expectations	Comments	Page no.
Income recognition			D+I	Satisfactory		Satisfactory	12
Categorisation and application of funds			D+I	Satisfactory		Satisfactory	13
Investment grants			D+I	Unsatisfactory – see finding raised		Satisfactory subject to finding raised	14
Valuation of property assets			D+I	Satisfactory		Satisfactory	15
Management override of controls			D+I	Satisfactory		Satisfactory	16



Overly prudent, likely to lead to future credit



Overly optimistic, likely to lead to future debit.

D+I: Testing of the design and implementation of key controls

Significant risks (continued)

Income recognition - Completeness of commercial income

Risk identified

ISA 240 states that when identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

The main components of income for HES, as summarised below, are government grant in aid and commercial income, comprising income from admissions and retail income from its trading subsidiary, Historic Environment Scotland Enterprises Ltd (HESe). Grant in aid is directed by the Scottish Government and not considered a significant risk as the process for receipt of this income is not complex and can be verified 100%. The significant risk is pinpointed to completeness of commercial income, being income from admissions and retail income from properties in care, specifically around cut-off of cash receipts around the year-end.

Key judgements and our challenge of them



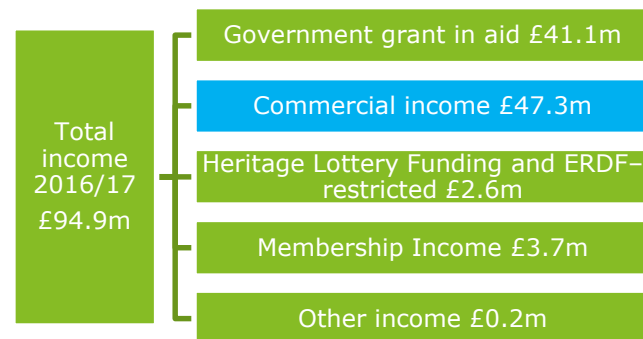
As commercial income comprises low value, high volume cash transactions across multiple locations there is an inherent risk of fraud in respect of these balances. We have pinpointed the significant risk to be the cut-off around the year-end.

Deloitte response



We have performed the following:

- obtained an understanding of the design and implementation of the key controls in place in relation to recording commercial income;
- assessed whether the income streams are recognised in line with the Charities SORP for HES and FRS102 for HESe;
- performed analytical procedures over commercial income reported for the year, based on visitor numbers and price changes;
- tested the visitor numbers by agreeing a sample back to till receipts to confirm completeness;
- traced income around the year-end from the ledger to the Galaxy cash receipting system to assess cut-off and accuracy of cash sales; and
- traced bank lodgements through to the Galaxy system and the ledger to assess cut-off, accuracy and completeness of cash sales.



Deloitte view

We have concluded that commercial income has been recognised in accordance with the Charities SORP and FRS102.

Significant risks (continued)

Categorisation and application of funds - Restricted and unrestricted income and expenditure

Risk identified

Practice Note 11 *The Audit of Charities in the United Kingdom (revised)* issued by the Auditing Practices Board states that restricted funds should be a presumed significant risk for all charities. As a result, we are required to examine the movement in the restricted funds from the Charity to ensure that the restricted funds have been accounted for correctly.

Key judgements and our challenge of them



The Charity must ensure that income is recorded correctly between restricted and unrestricted funds and expenditure is incurred in accordance with relevant charities legislation, the objects of the Charity and the specific fund balances. The key area of restricted funding for HES is the Heritage Lottery Fund monies received in relation to the Engine Shed Project.

Deloitte response



We have performed the following:

- obtained an understanding of the design and implementation of the key controls in place around the application of funds, specifically the recognition of income and the utilisation of restricted funds;
- tested a sample of income receipts to ensure initial classification is in accordance with the donor wishes;
- tested a sample of expenditure from restricted funds in the year to ensure the expense is in line with the donor wishes; and
- reviewed any other movements to/ from restricted funds (e.g. transfers) and obtain supporting documentation to confirm the validity of the movement.

	Heritage Lottery Fund £'000	Other Restricted Funds £'000
Balance at 1 April 2016	932	12
Income	2,191	2,151
Expenditure	(5)	(1,339)
Transfers	-	283
Balance at 31 March 2017	3,118	1,107
Total Restricted Funds	4,225	

Deloitte view

We have concluded that the categorisation and application of restricted funds is in accordance with the Charities SORP.

Significant risks (continued)

Investment grants - Accounting treatment under Charities SORP

Risk identified

When HES was formed on 1 October 2015, the organisation assumed the statutory responsibility from Historic Scotland (HS) to deliver grants, mainly to charitable trusts, as well as local authorities and individuals. As this is a material expenditure stream for HES, there is a significant risk associated with the accurate recording and cut off of these grants.

Key judgements and our challenge of them



Under the Charities SORP (FRS102) the award of a grant is recognised as a liability when the criteria for a constructive obligation is met, payment is probable, it can be measured reliably, and there are no conditions attaching to its payment that limit its recognition. This resulted in a significant change in 2015/16 with grants being recognised earlier than had been the case under FReM reporting, where grants were recognised at the point of commencement of the funded projects and has resulted in £13.5 million negative unrestricted reserves on the Balance Sheet carried forward from 2015/16.

Deloitte response



We have performed the following:

- obtained an understanding of the design and implementation of the key controls in place in relation to awarding and recognition of investment grants; and
- tested a sample of investment expenditure during the year, accruals at the year-end and commitments disclosed to assess whether they have been accounted for in accordance with the Charities SORP.

Key figures:

Accrual for grants payable where constructive obligation has been met
Falling due within 1 year- £23,120k
Falling due greater than 1 year - £6,912k
(note 22 of accounts)

Deloitte view

We have identified an uncorrected misstatement from our procedures to date in relation to the recognition of investment grants where a number of grants were found to have been accounted for incorrectly. Management have undertaken a full review of all investment grants to quantify the overall error. We have reviewed the work performed by management and are satisfied the adjustment is not material, therefore, this will not be adjusted in the financial statements. See page 31 for summary of the uncorrected misstatement.

Systematic errors have been found as a result of reconciliation errors in determining year-end accruals and commitments. We have recommended that the finance team should take primary responsibility for overseeing/performing the reconciliation process for financial statement purposes going forward to ensure year-end liabilities have been recognised in line with the relevant accounting standards.

Significant risks (continued)

Valuation of property assets

Risk identified

HES is required to hold all non-monument property at a modern equivalent use valuation. The valuations are by nature significant estimates which are based on specialist and management assumptions and which can be subject to material changes in value.

Key judgements and our challenge of them



HES held £26 million of property assets at 31 March 2017. The financial year to 31 March 2017 represents 1 of a 5 year rolling programme in which 20% of the portfolio has been revalued by the Valuation Office Agency (VOA). Assets not subject to a full revaluation in the year are updated using appropriate indices.

The revaluation performed in 2016/17 resulted in a net increase in the property portfolio of £1.092 million.

Deloitte response



We have performed the following:

- reviewed any external revaluations performed in the year, assessing whether they have been performed in a reasonable manner, on a timely basis and by suitably qualified individuals;
- tested a sample of revalued assets and re-performed the calculation assessing whether the movement had been recorded through the correct line of the accounts;
- considered material changes of assets not subject to full revaluation during the year and confirmed an indexation adjustment has been made; and
- involved the use of our internal property specialists to review and challenge the assumptions and methodology adopted by the VOA, including sample testing of inputs to the valuations.

Deloitte view

We have concluded that the NBV is not misstated. For those assets revalued during 2016/17, the valuation assumptions are in line with other similar bodies and fall within the expected range highlighted by Deloitte Real Estate.

Our review did identify some procedural matters which we recommend are discussed with the valuer in advance of the 2017/18 valuation exercise. In particular, the terms of engagement were not issued by the VOA until March 2017 despite inspections commencing in October 2016 and the valuation report was not issued in draft until June 2017, with the final report received in August 2017. A clear timetable should be put in place for future years to avoid any undue delay.

Significant risks (continued)

Management override of controls

Risk identified

International Standards on Auditing requires auditors to identify a presumed risk of management override of control. This presumed risk cannot be rebutted by the auditor. This recognises that management may be able to override controls that are in place to present inaccurate or even fraudulent financial reports.



Deloitte response

We have considered the overall sensitivity of judgements made in preparation of the financial statements, and note that:

- HES and HESe's results throughout the year were projecting to exceed budget in terms of revenue generated and this was closely monitored by the Board.
- SCRAN ceased trading in the prior year therefore transactions in 2016/17 were limited to clearing balances.
- Senior management's remuneration is not tied to particular financial results.

We have considered these factors and other potential sensitivities in evaluating the judgements made in the preparation of the financial statements.

Deloitte view

- We have not identified any significant bias in the key judgements made by management.
- The control environment is appropriate for the size and complexity of the organisation.

Journals

We have made inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments. We have then used Spotlight data analytics tools to test a sample of journals, based upon identification of items of potential audit interest. No inappropriate or unusual activity has been identified.

Accounting estimates

In addition to our work on key accounting estimates discussed above, our retrospective review of management's judgements and assumptions relating to significant estimates reflected in last year's financial statements completed with no issues noted.

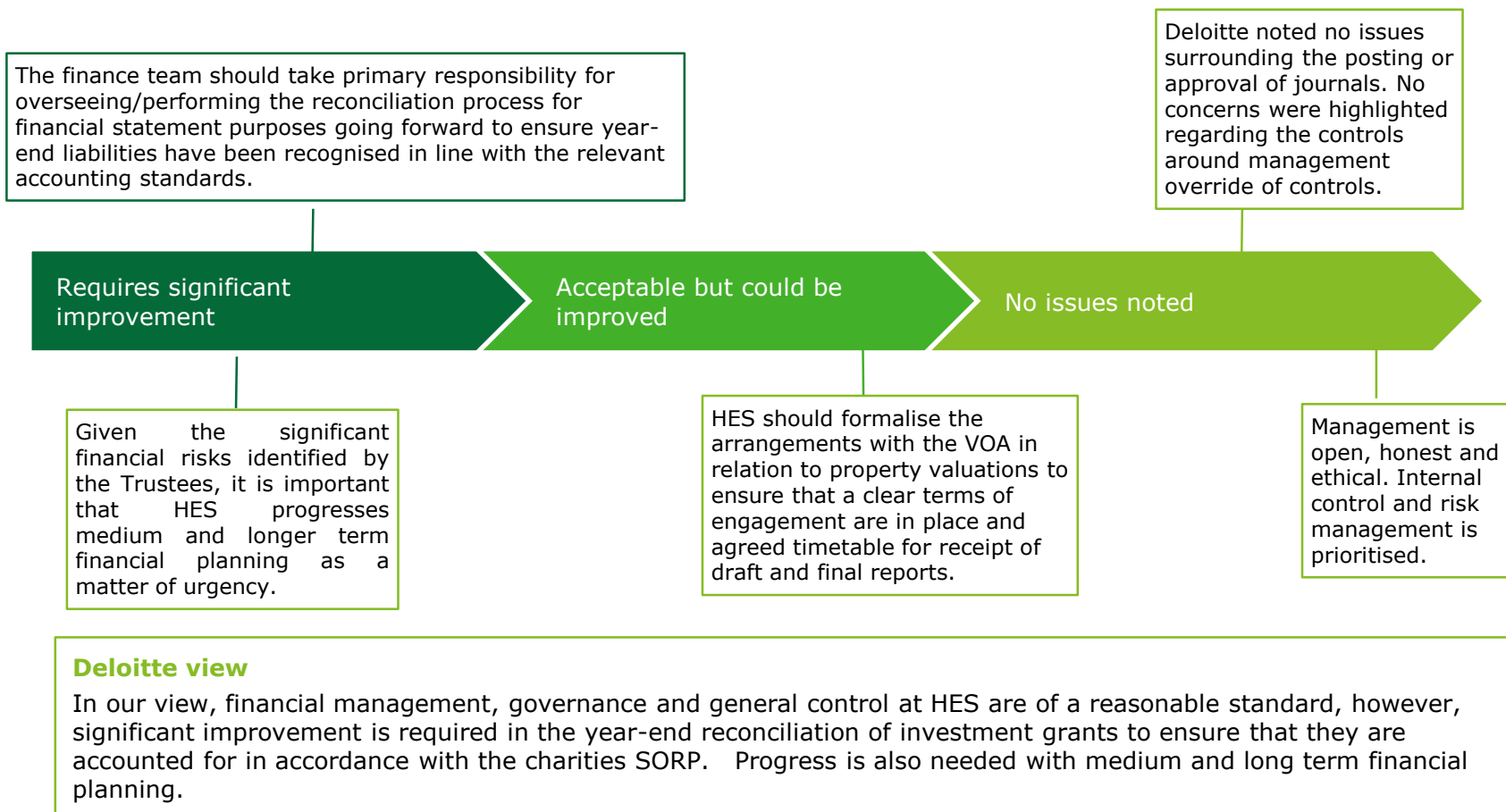
Significant transactions

We did not identify any significant transactions outside the normal course of business or transactions where the business rationale was not clear.

Other significant findings

Internal control and risk management

ISA 315.12 (UK and Ireland) requires we obtain an understanding of internal control relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. We do not test those controls we do not consider relevant to the audit. Below we provide a view, based on our audit procedures, on the effectiveness of your system of internal control relevant to the audit risks that we have identified.



Other significant findings (continued)

Insights delivered

We welcome this opportunity to set out for the Audit, Risk and Assurance Committee our observations from our substantive audit procedures. Below are other insights we have identified from our audit.

Insight

Deloitte response

From our property specialists review of the valuations performed in the year, a number of recommendations have been made in relation to the valuation process.

The following points should be considered when agreeing the work to be performed by the valuer for 2017/18:

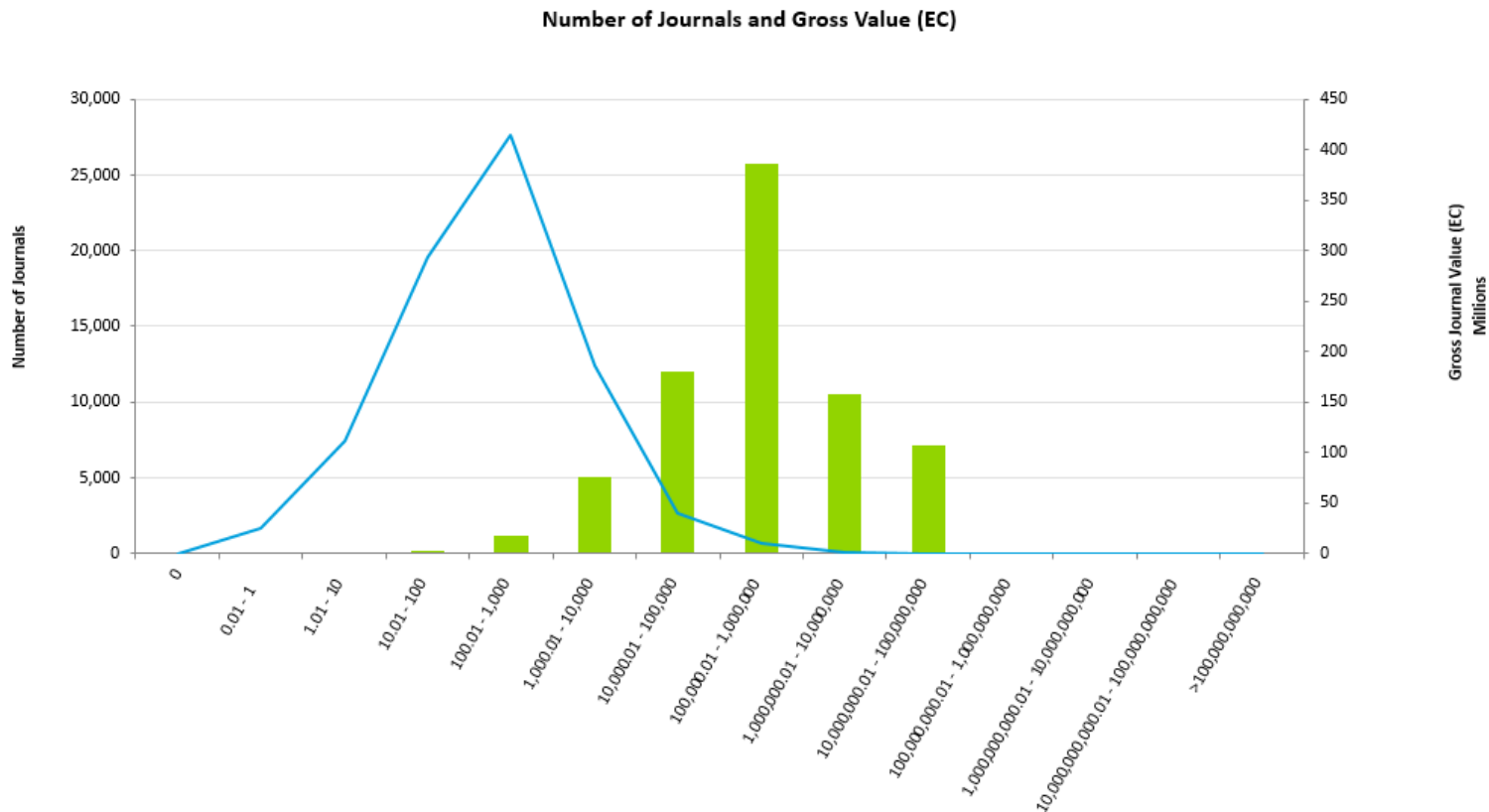
- We recommend that the valuer provides key valuation inputs including rent, yields, capital rates or market evidence within the schedules provided to provide greater transparency over the key considerations.
- We recommend that HES requests that the valuations with supporting valuation report and appendices are issued shortly after the valuation date, even if these are in draft form, to be finalised shortly thereafter.

Following our procedures performed on investment grants, systematic errors have been found as a result of reconciliation errors in determining year-end accruals and commitments.

We understand that this was the first year that the grants team has taken responsibility for the year-end grants commitments. The finance team should take primary responsibility for overseeing/performing the reconciliation process for financial statement purposes going forward to ensure year-end liabilities have been recognised in line with the relevant accounting standards.

Other significant findings (continued)

Insights delivered (continued)



The 'Number of Journals and Gross Value' chart above shows the total number of journals posted for each value banding, again reinforcing our suggestion that a significant degree of resources is expended throughout the year to process a relatively insignificant total value of journal postings.

These insights have been raised with the sole intention of adding value to the audit and helping management identify potential areas of improvement/efficiency. As we encounter more year-ends and collate more journal entry data we will be in a better position to perform more effective trend analyses with the intention of assisting management in identifying potential areas of concern.

Your annual report

We welcome this opportunity to set out for the Audit, Risk and Assurance Committee our observations on the annual report. We are required to provide an opinion on the remuneration report, the annual governance statement and whether the Trustees' report has been prepared in accordance with the statutory guidance.

	Requirements	Deloitte response
Trustees' report	<p>The SORP's requirements that all charities must follow are set out in the following headings:</p> <ul style="list-style-type: none"> • Objectives and activities; • Achievements and performance; • Financial review; • Structure, governance and management; • Reference and administrative details; • Exemptions from disclosure; and • Funds held as custodian trustees on behalf of others. 	<p>We have assessed whether the Trustees' report has been prepared in accordance with the Charities SORP. From our audit we have identified some disclosure omissions, including details on trustees induction and training. Management have agreed to include these details in the final report.</p> <p>We have also read the Trustees' report and confirmed that the information contained within is materially correct and consistent with our knowledge acquired during the course of performing the audit, and is not otherwise misleading.</p>
Annual Governance Statement	<p>The FReM requires a governance statement to be published with the financial statements and guidance on content is provided in the SPFM.</p>	<p>We have assessed whether the information given in the Annual Governance Statement is consistent with the financial statements and has been prepared in accordance with the accounts direction. No exceptions noted.</p>
Remuneration and Staff Report	<p>Charitable NDPBs are not required to comply with the requirements of chapter 5 of the FReM, therefore the remuneration disclosures in the notes, as required by the Charities SORP is all that is required. These disclosures replace the need for a separate remuneration report.</p> <p>HES has, however, chosen to publish a separate remuneration and staff report in accordance with the requirements of the FReM to aid transparency.</p>	<p>We have audited the auditable parts of the remuneration and staff report with no issues noted.</p> <p>We have confirmed that it has been prepared in accordance with the FReM.</p>

Wider scope requirements

Financial sustainability

Audit dimension

As part of the annual audit of the financial statements, we have considered the appropriateness of the use of the going concern basis of accounting. Going concern is a relatively short-term concept looking forward 12 to 18 months from the date the financial statements are approved. Financial sustainability interprets the requirements and looks forward to the medium (two to five years) and longer term (longer than five years) to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

Areas considered



- The financial planning systems in place across the shorter and longer terms
- The arrangements to address any identified funding gaps
- The affordability and effectiveness of funding and investment decisions made

Deloitte response



We have monitored HES's actions in respect of its short, medium and longer term financial plans to assess whether short term financial balance can be achieved, whether there is a long-term (5-10 years) financial strategy and if investment is effective.

Deloitte view

As discussed on page 23, while we are satisfied that annual financial planning and monitoring is applied on a robust basis, with accurate reporting throughout the year, given the significant financial risks identified by the Trustees, it is important that HES progresses medium and longer term financial planning as a matter of urgency.

Wider scope requirements (continued)

Financial sustainability (continued)

Short Term Financial Planning

HES generated £94.946 million income in 2016/17 and with costs of £85.100 million operated successfully within its financial envelope. The principal sources of income were from admission and retail income generated from historic properties which increased significantly in the year to £43.506 million and the Scottish Government £41.124 million grant in aid income.

The trustees have identified the following as the main financial risks in maintaining this performance:

- HES relies on Scottish Government Grant in Aid to enable it to continue its current level of charitable activities. Due to government annularity rules HES does not normally retain reserves.
- The Trustees recognise that investment is required for the conservation of Properties in Care and the Storage Collections in specialist accommodation. Surveys are carried out to monitor the condition of the properties to provide the Trustees with assurance that they provide a safe environment for staff and visitors. Any property not deemed to be safe would need to be closed.
- Most of HES's own income generation arises from admissions to Properties in Care and retail income. A principal risk to this is the effect of Brexit on tourism, in particular: changes in border control, changes in visa requirements and the availability of staffing due to a possible reduction in EU migrant workers. Other risks to income generation relate to maintaining the quality, security and safety of the visitor experience.

Medium/Long Term Financial Planning

While we are satisfied that annual financial planning and monitoring is applied on a robust basis, with accurate reporting throughout the year, given the significant financial risks identified by the Trustees, it is important that HES progresses medium and longer term financial planning as a matter of urgency. We would expect this to cover:

- A clear understanding of the business model and the costs of individual activities within it
- Scenario planning
- Details of assets/liabilities and how they will change over time
- Details of capital investments needs and how they will be paid for
- Analysis of demand drivers and projected income
- Evidence based savings plans and how they will be delivered
- Funding shortfalls if applicable and relevant mitigating actions

We understand that work is underway in developing a financial strategy, with a draft expected to be presented to the Board in December 2017. We will monitor progress with this as part of our 2017/18 audit work.

Wider scope requirements (continued)

Financial management

Audit dimension

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



Areas considered

- Systems of internal control
- Budgetary control system
- Financial capacity and skills
- Arrangements for the prevention and detection of fraud



Deloitte response

We have reviewed the budget and monitoring reporting to the Board during the year to assess whether financial management and budget setting is effective.

We have liaised with internal audit in relation to their work on the key financial controls.

Our fraud responsibilities and representations are detailed on page 35.

	2016/17 Budget £'000	2016/17 Actual £'000	2016/17 Variance £'000
Gross Expenditure	93,524	85,100	8,424
Income	94,944	94,946	2
Deficit/ (Surplus)	1,420	(9,846)	(8,426)

Deloitte view

We have reviewed internal audit reports issued in the year. From our testing throughout the audit we are satisfied that the Board has adequate systems of internal controls in place, with the exception of the issued noted regarding investment grants as detailed on page 17.

We are satisfied the Board has strong financial monitoring arrangements and is robust enough to sufficiently capture any changes in the achievement of financial targets.

We have considered the concerns of the previous auditors regarding the capacity within the finance team and note that there has been further recent changes, including a newly appointed Director of Finance and the departure of the Head of Finance. The finance team therefore remains stretched with capacity and continuity still an issue. We also note that significant challenges remain for the new Finance leadership particularly around financial planning and linking spend to the impact delivered on priority outcomes.

We are satisfied HES has appropriate arrangements for the prevention and detection of fraud and corruption.

Wider scope requirements (continued)

Governance and transparency

Audit dimension

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.

Areas considered



- Governance arrangements
- Scrutiny, challenge and transparency on decision making and financial and performance reports
- Quality and timeliness of financial and performance reporting

Deloitte response



We have reviewed how the governance arrangements have developed following the significant period of change in 2015/16. We note that the financial processes in HES follow the requirements of the SPFM and limits of delegation agreed with the Scottish Government. There is currently no interpretation of these in the form of tailored financial regulations, however, work has started on these with the recent recruitment of the Finance Compliance Manager.

We have reviewed the financial and performance reporting to the Board during the year and noted no issues with the quality and timeliness of these reports.

We have reviewed the minutes of all Committee meetings to assess the effectiveness of the governance arrangements and the level of scrutiny and challenge. Our attendance at the Audit and Risk Committee has also informed our work in this area.

Wider scope requirements (continued)

Governance and transparency (continued)

Internal Audit

The Internal Audit function has independent responsibility for examining, evaluating and reporting on the adequacy of internal controls. During the year, we have reviewed all internal audits presented to the Audit, Risk and Assurance Committee and the conclusions have helped inform our audit work, although no specific reliance has been placed on the work of internal audit. We note that HES has recently appointed a new Head of Internal Audit and Business Improvement.

We note the Internal Audit charter and strategy which define strategic performance criteria and that this has been subjected to independent positive review by Audit Scotland and Ernst and Young.

We are also pleased to note the substantial assurance provided in 2016/17 by internal audit with respect to risk, management, control and governance arrangements.

Deloitte view

We confirm that we have reviewed the arrangements and have identified no issues in this regard.

- From our review of the internal audit plan for 2016/17 and audit reports, we are satisfied that there are appropriate systems of internal control in place and no significant weaknesses have been identified. Appropriate disclosure has been made in the annual governance statement of issues identified from the work of internal audit and action being taken.
- We are comfortable with the fraud arrangements in place and confirm we have not been made aware of any financially significant frauds in the year.
- We have identified no issues with regard to the arrangements for maintaining standards of conduct and the prevention and detection of corruption.
- We have noted the several changes in senior leadership during the year, but do not consider this to be a concern.

Wider scope requirements (continued)

Value for money

Audit dimension

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

Areas considered



- Value for money in the use of resources
- Link between money spent and outputs and the outcomes delivered
- Improvement of outcomes
- Focus on and pace of improvement

Deloitte response



We have gained an understanding of HES'S self-evaluation arrangements to assess how it demonstrates value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.

Performance management

HES performance for 2016-17 is measured against targets laid out in the 2016-2019 Corporate Plan and the 2016-2017 Annual Business Plan. These measure internal key performance indicators and the wider HES contribution to the national performance framework and identify direct and indirect contributions to national performance outcomes.

The Board has reported successful delivery of over 96% of Year 1 KPIs and Business Plan Success Measures

Deloitte view

There is a clear framework in place to ensure that HES performance is monitored and reported. This is based on five key HES themes of lead, understand, protect, value and perform. It is clear that the Board has made substantial progress in its first full year of operation.

Going forward, we would like to see increased visibility of resource and financial planning being based on the evidenced based contribution to key HES priorities and national performance outcomes. This would link resource planning to the outcomes achieved with clear supporting KPI's.

Wider scope requirements (continued)

National Fraud Initiative

In accordance with Audit Scotland planning guidance, we are required to monitor the Board's participation in the National Fraud Initiative (NFI) and progress during 2016/17 and completed an NFI audit questionnaire by 30 June 2017.

A summary of the matches reported in the NFI system is provided in the table.

	Total
Total matches flagged	296
Total recommended matches to be investigated	39
Total processed	295
Frauds	0
Errors	8
Outcome	£12,296.20

Deloitte view

HES are engaged with the NFI exercise. The key contact has used the self-appraisal checklist published in the 2016 Report to help monitor progress with the 2016/17 exercise. We would recommend that this is also shared with the Audit, Risk and Assurance Committee in future. We also noted that internal audit have not historically reviewed the approach to NFI and we would recommend that this is considered in future.

From the analysis above, we noted that 8 errors were identified from the 2016/17 NFI exercise relating to duplicate creditor payments, which resulted in £12,296.20 payments being recovered. We would recommend that HES review its controls around creditor payments to ensure that appropriate controls are in place to prevent similar errors happening in the future.

Purpose of our report and responsibility statement

Our report is designed to help you meet your governance duties

What we report

Our report is designed to help the Audit and Risk Committee and the Board discharge their governance duties. It also represents one way in which we fulfil our obligations under ISA 260 (UK and Ireland) to communicate with you regarding your oversight of the financial reporting process and your governance requirements. Our report includes:

- Results of our work on key audit judgements and our observations on the quality of your Annual Report.
- Our internal control observations
- Other insights we have identified from our audit

What we don't report

As you will be aware, our audit was not designed to identify all matters that may be relevant to the Board.

Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.

Finally, our views on internal controls and business risk assessment should not be taken as comprehensive or as an opinion on effectiveness since they have been based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

We welcome the opportunity to discuss our report with you and receive your feedback.

The scope of our work

Our observations are developed in the context of our audit of the financial statements.

We described the scope of our work in our audit plan and the supplementary "Briefing on audit matters" circulated to you on 26 January 2017.

This report has been prepared for the Audit, Risk and Assurance Committee and Board, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose.



Deloitte LLP

Glasgow

25 September 2017

Appendices



Audit adjustments

Summary of corrected and uncorrected misstatements and disclosure deficiencies

Corrected misstatements

- No corrected misstatements have been identified from our audit work performed to date.

Uncorrected misstatements

- As noted on page 14, we have identified an uncorrected misstatement from our procedures to date in relation to the recognition of investment grants where a number of grants were found to have been accounted for incorrectly. Management have undertaken a full review of all investment grants to quantify the overall error. As the adjustment is not material, this will not be adjusted in the financial statements.

	Debit/ (credit) Assets £'000	Debit/ (credit) Liabilities £'000	Debit/ (credit) SOFA £'000
Misstatements identified in current year			
Accrual for grants payable		(638)	
Grants distributed			638
Total		(638)	638

Disclosure misstatements

- Auditing standards require us to highlight significant disclosure misstatements to enable audit committees to evaluate the impact of those matters on the financial statements. We have noted no material disclosure deficiencies in the course of our audit work.

A verbal update will be provided to the Audit, Risk and Assurance Committee if anything arises from any outstanding work before financial statements are signed.

Action plan

Recommendations for improvement

	Recommendation	Management Response	Responsible person	Target Date	Priority
Property Valuations	<p>The following points should be considered when agreeing the work to be performed by the valuer for 2017/18:</p> <ul style="list-style-type: none"> We recommend that the valuer provides key valuation inputs including rent, yields, capital rates or market evidence within the schedules provided to provide greater transparency over the key considerations. We recommend that HES requests that the valuations with supporting valuation report and appendices are issued shortly after the valuation date, even if these are in draft form, to be finalised shortly thereafter. 	<p>Management will discuss this recommendation with the existing valuer, however, there may be a limit to what can be agreed as this is the final year of the contract and work has already commenced in relation to 2017/18 valuations. Once the new contract has been awarded, management will work with the new valuer to address this recommendation fully.</p>	Director of Finance	June 2018	Medium

Action plan (continued)

Recommendations for improvement (continued)

	Recommendation	Management Response	Responsible person	Target Date	Priority
Investment Grants	The finance team should take primary responsibility for overseeing/performing the reconciliation process for financial statement purposes going forward to ensure year-end liabilities have been recognised in line with the relevant accounting standards.	Agreed. Management will review the process and take action to ensure that the necessary controls are in place.	Director of Finance	April 18	High
NFI	As a result of the outcome of the 2016/17 NFI exercise, we would recommend that HES review its controls around creditor payments to ensure that appropriate controls are in place to prevent similar errors happening in the future.	Agreed. Management will review processes and take action to ensure appropriate controls are in place.	Director of Finance	Mar 18	Medium
NFI	We would recommend that the self appraisal checklist is shared with the Audit, Risk and Assurance Committee in future. We also noted that internal audit have not historically reviewed the approach to NFI and we would recommend that this is considered in future.	The NFI self-appraisal checklist will be shared with the Audit, Risk and Assurance Committee and an internal audit review of our approach to NFI will be considered as we develop our new three year internal audit plan.	Head of Internal Audit & Business Improvement	Mar 18	Medium

Action plan (continued)

Recommendations for improvement (continued)

	Recommendation	Management Response	Responsible person	Target Date	Priority
Financial Sustainability	HES should progress medium and longer term financial planning as a matter of urgency.	Agreed. Medium and longer term financial planning is being progressed alongside other strategic initiatives such as Vision for 2030 and Visitor Strategy. The aim is to finalise the medium to longer term financial plan by April 2018.	Director of Finance	Apr 18	High
Value for Money	Going forward, we would like to see increased visibility of resource and financial planning being based on the evidenced based contribution to key HES priorities and national performance outcomes. This would link resource planning to the outcomes achieved with clear supporting KPI's.	HES is progressing towards being able to link resource planning to outcomes sought and will be investigating the feasibility of options to achieve this during 2017-18 and 2018-19.	Director of Finance	Mar 19	High
Finance team	The capacity of the finance team should be reviewed to ensure that there is a strong control environment in place.	Agreed. The Finance team structure is currently being reviewed by the Director of Finance.	Director of Finance	Jun 18	High

Fraud responsibilities and representations

Responsibilities explained



Responsibilities:

The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.



Required representations:

We have asked the Board to confirm in writing that you have disclosed to us the results of your own assessment of the risk that the financial statements may be materially misstated as a result of fraud and that you have disclosed to us all information in relation to fraud or suspected fraud that you are aware of and that affects the entity or group.

We have also asked the Board to confirm in writing their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.



Audit work performed:

In our planning we identified the risk of fraud in complying with recognition of grant income and management override of controls as a key audit risk for your organisation.

During course of our audit, we have had discussions with management and those charged with governance.

In addition, we have reviewed management's own documented procedures regarding fraud and error in the financial statements

We have reviewed the paper prepared by management for the Audit and Risk Committee on the process for identifying, evaluating and managing the system of internal financial control.

Concerns:

No concerns have been identified regarding fraud.



Independence and fees

As part of our obligations under International Standards on Auditing (UK and Ireland) we are required to report to you on the matters listed below:

Independence confirmation	We confirm that we comply with APB Ethical Standards for Auditors and that, in our professional judgement, we and, where applicable, all Deloitte network firms are independent and our objectivity is not compromised.
Fees	<p>The audit fee for 2016/17 is £74,639 as detailed in our Audit Plan. In addition, we have charged £10,000 + VAT and £2,000 + VAT respectively for the separate audit of the two subsidiaries, Historic Environment Scotland Enterprise Ltd and Scran Ltd.</p> <p>No non-audit fees have been charged by Deloitte in the period.</p>
Non-audit services	In our opinion there are no inconsistencies between APB Ethical Standards for Auditors and the Board's policy for the supply of non-audit services or any apparent breach of that policy. We continue to review our independence and ensure that appropriate safeguards are in place including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary.
Relationships	<p>We are required to provide written details of all relationships (including the provision of non-audit services) between us and the organisation, its board and senior management and its affiliates, including all services provided by us and the DTTL network to the audited entity, its board and senior management and its affiliates, and other services provided to other known connected parties that we consider may reasonably be thought to bear on our objectivity and independence.</p> <p>We are not aware of any relationships which are required to be disclosed.</p>



Sector developments

We welcome the opportunity to provide the Board of Trustees with an update on governance and financial reporting

The ICAEW Audit and Assurance Faculty has just released an important and interesting audit insight for the charity sector. It focuses on four areas:

ICAEW – Audit Insights for Charities

- How can charities demonstrate they are making a positive impact?
- How can charities retain public trust?
- How can charities become more resilient?
- How can charities maximise their resources?

We recommend that trustees consider these insights in the light of the current position of the charity and plans for the future.

Charity Commission review of public benefit reporting by charities

Telling your story well: public benefit reporting by charities was published in April 2017. The review of public benefit reporting was undertaken by the Charity Commission and identified that 54% of their sample (58 charities) did not meet the public benefit reporting requirement. A good report was considered to both include the statement that the charity had due regard to the Commission's guidance on public benefit and set out clearly an explanation of who benefitted from its activities. A report including only an explanation of the activities was not considered sufficient.

Information sheet 1: implementation issues

The Charity Commission has published in April 2017 its first information sheet covering SORP implementation issues. This does not have the authority of the SORP but is intended to clarify interpretation of the requirements.

The information sheet includes clarification that: the exemption from preparing a cash flow statement in the individual accounts of a qualifying entity is available to the parent charity; comparative figures are required for fund disclosures including the assets and liabilities by fund and the movements on material funds notes; and a reminder that governance costs should be allocated to costs of raising funds where appropriate.

Sector developments (continued)

Withdrawal of 'Hallmarks of a effective charity' in anticipation of a new Charity Governance Code

A consultation on a new Charity Governance Code has closed in February 2017 and the steering group are now working on finalising the code. The new code will replace the previous voluntary sector code *Good governance: a code for the voluntary and community sector*. In its response in February 2017, the Charity Commission indicated that it would withdraw CC10 *Hallmarks of an effective charity* and refer charities to the code as setting out relevant standards of good practice.

The charity governance code has six pillars (Leadership; integrity; decision making, risk and control; diversity; board effectiveness; and open and accountable), supporting organisational purpose and direction. The code structure reflects the style of the corporate governance code and larger charities (those with gross income of more than £500,000) will be encouraged to publish a statement, in their annual report, saying how they applied the Code and explaining their alternative approach in areas where they do not follow the Code's recommended practice.

Whilst the code has been styled the 'charity governance code' it is anticipated that it will apply to other not-for-profit organisations. The Board should consider the principles and practices in the Code and consider whether it will adopt the Code when it is finalised.

Reporting matters of material significance to a UK charity regulator

Following a consultation in May 2016, the three Charity regulators (England and Wales, Scotland and Northern Ireland) published in May 2017 their guidance on reporting matters of material significance to a UK charity regulator – A guide for auditors and independent examiners.

These are joint proposals which cover nine matters (seven existing matters and two new matters). Fraud and dishonesty, failures of internal controls and governance, money laundering, support of terrorism, putting beneficiaries at risk, breaches of law or the charity's trusts, and breach of an order or direction made by a regulator remain matters of material significance. Two new matters have been added: issuing a modified report, and conflicts of interest. One matter requiring auditors to report on resignation has been withdrawn. In England and Wales auditors are required to make a written report on any matters of material significance as soon as it arises during the normal course of their audit work.

Sector developments (continued)

In December 2016 the Cabinet office published 'Government grants minimum standards'. This should provide for more rigorous grant agreements and seeks to ensure that government grants give value for money. The ten standards are:

- 1: **named responsible officer for each grant**
- 2: **grant approvals process** – a robust grants approval process to approve spend over £100k
- 3: **new grants advice panel** – grants that are high risk, novel and contentious, as well as those undergoing a step change in scope or funding, should be considered for submission to the New Grants Advice Panel for scrutiny and advice from subject experts.
- 4: **the business case** - a robust business case, proportionate to the level of expenditure and risk, must be developed for all government grants; this will be scrutinised and approved in stages.
- 5: **competition for grant funding** - government grants should be competed by default.
- 6: **robust grant agreements** - all government grants must be awarded through robust grant agreements, including terms of eligible expenditure, outputs and longer term outcomes.
- 7: **due diligence and fraud risk assessment** - all government grants will be subject to timely and proportionate due diligence and fraud risk assessment.
- 8: **defining outputs**- all government grants will have outputs agreed and longer-term outcomes defined, wherever possible, to enable active performance management, including regular reviews and adjustments where deemed necessary.
- 9: **annual reviews** - all government grants will be reviewed annually at a minimum with a focus on financial reconciliation, taking into account delivery across the period, resulting in a decision to continue, discontinue or amend funding.
- 10: **mandatory training for grant makers** - all those involved in the development and administration of grants must undertake core training in grant management best practice.

Grant standards

The Cabinet Office will be undertaking a review of government department compliance with the new standards.

Sector developments (continued)

The Common Reporting Standard is already in force in the UK and many grant making charities will be subject to its regulations. If more than half of the charity's income is derived from financial assets, and any part of those assets are under management via a discretionary investment mandate then that charity is in the scope of the regulations.

These charities will have to provide details to HMRC about how their grants are applied. The first reporting period under the regime is the 2016 calendar year, in respect of which the report must be filed with HMRC by 31 May 2017. This reporting is separate to the tax return process.

Common Reporting Standard

Charities must ensure that they have processes in place to capture the necessary information. In particular the requirement to report only applies to grantees that are tax resident in another jurisdiction which has signed up to CRS. There are 56 countries already committed to report in 2017 and a further 40 due to join in 2018. They can use self certification forms from their grant recipients, as banks do.

The process must capture relevant information for new grants and those made since 1 January 2016. Existing grant recipients should be informed that the charity is subject to CRS reporting requirements and new grant agreements should be updated.

Further guidance has been issued by HMRC.

Sector developments (continued)

Tackling abuse and mismanagement 2015 to 16

In December 2016 the Charity Commission published its annual report on tackling abuse and mismanagement. The report summarises the statistics: case work and investigations carried out by the Charity Commission. It also includes some key steps that trustees can and should take. These provide a helpful checklist for charities to measure themselves against. Does the charity:

- set a business plan and budget and keep track of income and spend against it?
- have robust and effective financial controls in place including robust but proportionate policies and procedures about managing income and controlling expenditure?
- ensure trustees and senior management create the right culture, leading by example in adhering to the charity's internal financial controls and good practice?
- keep up-to-date and accurate records of all income and expenditure?
- ensure trustees receive up to date, accurate and regular information about the charity's finances?
- prepare annual accounts and ensure they are audited and filed with the commission as required by law?
- put in place appropriate safeguards for the protection of money, assets and staff if the charity operates outside the UK?

Annual return 2017 - consultation

In December 2016 the Charity Commission published a consultation on the information and use of its annual return. The consultation does not cover detailed financial information collected but looks at general information and information to be collected around the Charity Commission's thematic reviews. The consultation closed on 9 March 2017.

Sector developments (continued)

During the year the Charity Commission publish a number of case reports. Two recent case reports highlighted some key messages for trustees.

(January 2017) Money spent in high risk countries – reminders for trustees

- Trustees are responsible for their charity's financial affairs both in the UK and internationally. Trustees must keep records and an adequate audit trail to show that the charity's money has been properly spent on furthering the charity's purposes for the benefit of the public.
- Often when working internationally charities operate through local partners which can be an effective way of delivering significant benefits direct to a local community. However trustees are still responsible for ensuring the proper application of the charity's funds and must ensure that they put in place the proper process for due diligence and monitoring the charity's operations.

(February 2018) Grants funding to a non-charitable organisation – trustees need to check that the organisation they are providing grant funding to uses the funds only for the charity's purposes.

- The recipient (note this applies equally to a charity recipient) should understand and agree:
 - The aim of the grant and how it is expected to further the grant giving charity's purposes
 - What the grant can and can't be used for (eligible expenditure)
- Checks for assessing the risk of grants given include:
 - The 'mission fit' or match between the organisation's aims and the charity's purposes and interests
 - The organisation's track record for delivering the activities the charity is planning to fund
 - Its governance
 - Its reputation; and the full scope of its business and any conflicts with your charity's purposes or interests.

Trustees should review the processes within their own charity to ensure they are confident in the controls in place.

Case reports – key messages

Sector developments (continued)

Charity Commission revised regulatory statement

In January 2017, the Charity Commission published a revised regulatory statement, or statement of intent.

The Charity Commission states that it can best fulfil its objectives under the Charities Act by:

- concentrating on promoting compliance by charity trustees with their legal obligations
- enhancing the rigour with which it holds charities accountable
- ensuring that it upholds the definition of charity under charity law

The regulatory statement sets out how the Commission will do this and outlines the Commission's values of expertise, fairness, openness, clarity and speed, and accountability.

Official warnings to charities and trustees: Q and A

In December 2016 the Charity Commission published a summary of when the Commission may issue an official warning and what it means for a charity. The commission can issue an official warning when it considers there has been a breach of trust or duty or other misconduct or mismanagement in a charity. This power supplements the commission's existing powers to deal with wrongdoing in charities.



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