



## **Historic Environment Scotland**

Planning report to the Audit, Risk and Assurance Committee on the  
audit for the year ending 31 March 2018

12 January 2018

**Deloitte Confidential: Public Sector**

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# Planning report



# 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.

We have pleasure in presenting our draft planning report to the Audit, Risk and Assurance Committee (ARAC) of Historic Environment Scotland (HES) for the year ending 31 March 2018 audit. We would like to draw your attention to the key messages of this draft audit plan:

### **Audit Plan**

We have updated our understanding of HES including discussion with management and review of relevant documentation as well as Audit Scotland performance reports published during the year.

Based on these procedures, we have developed this plan in collaboration with HES to ensure that we provide an effective audit service that meets your expectations and focuses on the most significant areas of importance and risk to HES.

### **Key Risks**

We have taken an initial view as to the significant audit risks HES faces. These are presented as a summary dashboard on page 14.

- In our 2016/17 audit, we identified a control weakness relating to the accounting for investment grants. This therefore remains a significant risk area and key area of focus for our 2017/18 audit.

- In accordance with auditing standards, we have identified a potential significant risk associated with income. This risk is pinpointed to the completeness of the commercial income due to the higher risk associated with these cash transactions. Our testing will focus on reconciling differences between Galaxy (till receipt system) and the financial ledger as this is where the significant risk is deemed to be.
- In accordance with auditing standards, management override of controls has also been identified as a potential significant audit risk.
- In accordance with Practice Note 11 The Audit of Charities in the United Kingdom (revised) issued by the Auditing Practices Board, restricted funds is a presumed significant risk for all charities, the risk being that income for specific purposes are not used in accordance with the donors wishes.

# Director introduction (continued)

## The key messages in this report (continued):

### Audit Dimensions

- The 2016 Code of Audit Practice sets our four audit dimensions which set a common framework for all public sector audits in Scotland. Our audit work will consider how HES is addressing these and report our conclusions in our annual report to the ARAC in July 2018. In particular, our work will focus on:
  - **Financial sustainability** – As with all public sector bodies, HES continues to face significant financial challenges. The overall 2017/18 forecast position as at 31 October 2017 is projecting an over commitment of £2.291m reflecting the fact that the Scottish Government is reducing the Grant in Aid by £5.055m as a result of HES generating more commercial income. At the time of calculating the £5.055m, this was based on 60% of the additional income generated, with HES retaining the remaining 40%. There remains a risk that the Scottish Government will further reduce the Grant in Aid, while simultaneously HES will have to manage an ever increasing number of visitors to attractions and properties throughout Scotland. HES is dependent on grant funded activities to operate, therefore financial sustainability remains a risk and will be a key area of audit focus. We noted in our 2016/17 annual report that work was underway to develop a medium term financial strategy. We will therefore monitor progress with the development of this and also consider whether there is a long-term financial strategy in place and if investment is effective.
  - **Financial management** – we will review the budget and monitoring reports to the Board during the year and liaise with internal audit in relation to their work on the key financial controls to assess whether financial management and budget setting is effective. We will also consider the capacity of the finance team in view of the prior year audit recommendations. From our audit work in 2016/17 we found that HES had strong financial monitoring procedures in place however, the capacity and continuity of the finance team was raised as a concern. There remains a risk that a lack of appropriate financial management could result in HES not achieving its financial targets.
  - **Governance and transparency** – from our review of Board papers and attendance at ARAC we will assess the effectiveness of governance arrangements. We will also share best practice from elsewhere from our dedicated governance team. Given the number of changes in senior leadership during 2017, there is a risk that the skills and capacity are not sufficient for effective scrutiny and challenge.
  - **Value for money** – From our 2016/17 audit work we concluded that HES had a clear performance management framework in place. During 2017/18 we will review how HES is addressing areas where targets are not being met. There is a risk that insufficient resources are targeted to areas of under performance.

# Director introduction (continued)

## The key messages in this report (continued):

### **Other wider scope work**

We will continue to monitor HES's participation and progress with the National Fraud Initiative (NFI) during 2017/18 and complete an Audit Scotland audit questionnaire by 28 February 2018.

In accordance with Audit Scotland guidance, we will be requested to provide information to support national performance audits on Digital.

### **Regulatory Change**

There are limited changes this year affecting the audit. We will share any guidance received from Audit Scotland when available.

We have included a technical update on pages 27 -29, covering the new Charity Governance Code, FRED 68 (*Payments by subsidiaries to their charitable parents that qualify for gift aid*) and the new requirements in relation to General Data Protection Regulation. It is important that HES consider their impact ahead of implementation.

### **Our Commitment to Quality**

We are committed to providing the highest quality audit, with input from our market leading specialists, sophisticated data analytics and our wealth of experience.

### **Adding value**

Our aim is to add value to HES through our external audit work by being constructive and forward looking, by identifying areas of improvement and by recommending and encouraging good practice. In this way, we aim to help HES promote improved standards of governance, better management and decision making and more effective use of resources.

**Pat Kenny**  
**Audit Director**

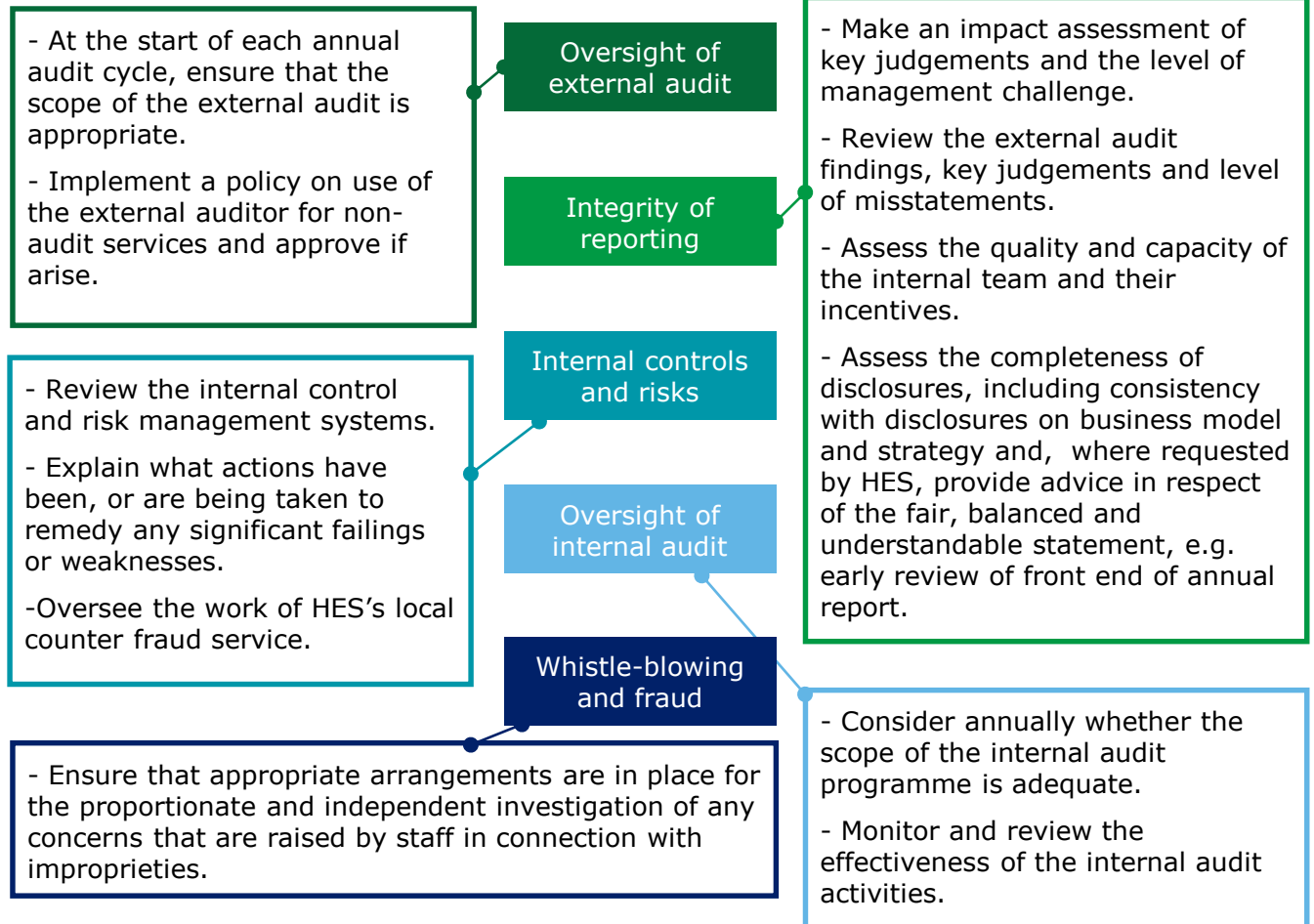
# Responsibilities of the Audit, Risk and Assurance Committee

## Helping you fulfil your responsibilities

The primary purpose of the Auditor's interaction with the Audit, Risk and Assurance 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 fulfil your 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, Risk and Assurance Committee in fulfilling its remit.



# Our audit explained

## We tailor our audit to HES and your strategy

### Identify changes in your Body and environment

HES continues to face significant financial pressures, with a risk of reduced funding in future years. A summary of these considerations is set out on page 10.

### Scoping

Our scope is in line with the Code of Audit Practice issued by the Audit Scotland.

Separate audits will be carried out for the two subsidiaries; Historic Environment Scotland Enterprises Limited (HESE) and SCRAN Limited (SCRAN).

More detail is given on page 12.

### In our final report

In our final report to you we will conclude on the significant risks identified in this paper, report to you our other findings, and detail those items we will be including in our audit report.



### Determine materiality

We have determined a materiality of £1,992k (2016/17: £1,702k) with a performance materiality of £1,494k (2016/17: £1,276k). This is based on forecasted gross expenditure as at October 2017 of £99,639k (2016/17: £85,031k), consistent with the basis used in the prior year. We will report to you any misstatements above £99k (2016/17: £85k), which is 5% of materiality in line with our current methodology.

### Significant risk assessment

We have identified significant audit risks in relation to HES. More details are given on pages 15 to 18. These are consistent with our prior year audit with the exception of valuation of property assets. Based on the extent of testing performed in the prior year and the satisfactory results, we have deemed that there is no associated significant audit risk in the current year.

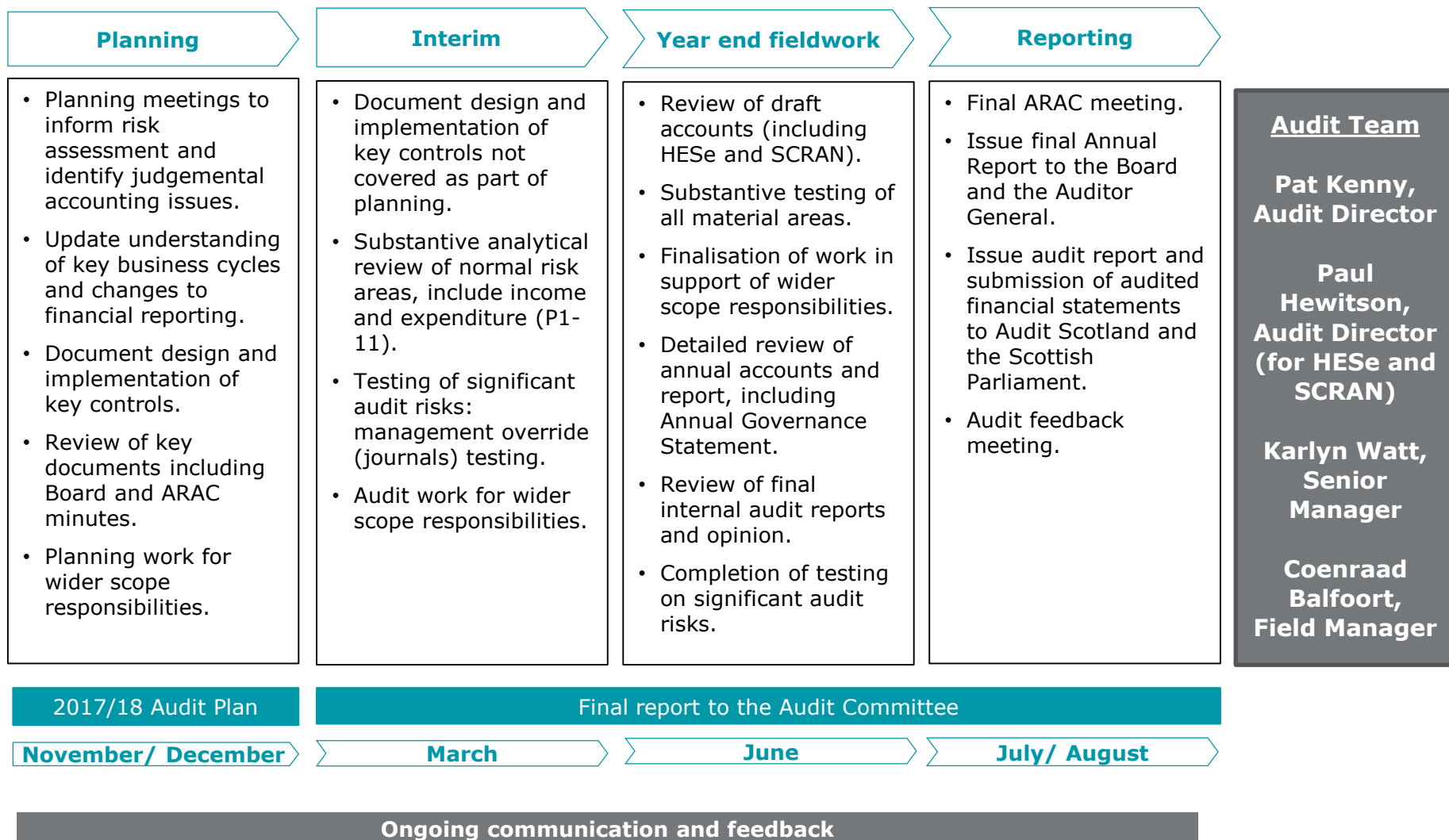
### Quality and Independence

We confirm all Deloitte network firms are independent of HES. We take our independence and the quality of the audit work we perform very seriously. Audit quality is our number one priority.



# Continuous communication and reporting

## Planned timing of the audit



# An audit tailored to you

## Focusing on your business and strategy

### Description

### Impact on our audit

#### Financial sustainability



HES continues to face significant financial challenges. The overall 2017/18 forecast position as at 31 October 2017 is projecting an over commitment of £2.291m reflecting the fact that the Scottish Government is reducing the Grant in Aid by £5.055m as a result of HES generating more commercial income. At the time of calculating the £5.055m, this was based on 60% of the additional income generated, with HES retaining the remaining 40%.

There remains a risk that the Scottish Government will further reduce the Grant in Aid, while simultaneously HES will have to manage an ever increasing number of visitors to attractions and properties throughout Scotland. HES is dependent on grant funded activities to operate, therefore financial sustainability remains a risk and will be a key area of audit focus.

We noted in our 2016/17 annual report that work was underway to develop a medium term financial strategy. We will therefore monitor progress with the development of this and also consider whether there is a long-term financial strategy in place and if investment is effective.

#### Finance team capacity



In our 2016/17 annual report, we noted that we had considered the concerns of the previous auditors regarding the capacity within the finance team and noted 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 remained stretched with capacity and continuity still an issue.

We also noted that significant challenges remain for the new Finance leadership particularly around financial planning and linking spend to the impact delivered on priority outcomes and recommended increased visibility of resource and financial planning being based on evidenced based contribution to HES priorities and national performance outcomes. It was agreed as part of the 2016/17 action plan that HES would investigate the feasibility of options to achieve this during 2017/18 and 2018/19, which relies not only on finance team capacity but on wider organisational capacity to make this work.

We will monitor the progress made within the finance team to recruit for vacant posts. We will also assess how the new finance leadership team is progressing with financial planning, linking spend to priority outcomes.



New significant risk



Continuing significant risk



Considered as part of wider scope audit requirements

# Materiality

## Our approach to materiality

### Basis of our materiality benchmark

- We have determined a materiality of £1,992k (2016/17: £1,702k) with a performance materiality of £1,494k (2016/17: £1,276k), based on professional judgement and risk factors specific to HES, the requirement of auditing standards and the financial measures most relevant to users of the financial statements.
- We have used 2% of forecasted gross expenditure as the benchmark for determining materiality.
- This approach is consistent with our prior year materiality calculation.
- HES has two wholly owned subsidiaries: Scran Ltd and Historic Environment Scotland Enterprises Limited (HESe), which are consolidated within HES financial statements. We will audit the two subsidiaries of HES to separate statutory materiality thresholds.
- This is 5% of materiality and is based on our current methodology.
- We will report to you misstatements below this threshold if we consider them to be material by nature.
- Our approach to determining the materiality benchmark is consistent with Audit Scotland guidance which states that the threshold for accumulating misstatements for reporting and correction to audit committees must not exceed £250k.

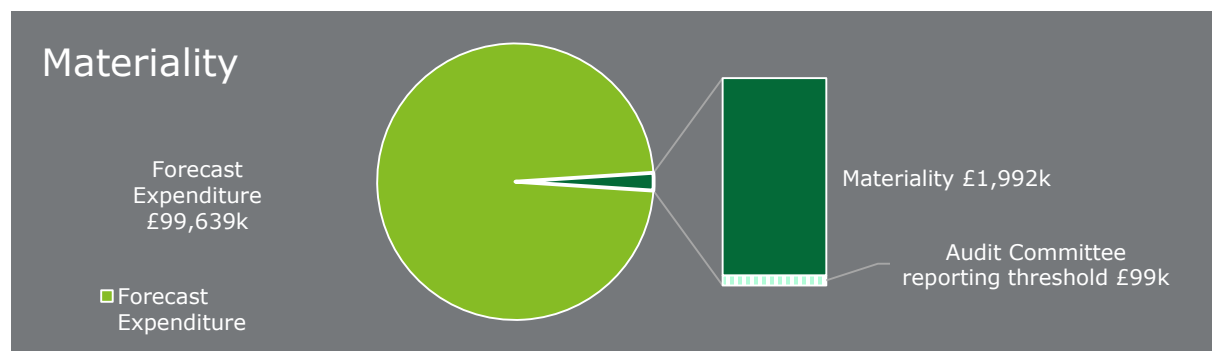
### Our annual audit report

We will:

- Report the materiality benchmark applied in the audit of HES;
- Provide comparative data and explain any changes in materiality, compared to prior year, if appropriate; and
- Explain any normalised or adjusted benchmarks we use, if appropriate.

### Reporting to those charged with governance

- We will report to you all misstatements found in excess of £99k (2016/17: £85k).



Although materiality is the judgement of the audit director, the Audit, Risk and Assurance Committee must satisfy themselves that the level of materiality chosen is appropriate for the scope of the audit.



# Scope of work and approach

## Our key areas of responsibility under the Code of Audit Practice

### Core audit

Our core audit work as defined by Audit Scotland comprises:

- providing the **Independent Auditor's Report** on the annual accounts (and any assurance statement on consolidation packs);
- providing the **annual report** on the audit addressed to HES and the Auditor General for Scotland;
- communicating **audit plans** to those charged with governance;
- providing **reports to management**, as appropriate, in respect of the auditor's corporate governance responsibilities in the Code;
- preparing and submitting **fraud returns**, including nil returns, to Audit Scotland where appropriate;
- identifying significant matters arising from the audit, alert the Auditor General for Scotland and support Audit Scotland in producing statutory reports as required; and
- undertaking work requested by Audit Scotland or local performance audit work.

### Wider scope requirements

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland:

- **Financial sustainability** – looking 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.
- **Financial management** – financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.
- **Governance and transparency** – the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.
- **Value for money** – using resources effectively and continually improving services.

# Scope of work and approach (continued)

## Our approach

### Liaison with internal audit

The Auditing Standards Board's version of ISA (UK) 610 "Using the work of internal auditors" prohibits use of internal audit to provide "direct assistance" to the audit. Our approach to the use of the work of Internal Audit has been designed to be compatible with these requirements.

We will review their reports and meet with them to discuss their work. We will discuss the work plan for internal audit, and where they have identified specific material deficiencies in the control environment we consider adjusting our testing so that the audit risk is covered by our work.

Using these discussions to inform our risk assessment, we can work together with internal audit to develop an approach that avoids inefficiencies and overlaps, therefore avoiding any unnecessary duplication of audit requirements on HES's staff.

### Approach to controls testing

Our risk assessment procedures will include obtaining an understanding of controls considered to be 'relevant to the audit'. This involves evaluating the design of the controls and determining whether they have been implemented ("D&I").

The results of our work in obtaining an understanding of controls and any subsequent testing of the operational effectiveness of controls will be collated and the impact on the extent of substantive audit testing required will be considered.

### Consideration of group entities

In line with 2016/17, we expect HES to consider the following as group entities: HESe and SCRAN Limited.

These are both audited separately to HES by us.

### Promoting high quality reporting to stakeholders

We view the audit role as going beyond reactively checking compliance with requirements: we seek to provide advice on evolving good practice to promote high quality reporting.

The National Audit Office prepare a checklist each year designed to ensure that entities covered by the Government financial reporting manual (FReM) have prepared their annual accounts in the appropriate form and have complied with all disclosure requirements. We would recommend HES consider this during drafting the annual accounts.

Obtain an understanding of the Board and its environment including the identification of relevant controls.

Identify risks and controls that address those risks.

Carry out "design and implementation" work on relevant controls.

If considered necessary, test the operating effectiveness of selected controls

Design and perform a combination of substantive analytical procedures and tests of details that are most responsive to the assessed risks.

# Significant risks Dashboard



Risk	Material	Fraud risk	Planned approach to controls testing	Level of management judgement	Page no.
Completeness of commercial income			Design and implementation		15
Investment grants			Design and implementation		16
Management override of controls			Design and implementation		17
Restricted funds			Design and implementation		18

Some degree of management judgement

Limited management judgement

# Significant risks (continued)

## Risk 1 – Completeness of commercial income

### Key focus for management

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**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, are government grant in aid and commercial income. 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. As regular reconciliations are performed between the bank accounts and the amounts recognised via the Galaxy till receiving system, the risk is focused on how any reconciling items are investigated and addressed. This will be our key area of audit focus.

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**Planned audit challenge**

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 will perform the following:

- obtain an understanding of the design and implementation of the key controls in place in relation to recording of commercial income;
- perform analytical procedures over commercial income reported for the year, based on visitor numbers and price changes, to confirm accuracy; and
- Detailed testing of the year-end reconciling difference as identified in the monthly control account reconciliation for account code 9111, being the difference between what is uploaded from the Galaxy system, and what is uploaded from the bank statements, to gain assurance over completeness of amounts recognised as income in the financial statements.

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**Deloitte Comment**

We are not aware of any issues arising which would impact on the treatment of income during the year, and we did not find any issues with the completeness of commercial income in our prior year audit work.

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# Significant risks (continued)

## Risk 2 – Investment grants

### Accounting treatment under Charities SORP

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**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.

From our testing in 2016/17, we identified an uncorrected misstatement in relation to the recognition of investment grants where a number of grants were found to have been accounted for incorrectly. Management undertook a full review of all investment grants, which quantified the total error as £638k. Systematic errors were found as a result of reconciliation errors in determining year-end accruals and commitments. We therefore 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.

As a result of the history of errors, this remains a significant risk area in 2017/18.

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**Planned audit challenge**

Under the Charities SORP (FRS102) the award of a grant is recognised as a liability 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. We will perform the following:

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

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**Deloitte Comment**

No testing has been performed to date as we will complete the above as part of our year-end visit.

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# Significant risks (continued)

## Risk 3 – Management override of controls

We will use computer assisted audit techniques to support our work on the risk of management override

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**Risk identified**

In accordance with ISA 240 (UK and Ireland) management override is a significant risk. This risk area includes the potential for management to use their judgement to influence the financial statements as well as the potential to override the HES's controls for specific transactions.

The key judgments in the financial statements are those which we have selected to be the significant audit risk around revenue recognition and investment grants. This is inherently the areas in which management has the potential to use their judgment to influence the financial statements.

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**Planned audit challenge**

In considering the risk of management override, we plan to perform the following audit procedures that directly address this risk:

- We will test journals, using our data analytics tool, to focus our testing on higher risk journals;
- We will review accounting estimates for bias that could result in material misstatements due to fraud;
- We will obtain an understanding of the business rationale of significant transactions that we become aware of that are outside of the normal course of business for the entity, or that otherwise appear to be unusual, given our understanding of the entity and its environment.

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**Deloitte Comment**

We did not identify in our prior year audit work any transactions which appeared unusual or outside the normal course of business.

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# Significant risks (continued)

## Risk 4 – Restricted funds

### Presumed risk under Practice Note 11 The Audit of Charities in the United Kingdom

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**Risk identified**

In accordance with Practice Note 11 The Audit of Charities in the United Kingdom (revised) issued by the Auditing Practices Board, restricted funds is 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.

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**Planned audit challenge**

In considering the risk of restricted funds being accounted for incorrectly as unrestricted funds, we plan to perform the following audit procedures that directly address this risk:

- As part of our income testing, we will consider if any restrictions apply;
- We will carry out tests of detail on restricted fund expenditure, and tie this back to the supporting documentation for the restricted income used to fund the expenditure to assess whether the restrictions of the income have been met and
- We will also assess the presentation and classification of transfers between restricted and unrestricted funds.

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**Deloitte Comment**

We did not identify in our prior year audit any issues with the classification of restricted or unrestricted funds.

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# Wider scope requirements

## Audit dimensions

The Code of Audit Practice sets our four audit dimensions which set a common framework for all public sector audits in Scotland. We will consider how HES in addressing these areas, including any risks to their achievement, as part of our audit work as follows:

Audit dimension	Areas to be considered	Impact on the 2017/18 Audit
<p><b>Financial sustainability</b> 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.</p>	<ul style="list-style-type: none"> <li>• The financial planning systems in place across the shorter and longer terms</li> <li>• The arrangements to address any identified funding gaps</li> <li>• The affordability and effectiveness of funding and investment decisions made</li> <li>• Workforce planning</li> </ul>	<p>We noted in our 2016/17 annual report that work was underway to develop a medium term financial strategy. We will therefore monitor progress with the development of this and also consider whether there is a long-term financial strategy in place and if investment is effective.</p> <p><b>Audit Risk:</b> There is a risk that the plans for efficiency are not robust to allow the benefits to be realised.</p>
<p><b>Financial management</b> is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively</p>	<ul style="list-style-type: none"> <li>• Systems of internal control</li> <li>• Budgetary control system</li> <li>• Financial capacity and skills</li> <li>• Arrangements for the prevention and detection of fraud</li> </ul>	<p>We will review the budget and monitoring reporting to the Board during the year to assess whether financial management and budget setting is effective. From our audit work in 2016/17 we found that HES had strong financial monitoring arrangements in place however, the capacity and continuity of the finance team was raised as a concern.</p> <p>Our fraud responsibilities and representations are detailed on pages 32 and 33.</p> <p><b>Audit Risk:</b> A lack of appropriate capacity and skills in the finance team could impact on HES's ability to implement sound financial controls and achieve financial targets.</p>

# Wider scope requirements (continued)

## Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2017/18 Audit
<p><b>Governance and transparency</b> is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.</p>	<ul style="list-style-type: none"> <li>• Governance arrangements</li> <li>• Scrutiny, challenge and transparency on decision making and financial and performance reports</li> <li>• Quality and timeliness of financial and performance reporting</li> <li>• Accountable officers' duty to secure Best Value</li> </ul>	<p>We will review the financial and performance reporting to the Board during the year as well as minutes of all Board meetings to assess the effectiveness of the governance arrangements. Our attendance at ARAC will also inform our work in this area. Our audit work in 2016/17 found no issues.</p> <p><b>Audit Risk:</b> Given the number of changes in senior leadership during 2017, there is a risk that the skills and continuity are not sufficient for effective scrutiny and challenge.</p>
<p><b>Value for money</b> is concerned with using resources effectively and continually improving services.</p>	<ul style="list-style-type: none"> <li>• Value for money in the use of resources</li> <li>• Link between money spent and outputs and the outcomes delivered</li> <li>• Improvement of outcomes</li> <li>• Focus on and pace of improvement.</li> </ul>	<p>From our 2016/17 audit work we concluded that HES had a clear performance management framework in place. During 2017/18 we will review how HES is addressing areas where targets are not being met.</p> <p><b>Audit Risk:</b> there is a risk that insufficient resources are targeted to areas of under performance.</p>

# Wider scope requirements (continued)

## Specific risks

As part of the 2017/18 planning guidance, Audit Scotland have identified the following areas as significant risks faced by the public sector. While we have not identified any specific risks in relation to these areas for HES, we will continue to monitor these areas as part of our audit work.

Risk	
<b>EU withdrawal</b>	<p>There remains significant uncertainty about the detailed implications of EU withdrawal. Nonetheless, given the potential timetables involved, it is critical public sector bodies are working to understand, assess and prepare for the impact on their business. Key aspects of this are likely to include three broad areas:</p> <ul style="list-style-type: none"><li>- Workforce</li><li>- Funding</li><li>- Regulation</li></ul>
<b>New Financial Powers</b>	<p>The provisions of the 2012 and 2016 Scotland Acts and the accompanying Fiscal Framework agreement are leading to fundamental changes to the Scottish public finances. New tax raising, borrowing and social security powers provide the Scottish Parliament with more policy choice, but also mean the Scottish budget is subject to greater volatility, uncertainty and complexity. There is also a stronger link between the performance of the Scottish economy (relative to the rest of the UK) and available funding.</p> <p>The changes are likely to impact across public sector bodies to varying degrees, both directly (for example where an organisation's activities include additional responsibilities as a result of the new powers) and indirectly (for example as a result of potential changes to the way the Scottish Government manages its overall budget).</p>

# Wider scope requirements (continued)

## Specific risks (continued)

Risk	
<b>Ending of public sector pay cap</b>	<p>Pay increases in the public sector have been frozen and then capped at 1% for seven years. Politicians in both Westminster and Holyrood are talking about ending the public sector pay cap.</p> <p>When introducing the Programme for Government 2017-18, the First Minister confirmed that the Scottish Government will lift the 1% public sector pay cap.</p> <p>All public bodies need to consider the potential impact of the ending the pay cap as they prepare their budgets and consider their financial sustainability.</p>
<b>Response to cyber security risks</b>	<p>Audit Scotland will issue further guidance in relation to this risk, setting out the risk context for public bodies, the new cyber resilience requirements being introduced by the Scottish Government and questions that auditors can pose to bodies to understand the risk and mitigating action in a local context. We will share this with management when this is available.</p>
<b>Openness and transparency</b>	<p>There are signals of changing and more challenging expectations for openness and transparency in public business. In view of this direction of travel, Audit Scotland noted that 2016/17 annual audit reports highlighted the need for public bodies to keep this area under review and to consider whether there is scope to enhance transparency.</p>

# Wider scope requirements (continued)

## NFI, Performance audits and impact reports

### National Fraud Initiative (NFI)

The NFI is a data matching exercise which matches electronic data within and between participating bodies to prevent and detect fraud and is run every two years. All data was submitted in October 2016 and boards received matches for investigation in January 2017. Audit Scotland expects bodies to investigate all recommended matches based on findings and the risk of error or fraud. Match investigation work should be largely completed by 30 September 2017 and the results recorded on the NFI system.

In accordance with Audit Scotland planning guidance, we are required to monitor the Board's participation and progress during 2016/17 and 2017/18 and complete an NFI audit questionnaire by 28 February 2018. The information contained in this questionnaire will be used for Audit Scotland's NFI report to be published in June 2018. In our 2016/17 annual report, we noted that HES were fully engaged with the NFI exercise and had processed 295 out of the 296 matches flagged.

### Performance Audits

In accordance with Audit Scotland planning guidance, we will be requested to provide information to support performance audits on the following subjects during the year:

<b>Performance audit title</b>	<b>Appointed auditor input</b>
Digital – cross cutting	No formal return. Audit Scotland will provide information and guidance on current issues and risks to consider as part of planning process.

### Impact reports

We will be requested to provide information to support Audit Scotland's Performance Audit and Best Value (PABV) team in assessing the impact of the following performance audits during 2017/18: Supporting Scotland's economic growth.

# Audit Quality

## Our commitment to audit quality



Our objective is to deliver a distinctive, quality audit to you. Every member of the engagement team will contribute, to achieve the highest standard of professional excellence.

In particular, for your audit, we consider that the following steps will contribute to the overall quality:

We will apply professional scepticism on material issues and significant judgements identified, by using our expertise in the central government sector and elsewhere to provide robust challenge to management.

We have obtained a deep understanding of your business, its environment and of your processes in income recognition, payroll expenditure and capital expenditure enabling us to develop a risk-focused approach tailored to HES.

Our engagement team is selected to ensure that we have the right subject matter expertise and industry knowledge. We will involve specialists to support the audit team in our work.

In order to deliver a quality audit to you, each member of the core audit team has received tailored learning to develop their expertise in audit skills, delivered by Pat Kenny, Audit Director. This is a director-led programme encouraging teams from across our practice to engage and discuss current sector and audit issues, sharing best practice and expertise. This is in addition to a practice wide public sector training day held prior to the end of the financial year to share key issues from across the country, to update on regulatory changes and provide early warning of issues other teams may have faced at the interim testing phase.



### **Engagement Quality Control Review**

We have developed a tailored Engagement Quality Control approach. Our dedicated Professional Standards Review (PSR) function will provide a 'hot' review before any audit or other opinion is signed. PSR is operationally independent of the audit team, and supports our high standards of professional scepticism and audit quality by providing a rigorous independent challenge.



# 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 establish our respective responsibilities in relation to the financial statements audit, to agree our audit plan and to take the opportunity to ask you questions at the planning stage of our audit. Our report includes:

- Our audit plan, including key audit judgements and the planned scope;
- Key regulatory and corporate governance updates, relevant to you.

### What we don't report

As you will be aware, our audit is 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.

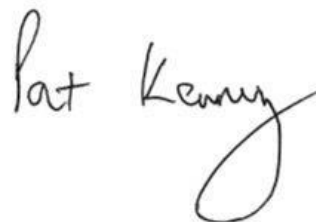
Finally, the views on internal controls and business risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed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

### Other relevant communications

We will update you if there are any significant changes to the audit plan.

This report has been prepared for the Audit, Risk and Assurance Committee, 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. Except where required by law or regulation, it should not be made available to any other parties without our prior written consent.

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



**Pat Kenny, CPFA**

for and on behalf of Deloitte LLP

Glasgow

4 January 2018

# **Technical update**

Information on sector developments



# Sector developments

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

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The Charity Governance Code was finalised in July 2017. The Code is not a legal or regulatory requirement but provides guidance on setting principles and recommended practice for good governance. The Code is intended to be a continuous tool for development and applicable to all charities, even though governance practice may differ significantly depending on the size, income, complexity and activities of the charity.

There are seven fundamental principles forming the code:

- Organisational Purpose;
- Leadership;
- Integrity;
- Decision-Making, Risk and Control;
- Board Effectiveness;
- Diversity; and
- Openness and Accountability.

## **Charity Governance Code**

It is intended that Charities applying the code include a brief statement in their annual report with an 'apply or explain' approach. The Code is voluntary so this is not 'comply or explain' as for example required by the UK Corporate Governance Code.

The Charity Governance Code Steering Group has published two versions for larger and smaller charities. It is expected that Charities with a typical annual income of over £1m and externally audited accounts will use the larger version of the code.

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# Sector developments (continued)



## **Payments by subsidiaries to their charitable parents that qualify for gift aid**

The FRC has published FRED 68 *Payments by subsidiaries to their charitable parents that qualify for gift aid*. The aim of the consultation is to unify the diverse practice in the sector following the publication of the ICAEW guidance TECH 16/14BL Revised. The amendment confirms that, for a wholly owned subsidiary, a distribution to a charitable parent, where it is probable that the payment will be made within the 9 months and will qualify to set against profits for tax purposes, can be treated as a tax expense. The tax effects of the payment shall be presented in the profit and loss and the tax effects shall be consistent with the treatment planned to be used in the entities filings. Such a payment is an exception to the principle that tax effects should be presented in the same component of total income or equity as the transaction.

The amendment does not make any change to the recognition of the liability and following FRS 102 32.8 a liability for the distribution can only be recognised when there is a deed of covenant in place, however the distribution can be shown as a designated reserve.

Currently the amendment has an effective date of accounting periods beginning on or after 1 January 2019 but can be early adopted where both this and the changes in FRED 67, the FRC triennial review of FRS 102, are adopted also.

# General Data Protection Regulation

The EU GDPR will come into effect from 25 May 2018, and will effectively supercede the existing Data Protection Act.

## Issue

The EU General Data Protection Regulation (“GDPR”) will come into effect in 2018, replacing the Directive that formed the basis for the Data Protection Act. The GDPR is expected to remain in effect for the foreseeable future, notwithstanding Brexit.

The key new concept is of “accountability” – being able to **demonstrate** compliance, with specific actions required with an evidence trail.

- Data Protection Impact Assessments are required for high risk processing of data, and there are specific requirements for transparency and fair processing of data. There are tighter rules where consent is the basis for processing data.
- There are requirements to keep records of data processing activities, with the removal of most charges for providing copies of records to patients or staff who request them.
- Penalties for breaches of the regulation are significantly higher than existing arrangements (up to €10m for data breaches and up to €20m for breaches of the principles), and apply to any breach of the regulation, not just data breaches.
- All public authorities, including NHS bodies, are required to appoint a suitably qualified and experienced Data Protection Officer.
- There is a legal requirement to notify security breaches to the Information Commissioner within 72 hours.

Getting ready to comply with the GDPR can start with reducing the risk of the data breaches – and reducing that risk doesn’t need to be complicated. The biggest causes of data breaches can be avoided by making sure the basics are in place: keep all operating systems and software up to date, implement encryption for sensitive data, and educate all employees about the risk of phishing and other social engineering attacks.

Your organisation might also consider the [Cyber Essentials scheme](#) and the [10 Steps to Cyber Security](#), both developed by Government to ensure any organisation can protect themselves from common cyber-attacks.

The Information Commissioner’s Office has also developed a useful [12 step guide](#) to help organisations consider their current data protection activities and what needs to be done to comply with the new regulations. They will be developing guidance over the coming months so keep an eye on [their website](#) for more information.

## Deloitte View

Privacy as a concept is broad and far-reaching. The GDPR impacts many areas of an organisation, and is not just a legal/compliance issue. The GDPR brings specific rights to the public, including the “right to be forgotten” and data portability.

The emphasis on organisational accountability will require proactive, robust privacy governance. A key challenge is the need to identify a suitably qualified Data Protection Officer, with an estimated need for 28,000 DPOs across Europe.

The requirements will change how information technologies are designed and managed, with a requirement for documented privacy risk assessments when implementing major new systems, with “Privacy by Design” now enshrined in law.

The requirement to notify security breaches within 72 hours will require new or enhanced incident response procedures.

Teams tasked with information management will need to provide clearer oversight on data storage, journeys and lineage. Greater clarity on what data is collected and where it is stored will make it easier to comply with the new data subject rights.

## Next steps

The Audit, Risk and Assurance Committee should consider how it is obtaining assurance over the adequacy of the Board’s action plans to ensure compliance with the GDPR.

# Appendices



# Prior year audit adjustments

## Corrected, uncorrected and disclosure misstatements

### **Corrected misstatements**

There were no corrected misstatements identified during the course of our prior year audit.

### **Uncorrected misstatements**

We identified an uncorrected misstatement from our prior year audit relating to the recognition of investment grants where a number of grants were found to have been accounted for incorrectly. Management undertook a full review of all investment grants to quantify the overall understatement of accrual for grants payable as £638k.

### **Disclosure misstatements**

There were no uncorrected disclosure misstatements identified during the course of our prior year audit.

# Fraud responsibilities and representations

## Responsibilities explained



### Your 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.



### Our responsibilities:

- We are required to obtain representations from your management regarding internal controls, assessment of risk and any known or suspected fraud or misstatement.
- 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.
- As set out in the significant risks section of this document, we have identified the risk of fraud in completeness of commercial income, accounting for investment grants, restricted funds and management override of controls as a key audit risk for your organisation.



### Fraud Characteristics:

- Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- Two types of intentional misstatements are relevant to us as auditors – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

### We will request the following to be stated in the representation letter signed on behalf of the Board:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We are not aware of any fraud or suspected fraud that affects the entity or group and involves:
  - (i) management;
  - (ii) employees who have significant roles in internal control; or
  - (iii) others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.





# Fraud responsibilities and representations

## Inquiries

We will make the following inquiries regarding fraud:



### **Management:**

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.
- Management's process for identifying and responding to the risks of fraud in the entity.
- Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity.
- Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
- Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.

### **Internal audit and Local Counter Fraud Specialist**

- Whether internal audit and the Board's local counter fraud specialist has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.



### **Those charged with governance**

- How those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.
- Whether those charged with governance have knowledge of any actual, suspected or alleged fraud affecting the entity.
- The views of those charged with governance on the most significant fraud risk factors affecting the entity.



# Independence and fees



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

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## Independence confirmation

We confirm the audit engagement team, and others in the firm as appropriate, Deloitte LLP and, where applicable, all Deloitte network firms are independent of HES and will reconfirm our independence and objectivity to the Audit Committee for the year ending 31 March 2018 in our final report to the Audit, Risk and Assurance Committee.

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## Fees

Fee range for the 2017/18 audit to be provided by Audit Scotland in mid December 2017 will be discussed and agreed with management and the Audit, Risk and Assurance Committee in early 2018.

Separate audit fees will also be discussed and agreed in relation to the audits of HESe and SCRAN Limited.

Details of any non-audit fees for the period will be presented in our final report.

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## Non-audit services

We continue to review our independence and ensure that appropriate safeguards are in place in relation to any non-audit services provided 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.

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## Relationships

We have no other relationships with the Board, its directors, senior managers and affiliates, and have not supplied any services to other known connected parties.

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# Our approach to quality

## AQR team report and findings



We maintain a relentless focus on quality and our quality control procedures and continue to invest in and enhance our overall firm Audit Quality Monitoring and Measuring programme.

In June 2017 the Financial Reporting Council ("FRC") issued individual reports on each of the six largest firms, including Deloitte, on Audit Quality Inspections which provides a summary of the findings of its Audit Quality Review ("AQR") team for the 2016/17 cycle of reviews.

The review performed by the AQR forms an important part of our overall inspection process. We perform causal factor analysis on each significant finding arising from both our own internal quality review and those of our regulators to identify the underlying cause. This provides insight which drives the developments in our quality agenda.

18 of the audits reviewed by the AQR were performed to a good standard with limited improvements required. We were disappointed that, despite the high standards we set and many areas of improvement in our quality record, the percentage of audits rated as requiring more than limited improvements has remained broadly similar to the previous year and that two reviews were identified as requiring significant improvement.

We have taken swift and decisive action to respond to the matters identified and will continue to monitor the implementation of these. We are firmly committed to achieving, and indeed exceeding, the FRC's objective that by 2019 90% of FTSE 350 audits reviewed will be assessed as requiring no more than limited improvements.

All the AQR public reports are available on its website.

### The AQR's 2016/17 Audit Quality Inspection Report on Deloitte LLP

"We reviewed selected aspects of 23 individual audits in 2016/17. In selecting which aspects of an audit to inspect, we took account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The communications with the Audit Committee and the audit of revenue were reviewed on nearly all of these audits..."

"The firm has taken the actions they committed to take following our last inspection. Some of the issues driving more adverse quality assessments this year are in similar areas to those reported last year, although some audits reviewed were undertaken before these actions had been carried out. Our main concern continues to be the adequacy of audit teams' challenge of management in key areas of judgment (particularly goodwill impairment) and further immediate action is required to improve audit quality in this area.

#### The firm has enhanced its policies and procedures in the following areas:

- Strengthened the evidence of the Engagement Quality Control Review ("EQCR") partner and audit technical reviewer involvement.
- Updated Deloitte's audit methodology to include additional focus on risk assessment and the related audit response (effective from 31 December 2016 year-end audits).
- Introduced more focused coaching for audit teams throughout the audit process.
- Issued more timely and focused guidance and reminders to the audit practice on key audit matters, to facilitate appropriate consideration by audit teams at the key stages of the audit.
- Increased mandatory technical training for qualified staff through to partner level

**Our key findings in the current year** requiring action by the firm, which are elaborated further in section 2 together with the firm's actions to address them, are that the firm should:

- Improve the extent of challenge of management in key areas of judgment, in particular impairment reviews and valuation of acquired intangible assets.
- Strengthen the firm's audit of revenue recognition.
- Make further improvements to the audit of defined benefit pension scheme balances in corporate entities.
- Continue to seek to improve the consistency of the quality of communications with Audit Committees."

# Our approach to quality

## Areas identified for particular attention

### How we have addressed these as a firm

### How addressed in our audit

Strengthen the firm's audit of revenue recognition.

A key theme of the enhancements to our methodology in 2016, (deployed after these engagements reviewed by the AQR were complete), was to enhance our risk assessment procedures and, as a result, encourage our auditors to develop more robust responses to the largest most critical account balances, with a natural focus on revenue.

This included the removal of capped sample sizes for very large balances and facilitation of a combination of test of details and substantive analytical procedures to enable more comprehensive audit responses to be designed.

This theme has continued in 2017 when our Summer Technical Training showcased our investment in analytic tools applied to the audit of revenue, as well as training on the accounting and auditing of revenue as we prepare to audit the implementation of the new revenue standard IFRS 15 'Revenue from Contracts with Customers' which is effective for periods beginning on or after 1 January 2018.

We have determined that the risk of fraud arising from revenue recognition is significant in relation to the completeness of commercial income, being income from admissions and retail income from properties in care.

This is based on the fact that commercial income comprises low value, high volume cash transactions across multiple locations and therefore there is an inherent risk of fraud in respect of these balances.

This is a significant audit risk and is addressed in page 15 of this paper.

Continue to seek to improve the consistency of the quality of communications with Audit Committees.

We take our responsibilities for reporting to the Audit, Risk and Assurance Committee very seriously. There is a natural follow on that if there is a failure in the underlying audit work we will inevitably fall short in our reporting on those areas. The majority of issues noted in the report linked directly to the review findings.

We continue to stress the critical importance of reporting matters to the Audit, Risk and Assurance Committee in the training we deliver and in the enhanced procedures we have established, in particular around key management estimates and judgments. We have issued refreshed Audit Committee reporting templates to the practice reflecting the observations of the reviews to ensure audit practitioners continue to focus on this critical aspect of our role.

We have reported to you in page 12 and 13 of this paper the Scope of work and the planned approach to the audit.

We would welcome any feedback on our approach to communicating with you.



# Our approach to quality

Areas identified for particular attention	How we have addressed these as a firm	How addressed in our audit
<p>Improve the extent of challenge of management in key areas of judgment, in particular impairment reviews and valuation of acquired intangible assets.</p>	<p>We have developed an Impairment Centre of Excellence and have mandated its involvement in all public interest entity audits with a material goodwill or intangibles balance for years ending on or after 15 December 2016. The specialists within the Impairment Centre of Excellence, in addition to having significant experience auditing complex impairment issues, have had specialist training to be able to identify and respond to the issues raised in the AQR report.</p> <p>Our Summer Technical Training in 2017 included interactive workshops on this area including sharing anonymised findings from internal and external review to illustrate the types of challenge and extent of audit evidence that teams should seek to achieve in this area.</p>	<p>HES does not have a goodwill balance or a material intangible asset balance, and so this is not applicable for the HES audit.</p>
<p>Make further improvements to the audit of defined benefit pension scheme balances in corporate entities.</p>	<p>We have improved our procedures to ensure confirmations are obtained from asset custodians where appropriate. In December 2015 we introduced a detailed practice aid dedicated to all areas of corporate pension balance auditing together with increased training.</p> <p>We have also mandated consultation with our Pension Audit Centre of Excellence for years ending on or after 15 December 2016 and refreshed the practice aid. This ensures our corporate audit teams have access to our experts in the audit of pension balances.</p>	<p>HES does not have an on-balance sheet defined benefit pension scheme, and so this is not applicable for the HES audit.</p>





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