



## **Historic Environment Scotland**

Planning report to the Audit, Risk and Assurance Committee on the  
audit for the year ending 31 March 2019

Issued 7 February 2019 for the meeting on 13 February 2019

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# 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 planning report to the Audit, Risk and Assurance Committee (ARAC) of Historic Environment Scotland (HES) for the year ending 31 March 2019 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.

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 accordance with auditing standards, we have identified a significant risk associated with income. This risk is pinpointed to the completeness of the commercial income due to the fact that HES receives a large amount of commercial income as 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 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. We also noted that there were limited controls in place to mitigate the risk of funds not being correctly classified as restricted. While we note that most of HES' income is unrestricted and that this risk is therefore limited, the restricted fund balance at 31 March 2018 was material therefore we will follow this up as part of the 2018/19 audit.
- Accounting for investment grants was classed as a significant risk in previous years audits. In our 2017/18 audit, no errors were identified and we noted an improvement in the year-end controls. However, given the change in finance staff during 2018/19, the year-end processes are currently being reviewed and updated. On the basis that similar controls and processes are put in place to those in 2017/18, we have deemed this to be no longer a significant risk area, but we will monitor and update the ARAC if there are any changes to this assessment.

# Introduction (continued)

## The key messages in this report (continued)

### **Audit Dimensions**

The Code of Audit Practice sets out 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 2019. In particular, our work will focus on:

**Financial sustainability** – As with all public sector bodies, HES continues to face significant financial challenges. Whilst HES is on target to achieve a balanced budget by the end of the year, the overall 2018/19 forecast position projected at 30 September 2018 was an over commitment of £2,157k, which has been largely driven by pressures from salary costs totalling £1,486k, operational expenditure of £351k and cost of sales of £157k. The main reason for the salary costs pressure is due to the fact that the budget assumed a challenging vacancy factor which has only been partially achieved. Action has been taken to address the pressures particularly through reviewing discretionary spend within operational and Investment Plan expenditure.

There remains a risk that the Scottish Government will continue to place pressure on HES by reducing the Grant in Aid (GiA). HES would need to manage this reduction in income whilst simultaneously managing the same or increasing numbers of visitors to attractions and properties throughout Scotland. This poses a risk to the ability of achieving delegated responsibilities. Therefore, it is important that HES looks at other means of increasing its non-GiA income, such as through increasing admission fees, or by diversifying income sources. The achievement of delegated responsibilities and how HES aims to improve non-GiA income going forward as part of ensuring its financial sustainability will be a key area of audit focus.

We noted in our 2017/18 annual report that work was ongoing to develop a medium-term financial strategy. The Board endorsed the Strategy in November 2018. We will therefore review this Strategy.

**Financial management** – We will review the budget and monitoring reports produced during the year and liaise with internal audit in relation to their work on the financial control environment to assess whether financial management and budget setting is effective.

From our audit work in 2017/18 we found that HES had strong financial monitoring procedures in place and that they had made improvements to the capacity and continuity of the finance team. However, given that many of the vacancies have been permanently filled only recently, it is still a relatively new finance team. We will therefore continue to monitor the capacity of the finance function, particularly with regards to the production of the annual report and accounts.

**Governance and transparency** – From our 2017/18 audit we noted good governance arrangements in place. There is no specific risk in this area and therefore we will limit our work in this area to the review of Board papers and attendance at ARACs to assess the effectiveness of governance.

**Value for money** – From our 2017/18 audit work we concluded that HES had a clear performance management framework in place. However, we identified that improvements could be made to increase visibility of resource and financial planning based on the evidence-based contribution to key HES priorities and national performance outcomes. During 2018/19 we will review what HES is doing to demonstrate the linkage between resources expended and the achievement of HES priorities and national outcomes.

# Introduction (continued)

## The key messages in this report (continued)

### **Other wider scope work**

Our audit work on the four audit dimensions incorporates the specific risks highlighted by Audit Scotland, in particular, the impact of EU withdrawal, the changing landscape for public financial management, dependency on key suppliers and increased focus on openness and transparency.

We will monitor HES' participation and progress with the NFI exercise during 2018/19 and into 2019/20 and, where appropriate, include references to the NFI in our annual audit reports for both years. We will also complete an NFI audit questionnaire and submit to Audit Scotland by 30 June 2019.

### **Regulatory Change**

Key sector developments are set out in our separate report. We will continue to review and assess the impact of sector developments on the audit plan throughout the year.

### **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

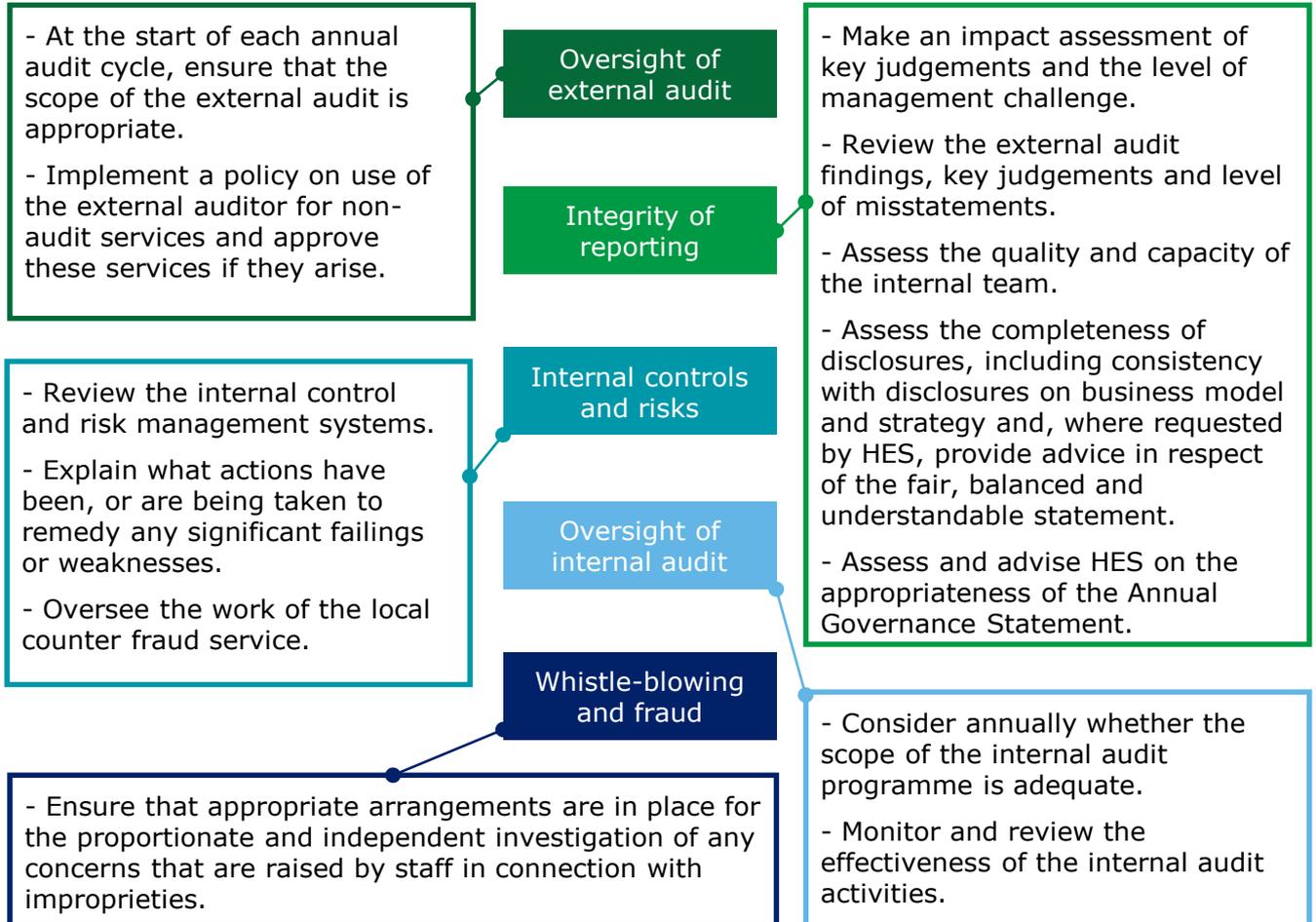
The primary purpose of the Auditor's interaction with the ARAC:

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

We use this symbol throughout this document to highlight areas of our audit where the ARAC need to focus their attentions.



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



# Our audit explained

## We tailor our audit to your body 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. As at 30 September 2018, HES is forecasting an over commitment of £2,157k.

A summary of these considerations is set out on pages 9-10.

### Scoping

Our scope is in line with the Code of Audit Practice issued by 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 pages 11-12.

### 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 group materiality of £2,031k (2017/18: £1,889k) with a performance materiality of £1,523k (2017/18: £1,417k). This is based on forecast gross expenditure in line with prior year. For the audit of HES (charity only) a materiality of £1,726k (2017/18: £1,700k) has been determined, with performance materiality of £1,294k (2017/18: 1,275k).

We will report to you any misstatements above £101k (2017/18: £94k). More detail is given on page 10.

The materiality levels for the two subsidiaries is also detailed on page 10.

### Significant risk assessment

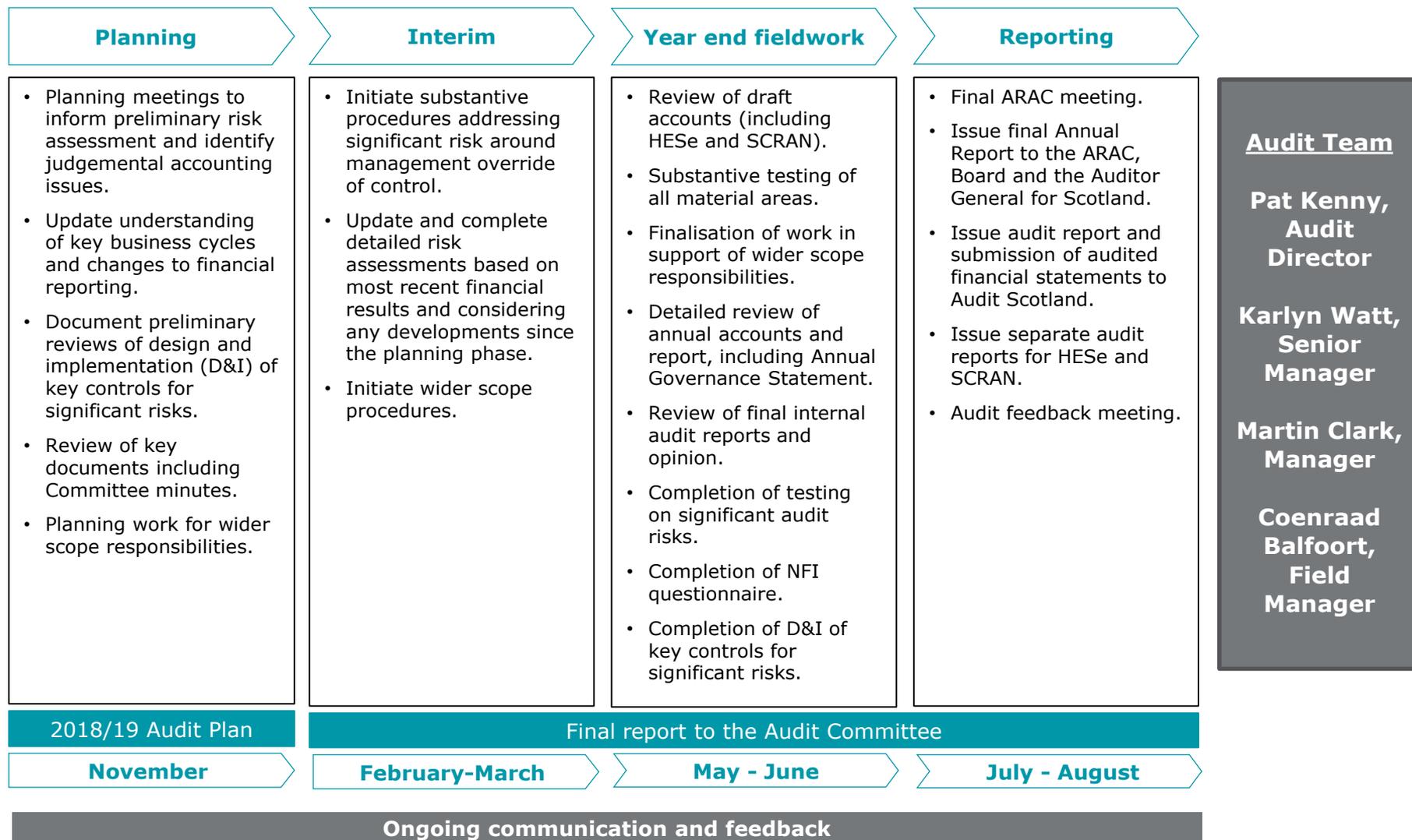
We have identified significant audit risks in relation to HES. More detail is given on pages 13-17. These significant risks are consistent with those identified in our prior year audit with the exception of investment grants which is no longer considered a significant risk. This is discussed further on page 18.

### 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

### Impact on our audit

Future strategy and financial sustainability



HES continues to face significant financial challenges. Whilst HES is on target to achieve a balanced budget by the end of the year, the overall 2018/19 forecast position projected at 30 September 2018 was an over commitment of £2,157k, which has been largely driven by pressures from salary costs totaling £1,486k, operational expenditure of £351k and cost of sales of £157k. The main reason for the salary costs pressure is due to the fact that the budget assumed a challenging vacancy factor which has only been partially achieved. Action has been taken to address the pressures particularly through reviewing discretionary spend within operational and Investment Plan expenditure.

The 2018/19 forecast for commercial income as at 30 September 2018 is in line with the original budget of £62,000k. There are risks associated with Brexit and how this will impact on visitor numbers as well as the ability to recruit staff (discussed further on page 22). There also remains a risk that the Scottish Government will continue to place pressure on HES by reducing the Grant in Aid. Furthermore, as a Non-Departmental Public Body (NDPB) HES are not allowed to retain reserves to be used in future years, which can act as a disincentive to maximising income given that any surpluses cannot be retained for spending in future years as they have to be spent in the year in which they are generated/received. Therefore financial sustainability remains a risk and will be a key area of audit focus.

We noted in our 2017/18 annual report that work was ongoing to develop a medium-term financial strategy. We will therefore monitor progress with the development and finalisation of this.

Central Management Information System (CMIS)



HES is in the process of implementing a new CMIS which is intended to support and enable strategic and operational decisions to be taken based on current and consistent information through the dynamic exchange and collation of information between its core corporate functions. In addition, CMIS is focused on business improvement within these core functions. Therefore, the building blocks that are required will include the improvement of systems in both HR and Finance, as well as the introduction of functionality and/or specific applications to deliver in the areas of: corporate risk management, corporate performance management, project management and corporate planning.

The Full Business Case was approved by the Board in May 2018 and has subsequently been approved by the Scottish Government. In addition, the project has been subject to external assurance review by the Scottish Government Technology Assurance Framework which noted significant progress having been made in the early stages of the project to support a confident delivery. HES has recruited for key posts within the project team to implement the system. We will monitor the progress of this project during the course of our audit.



New significant risk



Continuing significant risk



Considered as part of wider scope audit requirements

# Materiality

## Our approach to materiality

### Basis of our materiality benchmark

- The audit director has determined materiality for the group as £2,031k (2017/18: £1,889k) and a performance materiality of £1,523k (2017/18: £1,417k) based on professional judgement and risk factors specific to HES, the requirements of auditing standards and the financial measures most relevant to users of the financial statements.
- Performance materiality is the amount or amounts set at less than materiality for the financial report as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial report as a whole.
- We have used 2.0% of forecasted gross expenditure as the benchmark for determining materiality and applied 75% as performance materiality. This approach is consistent with our prior year materiality calculation.
- For the audit of HES (charity only) a materiality of £1,726k (2017/18: £1,700k) has been determined, with performance materiality of £1,294k (2017/18: 1,275k).

### Reporting to those charged with governance

- We will report to you all misstatements found in excess of our clearly trivial threshold which is £101k (2017/18: £99k); for the audit of HES (charity only) the threshold is £86k (2017/18: £85k).
- This is 5% of materiality, which is based on our current methodology and consistent with last year.

- 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

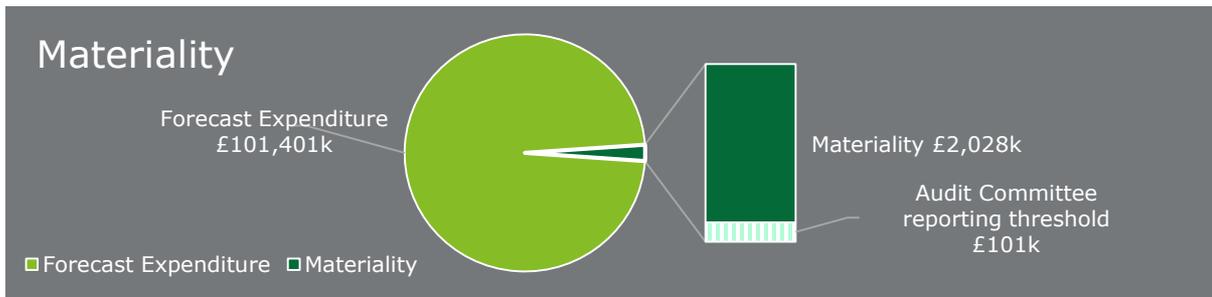
We will:

- report the group materiality, HES only materiality and the range we use for component materialities;
- 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.

### Group scoping

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:

- SCRAN materiality £34k (2017/18: £35k) and performance materiality £25k (2017/18: £26k); and
- HESe materiality £328k (2017/18: £303k) and performance materiality £246k (2017/18: £273k).



Although materiality is the judgement of the Audit Director, the ARAC 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 work	Planned output	Timeline
Perform an ISA (UK) compliant audit of the annual accounts	<ul style="list-style-type: none"> <li>Annual audit plan</li> <li>Interim report (if required)</li> <li>Independent auditor's report</li> </ul>	<ul style="list-style-type: none"> <li>13 February 2019</li> <li>April 2019</li> <li>July/August 2019</li> </ul>
Audit and report on the audit dimensions	<ul style="list-style-type: none"> <li>Annual audit plan</li> <li>Annual audit report</li> </ul>	<ul style="list-style-type: none"> <li>13 February 2019</li> <li>24 July 2019</li> </ul>
Contribute to performance audits (including performance audit reports, overview reports and impact reports)	<ul style="list-style-type: none"> <li>Data returns</li> </ul>	<ul style="list-style-type: none"> <li>As required</li> </ul>
Share audit intelligence with Audit Scotland including highlighting potential statutory reports	<ul style="list-style-type: none"> <li>Current issues returns</li> </ul>	<ul style="list-style-type: none"> <li>January and July 2019</li> </ul>
Carry out preliminary enquiries into referred correspondence	<ul style="list-style-type: none"> <li>None</li> </ul>	<ul style="list-style-type: none"> <li>N/A</li> </ul>
Provide information on cases of fraud	<ul style="list-style-type: none"> <li>Fraud returns</li> </ul>	<ul style="list-style-type: none"> <li>November 2018, February, May and August 2019</li> </ul>
Provide information on cases of money laundering	<ul style="list-style-type: none"> <li>Audit Scotland to advise</li> </ul>	<ul style="list-style-type: none"> <li>As required</li> </ul>
Contribute to National Fraud Initiative (NFI) report	<ul style="list-style-type: none"> <li>NFI audit questionnaire</li> <li>Reference, if necessary, in annual audit report</li> </ul>	<ul style="list-style-type: none"> <li>June 2019</li> </ul>
Contribute to technical guidance notes	<ul style="list-style-type: none"> <li>Consultation comments on draft technical guidance notes</li> </ul>	<ul style="list-style-type: none"> <li>As required</li> </ul>

# 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.

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.

### 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.

Audit Scotland has published good practice guides in relation to the annual report and the Governance Statement to support HES in preparing high quality drafts of the Annual Report and financial statements, which we would recommend HES consider during drafting.

### 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").

Obtain an understanding of the body 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

## Our risk assessment process

We consider a number of factors when deciding on the significant audit risks. These factors include:

- the significant risks and uncertainties previously reported in the annual report and financial statements;
- our assessment of materiality; and
- the changes that have occurred in the business and the environment it operates in since the last annual report and financial statements.

### Principal risk and uncertainties

- Brexit – potential impact on income and staffing related to EU migrant workers
- Conservation risk
- Archive collections risk
- Health, safety and security

### Changes in your business and environment

- Brexit is the biggest potential change in the environment (as discussed further on page 22)

The next page summarises the significant risks that we will focus on during our audit. All the risks mentioned in the prior year Audit, Risk and Assurance Committee report are included as significant risks in this year's audit plan, with the exception of Investment Grants



# Significant risks (continued)

## Dashboard

Risk	Material?	Fraud risk identified?	Planned approach to controls testing	Level of management judgement	Page no.
Completeness of commercial income <sup>1</sup>			Design and implementation		15
Management override of controls <sup>2</sup>			Design and implementation		16
Restricted funds			Design and implementation		17

- <sup>1</sup> This risk covers both HES and HESE
- <sup>2</sup> This risk covers HES, HESE and SCRAN



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, for both HES and HESe, 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 100% verified. The significant risk is pinpointed to completeness of commercial income, being income from admissions (HES) and retail income (HESe) from properties in care. As regular reconciliations are performed between the bank accounts and the amounts recognised via the Galaxy till receipting 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:

- obtaining an understanding of the design and implementation of the key controls in place in relation to recording of commercial income;
  - 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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# Significant risks (continued)

## Risk 2 – Management override of controls

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

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**Risk identified**

In accordance with ISA 240 (UK) management override is a significant risk for HES, HESe and SCRAN. 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 controls for specific transactions.

The key judgements in the financial statements are those which we have selected to be the significant audit risks around revenue recognition and investment grants. This is inherently the areas in which management has the potential to use their judgement 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 on the audit of HES, HESe, and SCRAN that directly address this risk:

**Journal testing**

- We will test the design and implementation of controls over journal entry processing.
- Using our Spotlight data analytics tool, we will risk assess journals and select items for detailed follow up testing. The journal entries will be selected using computer-assisted profiling based on areas which we consider to be of increased interest.
- We will test the appropriateness of journal entries recorded in the general ledger, and other adjustments made in the preparation of financial reporting.

**Accounting estimates**

- We will test the design and implementation of controls over key accounting estimates and judgements.
- We will review accounting estimates for biases that could result in material misstatements due to fraud. This will include both a retrospective review of 31 March 2018 estimates and a review of the corresponding estimates as at 31 March 2019.

**Significant and unusual transactions**

- 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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# Significant risks (continued)

## Risk 3 – 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. While we note that most of HES' income is unrestricted and that this risk is therefore limited, the restricted fund balance at 31 March 2018 was material therefore we will follow this up as part of the 2018/19 audit.

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.

In our 2017/18 audit report we raised a recommendation that a formal control should be put in place to ensure that funds are correctly categorised as restricted/unrestricted from the outset when input in the financial system, and to ensure all staff involved are alerted to the specific conditions attached to the funds.

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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:

- obtaining an understanding of the design and implementation of the key controls in place in relation to recording of restricted income, including following up on whether a formal control has been put in place to ensure that funds are correctly categorised as restricted or unrestricted, in line with the prior year recommendation;
  - as part of our income testing, we will consider if any restrictions apply;
  - 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; and
  - assess the presentation and classification of transfers between restricted and unrestricted funds.
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# Area of Audit Focus

## Investment grants considerations

### Accounting treatment under Charities SORP

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#### **Risk considerations**

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.

Accounting for investment grants was classed as a significant risk in previous years audits. In our 2017/18 audit, no errors were identified and we noted an improvement in the year-end controls. However, given the change in finance staff during 2018/19, the year-end processes are currently being reviewed and updated.

On the basis that similar controls and processes are put in place to those in 2017/18, we have deemed this to be no longer a significant risk area, but we will monitor and update the ARAC if there are any changes to this assessment.

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#### **Planned audit challenge**

We will perform the following:

- obtain an understanding of the design and implementation of the key controls in place in relation to accounting for investment grants at the year-end to conclude on whether adequate controls in place in order to downgrade the risk from significant; 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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# Wider scope requirements

## Audit dimensions

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. We will consider how HES is 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 2018/19 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 2017/18 annual report that work was underway to develop a medium term financial strategy, a draft of which was presented to the Board in May 2018. Given known pressures such as the risk of the reduction of Grant in Aid and the risk associated with potential EU withdrawal (e.g. reduced visitor numbers and availability of EU staffing), it is important that a medium term financial strategy is finalised which takes into consideration these factors.</p> <p>Furthermore, in view of the Scottish Government’s Medium Term Financial Strategy (MTFS) (discussed further on page 23) we will consider the extent to which HES has reviewed the potential implications of the MTFS for its own financial planning and whether it is taking these into account in its arrangement for financial management and financial sustainability.</p> <p>We will review the Board-endorsed medium term financial strategy, including progress against the strategy in 2018/19.</p> <p><b>Audit Risk:</b> There is a risk that plans for efficiency and financial sustainability don’t address emerging trends such as the potential reductions to Grant in Aid and the risks associated with potential EU withdrawal, as well as the Scottish Government’s five-year plan, and that the plans are therefore not sufficiently robust to allow the benefits to be realised.</p>

# Wider scope requirements (continued)

## Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2018/19 Audit
<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, including plans for replacing the recently departed Head of Finance.</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 2017/18 we found that HES had strong financial monitoring arrangements in place.</p> <p>We also noted improvements to the capacity and continuity of the finance team. However, given that many of the vacancies have been permanently filled only recently, it is still a relatively new finance team. We will therefore continue to monitor the capacity of the finance function, particularly with regards to the production of the annual report and accounts.</p> <p>In view of the Scottish Government’s new budget process (discussed further on page 23) we will confirm that underlying financial performance including any in-year changes to funding agreed with the Scottish Government, is transparently presented.</p> <p><b>Audit Risk:</b> The underlying financial performance of HES is not transparently reported.</p> <p>Our fraud responsibilities and representations are detailed on pages 30 and 31.</p>

# Wider scope requirements (continued)

## Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2018/19 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> </ul>	<p>During the 2017/18 audit we identified that HES had good governance arrangements in place. There is no specific risk in this area and therefore we will limit our work in this area to the review of Board papers and minutes, and attendance at ARACs.</p> <p>In view of the increased focus on how public money is used and what is achieved (as discussed further on page 24), we will consider how HES has reviewed its approach to openness and transparency.</p> <p><b>Audit Risk:</b> The approach taken by HES towards openness and transparency is not keeping pace with public expectation and good practice.</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>In view of the Scottish Government’s new budget process (discussed further on page 23) we will consider the extent to which HES’s performance report provides an accessible account of HES’s overall performance and impact of its public spending.</p> <p>In our previous years audit reports, we recommended that HES look to link resource planning to the outcomes achieved with clear supporting KPIs. While we recognise that the new CMIS system (as discussed further on page 9) is expected to deliver on this objective, we will follow up any action taken as an interim solution.</p> <p><b>Audit Risk:</b> HES does not clearly report on its contribution towards both HES priorities and national outcomes.</p>

# Wider scope requirements (continued)

## Specific risks

As part of the 2018/19 planning guidance, Audit Scotland have identified the following areas as significant risks faced by the public sector. Any specific risks in relation to these areas for HES have been included in our audit risk under the audit dimensions, discussed on the previous pages. We will continue to monitor these areas as part of our audit work.

Risk	
<b>EU withdrawal</b>	<p>There are uncertainties surrounding the terms of the UK's withdrawal from the European Union in March 2019. Some arrangements have been provisionally agreed, such as a transition period to the end of 2020, although they are dependent on a final deal being reached between the UK Government and the remaining EU countries. The outcome of negotiations should become clearer in the weeks up to March 2019. EU withdrawal has been recognised as a high risk in HES's risk register.</p> <p>Whatever the outcome, EU withdrawal will inevitably have implications for devolved government in Scotland and for audited bodies. Audit Scotland has identified three areas where EU withdrawal may have the most significant impact as summarised below:</p> <ul style="list-style-type: none"><li>• <b>Workforce</b> – Many public services are dependent on workers from EU countries, including health, social care and education. A decline in migration from the EU could potentially result in vacancies and skills gaps in some areas of the public sector. There is a risk that this could impact on some public bodies' ability to deliver 'business as usual' particularly given existing workforce and service pressures.</li><li>• <b>Funding</b> – Funding from the EU makes an important contribution to the Scottish public sector. The main sources of funding provide support to farmers and rural businesses, projects to encourage economic growth and support for research and education. The UK Government has made guarantees to meet some funding commitments to the end of existing programmes, but there are uncertainties about what any replacement funding may look like.</li><li>• <b>Regulation</b> – The EU Withdrawal Bill will transpose existing EU law into UK law immediately after the UK leaves the EU. Legislation in many devolved areas will transfer to the Scottish Parliament. The UK government has identified 24 devolved policy areas where it seeks to retain temporary control until UK-wide common legislative frameworks are developed.</li></ul> <p>In addition, some public bodies may be affected directly by changes to trade and customs rules, which could impact on supply chains and the procurement of goods or services from EU countries. This could influence the availability and cost of supplies and services (e.g. specialist medical equipment or drugs) with potential implications for public bodies' finances and their ability to deliver specific services.</p> <p>While there are considerable uncertainties about the detailed implications of EU withdrawal, at a minimum by the end of 2018/19, we would expect public bodies to have assessed the potential impact of EU withdrawal on their operations and identified any specific risks and how they will respond to them. We will assess how HES has prepared for EU withdrawal and how it continues to respond to any emerging risk after March 2019. Some suggested key questions for the Audit Committee are included in our separate Sector Update paper.</p> <p>In addition, in accordance with the FRC guidance, HES should consider the <b><u>disclosure within its annual report</u></b>, which distinguishes between the specific and direct challenges that it faces from the broader economic uncertainties. In some circumstances this may mean <b><u>recognising or re-measuring</u></b> certain items in the Balance Sheet. A comprehensive <b><u>post balance sheet events review</u></b> must be reflected in accounts and disclosures.</p>

# Wider scope requirements (continued)

## Specific risks (continued)

Risk	
<b>Changing landscape for public financial management</b>	<p>Scottish public finances are fundamentally changing, with significant tax-raising powers, new powers over borrowing and reserves, and responsibility for 11 social security benefits worth over £3 billion a year. This provides the Scottish Parliament with more policy choices but also means that the Scottish budget is subject to greater volatility, uncertainty and complexity.</p> <p>Parliamentary scrutiny of the public finances is increasingly important in this changing landscape. A new Scottish budget process has been introduced, which is based on a year-round continuous cycle of budget setting, scrutiny and evaluation. This involves parliamentary committees looking back to explore what public spending has achieved, looking forward to longer-term objectives and challenges, and considering what this should mean for future budgets.</p> <p>As part of the new budget process, the Scottish Government published an initial five-year Medium Term Financial Strategy (MTFS) in May 2018. This five-year outlook for the Scottish budget provides useful context for audited bodies' financial planning. As part of our wider scope audit work on financial management and financial sustainability (discussed further on pages 19-21), we will consider how HES has reviewed the potential implications of the MTFS for its own finances, including longer-term financial planning.</p> <p>The new budget process places greater emphasis on assessing outcomes and the impact of spending. There is an expectation that the Scottish Government and public bodies will report on their contributions towards the national outcomes in their published plans and performance reports, including their annual reports. Increased complexity and volatility is also likely to mean that the Scottish Government will be increasingly active in managing its overall budget position in-year, engaging with public bodies closely on their anticipated funding requirements. As part of our wider scope audit work on financial sustainability and value for money (discussed further on page 21) we will consider the extent to which HES's performance report provides an accessible account of the body's overall performance and impact of its public spending. We will also confirm that underlying financial performance, including any in-year changes to funding agreed with the Scottish Government, is transparently presented.</p>

# Wider scope requirements (continued)

## Specific risks (continued)

Risk	
<b>Dependency on key suppliers</b>	<p>It has become clear that the collapse of Carillion has had a significant impact across the public sector. This has brought into focus the risk of key supplier failure and the risk of underperformance in suppliers that are experiencing difficult trading conditions. The risk exists on two levels:</p> <ul style="list-style-type: none"><li>• Individual public sector bodies are dependent on key suppliers; and</li><li>• The Scottish public sector as a whole is subject to significant systematic risk.</li></ul> <p>We will determine as part of our detailed risk assessment the extent to which HES is dependent on key supplier relationships. Where dependency is significant, we will consider this as part of our audit work and report back to the ARAC.</p> <p>We will also be requested to complete a short questionnaire to establish the extent, value and nature of key supplier dependencies that can inform the national position.</p>
<b>Openness and transparency</b>	<p>There is an increasing focus on how public money is used and what is achieved. In that regard, openness and transparency supports understanding and scrutiny. We will consider this as part of our wider scope work on governance (discussed further on page 21).</p> <p>We would expect to see public bodies reviewing their approach to openness and transparency to ensure they are keeping pace with public expectations and good practice. Evidence of progress might include:</p> <ul style="list-style-type: none"><li>• increased public availability of board papers;</li><li>• more insight into why some business is conducted in private; and</li><li>• Development of the form and content of annual reports.</li></ul>

# Wider scope requirements (continued)

## Other responsibilities

### Performance Audits

In accordance with Audit Scotland planning guidance, we will be requested to provide information to support performance audits that Audit Scotland intends to publish during 2018/19 and 2019/20, as summarised below:

#### Title and planned publication date

Digital progress in central government –  
Spring/Summer 2019

#### Local auditor input

We will be asked to inform the performance audit team of any significant ICT and digital developments within their audited body. We are aware of the plan to implement a new CMIS. We will monitor progress of preparing for the implementation of the new system.

### Impact reports

We will also be requested to provide information to support assessing the impact of previously published performance audit reports. There are no specific impact reports which directly relate to the HES. We will provide an update to the ARAC if there are any changes to this plan.

### Anti-money laundering

The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 came into force on 26 June 2017 and replace the Money Laundering Regulations 2007. The regulations impose an obligation of the Auditor General to inform the National Crime Agency if she knows or suspects that any person has engaged in money laundering or terrorist financing. As part of our audit work, we will ensure we are informed of any instances of money laundering at HES so that we can advise the Auditor General.

### National Fraud Initiative (NFI)

A number of central government bodies, including HES, are participating in the NFI 2018/19. All data was required to be submitted in October 2018 and bodies will receive matches for investigation in January 2019. 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 2019 and the results recorded on the NFI system.

We will monitor HES's participation and progress during 2018/19 and into 2019/20 and, where appropriate, include references to the NFI in our annual audit reports for both years. We will also complete an NFI audit questionnaire and submit to Audit Scotland by 30 June 2019.

# 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 local 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 including income and expenditure 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 will receive tailored learning to develop their expertise in audit skills, delivered by Pat Kenny and other sector experts. This includes sector specific matters, and audit methodology updates.



### **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 HES.

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 ARAC, 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

7 February 2019

# Appendices



# Prior year audit adjustments

## Uncorrected and disclosure misstatements

### Corrected misstatements

There was one corrected misstatement above our clearly trivial threshold and no uncorrected material disclosure deficiencies.

		Debit/ (credit) Assets £m	Debit/ (credit) Liabilities £m	Debit/ (credit) Reserves £m	Debit/ (credit) SOFA £m	If applicable, control deficiency identified
<b>Misstatements identified in prior year</b>						
Adjustment to valuation of Engine Shed	[1]	1.2			(1.2)	N/A
<b>Total</b>		<b>1.2</b>			<b>(1.2)</b>	

[1] An adjustment was made to the valuation of the Engine Shed asset as a result of an incorrect land valuation and the incorrect exclusion of VAT.

### Uncorrected misstatements

No uncorrected misstatements were identified from our audit work performed in 2017/18.

### 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 did not note any material disclosure deficiencies in the course of our audit work to date.

# 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, management override of controls, and restricted funds 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 HES:**

- 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 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 HES's local counter fraud specialist has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain their 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:

## 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 ARAC for the year ending 31 March 2019 in our final report to the ARAC.

## Fees

The audit fee for 2018/19, in line with the fee range provided by Audit Scotland, is £92,130 as analysed below:

	£
Audit Remuneration	59,310
Contribution to Audit Scotland	3,550
Pooled Costs	14,270
<b>Total expected fee</b>	<b>77,130</b>
HESe (Net of VAT)	13,000
SCRAN (Net of VAT)	2,000
<b>Total Fee</b>	<b>92,130</b>

There are no non-audit services fees proposed for the period.

## Non-audit services

In our opinion there are no inconsistencies between the FRC's Ethical Standard and HES'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

Other than those services disclosed above, we have no other relationships with HES, its directors, senior managers and affiliates, and have not supplied any services to other known connected parties.



# 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 2018 the Financial Reporting Council ("FRC") issued individual reports on each of the eight largest firms, including Deloitte, on Audit Quality Inspections which provides a summary of the findings of its Audit Quality Review ("AQR") team for the 2017/18 cycle of reviews.

We take the findings of the AQR seriously and we listen carefully to the views of the AQR and other external audit inspectors. We remediate every finding regardless of its significance and seek to take immediate and effective actions, not just on the individual audits selected but across our entire audit portfolio. We are committed to continuously improving all aspects of audit quality in order to provide consistently high quality audits that underpin the stability of our capital markets.

We have improved the speed by which we communicate potential audit findings, arising from the AQR inspections and our own internal reviews to a wider population, however, we need to do more to ensure these actions are embedded. In order to achieve this we have launched a more detailed risk identification process and our InFlight review programme. This programme is aimed at having a greater impact on the quality of the audit before the audit report is signed. Consistent achievement of quality improvements is our aim as we move towards the AQR's 90% benchmark.

All the AQR public reports are available on its website. <https://www.frc.org.uk/auditors/audit-quality-review/audit-firm-specific-reports>

### The AQR's 2017/18 Audit Quality Inspection Report on Deloitte LLP

"The overall results of our reviews of the firm's audits show that 76% were assessed as requiring no more than limited improvements, compared with 78% in 2016/17. Of the FTSE 350 audits we reviewed this year, we assessed 79% as achieving this standard compared with 82% in 2016/17. We are concerned at the lack of improvement in inspection results. The FRC's target is that at least 90% of these audits should meet this standard by 2018/19."

"Where we identified concerns in our inspections, they related principally to aspects of group audit work, audit work on estimates and financial models, and audit work on provisions and contingencies. During the year, the firm has continued to develop the use of "centres of excellence", increasing the involvement of the firm's specialists in key areas of the audit. We have no significant issues to report this year in most of the areas we reported on last year."

"The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement."

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

- Increased use of centres of excellence ("CoE") involving the firm's specialists, including new CoEs focusing on goodwill impairment (established in response to previous inspection findings) and corporate reporting, to address increasing complexity of financial reporting.
- Further methodology updates and additional guidance issued to the audit practice including the audit approach to pension balances, internal controls, data analytics, group audits and taxation.
- A new staff performance and development system was implemented with additional focus on regular timely feedback on performance, including audit quality.
- Further improvements to the depth and timeliness of root cause analysis on internal and external inspection findings.

#### Our key findings in the current year requiring action by the firm:

- Improve the group audit team's oversight and challenge of component auditors.
- Improve the extent of challenge of management's forecasts and the testing of the integrity of financial models supporting key valuations and estimates.
- Strengthen the firm's audit of provisions and contingencies.

#### Review of firm-wide procedures. The firm should:

- Enhance certain aspects of its independence systems and procedures.



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