cutting through complexity

Creative Scotland

Annual audit report to Creative Scotland
and the Auditor General for Scotland

Audit: Year ended 31 March 2014

2 October 2014

Contents

The contacts at KPMG in connection with this report are:

David Watt
Director, KPMG LLP

Tel: 0141 300 5695
Fax: 0141 204 1584
david.watt@kpmg.co.uk

Keith Macpherson
Senior Manager, KPMG LLP

Tel: 0141 300 5806
Fax: 0141 204 1584
keith.macpherson@kpmg.co.uk

Duncan Fraser
Audit In-charge, KPMG LLP

Tel: 0141 300 4296
Fax: 0141 204 1584
duncan.fraser@kpmg.co.uk

About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

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

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Beneficiaries) for any purpose or in any context. Any party other than the Beneficiaries that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the Beneficiaries.

Headlines

This report is presented in connection with our audit of Creative Scotland and Creative Scotland National Lottery Distribution Fund for the year ended 31 March 2014. Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("the *Code*"). This specifies a number of objectives for the audit. In accordance with ISA (UK and Ireland) 260: *Communication with those charged with governance,* this report also summarises our work in relation to the financial statements for the year ended 31 March 2014.

We wish to record our appreciation of the continued co-operation and assistance extended to us by Creative Scotland staff during the course of our work.

Area	Summary observations	Analysis
Service overview		
Business issues	The governance framework and senior management structure at Creative Scotland has been subject to significant change in 2013-14, with a new chief executive and accounting officer being appointed, in addition to new directors. A new scheme of delegation has now been approved and budgetary approval levels have been revised. The 2011-14 corporate plan was replaced during the year with the 2014-24 strategic plan: *Unlocking Potential, Embracing Ambition*. The strategic plan sets out a shared vision for the arts, screen and creative industries in Scotland, as well as Creative Scotland's ambitions for the next ten years, underpinned by the priorities for the next three years. The strategic plan was subject to an open consultation exercise, which incorporated feedback received through a programme of open sessions with stakeholders and a sector reference group.	Page 6
Financial position	The level of Creative Scotland's grant commitments has risen steadily since its creation, with £92.2 million of funding to projects committed during 2013-14, comprising of £48.1 million from Scottish Government grant-in-aid and £43.1 million from National Lottery funds. Management has set a broadly balanced budget or 2014-15 for Creative Scotland, forecasting a small surplus (£397,000) which incorporates the revised Scottish Government grant funding notified in the latest Autumn spending review. The National Lottery Distribution Fund budget for 2014-15 anticipates a deficit of £4 million for year, leading to net liabilities for the Distribution Fund as at 31 March 2015 of £16 million recognising all 'hard, 'soft' and 'other' commitments. This reflects timing differences between ongoing National Lottery funding and the approval of commitments.	Pages 7 – 9
Financial statements and accounting		
Audit conclusions	We have issued unqualified audit opinions on the financial statements for 2013-14 and on the regularity of financial transactions.	Page 11
Significant risks and audit focus areas	We have considered inherent significant risks that the ISAs would require us to raise with you covering risks in relation to revenue recognition and management override of controls and have satisfactorily concluded our work in these areas. In addition, we have considered significant risks in respect of accounting of Arts Council Retirement Plan, accounting for National Lottery Distribution Fund commitment and going concern within the current financial environment.	Pages 12 – 14

Headlines (continued)

Area	Summary observations	Analysis
Financial reporting and accounting (continued)		
Year-end process	Draft financial statements, strategic, directors' and remuneration reports and governance statement were received during the audit, and were well supported by sufficient working papers.	Page 16
Control observations	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively.	Page 19
Governance and narrative reporting		
Governance framework	During the year there were a number of changes in the governance structure of Creative Scotland arising from changes in the membership and composition of the senior management team. The governance statement for 2013-14 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on the governance framework, the system of internal control, internal audit, internal financial controls and risk management arrangements and analyses the effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. The statement, which is made by the accountable officer, considers the effectiveness of the system of internal control based on information provided by the audit and risk committee and internal audit. The statement identifies that there have been no significant risk-related matters and no significant lapses of data security.	Pages 18 and 19
Performance management		
Performance management	During 2013-14 management have taken forward development of a performance management framework for Creative Scotland and identified the annual planning process as the means through which the organisation's performance will be managed. The annual plan 2014-15 sets out the intentions for Creative Scotland to use 2014-15 to collect baseline data and to continue to research and build performance measures.	Page 21

Scope and responsibilities

Purpose of this report

The Auditor General for Scotland ("the Auditor General") has appointed KPMG LLP as auditor of Creative Scotland and Creative Scotland National Lottery Distribution Fund under the Public Finance and Accountability (Scotland) Act 2000 ("the Act"). The period of appointment is 2011-12 to 2015-16, inclusive.

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at Creative Scotland and the Auditor General for Scotland. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit and risk committee at the outset of our audit for 2013-14.

Responsibilities

Audit Scotland's *Code of Audit Practice* ("the Code") sets out Creative Scotland's accountable officer's responsibilities in respect:

- preparation of financial statements;
- systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- financial position; and
- Best Value.

This report reflects our overall responsibility to carry out an audit in accordance with our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the Code.

The Code sets out the wider dimensions of public sector audit which involves not only the audit of the financial statements, but also consideration of areas such as financial performance and corporate governance.

An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. Weaknesses or risks identified are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260 *Communication with those charged with governance*, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity.

This annual audit report to members and our presentation to the audit and risk committee, together with previous reports to that committee throughout the year, discharges the requirements of ISA 260.

Service overview

Our perspective on key business issues and the financial position of the body

Key business issues

There have been significant changes in senior management during 2013-14.

The corporate plan 2011-14 has been replaced with a new ten year strategic plan *Unlocking Potential, Embracing Ambition* covering the period 2014-24. This is supported by an annual plan for 2014-15.

Creative Scotland's level of grant awards continues to rise. Replacement systems have been introduced to support the investment activity. Revisions to the funding programmes will be introduced to provide more stability to funded organisations.

Creative Scotland is the national body which supports the development of arts, screen and creative industries across all parts of Scotland. It is also the national body responsible for the distribution of Lottery funds towards the support of arts, screen and creative industries. It is funded primarily by grant-in-aid from the Scottish Government and by the National Lottery. In accordance with statute, it prepares a separate National Lottery Distribution Fund annual report and financial statements covering the activities undertaken as a Lottery Distributor.

During 2012, Creative Scotland was subject to significant negative publicity, including an open letter from a range of Scottish artists, criticising arrangements and raising concerns over decision-making. Following this, the chief executive and one of the directors of creative development left the organisation in early 2013.

As a result of these issues, the governance framework and senior management structure at Creative Scotland has been subject to significant change in 2013-14 with a new chief executive and accounting officer being appointed, in addition to new directors of creative development and a director of operations. In addition, a one year director of strategy position was created and filled. A new scheme of delegation has now been approved and budgetary approval levels have been revised. The 2013-14 year could therefore be seen as a period of transition.

The 2011-14 corporate plan was replaced during the year with a 2014-24 strategic plan: *Unlocking Potential, Embracing Ambition.* The strategic plan sets out a shared vision for the arts, screen and creative industries in Scotland, as well as Creative Scotland's ambitions for the next ten years, underpinned by the priorities for the next three years. The strategic plan was subject to an open consultation exercise, which incorporated feedback received through a programme of open sessions with stakeholders and a sector reference group.

The annual plan for 2013-14 was only finalised and published in August 2013. However, alongside the development of the strategic plan, the annual plan for 2014-15 was prepared and this has also been published in time for the start of the new financial year.

The level of Creative Scotland's grant commitments has risen steadily since its creation, with £92.2 million of funding to projects committed during 2013-14, comprising of £48.1 million from Scottish Government grant-in-aid and £43.1 million from National Lottery funds.

To support the increasing activity levels, a new financial system was put in place from 1 March 2013 and, more relevantly, a new investment management system ("CSI") was put in place in October 2013. Whilst CSI is now used for managing investments, historic manual processes for approvals of investments were maintained initially as there were a number of issues to be resolved to ensure CSI links effectively to the finance system.

Looking forward in support of the strategic plan, Creative Scotland is looking to make changes to its funding programmes, with the introduction of three year 'Regular Funding' for the period 2015-18. The aim of this is provide more stable support for a range of funded organisations, enabling them to be able to plan and make decisions on the basis of a three year funding envelope.

Financial position – Creative Scotland

Creative Scotland's total comprehensive expenditure for 2013-14 was £55.2 million (*2012-13 £53.6 million*) against Scottish Government grant-in-aid of £53.4 million (*2012-13 £51.2 million*).

Testing of controls over grants expenditure did not identify any significant deficiencies requiring to be brought to your attention.

Grants, awards and investments relate to monies that are distributed by Creative Scotland in its role as a grant funding body. These are spent on a variety of programmes throughout Scotland that contribute to the cultural environment.

During 2013-14, Creative Scotland invested over £48 million across over 900 projects and initiatives. The net operating cost for the year was £52.7 million, compared with £51.2 million drawn down in funding from the Scottish Government. Creative Scotland has increased net expenditure funded through grant-in-aid by just over £900,000 compared to 2012-13.

We have completed testing over the process and controls surrounding grant expenditure with no identified significant deficiencies to bring to your attention. This included testing a sample of grants for appropriate authorisation, vouching a sample of grants, awards and investments to supporting documentation and performing cut-off procedures surrounding grant expenditure to ensure recognition in the correct financial period.

The reduction in staff costs in the year arose as a result of revaluation in the provision for additional contributions required to fund the deficit in the Arts Council Retirement Plan (1994), which lead to a reversal of unutilised provision recognised in earlier years.

Income received by Creative Scotland comprises primarily the recharge to the National Lottery Distribution Fund ("NLDF"), reflecting the time for staff involved in processing and delivering NLDF-related activities. No significant change in total income was expected over the prior year. The recharge is based on an estimate of time involved in delivering NLDF activities.

Recommendation one

Statement of Comprehensive Net Expenditure	2013-14 £'000	2012-13 £'000	Variance £'000
Project income	183	202	(19)
Other income	2,231	2,086	145
Total income	**2,414**	**2,288**	**126**
Staff costs	(3,703)	(4,078)	(375)
Depreciation	(208)	(249)	(41)
Project expenditure	(458)	(498)	(37)
Grants, awards and investments	(48,118)	(45,891)	2,227
De-commitment of awards			
Direct delivery expenditure	268	140	128
Other operating expenditure	(675)	(766)	(91)
	(2,259)	(2,237)	(22)
Expenditure	**(55,153)**	**(53,580)**	**(1,573)**
Interest receivable	-	1	(1)
Impairment of PPE	(21)	(580)	559
Other finance income/(costs)	(15)	41	(56)
Net expenditure for the year	**(52,739)**	**(51,830)**	**(909)**

Source: KPMG analysis of 2013-14 draft financial statements

The net expenditure for the year increased by £0.9 million, as shown in the table above, compared with 2012-13. The budget for 2013-14 reflected total net expenditure of £53.1 million, demonstrating that Creative Scotland operated within the budget set for the year.

Financial position – National Lottery Distribution Fund

The National Lottery Distribution Fund reported a significant increase in both income and expenditure in 2013-14 compared to the previous year. The former is a result of National Lottery Fund performance and Creative Scotland's share in that, while expenditure is considered to be a more accurate reflection of the level of business activities that Creative Scotland will have in future years.

National Lottery Distribution Fund proceeds have reduced by £4.9 million in 2013-14 due to an decrease in the share of income receivable, resulting from variable purchasing habits of Lottery players. This reflects the nature of the National Lottery Fund and the way in which it distributes funding depending on performance of the investment. In accordance with the required accounting policies, the statement of comprehensive net expenditure includes only 'hard' commitments and income receivable in year. Award commitments are recognised as expenditure when a commitment has been made to a body to provide funding. In accordance with guidance from the Scottish Ministers, 'soft' commitments are those which have not yet been formally accepted by funded bodies and these are disclosed by way of a note.

The hard award commitments of £43.2 million represents a significant increase in award commitments in 2013-14, being £14.7 million higher than 2012-13 (which was in turn £7.7 million higher than 2011-12). The increase in award commitments was planned and in line with the corporate plan 2011-14 whereby Creative Scotland committed to forward commit Lottery balances in 2013-14 to provide funding for a number of projects, including Glasgow 2014 and a £5 million contribution to the V&A Museum of Design, Dundee project. The Lottery Fund budget for 2013-14 reflected total income of £34.7 million and total expenditure of £39.1 million, so that cumulative reserves were utilised.

We have completed detailed testing over the process and controls in place relating to award commitments and have substantively vouched expenditure to supporting documentation, while reviewing the classification of hard, and soft commitments. Satisfactory cut-off testing was completed to ensure commitments have been recognised in the correct accounting period.

Statement of Comprehensive Income	2013-14 £'000	2012-13 £'000	Variance £'000
National Lottery Fund proceeds	29,689	34,638	(4,949)
Other income	1,238	1,023	215
Total income	**30,927**	**35,661**	**(4,734)**
Award commitments	(43,161)	(28,410)	14,715
De-commitments	145	74	(71)
Project expenditure	(1,130)	(1,224)	(94)
Staff costs	(1,661)	(1,602)	59
Other operating expenditure	(1,848)	(1,013)	835
Transfer to Olympic Distribution Fund	-	(1,799)	(1,799)
Total expenditure	**(46,655)**	**(33,947)**	**(12,708)**
Total comprehensive net income	**(15,728)**	**1,714**	**(17,442)**

Source: KPMG analysis of 2013-14 draft financial statements.

The deficit on the statement of comprehensive income of £15.7 million has resulted in a net liabilities position of £700,000 as at 31 March 2014. This reflects the fact that the forward commitments now made exceed the investments within the National Lottery Fund available to Creative Scotland as a Lottery distributor.

Forward commitment plans within the budgets for 2014-15 and beyond indicate that this net liabilities position will continue for a number of financial years. We report on this later under our consideration of the going concern assumption for the National Lottery Distribution Fund financial statements.

Financial position – future plans

The budget for 2013-14 anticipates a continuation of the move from grant-in-aid to National Lottery funding, but an overall increase in net expenditure levels compared to prior years.

Financial plans for 2014-15

The combined Creative Scotland and National Lottery Distribution Fund budget for 2014-15 anticipates expenditure of £92.4 million, with a combined outturn deficit of £4.3 million. This results from the 2013-14 plan to utilise the £15 million balance in the general reserves of the National Lottery Fund and commitments in Lottery funding. Management believes this position is common among Lottery funding distributors.

While Lottery income budgeted values for 2013-14 included carried forward reserves and therefore does not allow for year on year direct comparison with 2014-15 budget, the 2014-15 budget allows for a increase in income following the end of the Olympic transfer and also expected higher lottery ticket sales, based on National Lottery predictions. This in funding profile is consistent with the corporate plan 2011-14.

Expenditure on investments, awards and projects is anticipated to significantly reduce (by £19.4 million) in 2014-15. This is mainly due to the completion of Creative Scotland's capital investment programme, which was budget at almost £38 million and was included in the 2011-14 corporate plan. This included the Place capital programme which commenced in 2012-13.

The budgeted outturn planned deficit of £4.3 million will result in a reserve position of £5 million net liabilities in 2014-15. This has been reported by management to be in line with the bodies' strategic aims and expectations over future grant funding.

	2014-15 budget total £'000	2013-14 budget total £'000
Investments, awards and projects	(84,848)	(104,217)
Direct delivery	(724)	(923)
Salaries	(4,614)	(4,332)
Other operating costs	(2,635)	(2,644)
Project overhead recovery	400	230
Total expenditure	**(92,421)**	**(111,885)**
Income – Creative Scotland	53,294	53,149
Income – Lottery Fund	34,861	44,183
Total income	**88,155**	**97,332**
Outturn planned	**(4,266)**	**(14,553)**

Source: Creative Scotland 2014-15 budget

Financial statements and accounting

Our perspective on the preparation of the financial statements and key accounting judgements made by management

Audit conclusions

We have issued an unqualified audit opinion on the financial statements and the regularity of transactions reflected in those financial statements.

Audit conclusions

Following approval of the financial statements by Creative Scotland's accountable officer we have issued an unqualified opinion on the truth and fairness of the state of Creative Scotland's affairs as at 31 March 2014, and of its net expenditure for the year then ended. In respect of the National Lottery Distribution Fund financial statements, we have also issued an unqualified opinion on the truth and fairness of the state of affairs as at 31 March 2014, and of its deficit for the year then ended; we have also issued an unqualified opinion on the regularity of transactions within the year. There are no matters identified on which we are required to report by exception.

In gathering the evidence for our opinion we have:

- performed a mixture of substantive and controls testing to ensure an efficient approach that covers all the key risks;
- liaised with internal audit as appropriate and reviewed their reports to ensure all key risk areas having a potential financial statements impact have been considered;
- reviewed assumptions and judgements made by management and considered these for appropriateness;
- considered if the financial statements may be affected by fraud through discussions with senior management and internal audit to gain a better understanding of their work in relation to prevention and detection of fraud with the potential to impact on the financial statements; and
- attended the audit and risk committee to communicate our findings to those charged with governance, but also to update our understanding of the key governance processes and obtain key stakeholder insights.

Significant risks

International Standard on Auditing (UK and Ireland) 315: *Identifying and assessing risks of material misstatement through understanding the entity and its environment* requires the auditor to determine whether any of the risks identified as part of our risk assessment are significant risks and therefore requiring specific audit consideration. In determining whether a risk is significant, judgement is applied in respect of the whether, for example, the risk is associated with the complexity of transactions, the degree of subjectivity involved in the measurement of financial information, whether the associated transactions are outside the normal course of business, or whether there is an associated risk of fraud.

International Standards on Auditing require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk and that management override of controls is a significant risk. Our planning work identified significant risks around accounting for the Arts Council Retirement Plan (1994), accounting for National Lottery Distribution Fund commitments and going concern within the current financial environment. Information on our work and conclusions in each of these areas is given on the following pages.

Audit conclusions

International Standards on Auditing require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk and that management override of controls is a significant risk. We have satisfactorily carried out audit work to address these risks.

Significant risks – mandatory on all audits	
Revenue recognition	International Standard on Auditing (UK and Ireland) 240 requires us to make a rebuttable presumption that the fraud risk from income recognition is a significant risk. However, the main income stream for Creative Scotland remains grant-in-aid which is agreed in advance of the year, with adjustments requiring Scottish Government approval. Therefore, we did not regard the risk of fraud in its recognition as significant. In respect of the National Lottery Distribution Fund, the main source of income represents the proceeds from the National Lottery Fund, which again has minimal level of judgement required in revenue recognition by management and therefore we did not regard the risk of fraud from this revenue recognition as significant. Overall, we have obtained sufficient evidence that the risks around revenue recognition are within our acceptable materiality levels. We did not identify any errors requiring adjustment in the financial statements or evidence of bias in determining income to be recognised.
Management override of controls	International Standard on Auditing (UK and Ireland) 240 also requires us to communicate the fraud risk from management override of controls as significant. Management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. We have not identified any specific additional risks of management override relating to this audit. Our audit methodology incorporates the risk of management override as a significant risk, along with appropriate audit procedures to address this risk. In response therefore, we have performed testing of journal entries during the year and at the year end, undertaken a review of unusual transactions in the year, made enquiries with employees outside the finance department, incorporated audit tests of an unpredictable nature and undertaken testing of controls, including 'higher level' controls and reviewed management's accounting estimates for bias. Our work did not identify any matters that required adjustment in the financial statements or which require to be brought to your attention.

Audit conclusions (continued)

We have satisfactorily concluded work to confirm that it is appropriate that participation in the Arts Council Retirement Plan (1994) continues on a defined contribution basis.

We have obtained satisfactory evidence that Creative Scotland National Lottery Distribution Fund has accounted correctly, in all material respects, in relation to the significant risk on recognition of grant awards and commitments.

Other significant risks	
Accounting for the Arts Council Retirement Plan (1994)	Creative Scotland participates in the Arts Council Retirement Plan (1994) which is a defined benefit pension scheme. This has historically been accounted for as a defined benefit pension scheme on the basis that Creative Scotland has been unable to identify its share of the relevant assets and liabilities. In the knowledge that a triennial valuation was being carried out as at 31 March 2013, our audit planning noted that, due to the relatively small number of existing members of this scheme, it would be necessary for management to reconsider the current accounting basis for this scheme in the light of the information gathered during the triennial valuation. We found that management had held discussions with Hymans Robertson LLP, the actuaries to the Plan, to update their understanding of the appropriate accounting treatment. This has identified that the Plan continues to operate in a manner in which: ▪ Creative Scotland does not have access to the information about the Plan that it would require to account on a defined benefit basis, primarily as the assets of the Plan are “non sectionalised” so that is there is one pool of assets, with no attempt made to attribute assets at a member level which would allow participating employers to identify their share; and ▪ the Plan exposes the participating entities to actuarial risks associated with the current and former employees of other entities, resulting in elements of cross-subsidisation. We have confirmed management’s assessment of the up to date position with our own KPMG actuaries and have agree that, based on this information, it would be inappropriate to account for the Arts Council Retirement Plan (1994) on a defined benefit basis. Management has therefore made the appropriate disclosures within the financial statements as if the Plan were accounted for on a defined contribution basis and we are in agreement with this treatment.
Accounting for National Lottery Distribution Fund commitments	The majority of Creative Scotland and the Distribution Fund’s expenditure relates to grants, awards and investments. Appropriate recognition of this committed expenditure at 31 March 2014 will be required to ensure accurate financial performance is reported in the financial statements. In particular, accurate disclosure in the Distribution Fund’s financial statements is reliant on the accurate identification of hard, soft and other commitments. Our audit approach included: ▪ review and testing of the categorisation of a sample of hard, soft and other commitments at 31 March 2014; and ▪ testing of cut-off of commitments at 31 March 2014 to ensure appropriately reflected in the financial statements. While the record keeping for accrued commitments requires detailed reconciliations between current and prior year award commitments against payments made, and resulted in detailed discussion between ourselves and management in respect of the best approach to obtain the listing of commitments of different categories as accounted for and disclosed in the financial statements, we are satisfied that the risk of incorrect accounting for commitments is within our acceptable materiality levels.

Audit conclusions (continued)

The financial statements of Creative Scotland and Creative Scotland National Lottery Distribution Fund have been prepared on a going concern basis; we are satisfied that this is appropriate.

Other significant risks (continued)	
Going concern within the current financial environment	**Creative Scotland** Creative Scotland's financial statements have been prepared under the assumption that the organisation is a going concern. This is based on the agreed grant-in-aid levels approved by the Scottish Government for the organisation for 2014-15, along with the indicative settlement for 2015-16. Taken together with the budget approved for the organisation for the forthcoming financial year, this indicates that Creative Scotland will be able to operate within the funds available to it. **Creative Scotland National Lottery Distribution Fund** The statement of financial position for the Fund reports net liabilities of £722,000 as at 31 March 2014. This has arisen principally because the 'hard' commitments accounted for within the financial statements exceed the cash and investments held within the National Lottery Fund. The Accounts Direction given by the Scottish Ministers advises that where "*the commitments exceed available resources shown on the Balance Sheet, there should be a note explaining the rationale for the over-commitment in terms of the benchmark being applied and the assumptions behind it, taking into account any advice received from the Scottish Ministers as appropriate.*" Management's financial forecast analysis indicates its expectation that the National Lottery Distribution Fund will continue to operate in a net liabilities position until 2017-18, after which the projections show a return of the Fund to balance. This will be achieved through the Distribution Fund operating on an in year surplus position from 2015-16 onwards, achieved through a level of grant awards significantly below that reported for 2013-14. This assumes continued funding through the National Lottery at levels broadly in line with current levels, although any changes in National Lottery participation presents some risk in the later years of the projections.

Audit conclusions (continued)

In addition to the significant risks identified as part of our audit, our audit planning also identified an area of audit focus around employee benefits valuation for participation in the Strathclyde Pension Fund.

Each of the assumptions used to value Creative Scotland's net pension deficit are within an acceptable range of KPMG's expectations.

We are of the view that this therefore represents a reasonable and balanced approach, in accordance with the requirements of IAS 19 (R).

Our work in this area has therefore been satisfactorily concluded.

Audit focus area

Creative Scotland accounts for its participation in the Strathclyde Pension Fund in accordance with IAS 19: *Employee benefits* on a defined benefits basis using valuation information prepared by actuarial consultants. Our audit of the accounting for employee benefits includes evaluation of the actuarial consultants as a third party expert, consideration of the data underlying the actuarial report, including the level of contributions made during the year, the financial assumptions and membership data provided to the actuary by Creative Scotland, and estimates of Creative Scotland's share of the pension fund assets.

We found that the actuarial consultants as a third party expert was objective and had the appropriate experience and expertise to provide the information for use by Creative Scotland. The level of contributions made in the year is estimated based on data prior to the year end. It is important that this number is accurate as it is used to inform the calculation of the liabilities at the period end. Our testing included review of actual data against that used in the actuarial calculations. No issues were identified.

The actuaries use a number of assumptions in their calculations based on market conditions at the year end, including a discount rate to derive the anticipated future liabilities back to the period end date and assumptions on future salary increases. Using our own actuarial specialists, we have reviewed the assumptions and concluded that the overall assumptions proposed represented a balanced position for the net deficit within our expected range. Details of key assumptions are included opposite.

Creative Scotland adopted IAS 19 (Revised) in 2013-14. Under previous IAS 19, interest cost on the defined benefit obligation and an expected return on plan assets were recognised in the statement of comprehensive net expenditure within interest payable. Under IAS 19 (R), these two amounts have been replaced by a single measure called 'net interest' calculated on the net defined benefit liability. Creative Scotland has appropriately applied IAS 19 (R) in the financial statements. If the standard had been adopted early in 2012-13, the estimated change to finance costs would be £45,000 and there would have been no impact on the previously reported net asset position. Creative Scotland has not restated the prior year comparative information given in 2013-14 financial statements in the light of the immateriality of the amounts involved. We agree with this treatment.

Assumption	Creative Scotland	KPMG central	Comment
Discount rate	4.3%	4.35%	Acceptable. The actuarial assumption has been calculated using a different approach from the prior year. It is KPMG's view that this represents an enhancement in methodology.
RPI inflation	3.6%	3.6%	Acceptable – Creative Scotland's assumption is more prudent (higher liability) than KPMG's central rate, but is within the acceptable range.
CPI inflation	2.8% RPI - 0.8%	2.6% RPI – 1%	Acceptable – Creative Scotland's assumption is more prudent (higher liability) than KPMG's central rate, and is within the acceptable range.
Salary growth (long term)	5.1% 1.5% above RPI	0-1.5% above RPI/CPI inflation	Acceptable – Creative Scotland's assumption reflects the extension of the public sector pay freeze to 2016, followed by a long term assumption of RPI plus 1.5%.

Accounting framework; year end process; other matters

There have been no substantive changes to the financial reporting framework as set out in HM Treasury's Financial Reporting Manual ("FReM").

The implementation of revisions to IAS 19: *Employee benefits* did not have a material impact on the organisation.

Accounting policies have been applied consistently.

Financial reporting framework	■ Creative Scotland prepared the financial statements in accordance with HM Treasury's Financial Reporting Manual 2013-14 ("FReM"). ■ Changes to the FReM in 2013-14 require Creative Scotland to prepare a strategic report in line with section 414C of the Companies Act 2006 as interpreted by the FReM. The strategic report requirements include disclosures previously required within the directors' report and new disclosures (if not previously included) on social, community and human rights issues, a description of the body's strategy and business model and a gender break down of directors, senior managers and employees. Appropriate disclosure has been included within the strategic report. ■ With the exception of the adoption of IAS 19 (Revised), during the year there have been no significant changes in financial reporting requirements, and consequently there are no other substantive changes to the Creative Scotland's accounting policies. We are satisfied that the accounting policies adopted remain appropriate. ■ No newly effective accounting standards are considered likely to have a material impact on Creative Scotland's financial statements in the coming year.
Financial statements preparation	■ Draft financial statements plus supporting working papers were provided during the audit fieldwork in June 2014. This included the remuneration report. Revisions were necessary to the draft annual report to incorporate the changes required for a strategic and directors' reports. Additional accompanying reporting statements, including the chairman's report and chief executive's report were not provided until after the conclusion our onsite fieldwork. ■ In advance of our audit fieldwork, we issued a 'prepared by client' request setting out a list of required analyses and supporting documentation. The standard of documentation was good and there was evidence of accountability and ownership of working papers across the finance department. ■ We provided feedback to management on the content of the financial statements, narrative information and remuneration report which were adjusted by management accordingly.
Other matters	■ Mandatory communications required by International Standards on Auditing are given in Appendix one. ■ There are no significant matters in respect of (i) audit differences; (ii) auditor independence and non-audit fees; and (iii) management representation letter content.

Governance and narrative reporting

Our overall perspective on your narrative reporting, including the remuneration report and annual governance statement

Update on controls findings from our audit

Corporate governance arrangements

We updated our understanding of the governance framework and did not identify any issues which require to be brought to your attention.

Annual governance statement and governance arrangements	■ We have outlined on page 6 the changes in governance structure made during the year, which have supported the development of Creative Scotland's new corporate plan. ■ The governance statement for 2013-14 outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on the governance framework, the system of internal control, internal audit, internal financial controls and risk management arrangements and analyses the effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. ■ The statement, which is made by the accountable officer, considers the effectiveness of the system of internal control based on information provided by the audit and risk committee and internal audit. The statement identifies that there have been no significant risk-related matters and no significant lapses of data security. ■ As part of our audit work, we updated our understanding of the governance framework and documented this through our overall assessment of Creative Scotland's risk and control environment. We have reviewed the governance statement and have confirmed that it is in line with guidance, reflects our understanding of Creative Scotland and appropriately reflects the changes in the governance structure identified in 2013-14.
Annual report, including the management commentary	■ Management is responsible for preparing financial statements that show a true and fair view. In addition ,they prepare separate financial statements in respect of the National Lottery Distribution Funds within their remit. ■ The financial statements form part of the annual report of Creative Scotland for the year ended 31 March 2014. We are required to consider the accompanying reports and provide our opinion on the consistency of it with the financial statements. ■ Following amendments to the FReM becoming effective for 2013-14, Creative Scotland is required to include both a strategic and a directors' report as part of the annual report. The strategic report must contain a minimum level of information, through prescribed headings, the information largely presented within the directors' report in prior years. As noted, initial draft annual reports by management did not contain the distinct strategic and directors' report elements. We asked management to prepare this information and subsequently provided management with a number of suggestions relating to areas where these reports could be enhanced and/or where additional information disclosures should be made. Management have responded positively to our suggestions and have made the appropriate updates to the final versions. ■ We are satisfied that the information contained within the strategic and directors' report is consistent with the financial statements.

Corporate governance arrangements (continued)

Internal controls	■ Creative Scotland management are responsible for designing and implementing appropriate internal control systems. Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively. ■ In our interim audit report, we raised one 'medium' risk and one 'low' risk recommendation over the authorisation of investment and grant awards controls, and the authorisation of journals, which were accepted by managements for immediate implementation.
Internal audit	■ As set out in our audit plan and strategy, we evaluated the work of internal audit and concluded that we can apply their work to inform our procedures, where relevant. We reviewed a number of reports, including those in respect of financial planning and reporting, investment administration procedures, corporate governance and risk management. ■ There were no significant issues identified in internal audits reviews that have impacted on our planned audit approach.
Prevention and detection of fraud / arrangements for maintaining standards of conduct	■ Management is responsible for implementing internal control systems. ■ No material fraud or other irregularities were identified during the year, and we consider that Creative Scotland has appropriate arrangements to prevent and detect fraud. These are supported by a fraud prevention policy and response plan, and a whistle blowing policy that can be found on the Creative Scotland intranet. ■ We also consider that Creative Scotland has arrangements to prevent inappropriate conduct and corruption, including policies and codes of conduct for staff and board members.
National Fraud Initiative ("NFI")	■ The National Fraud Initiative ("NFI") is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use for uploading data and monitoring matches. ■ We reviewed Creative Scotland's NFI participation and reported our findings in our interim management report. Overall, we are satisfied with the progress made in the investigation of matches and the level of engagement in the NFI exercise.

Performance management

Our perspective on the performance management arrangements, including follow up work on Audit Scotland reports

Performance management

Creative Scotland's Best Value and performance management arrangements remain largely unchanged and we did not identify any issues which require to be brought to your attention.

Performance management	In previous annual audit reports we have indicated that there was scope for enhancing the organisation's performance management arrangements and that management was working to do this. This had been recognised by the board and its audit and risk committee and also by conclusions from internal audit who had performed a review of performance management during 2012-13, concluding that current processes were limited and fragmented. During 2013-14 management have taken this forward and identified the annual planning process as the means through which the organisation's performance will be managed. The annual plan 2014-15 sets out the intentions for Creative Scotland to use 2014-15 to collect baseline data and to continue to research and build performance measures. The annual plan includes measures by which the organisation will monitor and report its performance during 2014-15, in order to focus on continual improvement and allow for open transparent reporting. The alignment of Creative Scotland's strategic goals to the Scottish Government's national performance outcomes is to be reported within a annual performance report, alongside the measured results on the achievement of own objectives. Survey based research into the performance measurement of the public's perception of the breadth and depth of the creative activities across Scotland is carried out by Creative Scotland. This is a primary measure of the organisation's performance, but will be impacted by the lever of activity by other public sector bodies in the promotion and development on the creative arts.
Best Value	In April 2002 the Scottish Ministers introduced a non-statutory duty on accountable officers to ensure there are arrangements designed to secure Best Value. Audit Scotland is committed to extending the Best Value audit regime across the whole public sector. Using the Scottish Executive's nine Best Value principles as a basis for audit activity, Audit Scotland previously selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). Management does not use the Best Value toolkits, but believe this to be embedded with policies and practices. We continue to encourage use of the toolkits to improve the practices applied at Creative Scotland, for example in respect of community engagement, partnership working and customer focus and responsiveness.
Local response to national studies	Audit Scotland periodically undertakes national studies on topics relevant to the performance of central government bodies. To ensure that added value is secured through the role of Audit Scotland and its appointed auditors, auditors will continue to ensure that audited bodies respond appropriately to reports from Audit Scotland's programme of national performance audits. As part of its targeted approach to following-up a number of performance audit reports each year, Audit Scotland has identified *Managing ICT contracts* for targeted follow-up by local auditors in 2013-14. The aim of the follow-up work is to establish to what extent central government bodies have applied the lessons learned highlighted by the report to their ICT contracts and arrangements. While we completed an initial assessment for Audit Scotland, Creative Scotland was not subsequently selected as a central government body to be included within the main targeted follow-up at this time.

Appendices

Mandatory communications

Mandatory communications regarding audit adjustments, auditor independence and representation letter content are given here.

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft financial statements which impacted on the net assets or the net expenditure for the year. A small number of numerical and presentational adjustments were required to some of the financial statements notes.	-
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences.	-
Confirmation of Independence Letter issued by KPMG to the Audit Committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of our Audit Director and audit staff.	Appendix two
Schedule of Fees Fees charged by KPMG for audit and non-audit services	Audit fees for 2013-14 were agreed with management in accordance with the range specified by Audit Scotland. Non-audit services in 2013-14 related to completion of a grant claim being made by Creative Scotland.	-
Draft management representation letter Proposed draft of letter to be issued by Creative Scotland to KPMG prior to audit sign-off	There are no significant changes to the standard representations required for our audit from last year.	-

Auditor independence and non-audit fees

Auditing Standards require us to consider and confirm formally our independence and related matters in our dealings with Creative Scotland.

We have appropriate procedures and safeguards in place to enable us to make the formal confirmation in our letter included opposite.

Professional ethical standards require us to provide to you at the conclusion of an audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed. This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence.

We have considered the fees paid to us by Creative Scotland for professional services provided by us during the reporting period. We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Directors and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards.

As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Communications
- Internal accountability
- Risk management
- Independent reviews

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the Chief Executive.

Confirmation of audit independence

We confirm that as of 2 October 2014, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This letter is intended solely for the information of the audit and risk committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

Action plan

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses.

Priority rating for recommendations		
Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the organisation or systems under consideration. The weaknesses may therefore give rise to loss or error.	**Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.	**Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
1 Staff cost recharge		**Grade three**
Other operating income received by Creative Scotland comprises primarily the recharge to the National Lottery Distribution Fund . The recharge should reflect the time for staff involved in processing and delivering NLDF-related activities. There has been no significant change in the recharge for 2013-14 over the prior year, despite increase in volume of grants issues by NLDF.	The recharge is based on an estimate of time involved in delivering NLDF activities, and should be reviewed on a recurring basis to ensure its accurate application.	Recharge basis will be reviewed on an annual basis. **Responsible officer:** Director of Finance **Implementation date:** April/May 2015 and ongoing

cutting through complexity