Scottish Qualifications Authority

Annual audit report to Scottish Qualifications Authority and the Auditor General for Scotland

Audit: year ended 31 March 2014

22 August 2014

Contents

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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 Scottish Qualifications Authority 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.

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Headlines

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practise* ("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 SQA staff during the course of our work.

Area	Summary observations	Analysis
Service overview		
Business issues and financial position	■ 2013-14 was the first year in which SQA delivered and therefore earned income relating to the new Curriculum for Excellence (CfE) qualifications. To address uncertainties around costs, activities and volumes arising from the introduction of CfE qualifications, SQA agreed with the Scottish Government and local authorities (via the Convention of Scottish Local Authorities to charge local authorities the same amount they had paid during 2012-13 for National Qualifications during this important, three year transitional period. ■ SQA reported net expenditure of £19.2 million in 2013-14, with £23.9 million grant funding income, resulting in a surplus of £4.7 million before consideration of the actuarial loss. This outturn is a consequence of income recognition associated with Curriculum for Excellence activity, but had no impact on cash receipts in the year and therefore the cash requirement from the Scottish Government.	Page 5
Financial statements and accounting		
Accounting policies	SQA adopted IAS 19 (Revised): *Employee benefits* for the first time during 2013-14 resulting in a restatement of prior year comparative information. No newly effective accounting standards are expected to have a material impact on next year's financial statements.	Page 12
Audit conclusions	We have issued an unqualified audit opinion on the 2013-14 financial statements and on the regularity of financial transactions.	Page 10
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.	Pages 10 – 11
Governance and narrative reporting		
Governance	Our review of governance arrangements did not identify any issues; corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision making.	Pages 14 –15
Performance management		
Performance management	Our work has identified that SQA's performance management arrangements are generally robust and appropriate to its business objectives.	Pages 17 - 18

Scope and responsibilities

Purpose of this report

The Auditor General for Scotland ("the Auditor General") has appointed KPMG LLP as auditor of Scottish Qualifications Authority ("SQA)" under the Public Finance and Accountability (Scotland) Act 2000 . 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 SQA 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 committee at the outset of our audit for 2013-14.

Responsibilities

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

- 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 committee, together with previous reports to that committee during the year, discharges the requirements of ISA 260.

Service overview

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

Business issues and financial position

The financial and operating environment in which SQA operates continues to change, with developing priorities and, through the strategy for growth, SQA continues to diversify income sources in response to the Scottish Government's challenge to reduce dependency on grant-in-aid and become self-financing.

However, SQA faces a number of significant risks in delivering its strategic objectives. In our view, the nature, volume and interdependence of these risks makes achievement of all strategic objectives challenging.

As the national accreditation and awarding body in Scotland, Scottish Qualifications Authority ("SQA") is committed to providing and maintaining a comprehensive portfolio of products and services that support lifelong learning, the needs of learners, business, industry, the economy, and the wider society.

In its accreditation role, SQA accredits vocational qualifications, including Scottish Vocational Qualifications, and approves bodies that wish to award them. As an awarding body, SQA develops, validates, quality assures and awards a national framework of qualifications. It therefore works with schools, colleges, universities, businesses and the government to provide high quality, flexible and relevant qualifications.

An important focus for SQA in 2013-14 and in the next two years is the continuing work with partners and stakeholders to develop and deliver significant changes to the qualifications and assessment system in support of the Curriculum for Excellence (CfE) programme.

CfE qualifications are being phased in as follows:

- National 1 to 5 – 2013-14 academic session;
- New Higher – 2014-15 academic session; and
- New Advanced Higher – 2015-16 academic session.

SQA faces a number of challenges – from reducing public sector funding, demographic movement and changes arising from CfE's flexibility as a qualification choice. Responsibilities to pursue income to reduce dependency on public funds and also to reduce costs brings a specific focus for management in this context.

Curriculum for Excellence

To address uncertainties around costs, activities and volumes arising from the introduction of CfE qualifications, SQA agreed with the Scottish Government and local authorities (via COSLA) to charge local authorities the same amount they had paid during 2012-13 for National Qualifications during this important, three year transitional period. Therefore, SQA's billable income from local authorities over these years will be fixed at the 2012-13 level, with no inflationary increases.

In order for SQA to devise a future, sustainable business model, management should initiate a dialogue with both the Scottish Government and COSLA to consider income and pricing following the expiration of the fixed price levy period. This might include consideration as to whether there are alternative models for the financial support for SQA's ongoing work.

Recommendation one

The introduction of the National 1 to 5 qualifications in 2013-14 has resulted in a revised application of SQA's accounting policy over income recognition. While the existing policy has been applied in 2013-14 for the final diet of the Standard Grade examinations and Higher, Advanced Higher and Intermediate Grades, the policy for CfE qualifications has been based on the principle that SQA carries out activities in support of qualifications throughout the year, with an equal weighting across each qualification, with the external assessment element for National 5 in 2014 to be recognised in 2014-15.

Business issues and financial position (continued)

There are increasing cost pressures and challenges associated with planned reductions in government funding, but SQA has not yet fully implemented a cost allocation, capacity planning and time recording project so that it has a comprehensive view of its cost base.

The basis of preparation of management accounts was not altered on a timely basis during 2013-14 to reflect the estimated impact of an amended income recognition policy following the implementation of CfE.

Costing

SQA has recognised the need to ensure it has robust information in respect of individual qualification and course costs to inform pricing decisions, both in respect of CfE and in commercial and international investment decisions. Significant work was undertaken during 2013-14 to improve the existing cost allocation model. This included workshops with SQA teams to gather time information against relevant business activities which was subsequently validated against existing time recording information.

While SQA has a costing model which is used in planning work (and all commercial ventures are fully costed and priced according to the delivery market), it does not yet have a fully developed cost allocation, capacity planning and time recording arrangement. A project to secure this was due to be implemented by the end of 2013-14, but this has not been fully realised. The introduction of a full system would enhance and consolidate the information currently available, making pricing decisions more meaningful. Such information would also be useful in the context of discussions on future income models and for the longer term sustainability of the organisation.

Recommendation two

Management accounts / reporting to Scottish Government

During 2013-14, cash flow management has continued as a key focus for SQA and this is reflected in the preparation of management accounts on the basis of cash billed, adjusted to remove items over which there is no direct control. This approach has also been used as the basis for setting the annual budget which is ultimately approved by the Scottish Ministers and then for budget monitoring throughout the year.

This approach broadly aligned to the overall impact of the revenue recognition policy, but in 2013-14, with the introduction of CfE, there has been a divergence between these bases. During 2013-14, SQA reported a forecast operational deficit in line with the original budget of £3 million on an accruals basis. The actual year end position, reflecting the application of the accounting policy which recognised CfE implementation is a surplus of £4.7 million (excluding the actuarial loss).

While the possibility that the accounting policy over income recognition could have had an impact on the 2013-14 outturn was reported to the SQA board and the Scottish Government during the year, we suggest that management should have quantified the potential impact of the income recognition policy more explicitly at an earlier stage.

Management should consider the basis of preparation for the management accounts and whether these could be aligned more closely to the financial statements.

Recommendation three

Appointee PAYE

As a result of the implementation of auto-enrolment and Real Time Information by HM Revenue and Customs on 6 April 2013, the timing of settlements for income tax in relation to appointees has changed. During 2013-14, SQA has had to settle in cash two years' worth of income tax relating to 2012-13 and 2013-14. To mitigate the cash impact of this, SQA received a one-off additional grant from the Scottish Government of £2.4 million. Whilst only one year's expense is recorded in the financial statements for 2013-14, two years of grant in aid is recorded. This is a non recurring situation.

Business issues and financial position (continued)

Net expenditure in 2013-14 was £19.2 million, with Scottish Government grant funding received of £23.9 million. This includes £14.1 million of programme funding for specific activities, the majority of which relates to the continued development and implementation of CfE.

The levels of net expenditure and grant funding during the year has been driven by activity associated with the implementation of CfE.

The outturn for the year is a consequence of income recognition associated with Curriculum for Excellence activity, but had no impact on cash receipts in the year and therefore the cash requirement from the Scottish Government.

Financial performance

During 2013-14, SQA incurred costs of £71.6 million, an increase of £3.9 million on the previous year. These costs were offset by income from entry charges at £45.6 million, other income of £7.3 million and grant-in-aid of £23.9 million (including notional funding of £1.5 million, in respect of the annual rent of the Optima building in Glasgow). These were increases of £5.9 million, £700,000 and £4.3 million, respectively, on the previous year.

Staff costs

There has been an increase in staff costs in 2013-14 of £2.9 million. This is due to the effect of an increased number of employees relating to generation of increased commercial/contracts income and CfE implementation and a pay award (in accordance with Scottish Government pay policy) costing £500,000. The effect of the application of IAS19 (Revised) has also increased other pension costs by £1.2 million compared to 2012-13.

Other expenditure

The increase in other expenditure is mainly in relation to an increase in appointee related fees. Release compensation in relation to appointees has increased by £500,000 in 2013-14 and appointee expenses have also increased in 2013-14 by £300,000. These increases in appointee related expenditure are as expected due to the additional verification activity which SQA carried out in 2013-14 at the request of the Scottish Government to ensure the successful implementation of the CfE programme. Claims for release compensation by local authorities have historically reflected custom and practice and not been consistent, with some authorities submitting claims and others not. While there is a pattern for these which SQA follows, the inconsistencies in practice distort the true cost base for the organisation. Release compensation should be a subject for discussion with the Scottish Government and local authorities.

Recommendation one

	2013-14 £'000	2012-13 £'000	Variance £'000
Staff costs	(30,514)	(27,606)	(2,908)
Depreciation and impairment	(2,473)	(2,479)	6
Other expenditure	(38,578)	(37,606)	(972)
Total expenditure	**(71,565)**	**(67,691)**	**(3,874)**
Entry charges	45,574	39,705	5,869
EU funding	-	125	(125)
Other income	7,341	6,645	696
Total income	**52,915**	**46,475**	**6,440**
Net expenditure	**(18,650)**	**(21,216)**	**2,566**
Interest (payable)	(554)	(339)	(215)
Total net expenditure	**(19,204)**	**(21,555)**	**2,351**
Grant funding received	23,933	19,676	4,257
Surplus/(deficit)	4,729	(1,879)	6,608

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

Income

Income from entry charges has increased by £5.9 million on the prior year. This is due to the effect of recognising income for CfE in 2013-14 for the first time. This is in line with our expectations as revenue has been recognised for Standard Grades with external assessment in May 2013 and a large proportion of National 1 to 5 charges relating to the academic year 2013-14.

Other income has increased in 2013-14 by £700,000. This is as a result of an increase in various income streams, such as consultancy, secondments and research and street works qualification register (increased by £400,000 and £200,000, respectively). Other, smaller increases in income streams were offset by a decrease in income from commercial events and interest receivable.

Business issues and financial position (continued)

The 2014-15 budget includes a funding gap of £1.6 million (£2.6 million cash deficit) on the basis of the best financial case, due to reduced grant-in-aid, wage and supplier inflation, auto-enrolment and increased investments in activities to support income generation.

Performance against budget

The 2013-14 budget included a funding gap of £2.3 million, due to reduced grant-in-aid, wage and supplier inflation, auto-enrolment and increased investments in activities to support income generation.

However, the actual result for the financial year was a surplus of £4.7 million. This was mainly due to the budget and management accounts being prepared on a revenue billed basis. Additional funding received to cover appointee income tax was only recognised on preparation of the draft financial statements, having only been disclosed in the supporting narrative to the management accounts.

Financial plans 2014-15

2014-15 will continue to be operationally challenging for SQA with the continued introduction of CfE remaining a priority. The focus on CfE has led management to recognise that the Scottish Government target of achieving self-financing status by 2015-16 is unlikely to be achieved.

The 2014-15 budget has been prepared in line with the objectives set out in the 2013-16 corporate plan to maintain levels of service, efficiency and quality while continuing to focus on developing a business model that enables SQA to achieve a self-financing status.

Grant-in-aid income continues to reduce in line with the target of becoming self-financing, from a budget of £3.8 million in 2013-14 to £1.8 million in 2014-15.

The financial plans for 2014-15 submitted to the Scottish Government reflect continued uncertainties around CfE and monitoring is undertaken against an upper and lower range of potential outturns. The budget column opposite reflects the "best financial case", showing a deficit of £1.6 million (£2.6 million on a cash basis), but the forecast range varies from a deficit of £1.6 million to one of £3.2 million. The principal variable is core expenditure covering staff, appointee and operational costs.

Grant funded income and expenditure relates to specific programme funding, the majority of which relates to continued development and implementation of CfE.

Budget income and expenditure	2014-15 £'000	2013-14 £'000
Core income:		
Entry charges	42,200	40,100
Other income	8,800	6,700
Grant-in-aid	1,800	3,800
Scottish Government – property	2,600	2,600
Capital grant release	1,100	1,000
Total income	**56,500**	**54,200**
Core expenditure:		
Staff costs	25,200	23,200
Appointee costs	14,800	16,600
Operational costs	13,100	11,900
Property rental	2,600	2,600
Depreciation	2,400	2,200
Total expenditure	**58,100**	**56,500**
Core deficit	**(1,600)**	**(2,300)**
Grant funding:		
Income	15,000	14,100
Expenditure	(15,000)	(14,100)
Grant deficit	**-**	**-**
Total deficit	**(1,600)**	**(2,300)**

Source: *SQA Board of management June 2014*

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.

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.

Audit conclusions

We have issued an unqualified opinion on the truth and fairness of the state of SQA's affairs as at 31 March 2014, and of SQA's net operating costs for the year then ended. We also provided our 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 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 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

Revenue recognition	As a result of the anticipated changes arising from CfE, we recognised that the fraud risk from revenue recognition relating to entry charges was a significant risk and planned and conducted appropriate procedures. This included performance of controls testing over income billing and a review in detail of the application of SQA's policy for income arising from new CfE qualifications. We found that management had considered different variables over the bases on which CfE income recognition might be recognised and had adopted a policy which reflected the changed circumstances. This was in a response to a recommendation from the previous year's audit. Where there was room for some interpretation, we found management's judgement to have been balanced. The income recognition policy arising from CfE implementation was not adopted in either management accounts during the year or the draft financial statements presented for audit. The latter was addressed through the processing of an adjustment during the course of the audit (appendix two). As grant is aid is agreed in advance of the year, with adjustments requiring Scottish Government approval, we did not regard the risk of fraud in its recognition to be significant.

Audit conclusions (continued)

In addition to the significant risks which International Standards on Auditing require us to address, our audit planning also identified an area of audit focus around employee benefits valuation.

Our work in this area has been satisfactorily concluded.

In line with changes to the financial reporting framework as set out in HM Treasury's *Financial Reporting Manual* ("FReM"), SQA has reflected the impact to the financial statements arising from revisions to IAS 19*: Employee Benefits*.

Significant risks (continued)	
Management override of controls	To address this risk, 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 focus area	
Employee benefits valuation	SQA 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 SQA, and estimates of SQA's share of the pension fund assets. We found that the actuarial consultants as a third party expert were objective and had the appropriate experience and expertise to provide the information for use by SQA. 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. Further information is given in Appendix 5. SQA 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 was recognised in the statement of comprehensive net expenditure within interest payable. Under IAS 19R, these two amounts have been replaced by a single measure called 'net interest' calculated on the net defined benefit liability. SQA has appropriately applied IAS 19 (Revised) in the financial statements. If the standard had been adopted early in 2012-13, the estimated change to finance costs would be £800,000. SQA has recognised this by restating the prior year comparatives given in 2013-14 financial statements. There was no impact on the previously reported net asset position.

Accounting framework; year end process; other matters

The financial statements have been appropriately prepared on a going concern basis.

Financial reporting framework	■ SQA prepares financial statements in accordance with HM Treasury's Financial Reporting Manual 2013-14 ("FReM"). ■ Changes to the FReM in 2013-14 require SQA 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. ■ We are satisfied that the accounting policies adopted remain appropriate to SQA. SQA has applied the revisions to IAS 19 *Employee Benefits,* restating the prior year comparatives in the 2013-14 financial statements. Appropriate disclosure has been provided within the accounting policies note. ■ No newly effective accounting standards are considered likely to have a material impact on SQA's financial statements.
Going concern	■ The financial statements have been prepared under the assumption that the organisation is a going concern. Given the nature of SQA and its critical role in the implementation of CfE which is supported by the Scottish Government, this is a reasonable assumption. Furthermore, SQA has reserves of £6 million as at 31 March 2014, which could meet the budgeted deficit in 2014-15 if no further funding was received from the Scottish Government. However, cash reserves are forecast to be fully utilised by February 2015 if no further funding is received.
Financial statements preparation	■ Supporting working papers and an initial draft of the financial statements were provided at the start of the audit fieldwork on 7 May 2014. This included the management commentary and remuneration report. ■ 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. ■ Throughout the course of the year we have had regular correspondence with the SQA finance team to ensure that disclosure within the financial statements was consistent with the requirements of the FReM. We provided feedback to management on the content of the financial statements, annual report and remuneration report, and we are pleased to report that these were consequently prepared appropriately.
Other matters	■ There was one adjusted audit difference in relation to entry charges income (Appendix two). There are no unadjusted audit differences. ■ There are no significant matters in respect of (i) auditor independence and non-audit fees; and (ii) management representation letter content.

Governance and narrative reporting

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

Corporate governance arrangements

We updated our understanding of the governance framework and did not identify any issues in relation to governance.

Annual governance statement and governance arrangements	■ 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 committee and internal audit. The statement identifies that there have been no significant risk-related matters and no significant lapses of data security. ■ Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls are designed appropriately and operating effectively. As part of our interim audit we updated our understanding of the governance framework as part of our overall assessment of SQA’s risk and control environment. We did not identify any issues during that work. We also considered this area as part of our work on the annual governance statement and again did not identify any issues.
Annual report, including the management commentary	■ Management is responsible for preparing financial statements that show a true and fair view. ■ The financial statements form part of the annual report of SQA for the year ended 31 March 2014. We are required to consider the management commentary and provide our opinion on the consistency of it with the financial statements. ■ Following amendments to the FReM becoming effective for 2013-14, SQA 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. We have reviewed the contents of the strategic and directors’ report against the revised disclosure requirements and are content with the reports. We 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 required to consider the strategic and directors’ reports, and provide our opinion on the consistency of it with the financial statements. We are satisfied that the information contained within the strategic and directors’ report is consistent with the financial statements.
Remuneration report	■ The remuneration report was included within the draft financial statements and supported by good quality information and working papers. The 2013-14 FReM included an additional requirement for disclosure of total directors’ remunerations as a single figure; this has been correctly included within the financial statements.

Corporate governance arrangements (continued)

Internal audit	■ We have considered the findings from internal audit reports finalised during 2013-14 to inform our assessment of risks that need to be considered and addressed during the audit. Our review of internal audit reports also helps ensure that any duplication of work is avoided. ■ The content of the internal audit plan is, in our view, comprehensive. We reviewed a number of reports, including those in respect of payroll and expenses, financial ledger and CfE.
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 SQA has appropriate arrangements to prevent and detect fraud. These are supported by a fraud prevention policy and response plan. ■ We also consider that SQA 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 SQA'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

Our work has identified that SQA's Best Value and performance management arrangements are generally robust.

For the financial year 2013-14 SQA had a cash releasing efficiency savings target of £400,000 from the Scottish Government, but only realised actual savings of under £200,000.

Framework

SQA's performance management arrangements remain unchanged from the prior year, focussed around detailed monitoring information on progress against key corporate milestones. Regular reporting to the audit committee and board of management includes details of recently completed or achieved milestones, those due to be achieved in the next period and a summary of potential risks which could arise. The performance review pack incorporates a number of reporting formats, graphs, charts and narrative and includes aspects of good practice such as noting actions required in respect of specific performance areas.

The audit committee also receives capital and revenue budget monitoring reports which compare the actual results for the quarter to date with the forecast position to date.

Efficiency savings

Efficiency savings are planned and are ongoing as part of SQA's goal to become self financing. Details of efficiency savings made in 2013-14 are summarised opposite.

The majority of the shortfall is through staff cost reductions not having been achieved as planned, due to the extra activities required to ensure the successful delivery of CfE qualifications in 2013-14. The savings that have been achieved were as a result of:

- IT cost reductions achieved through the more effective use of technology and equipment;
- improving business processes and working practices, for example ensuring full utilisation of internal meeting rooms; and
- embedding a culture of efficiency across the organisation while ensuring no reduction in outputs or quality of service.

	Actual savings £'000	Original target £'000	Variance £'000
Staff costs	3	200	(197)
Appointee costs	10	36	(26)
Assessment materials	112	130	(18)
Postage and telephone	5	40	(35)
External venues	9	6	3
IT	26	18	8
Property	-	1	(1)
Other	24	7	17
Total	**189**	**438**	**(249)**

Source: *SQA Quarterly performance review May 2014*

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).

A series of toolkits covering financial, performance and governance processes are available for public sector organisations and auditor to use, but auditors have not been required to complete specific toolkit(s) during the period. SQA may find that application of the toolkits offers support for the current organisational change agenda.

Performance management (continued)

Our work has identified that SQA's Best Value and performance management arrangements are generally robust.

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Local response to national studies

As part of its targeted approach to following-up a number of performance audit reports each year, Audit Scotland has identified the *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. Our work will focus on the operational systems in place to support CfE implementation.

We will submit a report to Audit Scotland concluding on this work by 30 November 2014.

Appendices

Mandatory communications

There was one adjusted audit difference.

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There was an adjusted audit difference in relation to entry charges income which resulted in an increase in entry charges of £5.9 million from the draft financial statements. A small number of minor numerical and presentational adjustments were required to some of the financial statements notes.	Appendix two
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 three
Schedule of Fees Fees charged by KPMG for audit and non-audit services	Audit fees payable to Audit Scotland are in accordance with the range specified by Audit Scotland and as reported to the audit committee. There were no non-audit services in 2013-14.	-
Draft management representation letter Proposed draft of letter to be issued by SQA to KPMG prior to audit sign-off	There are no significant changes to the standard representations required for our audit from last year.	-

Audit differences

There is an adjusted audit difference relating to entry charges income.

Adjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all adjusted audit differences, other than those which are trivial, to you.

There is an adjusted audit difference relating to entry charges income. Details of this adjusted audit difference are shown below.

Adjusted caption	Nature of difference	Statement of Financial Position	Statement of Comprehensive Net Expenditure
Changes to the prime financial statements		**£'000**	**£'000**
Entry charges income	Testing identified differences between the accrued amount and the amount which was subsequently invoiced.	5,885	
Prepayments and accrued income	The double entry of the above.	-	5,885
Net impact		**5,885**	**5,885**

Auditor independence

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

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

Auditor independence

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 SQA 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
- Regular 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 22 August 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 report is intended solely for the information of the audit 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 COSLA pricing agreement		**Grade one**
SQA agreed a fixed price levy with COSLA and the Scottish Government for three years from 2013-14. This was agreed to address the uncertainty of income in relation to the introduction of CfE qualifications.	Management should initiate a dialogue with both the Scottish Government and COSLA to consider income and pricing following the expiration of the fixed price levy period. This might include consideration as to whether there are alternative models for the financial support for SQA's ongoing work. This should address consistency of treatment of release compensation across local authorities.	The Scottish Government approves the pricing regime for National Qualifications in Scotland and the sponsor has arranged meetings to commence discussions on the approach to NQ Fees beyond 2015-16. The initial meeting date was February 2014, however these meetings have been cancelled by the sponsor team. A date in late July / early August is now being arranged. The meeting invite included the SQA directors of business development and finance, the SG representative of the association of directors of education and the representative officer from COSLA. The group recognises the need to have a wide ranging discussion on the options for funding the national qualifications system in Scotland including the costs of invigilation and release compensation. **Responsible officer:** Director of Finance **Implementation date:** This will be driven by Scottish Government - suggested date October 2014

Action plan (continued)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
2 Costing system		**Grade two**
SQA has previously recognised the need for a costing system to improve the quality of information available to inform pricing decisions. The introduction of a costing system would enhance and consolidate the information currently available, making pricing decisions more meaningful.	Management should continue to progress the implementation of a costing system.	The interim costing model which was developed during 2013-14 has significantly improved the organisation's understanding of its costs. This allows finance to collate data on the time spent on organisational activities and to allocate costs appropriately. The model can be updated at regular intervals to ensure that the allocation of costs remains appropriate and accurate. An integrated costing system will be pursued as part of a wider proposal to establish a new chart of accounts and coding structure commencing in the first quarter of 2015-16. In the meantime the interim model is meeting current needs. **Responsible officer:** Director of Finance **Implementation date:** September 2015
3 Management accounts preparation		**Grade one**
Management accounts during 2013-14 were prepared on a cash billed basis. Whereas in previous years this method aligned with the overall effect of the income recognition policy, this is no longer the case due to the impact of the CfE income in the year.	Management should consider the basis of preparation for the management accounts and whether these could be aligned more closely to the financial statements.	Following agreement on the approach to the income accrual for CfE the adjustment has been reflected in the management accounts quarter 0 forecast reported to the Board. **Responsible officer:** Director of Finance **Implementation date:** June 2014

Employee benefits

Each of the assumptions used to value SQA'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).

Defined benefit pension liability

Value (£000s) 2014	Value (£000s) 2013	KPMG comment
(15,487)	(11,370)	In line with our established practice and in advance of the audit fieldwork, our actuarial specialists reviewed the approach and methodology of the actuarial assumptions used in the IAS19R pension scheme valuation. Details of key actuarial assumptions are included in the table, along with our commentary.

Assumption	SQA	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
CPI inflation	2.8% RPI - 0.8%	2.6% RPI – 1%	Acceptable – SQA'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 – SQA's assumption reflects the extension of the public sector pay freeze to 2016, followed by a long term assumption of RPI plus 1.5%.

The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of between 17 and 23 years.

The closing deficit increased by £4.1 million from 2012-13, primarily due to the application of an updated discount rate. A reconciliation from opening to closing deficit is included on the next page.

Employee benefits (continued)

The table opposite shows the reconciliation of the movement in the balance sheet.

The main elements of volatility are in respect of the discount rate, which drives the valuation of the liabilities.

	£000	Deficit / loss	Surplus / gain	Impact	Volatility	Commentary
	Opening surplus/(deficit)			**(11,370)**	-	The opening IAS 19 deficit for the Scheme at 31 March 2013 was £6.641 million, in line with the Hymans Robertson's IAS 19 actuarial valuation report.
I & E	Service cost			(4,415)		The scheme is open to accrual. The service cost represents the value of new benefits built up over the year.
	Net interest			(529)		This is the difference between the expected return on assets of £4.388 million and the interest on the defined benefit obligation of £3.949 million.
	Other experience			31	-	
Cash	Contributions			3,649		SQA made cash contributions of £3.283 million.
OCI	Change in assumptions gain/(loss)			(4,875)		This represents an actuarial loss due to changes in assumptions, primarily due to the reduction in the discount rate.
	Contributions in respect of unfunded benefits			16		
	Return on assets			2,006		The actual return on assets is lower than the interest on assets of £2.6 million.
	Closing surplus/(deficit)			**(15,487)**	-	

Key: Low Medium High

Source: KPMG analysis of scheme valuation movements. Volatility assessment based on KPMG's market experience.

I&E – impacts on surplus /(deficit) within statement of comprehensive net expenditure

Cash – cash-flow impact

OCI – charged through other comprehensive income cutting through complexity