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cutting through complexity

Creative Scotland and National Lottery Distribution Fund

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

For the year ended 31 March 2016

7 October 2016

Contents

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 (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 introduction and responsibilities 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.

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Hugh Harvie, who is the engagement leader for our services to Creative Scotland, telephone 0131 527 6682 email: hugh.harvie@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN.

Executive summary

Executive summary

Audit conclusions		
●	We expect to issue an unqualified audit opinion on the financial statements of Creative Scotland and the National Lottery Distribution Fund, following receipt of management representation letters.	
Financial position		
●	The result for 2015-16 for Creative Scotland was £50.79 million net expenditure, compared to budgeted net expenditure of £51.2 million. The difference compared to budget is largely in relation to operating costs and direct delivery, which were £440,000 lower than expected. At 31 March 2016 Creative Scotland is recognising a deficit in total reserves of £5.3 million (2015: positive reserves of £1.2 million). The movement is primarily due to £7.8 million of grant commitments recognised for which it had not drawn down funding. Scottish Government have confirmed that cash will continue to be provided to meet these commitments as they fall due.	Pages 6 – 7
●	NLDF achieved a surplus of £3.27 million, against a budgeted deficit of £5.25 million. This was due to capital project delays and underspends on targeted funding, together with £2.4 million greater National Lottery proceeds than originally budgeted.	Pages 8 - 10
●	The 2016-17 budget for Creative Scotland shows net expenditure of £44.2 million, based on approved grant-in-aid from Scottish Government of £44.5 million. NLDF is budgeted to achieve a deficit of £632,000, with forecast lottery income of £32.5 million. We concur with management's conclusion that Creative Scotland and NLDF are going concerns; given that grants awarded need only be paid out as long as funds continue to be made available by the Scottish Government and the Department for Culture, Media and Sport, respectively.	Pages 6 - 10
Financial statements and related reports		
●	We have concluded satisfactorily in respect of each of the significant risks and audit focus areas identified in the audit strategy and plan document. We concur with management's accounting treatment and judgements. We have no matters to highlight in respect of: adjusted and unadjusted audit differences; independence; and changes to management representations.	Pages 11 - 20
Wider scope matters		
●	We considered the wider scope audit dimensions and concluded positively in respect of value for money and financial sustainability.	Page 24
●	We noted small areas for improvement in relation to financial management, due to not being able to ascertain from meeting minutes the extent to which financial information is scrutinised by the Board, and governance and transparency, due to Creative Scotland's register of interests not being kept up to date and declarations of interest not being maintained for all Board Members.	Pages 25 - 27

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 ("NLDF") 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 NLDF and the Auditor General. 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.

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 management and sustainability, governance and transparency and value for money.

Accountable officer responsibilities

The Code sets out Creative Scotland's responsibilities in respect of:

- preparation of financial statements that show a true and fair view;
- 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.

Auditor responsibilities

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. Appendix seven sets out how we have met each of the responsibilities set out in the Code.

Scope

An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. Management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems.

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 the audit and risk committee throughout the year, discharges the requirements of ISA 260.

Financial position

Financial position – Creative Scotland

Background

Creative Scotland and NLDF support the arts, screens and creative industries across Scotland. They distribute funding from the Scottish Government and The National Lottery. Separate annual reports and accounts are prepared for Creative Scotland for the activities undertaken as a Scottish Government funding distributor and for Creative Scotland National Lottery Distribution Fund for the activities undertaken as a Lottery Distributor.

Funding falls into three categories: regular funding for organisations for at least three years, open project funding for individuals and organisations and targeted development funding programmes for specific purposes. In 2015-16 Creative Scotland has continued to review and re-align categories of funding between grant-in-aid and National Lottery funding. Open funding is now predominantly paid through NLDF, and some ongoing projects have been re-categorised from grant-in-aid to lottery in the period.

In April 2014 Creative Scotland published a 10 year plan from 2014-2024. This is called Unlocking Potential, Embracing Action and is a shared plan for the arts, screen and creative industries. Alongside the 10 year plan, Creative Scotland have also published an annual plan for 2016-17, as well as a detailed budget for the financial year, broken down by funding programme and organisation, and separated into grant-in-aid and lottery funding.

The organisation moved into new rented premises at the Lighthouse in Glasgow city centre in May 2016.

Financial position – statement of comprehensive net expenditure

Creative Scotland achieved an outturn position for the year to 31 March 2016 of £50.79 million net expenditure, compared to budgeted net expenditure of £51.2 million. Grant expenditure was £94,000 lower than budgeted due to £536,000 capital grant expenditure being postponed to 2016-17, and additional expenditure of £469,000 on open project funding. Operating costs and direct delivery costs were £440,000 (9%) lower than budgeted due to projects and recruitment being delayed to 2016-17.

Statement of Comprehensive Net Expenditure

	2015-16 £'000	2014-15 £'000	Variance £'000
Project income	42	105	(63)
Other operating income	2,795	2,610	185
Total income	**2,837**	**2,715**	**122**
Staff costs	4,721	4,668	53
Grant commitments	46,551	46,028	523
Less: de-commitment of prior year grants	(880)	(141)	(739)
Project expenditure	430	629	(199)
Other operating expenditure	2,521	2,500	21
Depreciation	247	246	1
Total expenditure	**53,590**	**53,930**	**(340)**
Net operating costs for the year	**(50,753)**	**(51,215)**	**462**
Other finance costs	(33)	(23)	10
Net expenditure for the year	**(50,786)**	**(51,238)**	**452**

Source: KPMG analysis of Creative Scotland's annual accounts 2015-16.

Financial position – statement of financial position

Creative Scotland's balance sheet position decreased by £6.5 million in the period to 31 March 2016 to a net liability position of £5.2 million. This is due to changes in working capital requirements set by Scottish Government which have meant that £7.8 million of grant commitments made in the year, which are due to be paid out in future years, have not been funded by grant in aid. The changed requirements have also resulted in a £12.7 million reduction in Creative Scotland's cash balance year on year.

Financial position – Creative Scotland (continued)

Financial position – statement of financial position (continued)

Creative Scotland's net liability in the Strathclyde Pension Fund has reduced by £767,000 to £216,000 due to changes in actuarial assumptions compared to prior year.

Financial plans 2016-17 and beyond

Creative Scotland publishes a detailed annual plan setting out its key objectives for the coming year. In 2016-17 Creative Scotland's key areas of focus will be artists, organisations, leadership and skills development, society, the public and inclusion and the role of Creative Scotland.

Creative Scotland prepared an accurate budget for 2015-16. The key variance was in relation to grant-in-aid for the reasons noted in the above analysis.

The approved budget for 2016-17 shows income and expenditure of £44.3 million. The Scottish Government has awarded £44.5 million of grant-in-aid for 2016-17, with £15.0 million being allocated to targeted funding, the largest project continuing to be the Youth Music Initiative. Operating costs are budgeted to be £4.6 million, an increase of £362,000 (9%) on actual operating costs 2015-16 due to projects and recruitment deferred from 2015-16.

At the time of the audit, forecasting for 2017-18 and beyond had been updated to reflect changes of understanding or assumptions developed in 2015-16, but since budgets are only provided by Scottish Government for one year it is difficult for Creative Scotland to forecast beyond that with any certainty.

Going concern

Creative Scotland continues to operate in a challenging financial climate, and as noted above changes to working capital targets set by Scottish Government have meant that Creative Scotland is in a net liability position as at 31 March 2016.

Management have considered it appropriate to adopt a going concern basis for the preparation of the financial statements. It considers that core grant in aid together with acknowledgement from Scottish Government of the need to fund grant commitments of £7.8 million, made in the year to 31 March 2016, which relate to future years, is sufficient to ensure that Creative Scotland is able to meet debts as they fall due.

Conclusion

Creative Scotland has continued to make improvements to its grant approval processes, and has continued to control operational costs, helping it to maintain a comfortable financial position. It has responded to revised Scottish Government working capital targets by bringing its cash balance down by £12.7 million to £2.7 million, and plans for this balance to be brought down to a target of £1 million by 31 March 2017, through improvements in the timely payment of outstanding grants.

Whilst Creative Scotland has a net liabilities position we do not consider this impacts its ability to continue as a going concern given Scottish Government's acknowledgement that the grant commitments which have given rise to this will require to be funded in 2016-17 and that they will consider this need in the Autumn or Spring Budget revisions.

We are content that the going concern assumption is appropriate for Creative Scotland, in light of the matters set out above.

Financial position – NLDF

Financial position – statement of comprehensive income

NLDF achieved a surplus of £3.15 million for the year-ended 31 March 2016, against a budgeted deficit of £5.25 million. The key factors for this movement are:

- £3.3 million less capital spend, largely due to projects being delayed to 2016-17;
- £2.4 million greater National Lottery proceeds due to increased National Lottery sales; and
- £2.0 million less targeted funding spend compared to budget.

National Lottery income and expenditure are 1.5% and 1.6% down on prior year respectively, due to changes in lottery sales.

Financial position – statement of financial position

Net liabilities have decreased from £7.9 million to £4.7 million.

Current assets have increased by £4.7 million (24%) compared to 2014-15. The components of this are an increase of £2.9 million in investments in the National Lottery Distribution Fund, and an increase of £2.0 million in the cash balance, which has been offset by a small decrease in other receivables.

Non-current liabilities have increased by £1.1 million (16.1%) due to an increase in the grants outstanding balance, following delays in some of the capital projects, as noted above.

Financial plans 2016-17 and beyond

The approved budget for 2016-17 shows a forecast deficit of £632,000, with forecast lottery income of £32.5 million. £2.6 million has been budgeted for expenditure on capital projects.

The graph on the following page shows the variances between the 2015-16 budget that was set for NLDF compared to the actual outturn position.

Statement of Comprehensive Income

	2015-16 £'000	2014-15 £'000	Variance £'000
National Lottery Fund proceeds	34,375	34,882	(507)
Other income	459	419	40
Total income	**34,834**	**35,301**	**(467)**
Grants	29,839	30,444	(491)
Less: de-commitment of prior year grants	(1,119)	(1,313)	194
Project expenditure	234	260	(26)
Staff costs	1,806	1,788	18
Other operating expenditure	807	951	(144)
Total expenditure	**31,567**	**32,130**	**(449)**
Surplus	**3,267**	**3,171**	**(18)**

Source: KPMG analysis of NLDF's annual accounts 2015-16.

Going concern

The net liability position as at 31 March 2016 has arisen principally because the commitments accounted for within the financial statements continue to 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 2018-19, after which the projections show a return of the Fund to surplus. This will be achieved through the Distribution Fund operating with an in year surplus from 2017-18 onwards.

Financial position – NLDF
(continued)

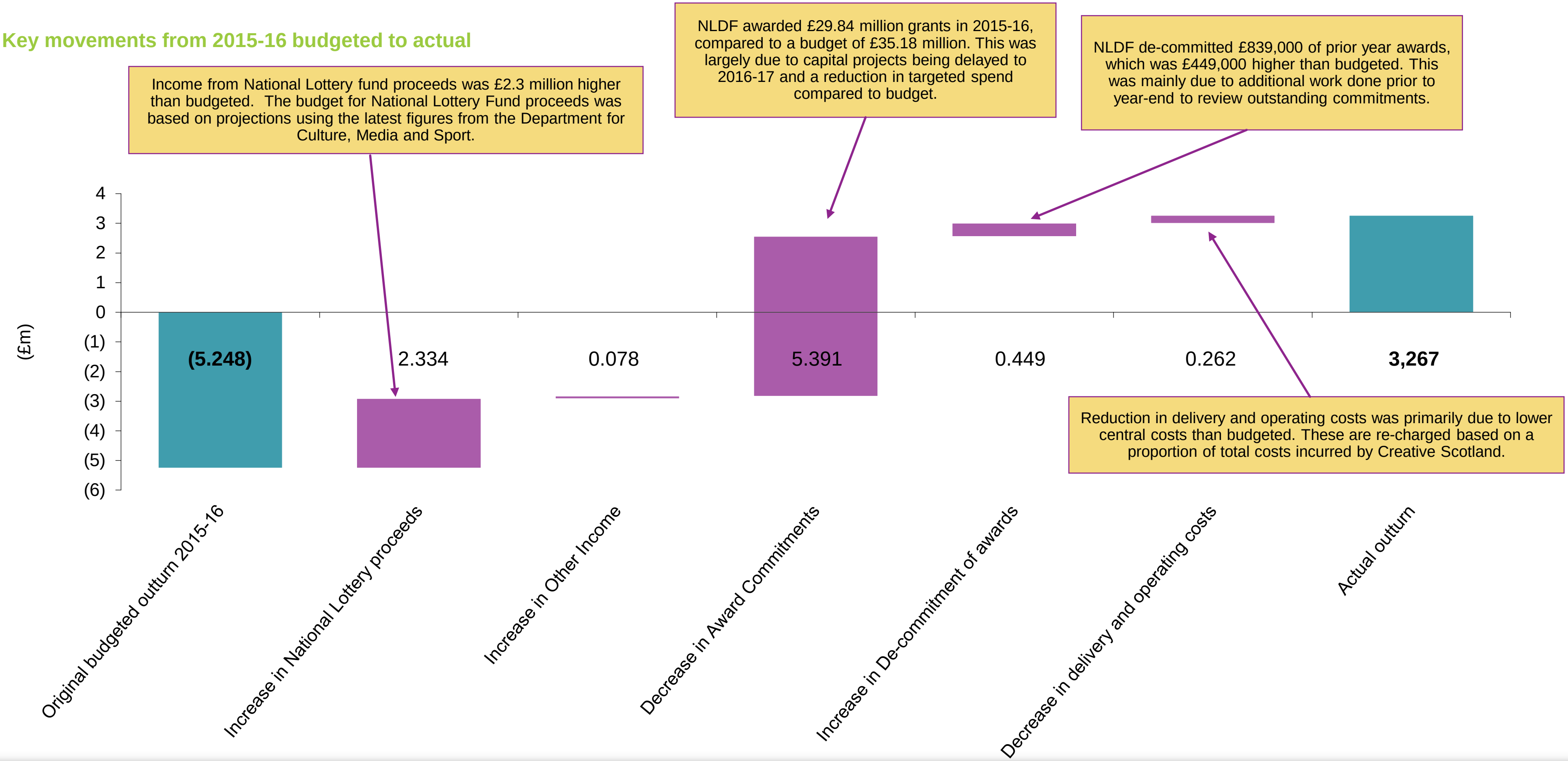
Conclusion

We concur with management’s view that the going concern assumption remains appropriate.

Financial position (continued)

The graph below shows the movement in the actual deficit in 2015-16 compared to the budgeted breakeven position.

Key movements from 2015-16 budgeted to actual



Financial statements and related reports

Audit conclusions

Audit opinion
Our audit work is complete subject to receipt of management representations and update of subsequent events. Following approval of the annual accounts by the audit and risk committee we intend to issue an unqualified opinion on the truth and fairness of the state of Creative Scotland's and NLDF's affairs as at 31 March 2016, and of net expenditure for the year then ended. There are no matters identified on which we are required to report by exception.
Financial reporting framework, legislation and other reporting requirements
Creative Scotland and NLDF are required to prepare financial statements in accordance with International Financial Reporting Standards, as interpreted and adapted by the FReM. NLDF is also required to prepare its financial statements in accordance with the accounts direction issued by Scottish Ministers under Section 35 of part II of the National Lottery etc. Act 1993. Our audit confirmed that the financial statements have been prepared in accordance with the FReM and relevant legislation.
Regularity
Our audit work, as outlined on the following pages, has concluded that in all material respects the expenditure and income in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers.
Statutory reports
We have not identified any circumstances to notify the Auditor General that indicate a statutory report may be required.
Other communications
We did not encounter any significant difficulties during the audit. There were no other significant matters arising from the audit that were discussed, or subject to correspondence with management that have not been included within this report. There are no other matters arising from the audit, that, in our professional judgement, are significant to the oversight of the financial reporting process.
Audit misstatements
There were no audit adjustment required to the draft annual accounts. There was one unadjusted audit difference, the details of which are set out in appendix one.
Written representations
There are no changes to the standard representations required for our audit from last year.

Materiality

We summarised our approach to materiality in our audit strategy. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels.

Creative Scotland

We concluded that our planning materiality for 2015-16 of £1 million (2% of gross expenditure) remains appropriate. We have reported all misstatements greater than £50,000.

NLDF

We revised our materiality down from planning materiality of £760,000 to take into account the large reduction in actual gross expenditure compared to that budgeted at the time of our interim audit. Our final materiality for NLDF was £635,000 (2% of gross expenditure). We have reported all misstatements greater than £32,000.

Forming our opinions and conclusions

In gathering the evidence for the above opinion(s) and conclusion(s) we have:

- performed controls testing and substantive procedures to ensure that key risks to the annual accounts have been covered and that the regularity of income and expenditure was in accordance with regulations;
- communicated with internal audit and reviewed its reports as issued to the audit and risk committee to ensure all key risk areas which may be viewed to have an impact on the annual accounts have been considered;
- reviewed estimates and accounting judgements made by management and considered these for appropriateness;
- considered the potential effect of fraud on the annual accounts through discussions with senior management and internal audit to gain a better understanding of the work performed in relation to prevention and detection of fraud; and
- attended audit and risk committees to communicate our findings to those charged with governance, and to update our understanding of the key governance processes.

Financial statements preparation

High quality working papers and draft financial statements were provided at the start of the audit fieldwork on 20 June 2016. This included sections of the performance report, accountability report and directors report. The completed financial statements including the Chair’s and CEO’s reports were provided on 12 August 2016.

Significant risks and other focus areas in relation to the audit of the financial statements

We summarise below the risks of material misstatement as reported within the audit strategy. We set out the key audit procedures to address those risks and our findings from those procedures, in order that the audit and risk committee may better understand the process by which we arrived at our audit opinion.

Significant risks:

- management override of controls fraud risk.

Significant risks and other focus areas in relation to the audit of the financial statements

Other focus areas:

- pension liabilities;
- accounting for grant awards and commitments; and
- financial position

We have no changes to the risks or our approach to addressing the assumed ISA risk of fraud in management override of controls. We do not have findings to bring to your attention in relation to these matters. No control overrides were identified.

Significant risks

SIGNIFICANT RISK	OUR RESPONSE	AUDIT CONCLUSION
Fraud risk from management override of controls Professional standards require us to communicate the fraud risk from management override of controls as significant because management is typically in a unique position to perpetrate fraud due to its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. As the audit progressed we considered that there was an increased risk of fraud due to senior management having access to both post and review journals in the finance system, SAGE. This was taken into account when performing our year-end journals testing.	Our audit methodology incorporates the risk of management override of controls as a significant risk, along with appropriate audit procedures to mitigate such as testing of controls, review of journals and procedures of an unpredictable nature. We consider the fraud risk from management override of controls when planning our approach to the auditing of journals, and to address this risk we reviewed all journals posted by those members of senior management identified as having access to both post and approve journals within SAGE.	We have previously raised findings in relation to journals authorisation and documentation, which was communicated in our audit strategy and interim report. We carried out additional substantive testing of journals as part of our year-end fieldwork. Based on this testing we are satisfied with the appropriateness of journals posted. Our audit testing did not identify any further concerns of management override of controls.

Other focus areas

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
Financial position Creative Scotland is operating in a challenging economic environment, with funding reductions and increasing expenditure pressures. This presents the potential risk that the organisation is not financially sustainable. In 2014-15 Creative Scotland recorded a deficit on ordinary activities of £0.079 million. The 2015-16 budget published in the annual plan assumed a breakeven position.	Our work consisted of: ■ performing controls testing over the budgeting process including the monitoring of budgets throughout the year; ■ test of details over grants expenditure and grant commitments; and ■ performing a substantive analytical procedures over expenditure.	Overall we are satisfied with Creative Scotland's financial sustainability in the short-term. Creative Scotland recorded a deficit of £7.4 million on ordinary activities in the year to 31 March 2016, however, this was due to grant in aid of £7.8 million not having been drawn down (and therefore not recognised) by year-end. Scottish Government have acknowledged that Creative Scotland will require the remaining funding throughout 2016-17 to continue to meet its commitments to make grant payments and have confirmed this will be considered in the Autumn or Spring Budget revisions. Operating costs were 10% lower than budgeted for, suggesting good control of costs. We are satisfied with controls over budget setting and monitoring.

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
Retirement benefit obligations Creative Scotland participates in two pension schemes: Strathclyde Pension Fund and the Arts Council Retirement Plan. Both plans are defined benefit pension schemes, however, the accounting treatment of these differ. Strathclyde Pension Fund is accounted for in accordance with IAS 19 *Retirement benefits*, using a valuation report prepared by actuarial consultants, whereas the Arts Council Retirement Plan has historically been accounted for as a defined contribution scheme on the basis that Creative Scotland has been unable to identify its share of the relevant assets and liabilities.	Our work consisted of: - KPMG specialists reviewing the financial assumptions underlying actuarial calculations and comparison to our central benchmarks; - testing of scheme assets and rolled-forward liabilities; - testing of the level of contributions used by the actuary to those actually paid during the year; - testing of membership data used by the actuary to data from SDS; and - agreeing actuarial reports to financial statement disclosures.	We are satisfied that the retirement benefit obligation: - is correctly stated in the balance sheet as at 31 March 2016; and - has been accounted for and disclosed correctly in line with IAS19 *Retirement benefits*. We are satisfied that the assumptions used in calculating the estimated obligations are appropriate and within the acceptable KPMG range. We set out further information in respect of the defined benefit obligation on page 37. The defined benefit obligation decreased by £767,000 compared to 31 March 2015, driven by a lower discount rate and increased mortality assumption.

Other focus areas

OTHER FOCUS AREA	OUR RESPONSE	AUDIT CONCLUSION
Accounting for grant awards The majority of Creative Scotland's expenditure relates to grants, awards and investments. Appropriate recognition of this expenditure at 31 March 2016 will be required to ensure accurate financial performance is reported in the financial statements.	Our work consisted of: ■ testing controls over the approval process for assessing grant award applications, granting awards, and paying grant awards; and ■ testing a sample of grants at year end and agreeing to supporting documentation to ensure they have been accounted for correctly, including associated payables.	We are satisfied with Creative Scotland's accounting treatment of grant awards.

REPORT	SUMMARY OBSERVATIONS	AUDIT CONCLUSION
Performance report	The performance report is a new requirement under the 2015-16 FReM. The report was included within the unaudited annual accounts and supporting reports and working papers were provided.	We are satisfied that the information contained within the performance report is consistent with the financial statements. We reviewed the contents of the management commentary against the guidance contained in the FReM and are content with the proposed report. We provided management with some relatively minor suggestions relating to how the management commentary could be enhanced and where additional information disclosures should be made.
Accountability report	The 2015-16 FReM requires relevant bodies to produce an accountability report, including the following: ■ Corporate governance report ■ Remuneration and staff report ■ Parliamentary accountability and audit report The governance statement outlines the corporate governance and risk management arrangements in operation in the financial year. It provides detail on Creative Scotland's governance framework, operated internal controls, and risk management arrangements, and outlines the key risks to Creative Scotland's business. The remuneration report was included within the unaudited annual accounts and supporting reports and working papers were provided. Minor amendments were required to the draft accountability report to ensure that it complied with FReM chapter 5.	We consider the governance framework to be appropriate for Creative Scotland and that the accountability report is in accordance with guidance and reflects our understanding of the organisation. We are satisfied that the information contained within the remuneration report is consistent with the underlying records and the annual accounts and all required disclosures have been made. Our independent auditor's report confirms that the part of the remuneration report subject to audit has been properly prepared.

Qualitative aspects

ISA 260 requires us to report to those charged with governance our views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

We consider the accounting policies adopted by Creative Scotland to be appropriate, and there have been no changes to adopted accounting policies in the year. There are no significant accounting practices which depart from what is acceptable under the FReM.

Significant accounting estimates relate to the present value of defined benefit obligations under IAS 19 (as calculated by Creative Scotland’s actuary) using agreed financial assumptions. We found the assumptions and accounting for pensions to be appropriate, as discussed on page 37. We did not identify any indications of management bias.

Financial statement disclosures were considered against requirements of the FReM and IFRS. No departures from these requirements were identified.

Future accounting and audit developments

There are no significant changes to the FReM for 2016-17. There are no changes to or new IFRS’ for 2016-17 which will have a significant impact on Creative Scotland.

ISA (UK & Ireland) 700 and 720 have been revised for accounting periods beginning on or after 17 June 2016. These revise the requirements for the structure and content of the independent auditor’s report. Audit Scotland is considering whether to early adopt the standards for 2016-17.

Wider scope

Wider scope
Audit dimensions introduction

Introduction

The 2016 Code frames the wider scope of our audit in terms of four audit dimensions; financial management, financial sustainability, governance and transparency and value for money. At the centre of these dimensions is Best Value.

It remains the responsibility of the audited body to ensure that they have proper arrangements in place across each of these audit dimensions. These arrangements should be appropriate to the nature of the audited body and the services and functions that it has been created to deliver. We review and come to a conclusion on these proper arrangements.

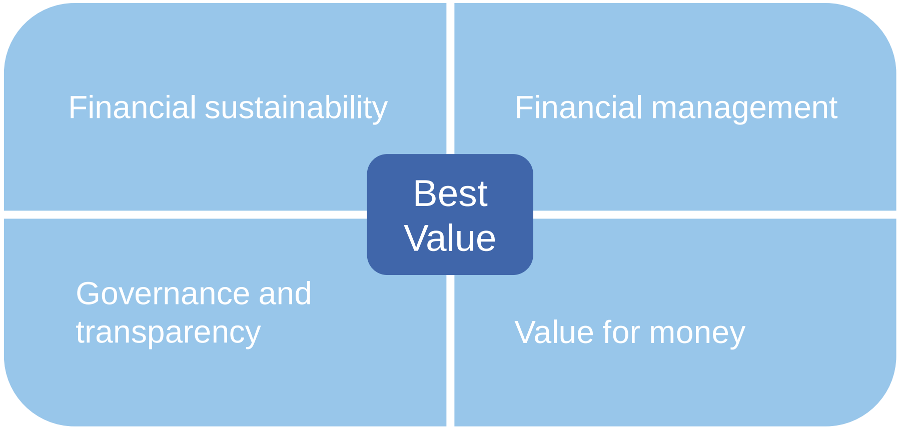
During our work on the audit dimensions we have considered the work carried out by internal audit and other scrutiny bodies to ensure our work meets the proportionate and integrated principles contained within the Code.

Audit work and conclusions

We summarise over the next few pages the work we have undertaken in the year to obtain assurances over the arrangements in place for each audit dimension and our conclusions on the effectiveness and appropriateness of these arrangements.

The next page sets out those risks we identified during our audit planning stage, any emerging risks during the course of audit work and our overall conclusion on each audit dimension.

Where we have found arrangements to not be effective or are absent we have provided further narrative on the following pages and recommendations for improvement. Where we have found the arrangements to be generally effective and operating as expected we have identified this in the conclusions we have formed.



Wider scope

Audit dimensions risk map and conclusions

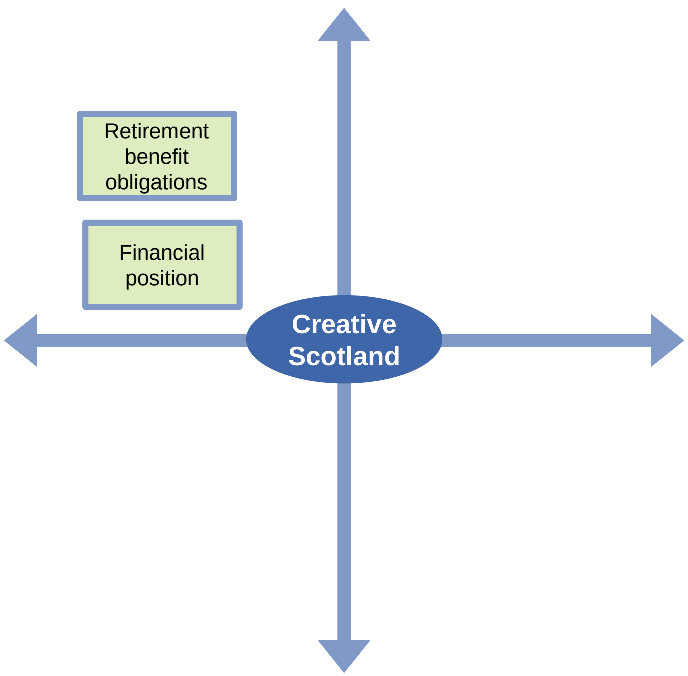
Financial sustainability (Page 24)

Financial sustainability is an area that continues to be monitored given the challenging financial environment in which Creative Scotland operates. Although financial plans are prepared with a five-year outlook these are not regularly updated when assumptions change.

Recent changes to Scottish Government working capital requirements has resulted in a net deficit in reserves being recorded. Procedures and terms and conditions related to grant awards and payments are being worked on to lessen the effect of this going forward.

Financial management (Page 25)

Creative Scotland's finance department has appropriate financial capacity for current operations. Sound budgetary processes are supported by a strong internal control environment, and no significant control deficiencies were identified. This is supported by regular reporting and scrutiny by senior management and those charged with governance, although our testing identified that such scrutiny is not always appropriately documented in meeting records.



Risks identified during our audit planning procedures

Emerging risks identified during the course of our audit

Governance and transparency (Page 27)

Creative Scotland has sound and well-established governance arrangements that ensure effective scrutiny, challenge and transparency on decision-making, through high quality reporting.

Board members were requested by management to submit updated declarations of interest for the 2015-16 financial period. Three members did not submit a declaration and therefore in these instances we have had to place reliance on management's representations that all related parties have been declared.

Value for money (Page 24)

Creative Scotland strives to achieve value for money in its delivery of services and has appropriate arrangements to enable Best Value to be secured. This has been seen through effective controls over the approval and payment of grant awards.

Wider scope

Financial sustainability and value for money

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

In considering the financial sustainability of Creative Scotland and NLDF we performed the following work:

- *Reviewing the financial performance of Creative Scotland and NLDF as at 31 March 2016 and future budgets and forecasts;* we provide commentary on the financial position on pages 6 to 10. This includes consideration of the grant commitments for both Creative Scotland and NLDF.
- *Reviewing financial forecasting, financial strategies and key risks over financial sustainability.* Creative Scotland prepares medium-term (five year) financial budgets which provide high level summaries and include projections for income, grant and operating costs. The current budget is the 2014-19. It is updated annually when funding is confirmed by Scottish Government, however, budgets are only provided to Creative Scotland for one year, making it difficult to forecast beyond the next financial year with any certainty. In many cases grants are awarded by Creative Scotland which span more than one year. No forward funding commitments are provided which would support the consideration of financial sustainability. In recognition of this miss-match in funding commitments Creative Scotland are developing procedures and controls to better manage their exposure as a result of making awards which due to this multi-year nature will have elements where funding is uncertain.

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

We consider value for money and Best Value throughout our testing. Some of the areas where we had a specific focus on value for money and Best Value are:

- *Reviewing Creative Scotland's procedures for approving and paying grant awards.* Through our testing we found that there were appropriate controls in place to ensure that all grant payments made were done so with the appropriate authorisation.
- *Workforce planning.* Wages and salaries are the largest individual item of expenditure to Creative Scotland and NLDF after the payment of grants awarded. As discussed on page 28 we performed a review of Creative Scotland's workforce planning for Audit Scotland, and found processes to be adequate.
- *Employee settlements.* Creative Scotland is currently in a formal process with a former employee and has recognised the potential outcome costs in the 2015-16 financial statements. Once the outcome is fully known any details will be disclosed in the 2016-17 financial statements. We understand that Scottish Government has been consulted about the negotiations, in accordance with value for money principles.

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

Our conclusion on page 23 is derived from the following audit tests, carried out to determine the effectiveness of the financial management arrangements. This included:

- *Assessing the budget setting and monitoring processes within Creative Scotland, including the approval of budget changes.* We found these to be robust, with regular accurate reporting to senior management and those charged with governance, however, our testing identified that such scrutiny is not always appropriately documented in meeting records.

Recommendation one

- *Review of Creative Scotland's compliance with Scottish Government's funding requirements by managing its resources to budget.* Effective management of resources ensured Creative Scotland was able to reduce its cash balance by £12.7 million to £2.7 million, which is a significant step towards the target balance of £1 million required by Scottish Government.
- *Consideration of the finance function and financial capacity within Creative Scotland.* We noted that financial processes are generally effective. Finance team members have appropriate skills, capacity and capability to support Creative Scotland and NLDF.

We are also required to provide specific conclusions on the following areas, which relate to financial management and support our overall conclusion on this wider scope area.

Internal controls

Management is responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the financial statements. Details of controls tested during our interim audit were reported to those charged with governance in our interim audit report.

During the final audit we also performed controls testing over starters and leavers to provide further assurance over best value. No significant recommendations were raised. One 'grade three' (minor) recommendation was raised in relation to the retention of documentation supporting journals posted.

A summary of the completion of prior year audit recommendations is provided at appendix four. Three 'grade three' recommendations were raised in 2014-15; two are overdue.

Conclusion: Internal controls were tested over risk management, financial, operational and compliance systems and procedures are designed, implemented, and operating effectively.

National Fraud Initiative

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 submitted a return to Audit Scotland summarising our conclusions on Creative Scotland's participation in NFI. The questionnaire covered reporting of NFI progress and outcomes, recording of results of investigations in the NFI system, action taken for alleged fraud cases and the overall engagement of Creative Scotland with NFI.

Conclusion: The return concluded that Creative Scotland discussed and reported relevant feedback and responded effectively and efficiently to outcomes, utilising resources appropriately to respond to the outcomes. No alleged or actual fraud was identified through NFI.

Arrangements for the prevention and detection of fraud and error

Testing over the processes to prevent and detect fraud and error included:

- *Review of policies (fraud prevention policy and response plan) against best practice guidance and examples.* Creative Scotland's policies were found to be in line with relevant guidance.
- *Consideration of the accessibility of policies to staff and board members and if the policies had been implemented effectively.* The policies and processes tested are readily available to staff and had been implemented effectively.

Conclusion: Creative Scotland has appropriate arrangements to prevent and detect fraud.

Standards of conduct and the prevention and detection of corruption

Testing over the processes to prevent and detect corruption included:

- *Review of policies (codes of conduct for staff and board members, the whistleblowing policy and registers of interests) against best practice guidance and examples.* SDS's policies were found to be in line with relevant guidance.
- *Consideration of the accessibility of policies to staff and board members and if the policies had been implemented effectively.* The policies and processes we tested are readily available to staff and had been implemented effectively.
- *Testing of completeness of registers of interests of senior staff and board members.* No errors were identified in this testing, although it is noted management is considering the timing of completion of register of interests to ensure related parties are not inadvertently missed from the financial statements.

Recommendation two

- *Review of reporting arrangements for conflicts of interests and whether these had been followed.* Conflicts of interest are a standing agenda item for committees to ensure appropriate reporting.

Conclusion: Creative Scotland has appropriate arrangements to prevent and detect inappropriate conduct and corruption.

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.

In considering governance and transparency we performed the following work:

- *Reviewing the organisational structure, reporting lines and level of scrutiny within Creative Scotland.* Creative Scotland demonstrates effective scrutiny, challenge and transparency on decision making through various levels of committee reporting reviewed. Decisions are transparent as actions are documented within detailed board minutes which are available to key stakeholders.
- *Reviewing financial and performance reporting within the organisational structure.* Reporting is of high quality, accurate and transparent. Management considers ways to enhance reporting, with dashboards used to focus reporting on objectives and targets at an appropriate level of detail on a timely basis to ensure transparency.
- *Reading the corporate governance statement;* as discussed on page 19.

We are required to provide specific conclusions on the following areas which relate to governance and transparency and support our overall conclusion on this audit dimension.

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Corporate governance

We updated our understanding of the governance framework and documented this through our overall assessment of Creative Scotland's risk and control environment. This included testing entity wide controls, including risk management, operational and compliance controls, as reported in the interim management report.

As also identified in 2014-15, Creative Scotland does not maintain an up to date register of interests on its website. We requested updated declarations of interest but three Board Members did not

Conclusion: Governance controls were found to be operating effectively and we consider the governance framework to be appropriate for Creative Scotland.

Internal audit

We considered the activities of internal audit against the requirements of Public Sector Internal Audit Standards (‘PSIAS’), focusing our review on the public sector requirements of the attribute and performance standards contained within PSIAS. We updated the review we undertook in 2014-15, which included a review of the internal audit charter, reporting lines, independence, objectivity and proficiency and the range of work carried out by internal audit. We also considered the requirements of International Standard on Auditing 610 *(Considering the Work of Internal Audit)*.

We reviewed internal audit reports and conclusions, and through discussion obtained their views of risks of fraud within Creative Scotland.

Conclusion: We apply internal audit’s work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there was no impact on our planned substantive testing.

Wider scope

Local follow up work

In November 2013 the Accounts Commission and Auditor General for Scotland published a report on Scotland's public sector workforce. The report highlighted a number of key messages on workforce changes across Scotland in the public sector and made recommendations to the Scottish Government.

We performed follow up work on this report, and submitted a return to Audit Scotland summarising our findings and conclusions. This work concluded on the following key issues:

- Planning: Creative Scotland ensure they have the right people with the right skills in place at the right time through a Performance and Planning Framework which includes the ten year plan, the published annual plan and the annual Corporate Work Planner.
- Service delivery: a staff structure based on required skills and knowledge has been approved and is modelled at individual staff level to create 3 year financial projections and recruitment plans.
- Partnership working: the Creative Scotland Director of Creative Industries role is shared and co-funded with the Scottish Funding Council. The Scottish Government procurement and digital shared services are both utilised. Some Creative Scotland funding is devolved to partners mostly in the third sector plus Big Lottery.
- Reporting: staff savings are communicated to senior management and Board.
- Challenge and scrutiny: the Planning and Performance Framework is reviewed by Senior Management to ensure that it needs of the organisation.

Appendices

Appendix one
Audit differences

Adjusted and unadjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all corrected and uncorrected misstatements, other than those which are trivial, to you. There were no audit adjustment required to the draft annual accounts which impacted on the net assets and financial and investment income and expenditure for the year. There was one unadjusted audit differences.

A small number of minor numerical and presentational adjustments were required to some of the financial statement notes.

		BALANCE SHEET		INCOME AND EXPENDITURE	
CAPTION	NATURE OF ADJUSTMENT	£000 DR	£000 CR	£000 DR	£000 CR
NLDF	We found that grants outstanding are overstated by £47,931. This is due to issues with the transfer of grants data into the new system, which was identified when trying to reconcile the ledger balance with the list of grant commitments maintained out with SAGE. This has not been adjusted in the final accounts.				
Grants outstanding		47.9		-	
Retained earnings			47.9		-

To the Audit and Risk Committee members

Assessment of our objectivity and independence as auditor of Creative Scotland and NLDF (the Company)

Professional ethical standards require us to provide to you at the conclusion of the 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 and addresses:

- General procedures to safeguard independence and objectivity;
- Independence and objectivity considerations relating to the provision of non-audit services; and
- Independence and objectivity considerations relating to other matters.

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 partners 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.

We are satisfied that our general procedures support our independence and objectivity.

Auditor independence (continued)

Independence and objectivity considerations relating to the provision of non-audit services

Summary of fees

We have considered the fees charged by us to the company and its affiliates for professional services provided by us during the reporting period.

We have detailed the fees charged by us to the company and its related entities for significant professional services provided by us during the reporting period in the attached appendix, as well as the amounts of any future services which have been contracted or where a written proposal has been submitted. Total fees charged by us for the period ended 31 March 2016 can be analysed as follows:

	Current Year	Prior Year
	£000	£000
Audit of Creative Scotland*	36	36
Audit of NLDF*	30	30
Total Audit	66	66

** Fees presented exclude VAT.*

Independence and objectivity considerations relating to other matters

There are no other matters that, in our professional judgment, bear on our independence which need to be disclosed to the Audit and Risk Committee.

Confirmation of audit independence

We confirm that as of the date of this letter, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the partner and audit staff is not impaired.

This report is intended solely for the information of the Audit and Risk Committee and should not be used for any other purposes.

We would be very happy to discuss the matters identified above (or any other matters relating to our objectivity and independence) should you wish to do so.

Yours faithfully

KPMG LLP

Appendix three
Action plan

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

We present the identified findings across four audit dimensions:

- financial sustainability;
- financial management;
- governance and transparency; and
- value for money.

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 Scrutiny of financial information by senior leadership *Risk dimension: financial management*		**Grade three**
In our testing of the budget monitoring controls we found that for one of the month's tested, the minutes of the Senior Leadership Team (SLT) meeting did not contain a record of what was discussed in relation to the monthly management accounts. There is a risk that effective scrutiny by management cannot be demonstrated if meeting minutes are not sufficiently detailed.	It is recommended that minutes recorded always contain note of what was discussed in relation to monthly management accounts.	SLT meeting minutes will contain a note of what was discussed regarding the management accounts. **Responsible officer:** Director, Finance **Implementation date:** August 2016

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
2 Register of interests *Risk dimension: governance and transparency*		**Grade three**
Under the FReM, Creative Scotland are required to make certain disclosures about related parties, and related party transactions, in the year. The draft financial statements for both Creative Scotland and NLDF state that a register of interests of senior management and those charged with governance is maintained and available on Creative Scotland's website, however, on inspection, we found that this register has not been updated since 2012-13. This was also raised in our 2014-15 audit. Despite requesting updated declarations of interest as part of the 2015-16 accounts process management were unable to obtain these in respect of three Board members. There is a risk that Creative Scotland do not meet industry best practice in relation to governance and transparency by failing to make up to date information publicly available.	It is recommended that the Board members update the register of interest forms as requested by management to allow current information to be made available on the website.	Board members have been requested to complete the register of interests form and these will be published on the Creative Scotland website after all returns have been received. **Responsible officer:** Director, Finance **Implementation date:** September 2016

Appendix four
Prior year recommendations

We follow up prior year audit recommendations to determine whether these have been addressed by management. The table below summarised the recommendations made during the 2014-15 audit and their current status.

Grade	Number recommendations raised	Implemented	In progress	Overdue
One	-	-	-	-
Two	-	-	-	-
Three	3	2	-	1

We have provided a summary of progress against overdue actions below, and their current progress.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions	Status
Register of interests Creative Scotland has a number of related parties. The Creative Scotland National Lottery Distribution Fund has a number of transactions with Creative Scotland through recharges and there are further transactions with the Scottish Government. We were unable to review the register of interests for 2014-15 as these had not been completed by all the Board members and the information available on the website was for 2012-13.	It is recommended that the Board members update the register of interest forms as requested by management to allow current information to be available on the Creative Scotland website.	**Responsible officer:** Director of Finance **Implementation date:** September 2015 Board members will be reminded of their obligations to submit the register of interests form on an annual basis. The updated register will then be published on our website.	Overdue. See action plan page 34.

Appendix five

Defined benefit obligations

In respect of employee benefits, each of the assumptions used to value the 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.

We set out below the assumptions in respect of defined benefit obligations.

Defined benefit pension liability

2016 £'000	2015 £'000	KPMG comment
(216)	(983)	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 IAS19 pension scheme valuation. Details of key actuarial assumptions are included in the table, along with our commentary. The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of around 20 years. The closing deficit decreased by £767,000 compared to 2014-15, primarily due driven by a lower discount rate and increased mortality assumption.

Assumption	Creative Scotland	KPMG central	Comment
Discount rate (duration dependent)	3.50%	3.50%	Acceptable. The proposed discount rate is within an acceptable range of KPMG's central rates as at 31 March 2016, and are derived using methodology consistent with that used last year.
CPI inflation	RPI less 1.0%	RPI less 1.0%	Acceptable. The proposed methodology for calculating CPI is in line with KPMG's central methodology.
Net discount rate (discount rate – CPI)	1.3 - 1.4%	1.25%	Acceptable. The difference between the KPMG central discount rate and the CPI inflation assumptions (ie the net discount rate) is based on market information at 31 March 2016. The range that we would consider acceptable for this gap under IAS 19 is +/- 0.3% around the corresponding KPMG central rate.
Salary growth	RPI + 1%	Typically 0% - 1.5% above inflation	Acceptable. The proposed assumptions are within the acceptable range.

Appendix six
Appointed auditors responsibilities

Area	Appointed auditors responsibilities	How we've met our responsibilities
Corporate governance	Review and come to a conclusion on the effectiveness and appropriateness of arrangements to ensure the proper conduct of the bodies affairs including legality of activities and transactions, Conclude on whether the monitoring arrangements are operate and operating in line with recommended best practice.	Page 27 sets out our conclusion on these arrangements.
Financial statements and related reports	Provide an opinion on audited bodies' financial statements on whether financial statements give a true and fair view of the financial position of audited bodies and their expenditure and income Provide an opinion on whether financial statements have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements Provide an opinion on the regularity of the expenditure and income.	Page 12 summarises the opinions we expect to provide.
Financial statements and related reports	Review and report on, as appropriate, other information such as annual governance statements, management commentaries, remuneration reports, grant claims and whole of government returns.	Page 19 reports on the other information contained in the financial statements, covering the performance and accountability reports.
Financial statements and related reports	Notify the Auditor General or Controller of Audit when circumstances indicate that a statutory report may be required.	Page 12 sets out any notifications we have made to the Auditor General or Controller of Audit.
Financial statements and related reports	Review and conclude on the effectiveness and appropriateness of arrangements and systems of internal control, including risk management, internal audit, financial, operational and compliance controls.	Page 23 sets out our conclusion on these arrangements.
Standards of conduct – prevention and detection of fraud and error	Review and conclude on the effectiveness and appropriateness of arrangements for the prevention and detection of fraud and irregularities, bribery and corruption and arrangements to ensure the bodies affairs are managed in accordance with proper standards of conduct. Review National Fraud Initiative participation and conclude on the effectiveness of bodies engagement.	Page 26 sets out our conclusion on these arrangements. Page 25 concludes on the bodies participation in the National Fraud Initiative.

Appendix six

Appointed auditors responsibilities (continued)

Area	Appointed auditors responsibilities	How we've met our responsibilities
Financial position	Review and conclude on the effectiveness and appropriateness of arrangements to ensure that the bodies financial position is soundly based.	Pages 23 sets out our conclusion on these arrangements.
Financial position	Review performance against targets	Pages 6 to 10 summarise our review of how the body has performed against it's financial targets.
Financial position	Review and conclude on financial position including reserves balances and strategies and longer term financial sustainability.	Pages 6 to 10 set out our conclusion on the bodies financial position. Pages 7 and 9 set out our conclusion on the bodies financial strategies and longer term financial sustainability.
Best Value	Review and conclude on the effectiveness and appropriateness of arrangements of accountable officers specific responsibility to ensure that arrangements have been made to secure Best Value.	Page 24 sets out our conclusion of the bodies arrangements.

cutting through complexity

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