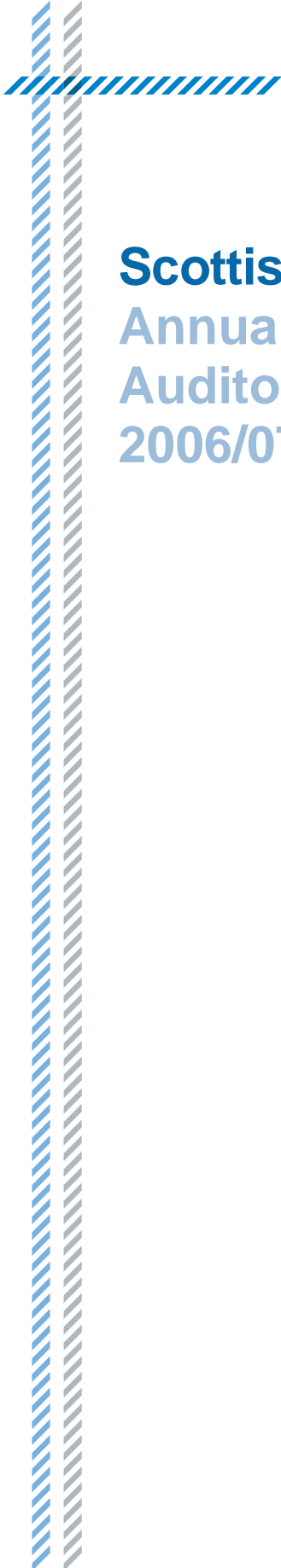




SCOTT-MONCRIEFF

EDINBURGH AND GLASGOW



Scottish Arts Council
Annual Report to the Council and the
Auditor General for Scotland
2006/07

August 2007



Scottish Arts Council

Annual Audit Report to the Council and the Auditor General for Scotland 2006/07

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1 Summary

Governance

- The Scottish Executive announced in 2006 that Scottish Arts Council and Scottish Screen will be replaced by a new body called Creative Scotland. Scottish Screen and the Scottish Arts Council have been operating under a Joint Board and related committee structure since 1 February 2007.
- The Council agreed a retirement package with its former Chief Executive, effective from 26 February 2007. The Council appointed a sub-committee to consider the package before the offer to the former Chief Executive was made. Neither the Council's decision to establish a sub-committee for this task or the meeting of the sub-committee was recorded at the time. The Chief Executive post has been filled on an acting-up basis by the Deputy Chief Executive.

Performance

- The Council is on track to meet its targets agreed with the Scottish Executive to increase cultural successes and participation.
- The Joint Board approved a Corporate Plan covering the period 2007 – 2009 in March 2007 which set out the priorities for the Scottish Arts Council over this period.

Finance

- Our audit opinions on the truth and fairness of both the Scottish Arts Council Non-Departmental Public Body (SAC NDPB) financial statements and the Scottish Arts Council National Lottery Distribution Fund (SAC NLDF) financial statements are unqualified.
- Our regularity opinion is qualified in both the SAC NDPB financial statements and the SAC NLDF statements due to the irregular payments made to the Council's former Chief Executive.
- The funds available to the Scottish Arts Council in future years will decrease as responsibility for the funding of the National Companies has transferred to the Scottish Executive and there continues to be a fall-off in lottery funds to the Council.

Conclusion

This report concludes the 2006/07 audit of the Scottish Arts Council. We have performed our audit in accordance with the Code of Audit Practice published by Audit Scotland, International Standards on Auditing and Ethical Standards.

This report has been discussed and agreed with the Chief Executive and Finance Director and has been prepared for the sole use of the Scottish Arts Council and the Auditor General for Scotland and Audit Scotland. We would like to thank all members of the Scottish Arts Council's management and staff who have been involved in our work for their co-operation and assistance during our audit visits.

Scott-Moncrieff

August 2007

2 Introduction

2.1 Auditor General and Audit Scotland

The Auditor General for Scotland is responsible for reporting to the Scottish Parliament on how public bodies spend public money, manage their finances and achieve value for money in the use of public funds. In discharging this responsibility the Auditor General appoints central government auditors and sets the terms of their appointment.

Audit Scotland is an independent statutory body that provides the Auditor General with the services required to carry out his statutory functions, including preparing a Code of Audit Practice setting out the role and responsibilities of the external auditor.

2.2 Audit appointments

The Auditor General for Scotland has appointed Scott-Moncrieff as external auditor of the Scottish Arts Council for the five year period 2006/07 to 2010/11. This appointment also covers the establishment of Creative Scotland during the five year period.

Under the National Lottery etc Act 1993 (as amended), the Scottish Arts Council is appointed to distribute National Lottery funds for expenditure on or connected with the arts in Scotland. Scottish Ministers guidance requires the Scottish Arts Council to prepare separate statements of accounts relating to these activities. The Auditor General for Scotland has also appointed Scott-Moncrieff as external auditor of the Scottish Arts Council National Lottery Distribution Fund (SAC NLDF).

This annual report summarises our 2006/07 audit of the Scottish Arts Council and highlights the key issues arising from our work.

2.3 Independence and ethical standards

Ethical Standard 1 – *Integrity, objectivity and independence*, issued by the Auditing Practices Board (APB), requires that external auditors ensure that the Audit Committee is appropriately informed on a timely basis of all significant facts and matters that bear upon the auditors' objectivity and independence.

In addition to providing the external audit service to the Scottish Arts Council, Scott-Moncrieff also provided the following services to the Scottish Arts Council group:

- External audit to the Centre for Contemporary Arts (CCA) – a subsidiary of the Scottish Arts Council,
- External audit to the National Theatre of Scotland (NTS) – a subsidiary of the Scottish Arts Council until 31 March 2007, and

- Internal audit services to Scottish Arts Council.

The continued appointment of Scott-Moncrieff as internal auditors to the Scottish Arts Council has been specifically permitted by Audit Scotland and reflects the fact that from 1 April 2008 the Joint Board will appoint internal auditors to cover the Scottish Arts Council and Scottish Screen and any successor body.

APB Ethical Standard 5 – *Non-audit services provided to audit clients* prohibits the provision of internal audit services to an audit client where it is reasonably foreseeable that the external audit will place significant reliance on the work of internal audit. Whilst, we have reviewed the work of internal audit, we have not placed any significant reliance on their work for the purposes of the audit of the financial statements.

In addition, to ensure the objectivity of the audit team the following safe guards were put in place:

- The external and internal audit services were undertaken by separate teams, and
- The external audit was subject to an independent partner review.

We can confirm that we have complied with the APB Ethical Standards throughout the audit and that, in our professional judgement, we have remained independent and our objectivity has not been compromised in any way.

2.4 Key risks

Our audits are risk based. This means that we focus our resources in the areas of highest priority or risk to the Board. The key audit issues identified for the 2006/07 audit were summarised in our external audit plan presented to the Audit Committee on 5 March 2007. These audit issues were:

- Governance arrangements with the move to Creative Scotland,
- Group companies,
- Accounting for advances to funded organisations ,
- Allocation of overheads.

This report includes our findings in relation to these key risks.

2.5 Scope of the audit

Our audit work can be classified under the following three headings: governance, performance and finance. The main audit objective for each of these areas is summarised below, along with the key priorities and risks for each area.

2.5.1 Audit areas and audit objectives

Audit area	Audit objective
Governance	To review the Council's governance arrangements in relation to: <ul style="list-style-type: none">• systems of internal control and risk management,• the prevention and detection of fraud and irregularity,• standards of conduct and prevention and detection of corruption.
Performance	To review the Council's arrangements for managing its performance and for securing economy, efficiency and effectiveness in its use of resources.
Finance	To provide an opinion on the truth and fairness of the Council's financial statements and on the regularity of transactions. To review the Council's financial standing, and financial management arrangements.

The remainder of this report sets out the results of our work in 2006/07 under the headings of Governance, Performance and Finance. The action plan in section 6 details the recommendations we have made during the year.

3 Governance

3.1 Introduction

It is our responsibility to review the Council's governance arrangements in relation to:

- systems of internal control and risk management,
- the prevention and detection of fraud and irregularity,
- standards of conduct and prevention and detection of corruption.

It is also our responsibility to review the Council's governance arrangements in relation to its financial position. This is reported in section 5 – Finance.

3.2 Creative Scotland

Following a review of the arts and creative sector in Scotland by the Cultural Commission, the Scottish Executive announced that the Scottish Arts Council and Scottish Screen will be replaced by a new body called Creative Scotland. Whilst external consultation on the Culture Bill has now closed, the Bill is still to move through the parliamentary process, only after which will the definitive position be known. This will have a significant impact on the structure and governance of arts and creative sector in Scotland.

A Joint Board for both Scottish Screen and Scottish Arts Council has already been established and had its first meeting on 9 February 2007. The Joint Board will assist in developing a transition plan and monitoring the two organisations until the transfer of responsibilities to Creative Scotland. Richard Holloway - who up until the establishment of the Joint Board was chair of the Scottish Arts Council - has been appointed as Chair of this new Joint Board.

The Scottish Executive will carry out a location review for Creative Scotland. Any relocation of the Scottish Arts Council's current operations may result in additional expenditure and the potential loss of staff.

There are a number of outstanding balances between Scottish Arts Council and Scottish Screen which have been on-going for a number of years. We recommend that these are resolved promptly (**see Action Plan 6.2.1**).

With such organisational changes to Scottish Arts Council on the horizon, the future of the Scottish Arts Council National Lottery Distribution Fund has still to be clarified. The Scottish Arts Council was appointed by the National Lottery etc Act 1993 (as amended) to administer the Scottish Arts Council National Lottery Distribution Fund. Any changes to the Scottish Arts Council will not automatically lead to changes in the structure and status of the Lottery Fund. We recommend that the Scottish Arts Council continues to discuss the arrangements for

transfer of responsibility for the Fund from the Scottish Arts Council to Creative Scotland with appropriate stakeholders.

Organisations currently with charitable status are having this status reviewed under the new Charities and Trustee Investment Act (Scotland) 2005. Under the Act, an organisation must be independent from control of Scottish Ministers. The Scottish Arts Council's charitable status has not been reviewed yet. Creative Scotland will not however be given charitable status. This will have financial implications, for example the organisation will lose its entitlement to exemption from non-domestic rates.

3.3 Payments to former Chief Executive

In a letter dated 8 January 2007, the former Chief Executive informed the Chairman and the Council of his intention to retire early. The former Chief Executive requested to have his pension enhanced to the level he would have received if he retired at the normal retirement age.

The former Chief Executive's intention was discussed at a private session of the first meeting of the Joint Board on 9 February 2007. The Joint Board unanimously agreed that, in light of the need to ensure Scottish Screen and the Scottish Arts Council worked together in advance of the establishment of Creative Scotland it was important that the former Chief Executive left at the earliest opportunity. The Scottish Arts Council did not have a remuneration committee at that time and appointed a sub-committee of the Joint Board, comprising the Chairman and two members of the Audit Committee, to review the options available to the Joint Board. There were no official minutes of the private session of the Joint Board.

The Chairman asked the Head of Human Resources to prepare a paper setting out the various options available to the Council and the cost implications of these options. This paper was reviewed by the sub-committee. The option of granting early retirement was costed at approximately £120,000 and was rejected due to the high cost. After careful consideration, the sub-committee agreed that the Chairman would approach the former Chief Executive with the following package:

- The date of termination would be 28 February 2007;
- The former Chief Executive would receive fully taxable salary in lieu of outstanding notice of £40,000

The former Chief Executive would also receive an ex-gratia payment of £30,000. The above terms were subject to the former Chief Executive entering a compromise agreement with the Scottish Arts Council which absolved the Scottish Arts Council of any future liability.

The sub-committee considered that this option offered in the circumstances the best value for money to the Scottish Arts Council.

There were no official minutes kept of the sub-committee's meeting to consider the options available.

The Chairman set out the proposed terms in a letter to the former Chief Executive dated 15 February 2007. The Chair also sent a letter dated 15 February 2007 to the Head of Cultural Policy Division of the Scottish Executive confirming the early termination of employment of the former Chief Executive and the details of the termination package. The Scottish Public Finance Manual (SPFM) requires the Council to refer proposals to secure early retirements to the relevant Scottish Executive finance team for approval before any offer is made. It is our opinion that that Scottish Arts Council did not comply with this requirement and this has led us to qualify our regularity opinion as reported in section 5.4.

The former Chief Executive accepted the proposal and the compromise agreement was signed on 16 February 2007 with the former Chief Executive leaving the Scottish Arts Council employment on 28 February 2007.

In our opinion, a Remuneration Committee would have improved the transparency and objectivity of the decision making process. We understand that the Joint Board has subsequently established a Remuneration Committee.

As highlighted above, neither the Joint Board's decision to appoint a sub-committee to consider the options or the sub-committee's meeting were minuted. In our view major decisions should be taken in an open and transparent way and we recommend that such decisions are appropriately minuted in future.

3.4 National Performing Companies

Scotland's five national performing companies are:

- Scottish Opera,
- Scottish Ballet,
- Royal National Scottish Orchestra,
- Scottish Chamber Orchestra, and
- National Theatre of Scotland.

In 2006/07, as in previous years, these national companies were funded by the Scottish Arts Council. The companies have been given official status and have been funded directly by the Scottish Executive since 1 April 2007. As reported in section 5.8.1, this has resulted in a significant reduction in Scottish Arts Council's grant-in-aid in 2007/08. Additionally, this has triggered the transfer of ownership of the National Theatre of Scotland (NTS) from the Scottish Arts Council to NTS's board members.

3.5 Statement on Internal Control

The framework of internal controls operating at the Scottish Arts Council is within the Statement on Internal Control (SIC) included within both the SAC NDPB and SAC NLDF annual accounts. The Council has not identified any significant areas which require to be disclosed in the SIC.

We are satisfied that the contents of the SIC are not inconsistent with information gathered during the course of our normal audit work.

3.6 Risk management

Risk management is important to the establishment and regular review of systems of internal control. We have reviewed the Council's risk management arrangements.

The Scottish Arts Council approved a Risk Management Policy and issued Risk Management Procedures during 2005/06. The Scottish Arts Council has a risk register in place and this is maintained by the Finance Director, who along with senior management is responsible for reviewing and updating the risk register on a monthly basis. Changes to the action plan and risk register are reported to the Audit Committee at quarterly meetings. Following discussion at the Audit Committee the report is presented at the next Council (now Joint Board) meeting.

The current risk register contains those risks which could potentially result in the closure of the Scottish Arts Council or its business. Risks have been identified under three main categories of risk which are:

- Funding decisions
- Transfer of National Companies to the Scottish Executive
- Start up of Creative Scotland.

We have concluded that the Council appears to have reasonably robust risk management systems in place.

3.7 Internal audit

Internal audit is a key component of the Council's corporate governance arrangements. As reported in section 2.3, the Council's internal audit service is provided by Scott-Moncrieff. In their role as the external auditors in 2005/06, Audit Scotland performed a review of the internal audit service provided by Scott-Moncrieff and concluded that they could place reliance on their work. It would not be appropriate for us to review the internal audit service provided by Scott-Moncrieff in 2006/07, however, we can confirm that the internal audit service have completed the work plan for the year.

During 2006/07 we reviewed the following Internal Audit reports:

- Income, banking and treasury management
- Creditors and non-pay expenditure and processing
- Grants Administration
- Fraud prevention procedures.

We considered the results from these reports on our own risk assessments. We did not place any significant reliance on the work of internal audit.

To ensure compliance with the Scott-Moncrieff ethical standards it was agreed with Audit Scotland that the external and internal audit service from Scott-Moncrieff would be undertaken by separate teams and the external audit service would be subject to an independent partner review. We can confirm that this has happened.

3.8 Prevention and detection of fraud and irregularity

We are required to consider the arrangements made by management for the prevention and detection of fraud and irregularity. Fraud is defined as deception made for personal gain and irregularity is defined as transactions which do not comply with Scottish Ministers guidance.

We consider the arrangements made by management in the following ways:

- We examine the financial instructions issued by the Council to ensure that they deal adequately with fraud and irregularities and provide a framework for exercising strong internal control,
- Our systems based audit is planned so as to provide a reasonable expectation of detecting misstatements in the annual accounts resulting from fraud or irregularity,
- We focus on specific areas of high risk for potential fraud and irregularity and review the arrangements in place in these areas,
- We review the Technical Bulletins produced by Audit Scotland with regard to fraud reports and ensure that the Council has arrangements in place to prevent similar frauds occurring,

We are pleased to report that we identified no issues of concern in relation to the arrangements for the prevention and detection of fraud.

With the exception of the irregular payments to the former Chief Executive as reported in section 3.3 and 5.4.1, we did not identify any other instances of concern with regard to the legality of transactions.

3.9 Standards of conduct, integrity and openness

We are required to consider the arrangements made by management in relation to standards of conduct and prevention and detection of corruption.

Propriety requires that public business is conducted with fairness and integrity. This includes avoiding personal gain from public business, being even-handed in the appointment of staff, letting contracts based on open competition and avoiding waste and extravagance.

Guidance on standards of conduct, accountability and openness has been issued by the Scottish Executive.

Our work in this area included a review of the arrangements for adopting and reviewing standing orders, financial instructions and schemes of delegation and complying with national

and local Codes of Conduct. We also considered controls over ordering and procurement, registers of interest and disposal of assets.

We are pleased to report that our audit identified no issues of concern in relation to standards of conduct and the prevention and detection of corruption.

3.10 Impact of the 2007 Scottish Parliament Elections

The election of a new Scottish Parliament in May 2007 saw the advent of a new SNP minority administration. Any impact of this change on the future role and remit of the Scottish Arts Council will become clearer once the new administration determines its vision for the future of the creative sectors. A more definitive position is likely as the Culture Bill progresses through the Scottish Parliament, with various stakeholders (including the Joint Board) having submitted responses to the Bill at the consultation stage.

4 Performance

4.1 Introduction

This section of the report looks at key performance areas for the Scottish Arts Council as well as its key corporate objectives for future years.

4.2 Performance against targets

The Scottish Arts Council has agreed the following two targets with the Scottish Executive and these are reported in *Building a Better Scotland – Spending Proposals 2005 – 2008*.

Scottish Executive Target: Increase the number of cultural successes by 3% by end March 2008

The Scottish Arts Council categorises cultural successes as artists, born or resident in Scotland, and artistic companies, group, institutions, and films based in Scotland, short-listed or nominated for major UK and international cultural awards and prizes. The Scottish Arts Council has reported the following performance to date against this target:

	Baseline 2004/05	2005/06	2006/07	Increase / (Decrease)
Winners	42	33	36	(14%)
Shortlist / nominations / etc	68	104	105	54%
Totals	110	137	141	28%

Scottish Executive Target: Increase numbers taking part in cultural activities funded by the Scottish Executive by 3% by March 2008, maintaining the balance of participation across the population

The Scottish Arts Council's Core Funded Organisation (CFOs) have collected the data used to assess the Council's performance against this target. The Scottish Arts Council has reported its performance to date as follows:

	2004	2006	Increase
	% of Group	% of Group	
All Scottish adults	85	90	6%
Children (defined as < 16 yrs old)	72	100	N/A
People aged 16 to 24 years old	91	95	4%
People aged > 65	73	77	5%
Woman	86	92	7%
Disabled people defined as self-declared disabled	70	77	10%
People from minority ethnic groups	82	82	0%
People living in rural areas	86	88	2%
People living in areas of deprivation	76	83	9%

Please note that the changes between the 2004 and 2006 statistics for children are not comparable due to changes in methodology.

Overall the Scottish Arts Council appears to be on track to surpass the targets set by the Scottish Executive.

4.3 Performance management

Due to difficulties in obtaining the information, performance against these targets is only determined on an annual basis. Performance against targets is not regularly reported to the Council.

4.4 Corporate planning

In March 2007 the Council and the Scottish Minister approved the Corporate Plan covering the period 2007-2009. The Plan sets out six priorities for 2007-2009 which are set out below:

- Increase the scope and quality of support to artists,
- Secure the foundation of Scotland's artistic development,
- Create flexibility to support the new and the innovative,
- Create opportunities for participation in the arts,
- Build a culture of co-operation with partners and the arts community,

- Make the transition to Creative Scotland.

At the time the Corporate Plan was published it was envisaged that in 2007/08 the Scottish Arts Council would have around £60 million to invest in these corporate priorities. The core funding grant for 2007/08 is certain as the Scottish Executive announced the Scottish Arts Council's grant for 3 years (2005/6 to 2007/8) as part of their spending review in 2004. The Scottish Arts Council has also received an additional £7 million investment in the arts from 2007/08 onwards.

The budgeted income from the National Lottery has been based on actual income and allocations from management of the National Lottery Distribution Fund balances and remains consistent with 2006/07 at approximately £15 million. As reported in section 5.8.1, since the development of the plan the UK government have announced that further lottery resources will be re-directed to help support the London Olympics and Paralympic Games in 2012. This means the actual Lottery Fund investment over the two years is likely to be less than originally envisaged. This may impact on the Scottish Art Council's performance against its targets.

5 Finance

5.1 Introduction

We are required to audit the financial statements in accordance with International Standards on Auditing and to give an opinion on:

- whether they give a true and fair view or present fairly the financial position of the audited body and its expenditure and income for the period;
- whether they have been prepared in accordance with relevant legislation and applicable accounting standards;
- on the regularity of the expenditure and receipts.

We are also required to review Scottish Arts Council's governance arrangements in relation to the financial position of the Fund.

5.2 Annual accounts

As reported in section 2.2, Scottish Ministers guidance requires the Scottish Arts Council to prepare separate accounts for its Non-Departmental Public Body account (SAC NDPB) as well as its National Lottery Distribution Fund (SAC NLDF) account. The SAC NDPB is a group account and incorporates the Scottish Arts Council's two subsidiaries – Centre for Contemporary Arts (CCA) and National Theatre of Scotland (NTS). NTS was transferred to the Scottish Executive on 31 March 2007 and therefore the SAC NDPB account incorporates NTS's results for the year but not its assets and liabilities as at 31 March 2007.

We are pleased to report that both sets of accounts are due to be approved by the Board of the Scottish Arts Council group on 31 August 2007 and are due to be submitted to the Scottish Executive and the Auditor General for Scotland thereafter.

As an NDPB, the Scottish Arts Council is required to comply with the Financial Reporting Manual (FRoM) when preparing both sets of financial statements. We are pleased to report that the SAC NDPB 2006/07 accounts and the SAC NLDF 2006/07 accounts comply with the requirements of the FRoM in all material respects.

We received draft accounts and supporting papers on 25 June 2007 as agreed. Generally, the audit process ran smoothly. However, the draft accounts did contain a high number of errors, mainly of a presentational nature. We recommend that the accounts are subject to a detailed review before being presented for audit (**Action point 6.3.1**).

5.3 Unqualified audit opinion on the financial statements

We are pleased to report that our audit opinion on truth and fairness of the financial statements of both the SAC NDPB and the SAC NLDF are unqualified.

5.4 Qualified audit opinion on the regularity of transactions

We are required to report whether, in all material respects, expenditure and income were incurred or applied in line with any applicable enactments and guidance issued by Scottish Ministers. This is known as our 'regularity opinion'.

We have qualified our audit opinion on the regularity of transactions for both the SSAC NDPB and SAC NLDF as the payment in lieu of notice and ex-gratia made to the former Chief Executive did not comply with guidance issued by the Scottish Ministers.

With the exception of the payment to the former Chief Executive, our regularity audit opinion is unqualified.

5.4.1 Irregular payments to former Chief Executive

As reported in section 3.3, the former Chief Executive received a £30,000 ex-gratia payment and £40,000 taxable pay in lieu of notice when he agreed to retire effective from 28 February 2007.

The payments to the former Chief Executive are disclosed in the Remuneration Report in the financial statements of both SAC NDPB and SAC NLDF. The payment of lieu of notice of £40,000 is included within the salary costs and the ex-gratia payment of £30,000 is disclosed in the narrative.

Scottish Ministers' guidance

The Scottish Arts Council is required to comply with the Scottish Public Finance Manual (SPFM) approved and issued by Scottish Ministers. The SPFM includes the following relevant paragraph:

*"Compensation is not normally payable when someone resigns voluntarily outwith any approved scheme. Exceptionally, circumstances may arise where it is highly desirable that an individual should leave, but where the individual concerned would not satisfy the criteria for compensation under an existing approved scheme. However, in such circumstances any proposal to offer a financial consideration to secure the early voluntary resignation of the individual concerned should be regarded as **contentious**. Such proposals by constituent parts of the Scottish Administration or bodies sponsored by the Scottish Executive must therefore be referred to the relevant departmental Finance Team for approval before any offer is made, whether orally or in writing."*

SPFM: Severances, early retirement and redundancy terms, paragraph 7

In our view, the payment in lieu of notice of £40,000 and the ex-gratia payment of £30,000 represented payments to secure the early resignation of the former Chief Executive. Therefore the Scottish Arts Council should have referred the proposal to the relevant departmental Finance Team for approval before any offer was made.

Whilst we have obtained evidence that the Chairman informed the Scottish Executive of the early termination of employment on the same day as the offer was made to the former Chief Executive, we have not been able to obtain any evidence that the Scottish Executive approved the proposal in writing either before the offer was made or subsequently.

In our opinion the Scottish Arts Council did not comply with the Scottish Ministers guidance as it did not receive approval for its termination package for the former Chief Executive. We consider the payments to the former Chief Executive to be material and therefore we have qualified our regularity opinion.

An element of the payments to the former Chief Executive were recharged to the SAC NLDF account and therefore our regularity audit opinion has been qualified in both sets of accounts. The former Minister for Tourism, Culture and Sport subsequently wrote to the Chairman noting that the Scottish Arts Council had considered the options in terms of the costs and effectiveness of the organisation during the period of transition to Creative Scotland but nevertheless pointing out that the actions of the Board represented a breach of the Scottish Public Finance Manual for the reasons set out above.

5.5 Financial performance

5.5.1 Review of 2006/07

SAC NDPB

The SAC NDPB accounts report a net deficit of £64.56 million for 2006/07. This figure does not include the grant-in-aid received from the Scottish Executive of £62.474 million. Therefore, the Scottish Arts Council had net expenditure in excess of funding of £2.086 million (2005/06 funding in excess of expenditure of £2.324 million).

The fluctuations in expenditure are largely due to the timing of when grant recipients incur expenditure in relation to the grants received.

SAC NLDF

The SAC NLDF received an allocation of £16.884 million (2005/06 £19.442 million) from the National Lottery Fund and had net grant expenditure of £18.306 million (2005/06 £14.718 million) during 2006/07.

The total funds held under the stewardship of the National Lottery Distribution Fund at 31 March 2007 amounted to £31.769 million (31 March 2006 £34.517 million).

The SAC NLDF has available funds less hard and soft commitments of £7.181 million as at 31 March 2007 (31 March 2006 £10.145 million).

5.6 Significant issues in the financial statements

In order to assist Council members' understanding of the financial statements, we have summarised the issues below that we believe are of particular significance to the 2006/07 financial statements.

5.6.1 Change in accounting policy

During the year the Government Financial Reporting Manual ('FRm') was amended to require NDPBs to account for grant-in-aid as financing through reserves rather than as income in the Income and Expenditure account (I&E). SAC NDPB's Income and Expenditure Account reports a deficit of £64.514 million for 2006/07. The deficit would have been £2.086 million if there had not been a change in accounting policy.

The Statement of Financial Activities (SOFA) is governed by the Charities SORP which requires grant-aid-aid to be shown within voluntary income.

The 2005/06 comparative figures have been restated to reflect this change in accounting policy. The effect of this restatement is shown in note 15 to SAC NDPB's financial statements.

5.6.2 Disposal of NTS

The Scottish Arts Council transferred ownership of NTS to the board of the National Theatre on 31 March 2007. The 2006/07 group accounts include NTS's results for the year and report a loss on disposal of this subsidiary of £430,000.

5.6.3 Allocation of expenditure

The Scottish Arts Council incurs costs which are shared between activities funded by grant-in-aid and activities funded by the National Lottery. In 2005/06 the Scottish Arts Council's overheads were split on a 50:50 basis between the Council and the Lottery Fund. In 2006/07 this split is 59:41 which was calculated based on the overhead budgeted figures for the Scottish Arts Council and Lottery Fund. The allocation of overheads in 2006/07 appears to have been calculated on an arbitrary basis. We understand that a new method is now in place and we plan to review this during our 2007/08 audit (**see Action Plan 6.3.3**).

5.6.4 Advances

The Scottish Arts Council has enforced its policy in relation to advances of grants. This has resulted in a decrease in advances at the year end from £6.058 million at 31 March 2006 to

£4.289 million at 31 March 2007. The majority of advances at the year end were made in the last days of March to ensure that the funds were available for the grant recipients in April 2007.

5.7 Issues arising from the audit

We noted the following issues during our audit and have included recommendations in our action in section 6 to address these.

- The FReM requires the Scottish Arts Council NDPB account to report its fixed assets at their current values. The Council is currently not complying with this requirement (**see Action Plan 6.2.2**).
- The financial operating procedures currently being used were drawn up in 2000 and do not reflect current practice (**see Action Plan 6.2.3**).
- The Grants Administration department do not use an authorised signatory list when checking for grant approval and authorisation of payments (**see Action Plan 6.2.4**).

5.8 Financial management

The Scottish Arts Council group has a responsibility to conduct its financial affairs in a proper manner. As part of our audit, we are required to consider the Scottish Arts Council's arrangements for financial planning, budgetary control and financial reporting.

Budgets are devised at the start of the year and approved by the Council and are updated during the year to take account of new information. Management accounts are presented to each Council (now Joint Board) meeting for review.

We found that Scottish Arts Council had adequate financial planning arrangements in place.

5.8.1 Financial plan 2007/08

Significant changes to the financial plans in 2007/08 have arising from the following items;

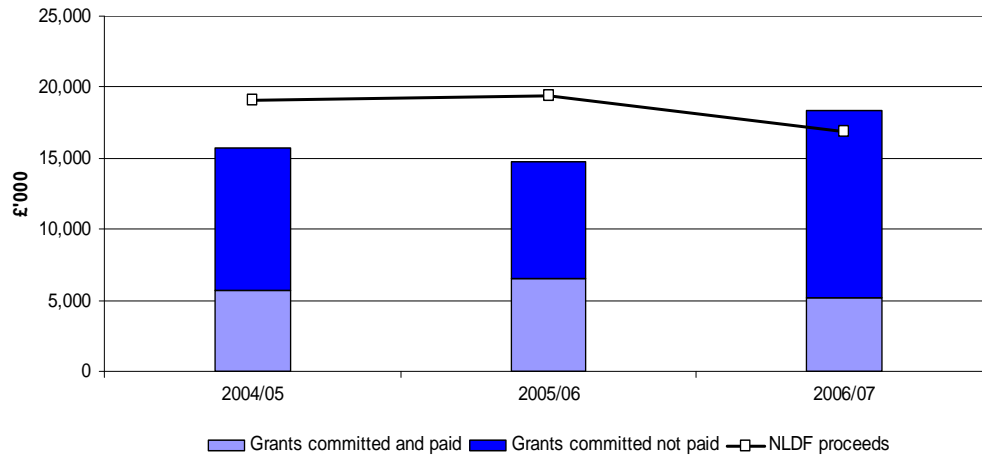
Transfer of National Companies

As reported in section 3.4, the responsibility for the funding for the National Companies has transferred to the Scottish Executive. This has resulted in a reduction in the Scottish Arts Council's grant-in-aid in 2007/08 of £19.250 million, approximately 35% of core grant-in-aid

Lottery funding

The UK government have announced that further lottery resources will be re-directed to help support the London Olympics and Paralympic Games in 2012. This means that the proceeds available to SAC NLDF are likely to decrease over future years. The graph below shows the trend in lottery income against grants made over the past three years:

Annual Lottery Fund Grant Commitments and National Lottery Distribution Fund proceeds



5.9 International Financial Reporting Standards (IFRSs)

The Chancellor announced in his 2007 budget speech the decision to adopt IFRSs for public sector accounting by 2008/09. Whilst this does not have an immediate impact on the Scottish Arts Council's accounts the Council should be aware of this issue as it could have significant implications in the future.

6 Action Plan

Our annual report action plan details the control weaknesses and opportunities for improvement that we have identified during 2006/07. These are the issues that we believe need to be brought to the attention of the Council.

It should be noted that the weaknesses identified in this report are only those that have come to our attention during the course of our normal audit work. The audit cannot be expected to detect all errors, weaknesses or opportunities for improvements in management arrangements that may exist.

6.1 Priority rating

To assist the Council in assessing the significance of the issues raised and prioritising the action required to address them, the recommendations have been rated. The rating structure is summarised as follows:

Priority 1 High risk, material observations requiring immediate action.

Priority 2 Medium risk, significant observations requiring reasonably urgent action.

Priority 3 Low risk, minor observations which require action to improve the efficiency, effectiveness or economy of operations or which otherwise require to be brought to the attention of senior management.

6.2 Issues from our 2006/07 Audit

Title	Issue Identified	Risk and Recommendation	Management Comments
<p>6.2.1</p> <p>Balances with Scottish Screen</p> <p>(Section 3.2)</p>	<p>Scottish Arts Council's balance sheet has a number of old outstanding balances.</p>	<p>There is a risk that these old balances are incorrect or misstated.</p> <p>Balances between Scottish Screen and Scottish Arts Council should be agreed and cleared.</p> <p>Priority 3</p>	<p>This will be addressed as part of the merger</p> <p>The previous Chief Executive considered it unnecessary to resolve these as they will disappear on the merging of SAC and SS balance sheets into Creative Scotland's.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: In line with merger</p>
<p>6.2.2</p> <p>Valuation of fixed assets</p> <p>(Section 5.7)</p>	<p>The FReM requires Scottish Arts Council to report its fixed assets at current values. The Scottish Arts Council report its property at valuation and all other fixed assets at cost less depreciation. The property was last revalued at 15 December 2005.</p>	<p>The Scottish Arts Council's group is currently misstating the value of its assets as they have not been updated as at 31 March 2007.</p> <p>We recommend that the Scottish Arts Council apply indexation to its fixed assets in future. We do not consider the difference to be material for the purposes of the 2006/07 financial statements.</p> <p>Priority 2</p>	<p>The SAC approach has been to work on the disposal of non core assets, such as the building referred to. In the event that disposal is not achieved by March 2008, indexation will be applied.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: March 2008</p>

Title	Issue Identified	Risk and Recommendation	Management Comments
<p>6.2.3</p> <p>Financial operating procedures</p> <p>(Section 5.7)</p>	<p>The financial procedures manual was last updated in 2000 and does not reflect current practice.</p>	<p>As there are no up to date procedures in the Finance Department staff may be adopting inconsistent practices which may lead to a higher risk of errors.</p> <p>We recommend that the financial procedures are updated to reflect current practice.</p> <p>Priority 2</p>	<p>These procedures have been updated in practice but the changes not formally incorporated into a single document. This will now be done.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: October 2007</p>
<p>6.2.4</p> <p>Authorised signatory list</p> <p>(Section 5.7)</p>	<p>The Grants Administration department do not use an authorised signatory list when checking for grant approval and authorisation of payments.</p>	<p>The risk is that grants and payments are being approved fraudulently and/or by the wrong person(s).</p> <p>We recommend that the Grants Administration department are provided with an authorised signatory list to use when checking for grant approval and authorisation of payments.</p> <p>Priority 3</p>	<p>Although there is no signatory list, signatures are known and queried when staff change. Signatories are also checked by Finance at the payment stage. In practice the risk is therefore negligible, but a signatory list will be created to highlight the importance of such checks.</p> <p>Responsible Officer: Head of Grants</p> <p>Implementation Date: September 2007</p>

6.3 Follow Up of issues from the 2005/06 audit

Title	Original Issue Identified	Original Management Comments	Update at August 2007
<p>6.3.1</p> <p>Delays in preparing final accounts</p>	<p>The previous auditors raised concerns over the accounts preparation process and recommended that SAC reviews the overall resourcing and planning of the accounts.</p>	<p>The original management response attributed the delay in the accounts preparation process to the delays with the subsidiary accounts.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: 30 June 2007</p>	<p>We are pleased to report that accounts preparation process appears to have improved from previous years. However, the draft financial statements did contain a high number of errors, mainly of a presentational nature.</p> <p>We accept that the regularity audit qualification resulted in additional time pressures. However, we recommend that the draft accounts are subject to a detailed review prior to being presented for audit in future years.</p> <p>Further action required</p>
<p>6.3.2</p> <p>Commitment accounting practices in the SAC NDPB account</p>	<p>The previous auditors recommended that SAC reviews its accounting policies and associated guidance in respect of grant expenditure.</p>	<p>The original management response did not accept the recommendation.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: 30 June 2007</p>	<p>We reviewed the SAC's grant accounting policies and are satisfied that these comply with the requirements of the FReM.</p> <p>No further action required</p>

Title	Original Issue Identified	Original Management Comments	Update at August 2007
<p>6.3.3</p> <p>Costs of administering Lottery Funds</p>	<p>The previous auditors recommended that the charging level between the SAC NDPB and the SAC NLDF is reviewed</p>	<p>A more scientific basis of applying cost which takes account of activity levels has been devised and will be implemented for 2007/08.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: 30 April 2007</p>	<p>The Council's overheads are now apportioned between the Council and the Lottery Fund according to the budgeted overhead figures for the year. This is still considered to be an arbitrary method of allocation.</p> <p>We understand that a more sophisticated approach has been developed for use in 2007/08. We will review this as part of our 2007/08 audit.</p> <p>Further action required</p>
<p>6.3.4</p> <p>Accounting arrangements relating to the administration of Lottery funds</p>	<p>The previous auditors recommended that SAC give consideration to simplifying treatment of re-charge costs.</p>	<p>Consideration will be given to the workload involved and the benefit of the additional information provided.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: 30 April 2007</p>	<p>The management accounting tools rely on this structure, the proposed change cannot be implemented until sufficient time is found to revise the reporting tools as well.</p> <p>Further action required</p>
<p>6.3.5</p> <p>Accounting treatment for advances in SAC NDPB accounts</p>	<p>The previous auditors recommended that SAC review its practice of treating advances in February as expenditure and advances in March as debtors.</p>	<p>SAC has revised its advances policy and issued a much reduced value of advances in 2006/07.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: 30 April 2007</p>	<p>We have confirmed that the advances at the year end relate solely to advances of 2007/08 grants made on the last days of March. We have accepted this accounting treatment.</p> <p>No further action required</p>

Title	Original Issue Identified	Original Management Comments	Update at August 2007
<p>6.3.6</p> <p>Adjustment of GMS figures in NDPB account</p>	<p>The previous auditors recommended that staff are reminded of the need to comply with established procedures to remove commitments where there is no signed agreement or where the activity has not commenced from GMS.</p>	<p>Staff will be reminded of the procedure.</p> <p>Responsible Officer: Finance Director</p> <p>Implementation Date: 30 April 2007</p>	<p>We have confirmed that the ineligible amounts have been removed from the GMS figures.</p> <p><i>No further action required</i></p>



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