South Lanarkshire College Report to the Board and the Auditor General for Scotland

Year ended 31 July 2008

BDO Stoy Hayward

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1 Executive Summary

Introduction

- The purpose of this report is to highlight and explain key issues arising from our audit of the financial statements of South Lanarkshire College ('the College') for the year ended 31st July 2008.
- The matters raised in this report, are only those which have come to our attention arising from or relevant to our work that we believe need to be brought to your attention. Our audit work is designed to enable us to form an audit opinion on the financial statements of the College and it should not be relied upon to disclose all irregularities that may exist nor to disclose errors that are not material in relation to the financial statements.
- This report has been prepared solely for the use by the Board of Management of South Lanarkshire College and the Auditor General for Scotland.
- We have completed our audit work in respect of the financial statements for the year ended 31 July 2008 and will be issuing an unqualified audit opinion for the year.

Scope of Work

- The accounting rules and regulations applied to Further Education Colleges are specifically laid out in various documents as discussed in section 3 of this report. We can confirm that the College is in compliance with the regulations and disclosures required to be made in the financial statements in respect of these documents.

Corporate Governance Arrangements

- The corporate governance statement within the College's financial statements states that the College has been fully compliant with guidance on corporate governance for the year ended 31 July 2008. We identified no issues of concern in relation to fraud and irregularity nor did we identify any major errors or weaknesses during our audit. In general the College's systems of internal control appear to be adequate.

Compliance with Scottish Funding Council ('SFC') Accounts Direction

- We can confirm in preparing the financial statements the College has complied with the Accounts Direction for Scotland's colleges and universities issued under circular SFC/35/2008.

Conclusion

- The audit of South Lanarkshire College was performed in accordance with relevant legal and regulatory requirements and with International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Auditor General for Scotland. This report has been issued to College management and will be considered by the Audit Committee.

Acknowledgement

- The 2007/08 audit process brought us into contact with a number of staff within the College. We wish to place on record our appreciation of the co-operation extended to us by those personnel.

2 Introduction

Purpose of Report

- This report has been prepared in connection with our audit of the financial statements of the College for the year ended 31 July 2008. This report summarises the principal matters that have come to our attention during the course of the audit.

- The contents of the report should not be taken as reflecting the view of BDO Stoy Hayward LLP except where explicitly stated as being so. To a certain extent, the content of this report comprises general information which has been provided by, or is based on discussions with, the management of the College. Except to the extent necessary for the purposes of the audit, this information has not been independently verified.

- One of the purposes of this report is to record features of the year's activities, the way they are treated in the financial statements and the comments thereon provided to audit staff by the College's staff.

Audit Bodies

- The Auditor General, a royal appointment on the nomination of the Scottish Parliament, plays a key role in holding the Scottish public spending bodies to account for the proper, efficient and effective use of public money.

- Audit Scotland is an independent statutory body which was set up in April 2000 to provide assistance and support to the Accounts Commission and to the Auditor General for Scotland in the exercise of their respective functions. The Auditor General is responsible for securing the audit of the Scottish Executive, Further Education Colleges and other public bodies.

- BDO Stoy Hayward LLP was appointed by Audit Scotland as external auditor to South Lanarkshire College for 5 years covering the financial years 2006/07 to 2010/11. This report summarises our audit work for 2007/08 and details how the requirements of the Statement of Responsibilities and the Code of Audit Practice have been met by the College and by BDO Stoy Hayward LLP

College Responsibilities

- The College is publicly accountable for the conduct of business and the stewardship of funds under its control. The College's Board of Management is therefore responsible for:

    - establishing adequate corporate governance procedures;
    - ensuring funds from the SFC are used only for the purposes for which they have been given and in accordance with the Financial Memorandum with the SFC and any other conditions which the SFC may from time to time prescribe;
    - ensuring that there are appropriate financial and management controls in place to safeguard public funds and funds from other sources;
    - safeguarding the assets of the College and taking reasonable steps to prevent and detect fraud and other irregularities;
    - securing the economical, efficient and effective management of the College's resources and expenditure;
    - maintaining proper accounting records and preparing financial statements which give a true and fair view of the financial position of the College at the year-end and its income and expenditure for the year.

Auditors' Responsibilities and Approach

- We are required to report to the Board of Management of the College and to the Auditor General for Scotland on the financial statements of the College. Our responsibilities are to:

  - provide an opinion, to the extent required by the relevant authorities, on the financial statements of the College and the regularity of transactions in accordance with standards and guidance issued by the Auditing Practices Board.

  - review and report on the requirements of Audit Scotland's Code of Audit Practice (March 2007), regarding the College's corporate governance arrangements relating to:

    - the College's review of its systems of internal control

    - the prevention and detection of fraud and irregularity

    - standards of conduct, and prevention and detection of corruption

    - its financial position.

  - obtain an understanding of the accounting and internal control systems in place in the College sufficient to allow the audit to be planned and an effective audit approach developed.

- Our audit work is designed to enable us to form an audit opinion on the financial statements of the College and it should not be relied upon to disclose all irregularities that may exist nor to disclose errors that are not material in relation to the financial statements.

3 Scope of Work

- We took reasonable steps to plan and carry out the audit to ensure that the above responsibilities were met and that we complied with the requirements of Audit Scotland's Code of Audit Practice.

- In essence the scope of our work is similar to that applied to a limited company audit, however, the accounting rules and regulations applying to Further Education Colleges are specifically laid down in various documents as detailed below.

Financial Memorandum

- This memorandum sets out the terms and conditions under which the Scottish Funding Council will make payments to the Board of Management of Colleges of Further Education out of funds made available by the First Minister of Scotland. We can confirm the College fully complies with the terms and conditions of the memorandum.

Accounts Direction

- In preparing its annual accounts the College is required to comply with the directions of the Scottish Funding Council (SFC). The Accounts Direction is designed to ensure that disclosures in the financial statements of all colleges follow best practice. We can confirm the College's financial statements comply with the Accounts Direction.

Guidance on Audit

- Audit Scotland's Code of Audit Practice (March 2007) sets down Audit Scotland's requirements for both internal and external audits. In carrying out our audit work we are also required to comply with International Standards on Auditing (UK and Ireland) and to take cognisance of any relevant Practice Notes and other guidance and advice issued by the Auditing Practices Board. We also comply with relevant ethical standards and guidance issued or adopted by the relevant professional accountancy bodies and any supplementary guidance issued by Audit Scotland.

Statement of Recommended Practice (SORP)

- A revised SORP: Accounting for Further and Higher Education was published in July 2007 which was effective for all colleges in 2007/08. This reflects changes in accounting standards and in best accounting practice since the previous SORP was published in 2003. The key change in the SORP which is relevant to the College is as follows:

    - The requirement for an operating and financial review which encompasses an overview of the College's finances and operations and takes account of good practice.

- We can confirm that the financial statements of the College, and in particular the operating and financial review, are in general in compliance with the requirements of the 2007 SORP.

- In addition to the key change affecting the College the following areas are subject to new emphasis within the revised SORP which affect the College:

    - Component accounting – see page 13

    - The disclosure requirements in respect of *FRS 17 Retirement benefits* has been amended. It now states that the Local Government Pension Scheme (LGPS) is a multi employer scheme where it is normally possible for individual employers as admitted bodies to identify their share of assets and liabilities. The SORP therefore considers these schemes should be accounted for as defined benefit schemes (provided that the assets and liabilities relating to colleges can be measured on a reliable and consistent basis) and that the exemption which allows accounting on a defined contribution basis is unlikely to apply. However, in the unlikely case that the exemption does apply, the SORP requires that, in addition to the defined contribution disclosures required by FRS 17, colleges should disclose:

- the reason why sufficient information is not available to account for the scheme as a defined benefit scheme;

- the fact that the scheme is a defined benefit scheme but the College is unable to identify its share of the underlying assets and liabilities;

- any available information about the existence of the surplus or deficit in the scheme and the implications of that surplus or deficit for the College.

The College is already accounting for the SPF scheme on a defined benefit basis for 2007/08.

4 Audit Findings

Preparation of Financial Statements

- The required working papers were ready for audit on 20 October 2008 as per the agreed timetable. The financial statements were made available on Friday 24 October 2008.

Audit Opinion

- We are satisfied that the financial statements of the College present a true and fair view of its financial position as at 31 July 2008. Following approval of the financial statements by the Board of Management on 18 December 2008, our audit report expresses unqualified opinions on (1) the financial statements of the College for the year ended 31 July 2008 and (2) regularity.

Financial Commentary

- This section summarises the main financial features and key movements from the prior year.

Income and expenditure account

- The College made an operating surplus of £79k, 0.6% of total income (2006/07: surplus of £91,000 and 0.9%) in respect of the year ended 31 July 2008. The sector average for 2006/07 was 1.6%.

Income

Total income increased by £2,582,000 (27%). The increase is primarily due to the release of £1.5 million from built up non recurrent SFC funding to support revenue expenditure in relation to the new build, an increase in Grant in Aid of £387k, increased tuition fees and education contracts of £199k, against a fall in European grant income of £250k. In addition, release of deferred capital grants has increased by £597k being the amortisation of deferred capital grants in respect of the new build.

- The table below summarises the main sources of income for 2007/08 and 2006/07.

	2007/08	**2006/07**	**2007/08**	**2006/07**
	£'000	**£'000**	**%**	**%**
Scottish Funding Council Grants	9,494	7,048	78%	73%
Tuition Fees and Education Contracts	1,817	1,618	15%	17%
Other income	551	704	4%	7%
Investment Income	334	244	3%	3%
Total Income	**12,196**	**9,614**	**100%**	**100%**

- A significant proportion of income is received from the Scottish Funding Council with the percentage increasing in the year due to revenue funding in relation to the new build. From review of the 2006/07 Scottish Funding Council performance indicators, the College is more dependent on SFC Grants than other colleges delivering over 40,000 WSUMs. Total Funding Council Grant income is normally in the region of 74%, based on the 2006/07 statistics for colleges in this category. The percentage reduction in other income is the reduction in European grant income of £250k.

- In addition to the above, the College recorded a gain on disposal of its former land and buildings of £4.68m.

Expenditure

- Total expenditure increased by £2,594,000 (27%) in comparison to 2006/07. This is consistent with the increase in income and therefore the reported operating surplus. The increase in costs is, in the main, due to the move to the new larger College with the most significant movements detailed below:

    - An increase in staff costs of £743,000 due to the planned increase in activity over target; and

    - An increase in other operating expenses of £841,000 due largely to running four premises for part of the year and the costs of migration and set up.

- The table below summarises the main sources of expenditure for 2007/08 and 2006/07.

	2007/08	**2006/07**	**2007/08**	**2006/07**
	£'000	**£'000**	**%**	**%**
Staff costs	7,823	7,080	65%	74%
Other Operating Expenditure	3,070	2,229	25%	24%
Depreciation	832	188	7%	2%
Interest payable	392	26	3%	-
Total	**12,117**	**9,523**	**100%**	**100%**

The increase in the depreciation charge and interest payable are as a result of the new building at East Kilbride.

Balance sheet

- Net assets at 31 July 2008 are £29,547,000 (31 July 2007: £18,619,000). The increase in net assets is essentially attributable to the gain on sale of assets and the net increase in deferred capital grants.

- The balance on the income and expenditure account carried forward as at 31 July 2008 is a surplus of £1,383,000 (31 July 2007: surplus of £1,043,000).

- The balance on revaluation reserve carried forward as at 31 July 2008 is nil (31 July 2007: surplus £6,420,000).

- The balance on the restricted reserve carried forward as at 31 July 2008 is nil (31 July 2007: surplus of £88,000).

- The balance on the designated reserve carried forward as at 31 July 2008 is nil (31 July 2007: surplus of £378,000).

- The balance on the pension reserve carried forward as at 31 July 2008 is a deficit of £77,000 (31 July 2007: surplus of £337,000).

- The balance on deferred capital grants carried forward as at 31 July 2008 is £28,241,000 (31 July 2007: £10,353,000).

Cash Flow

- During 2007/2008 the College experienced a net inflow of cash of £307,000 (2006/07: outflow of £878,000).

Financial Forecasting

- The 2007-08 financial plan forecast a surplus of £102k.
- The main variance is in relation to the gain on sale arising on the sale of the old sites.

Financial Forecasting	**2007/08**
	£'000
2007-08 forecast outturn	102
Gain on sale of old sites	4,680
Other variances	(23)
2007/08 actual outturn at 31 July 2008	**4,759**

- The following table summarises the forecast income, expenditure and cash balances for the College for 2008/09.

	£'000
Income	11,373
Expenditure	11,256
Forecast surplus for the year ending 31 July 2009	117
Cash balance at 31 July 2008	5,310
Forecast movement in cash during 2008/09	-4,310
Resulting cash balance at 31 July 2009	**1,000**

- Funding Council Grant income is expected to fall in 2008/09 in relation to the increased release of non recurrent funding this year to finance non capital expenditure and migration costs in relation to the new build. This should have a corresponding reduction in expenditure next year.
- Alternatively, the College will act upon its strategic objective to increase commercial and overseas income, as European funding diminishes.
- The reduction in cash forecast for 2008/09 arises primarily as a result of the repayment of the SFC loan and the first Lennartz installment.

Going Concern Basis

- In preparing the accounts on a going concern basis the Board of Management is satisfied that SFC will provide sufficient funding to enable the College to operate for at least twelve months from 10 December 2008.

Performance Indicators

- The Scottish Further Education Funding Council's ('SFEFC') financial security campaign was announced in December 2002, its principal objective being that all colleges would report underlying operating surpluses by the end of 2005-06. Financial security is defined as the ability, on a continuing basis, to generate operating surpluses reliably and as planned, and through that accumulate a reasonable level of financial reserves. The college must also generate sufficient cash to finance its operations and meet its liabilities; regular operating surpluses would ensure this.
- Under the terms of the financial memorandum between SFC and the College, it is the responsibility of the governing body "*to ensure that the institution strives to achieve best value from its use of public funds from all sources*". It is intended that the financial performance

indicators used by the Funding Council, when set alongside other performance data, will support the college in seeking best value.

- The table below has been produced from the data published by the Funding Council through circular SFC/44/2008 in respect of the Financial Statements as at 31 July 2007. The formulae have then been applied to the 2007/08 Financial Statements.

- As can be seen South Lanarkshire College performs behind other Colleges on most of the chosen benchmarks within their Group (Income base > £10m to £15m) and the Sector.

	South Lanarkshire College Factor 2007-08	South Lanarkshire College Factor 2006-07	Group Average Factor 2006-07	Sector Average Factor 2006-07
Underlying operating surplus % of total income	0.6%	0.9%	2.6%	3.3%
Operating surplus % of total income	0.6%	0.9%	2.0%	1.6%
Designated plus I&E reserves % of total income	10.7%	14.8%	6.1%	17.0%
Historical cost surplus % of total income	0.6%	2.9%	3.5%	4.0%
Current assets: Current liabilities	1.1	0.2	1.7	1.4
Interest Cover	0.2	3.5	6.5	5.0

Grant in Aid Funding

- The College are involved in the Strategic Growth project with SFC. This requires the College to achieve additional WSUMS throughout 2006/07 to 2008/09. The College are on target to achieve the cumulative additional WSUMS of 6,600 by end of 2008/09.

- The College's revised WSUMS target for 2006/07 of 40,498 was also achieved. As a result the College will not be liable to refund any amounts received during 2008/09.

Corporate Governance Framework and Statement

- The Board of Management has five formally constituted committees which have specific terms of reference and act with delegated authority from the Board.

- We reviewed the College's corporate governance arrangements. Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour at the upper levels of the organisation. The College has a responsibility to put in place arrangements for the conduct of its affairs, ensure the legality of activities and transactions and to monitor the adequacy and effectiveness of these arrangements in practice.

- From our review of Corporate Governance arrangements within the College we do not believe the Corporate Governance statement to be misleading or inconsistent with other information made available to us during the audit process.

System of Internal Control

- A review and assessment of the College's corporate governance arrangements was carried out. This assessment included a review of the College's committee minutes and completion of a number of standard checklists. The checklists cover issues relating to systems of internal control, arrangements for the prevention and detection of fraud and corruption, standards of conduct, issues of legality and the College's financial position.

- The College, in accordance with the Accounts Direction, has included in its financial statements, a statement covering the responsibilities of the Board of Management in relation to corporate governance.

- Our review of the statement concluded that it complies with guidance and is not inconsistent with other information we are aware of from our audit.

Prevention and detection of Fraud and Corruption

- The College's arrangements for preventing and detecting fraud and corruption were assessed during the audit. This assessment showed the arrangements to be operating satisfactorily. No frauds were identified by the College in 2007/08.

Review of Internal Audit

- Internal audit is a key element of the internal control system set up by management. A strong internal audit function is necessary to ensure the continuing effectiveness of the internal control systems established. The College therefore, needs to have in place a properly resourced internal audit service of good quality.

- Internal audit services are provided by Wylie and Bisset. An assessment was made of the adequacy of the internal audit input and it was concluded that we as external auditors were able to place reliance on the work of internal audit. Accordingly a certain amount of reliance was placed on the work of internal audit in the following areas during 2007/2008.

    - Budgetary and Financial Controls
    - Fixed Assets, Estates Management and Inventories
    - Value For Money
    - Computer Systems
    - Personnel and Payroll

- Wylie and Bisset have issued the internal audit report for the year ended 31 July 2008. This concluded that the College does have adequate and effective risk management, control and governance processes to manage its achievement of the College's objectives.

Misstatements

- Unadjusted misstatements totalling £80k were identified during our audit work which would increase the operating surplus in the year to £159k.

Accounting and Internal Control System Weaknesses

- No internal control weaknesses were identified during the course of our audit. In the prior year one internal control weakness was identified and implementation of this has now taken place. This is discussed in section 5.

Qualitative Aspect of the College's Accounting Practice and Financial Reporting

- Our overall assessment, based on our work undertaken, is that the financial procedures of the College are adequate to enable annual financial statements to be produced in the prescribed form.

Capital projects

- The College sold its former sites in Cambuslang and East Kilbride and relocated to a new single site £32m campus in East Kilbride.

  The level of capital grant offered by the Capital Investment Committee of the SFC was determined by reference to the funding gap identified in the initial business case and in subsequent reviews. The business case identified several funding sources for the campus, including proceeds of sale of existing building, ERDF monies and the College's own funds. The shortfall in funding identified was £12.6 million and this was the amount of the original capital grant given by SFC.

  The treatment of the proceeds of sale of the existing campus were subject to Procedure Notes for the Disposal of Exchequer-Funded Assets and the Retention of Proceeds by FE Colleges. The Management Statement between the Scottish Government and the Scottish Funding Council (SFC) highlights the obligation on the SFC to ensure it recovers an appropriate proportion of the value of an exchequer-funded asset, when it is disposed of by a college.

In practice, the SFC will always seek to act reasonably, and will take into account a college's:

- estates strategy;
- sources of funds available;
- affordability; and
- financial security.

The SFC determined that the College could retain the full proceeds of the sale which it deemed to be, in effect capital funding on the project. The College has treated this in a similar manner to all other capital funding as noted in the financial statements.

Component accounting

- The College has accounted for the new building at East Kilbride as one component. Paragraph 9 of FRS 15 "Tangible Fixed Assets" requires that where a tangible fixed asset comprises two or more major components with substantially different useful economic lives, each component should be accounted for separately for depreciation purposes and depreciated over its individual economic useful life.
- Included within the cost the cost of land and buildings of £31.7m are integral items such as lifts, heating system, air conditioning system and rooms containing specialist equipment for teaching purposes.
- These costs should be subject to different rates of depreciation than the cost of the building. We covered this point with the College during our audit planning. Management maintain that separate costs are not available for individual components and have depreciated the full cost of the new College (excluding the cost of land) at a depreciation rate of 2 percent. The depreciation rate to be applied to the integral components is likely to be in excess of 2% as the components will have a shorter useful economic life. As the individual components have not been identified nor quantified, we are unable to quantify the extent of the understatement of the depreciation.
- We accept that an increase in the depreciation charge to income and expenditure account would be compensated in part by an increased release to income and expenditure account from deferred grant reserve.

Treatment of VAT on new build

- Fixed assets have been capitalised including the cost of Value Added Tax. During the year the College received £2.4m from HMRC in respect of the Lennartz ruling. This is in effect an interest free loan to be repaid over 10 years, allowing the College to earn interest on the outstanding amount during this period.

- The College use the services of VAT specialists who are endeavouring to have the new build project awarded a VAT zero rating. If this VAT zero rating can be achieved, the College would be in line for a repayment of VAT circa £4 million but would have to repay the Lennartz loan in full. If a repayment was obtained an amendment to the cost of the building would be required with an adjustment to cumulative and annual depreciation.

FRS 17 – Retirement Benefits

- This standard was published in November 2000 introducing significant changes to the way in which colleges should account for defined benefit pension schemes. Full implementation of FRS17 – 'Retirement Benefits' was mandatory from 2005/06 year ends. The College participates in the Scottish Teachers Superannuation Scheme ('STSS') and the Strathclyde Pension Fund ('SPF') which are defined benefit pension schemes. All colleges treat the STSS scheme as a defined contribution scheme as there is general agreement that they are unable to identify their share of the scheme's assets and liabilities.

- In relation to the SPF scheme assets are currently apportioned based on the liability profile though employer assets have been tracked for each employer since 2002. The actuaries provided information on the College's interests in the scheme as at 31 July 2008. Management took the view that this information was sufficiently robust for it to account for its participation on a defined benefit basis.

Early retirement provision

- Included in the balance sheet is a provision for the cost of providing for enhanced pensions. The College recalculated this early retirement provision using the actuarial tables, guidance issued by SFC and an appropriate interest rate.

Recognition of Income - European Social Fund (ESF)

- The College has taken a prudent approach to accounting for ESF income in its income and expenditure account. During the course of our audit work we uncovered no breaches of the conditions attached to the ESF claims and we received assurances from management that this was the case.

5 Internal control systems weakness

Findings from 2008 audit

- No recommendations have been made in 2008.

Recommendations made during 2007 audit process

Observation

- The College have a disaster recovery contract in place with Capita, but no official plan has been documented.

Issue

- The College needs to have an agreed Disaster Recovery Plan which can be implemented timeously in the event of a disaster.

Recommendation

- A documented Disaster Recovery Plan should agreed by the College Board of Management.

Management response at 31 July 2007

- The Risk Management Group of the College has been given the responsibility for the documentation of the Disaster Recovery Plan. This plan will be reviewed by the Finance Committee and thereafter presented to the Board of Management.

Management response at 31 July 2008

- The Plan was formalised via the Risk Management Group for the previous buildings, but has been referred back to that group following the move to the new building. It is planned to have this Plan, and the Business Continuity Plan as updated for the new premises, presented to the first Finance Committee of 2009.

6 Other Matters

- The Charities and Trustee Investment (Scotland) Act 2005 ("the Act") came into force in April 2006, introducing new duties and responsibilities for the Office of the Scottish Charity Regulator ("OSCR").

All charities, including Scotland's colleges, are required to demonstrate to the Office of the Scottish Charity Regulator (OSCR) that they meet the new charity test, set out the in the Act. In a pilot, on John Wheatley College, OSCR ruled that the college did not meet the charity test because its constitution permits Scottish Ministers to direct or otherwise control its activities. A statutory instrument was laid in parliament in June 2008 which came into force on the 27th June 2008. This disapplies the section in the Act in relation to controlling activities, consequently charitable status is maintained.

BDO Stoy Hayward LLP

22 December 2008