KPMG

INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Barony College

Annual audit report to the Board of Management and Auditor General for Scotland
Year ended 31 July 2009

21 December 2009

AUDIT

AUDIT ▪ TAX ▪ ADVISORY

Contents

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

This report is for the benefit of only Barony College and is made available to Audit Scotland (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

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

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

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Executive summary

Financial commentary

The financial outturn (£109,000) is ahead of forecast (£38,000) due to gains on fixed asset disposals (£50,000) and the impact of pension accounting (£38,000) on the income and expenditure account for the year. The financial position at the end of the year has been impacted by the accounting for the defined benefit pension schemes which has reduced the general reserve to £135,000 from £745,000 at 31 July 2008.

The most recent financial plan forecasts a surplus of £47,000 for 2009-10. College management are shortly to commence scenario modelling for future years in response to possible public sector spending constraints. Manage forecast that the College will require to utilise the overdraft facility in 2009-10 to accommodate the timing of cash flows.

Governance and risk management

Governance and risk management processes of the College are strong. These have been strengthened during the year through updates to risk management processes and ongoing updates to the risk register.

Internal audit's annual report concluded that the College "did have adequate and effective risk management, control and governance processes to manage its achievement of the College's objectives". This supports the corporate governance statement accompanying the financial statements.

The operating and financial review has been updated this year and is in line with guidance and best practice.

Financial statements audit

On 21 December 2009 we issued unqualified opinions on the financial statements and the regularity of transactions.

We received a high quality first draft of the financial statements at the commencement of our audit work. One numerical change was made to the financial statements which had no impact on the outturn for the year.

Introduction

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice*. This, and supplementary planning guidance issued by Audit Scotland, specifies a number of objectives for our audit.

Audit framework

This was the third of our five-year appointment by the Auditor General for Scotland as external auditors of Barony College ("the College"). This report to the College's Board of Management and the Auditor General provides our opinion and conclusions and highlights significant issues arising from our work.

We outlined the framework under which we operate, under appointment from Audit Scotland, in the audit plan overview discussed with the Board of Management's audit committee on 5 May 2009.

In accordance with Audit Scotland's Code, the scope of our work for 2008-09 was to:

- provide an opinion on the College's financial statements and, as required by the relevant authorities, the regularity of transactions;
- review and report on (as required by relevant legislation, the Code and any guidance issued by Audit Scotland):
  - corporate governance arrangements as they relate to: its review of systems of internal control; the prevention and detection of fraud and irregularity; standards of conduct, and prevention and detection of corruption; its financial position
  - aspects of the College's arrangements to manage its performance, as they relate to economy, efficiency and effectiveness in the use of resources.

Responsibilities of the Board and auditors

External auditors do not act as a substitute for the Board of Management's own responsibilities for putting in place proper arrangements to account for the stewardship of resources made available to its and its financial performance in the use of those resources, to ensure the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the effectiveness of those arrangements and, through the College principal, to make arrangements to secure Best Value.

Acknowledgement

Our audit work has again brought us into contact with a range of College staff. We wish to place on record our appreciation of the cooperation and assistance extended to us by staff again this year during the discharge of our responsibilities.

Service overview; overall position for year

- The College achieved a surplus of £109,000 compared to a forecast surplus of £52,000 and a £275,000 deficit in the prior year.
- The 2009-10 financial plan forecasts a surplus of £47,000 and reduction in cash of £230,000.

Service overview

The financial statements report a surplus for the year of £109,000, an increase of £384,000 compared to the 2007-08 deficit and £57,000 higher than the projected outturn anticipated in reporting to the Scottish Funding Council during the year. At 31 July 2009 there were retained general reserves of £135,000, down from £745,000 in the prior year .

Income

Overall income for the year has decreased by £85,000 (2%) compared to 2007-08, as summarised in the table below. This table demonstrates a significant reduction in other grant income year on year. This is due to the release of capital grants in the prior year to partially offset the downward revaluation of the dairy technology centre.

Adjusting for the impact of the capital grants in the prior year, income has increased since the prior year due to the following factors:

- Scottish Funding Council grant income has increased by £171,000 mainly due to increased student numbers across a variety of grant funded courses including ESOL, HNDs and HNCs; and
- tuition fee and education contract income has increased by £112,000 due to increased income from the Darnley Career Academy scheme and an increased number of short courses in the year.

Income	2008-09 £'000	*2007-08 £'000*	Movement £'000	Movement %
Scottish Funding Council grants	2,833	*2,662*	171	6
Tuition fees and education contracts	609	*497*	112	23
Other grant income	63	*477*	(414)	(87)
Other operating income	1,481	*1,399*	82	6
Investment income	27	*63*	(36)	(57)
Total	**5,013**	***5,098***	**(85)**	**(2)**

Source: draft financial statements

Expenditure

Expenditure

Expenditure has also reduced from the prior year from £5,371,000 in 2007-08 to £4,955,000, as detailed in the table below. As with income, the largest movement within this is due to the impairment in carrying value of the dairy technology centre in 2007-08. The revaluation exercise in relation to land and buildings is carried out every five years, therefore no adjustment is recorded in the current year financial statements.

Expenditure also shows and underlying increase in the year with the main movements being an increase of:

- £256,000 in staff costs due to a combination of a salary increase and an increase in the number of full time equivalent employees in the year; and
- £147,000 in other operating expenses as a result of increases in farm expenditure including fertilizer, feed and fuel, and also a loss on foreign exchange from the Euro loan.

Expenditure	2008-09 £'000	*2007-08 £'000*	Movement £'000	Movement %
Staff costs	2,741	*2,485*	256	10
Other operating expenses	1,909	*1,762*	147	8
Depreciation	242	*187*	55	29
Impairment	-	*873*	(873)	(100)
Amortisation of intangible assets	13	*13*	-	-
Interest payable	50	*51*	(1)	(2)
Total	**4,955**	***5,371***	**(416)**	**(8)**

Source: draft financial statements

Gain on disposal of fixed assets

The College's financial position benefited from £59,000 of gains on sale of fixed assets in the year relating primarily to a number of items of farm equipment.

Balance sheet

The balance sheets at 31 July 2009 and 2008 are detailed in the table below. This shows a decrease of £780,000 in net assets since the previous year end. Significant movements are detailed on the following page.

Balance sheets	2009 £'000	2008 £'000	Movement £'000	Movement %
Fixed assets				
Tangible fixed assets	6,283	6,268	15	-
Intangible assets	53	66	(13)	(20)
Investments	42	34	8	24
Current assets and liabilities				
Stock	509	474	35	7
Debtors	189	229	111	48
Cash at bank and in hand	381	426	(45)	(11)
Creditors due within one year	(807)	(828)	(21)	(16)
Net current assets	**272**	**301**	**(29)**	**(10)**
Creditors due after one year	(589)	(634)	45	7
Pension liability	(976)	(170)	(806)	(474)
Net assets including pension liability	**5,085**	**5,865**	**(780)**	**(13)**
Deferred capital grants	1,280	1,317	(38)	(3)
Income and expenditure account, including pension reserve	135	745	(610)	(82)
Revaluation reserve	3,670	3,803	(133)	(3)
Total	**5,085**	**5,865**	**(780)**	**(13)**

Source: draft financial statements

Balance sheet

Net pension liability

The College's share of assets and liabilities of the Dumfries and Galloway Council Pension Fund have been valued and accounted for in accordance with FRS 17 *Retirement benefits*. There has been a significant increase it the net liability from £170,000 at 31 July 2008 to £976,000 at 31 July 2009. This is as a result of:

- a reduction in asset values due mainly to the poor performance of the stock market over the last year; and
- increased liabilities due to changes to the assumptions used by the actuary which reflect a worsening in wider financial conditions.

The impact of the change in the net pension liability in the financial statements has been to reduce the general reserve from £745,000 in the prior year to only £135,000 at the end of 2008-09. This demonstrates the potential short term volatility of accounting for defined benefit pension schemes which is not possible to predict.

Fixed assets

Fixed assets include £75,000 of additions in relation to the biomass boiler, construction of which was started in 2009. This will be completed in November 2009 with an expected total cost of around £500,000. The construction is being financed by an interest-free term loan from Salix Finance Ltd ("Salix") which is repayable over four years and a £200,000 grant from Community Energy Scotland. Salix is an independent publicly funded company which provide financing to public sector organisations for energy efficiency technologies.

Financial forecasts

The following table summarises the forecast surplus for 2009-10 and cash balance at 31 July 2010 from the financial forecast submitted to the Scottish Funding Council in June 2009.

	£'000
Income	5,331
Expenditure	5,284
Forecast surplus for the year ending 31 July 2010	**47**
Cash balance at 31 July 2009	381
Forecast cash balance at 31 July 2010	150
Forecast movements in cash during 2009-10	**(231)**

Source: 2009 financial forecast return

Income and expenditure

In line with policy and prior years the College has forecast to achieve a small surplus in 2009-10. This is consistent with the actual result for 2008-09 of £59,000 before gains from the disposal of assets.

Income is expected to grow next year as a result of an increase in the Scottish Funding Council recurrent grant and increased revenues from the College's business development centre. The increase in Scottish Funding Council grant is driven by the increasing wSUMS scoring of the College. The business development centre revenues are expected to grow due to the popularity of short courses being run for external parties in disciplines such as forestry.

Expenditure is expected to grow in similar proportions to revenue with increases year on year for staff costs, supplies and services and costs of the farm. Staff costs are expected to grow due to the award of pay increases which have been budgeted at 2% across all staff. Supplies and services costs have been increasing steadily due to the increased activity of the College. In the past year the farm has experienced significant cost pressures in areas such as fertilisers, feeds and fuels which is expected to continue into 2009-10.

Cash position

The College has forecast that the cash position will deteriorate significantly in 2009-10. This is primarily due to capital expenditure and repayments of the Salix loan which will commence early in 2010. The loan repayment period is significantly shorter than the useful life for depreciation purposes. Management actively manage the impact of the differences in timing between cash inflows and outflows of the College, but still expect to require the use of an overdraft facility which was renewed in December 2009.

Management recognise the tight cash position of the College and the likely pressures on the College from increasing challenging economic conditions. As a result the Board of Management has tasked the finance team with producing scenario planning for the impact of reductions in key income streams over the next few years. This is expected to be produced early in 2010.

Governance and risk management

- The corporate governance statement does not disclose any significant weaknesses in the systems of internal control. The content of the statement is consistent with our understanding.
- Internal audit concluded that the College "did have adequate and effective risk management, control and governance processes to manage its achievement of the College's objectives".
- The College has in place a formal process to record, distribute and monitor action in response to key guidance and circulars.
- The operating and financial review provides a comprehensive account of the College's activities and exceeds the requirements of the SORP 2007.

Introduction

Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all publicly-funded bodies.

Through the College principal, the Board of Management is responsible for establishing arrangements for ensuring the proper conduct of its affairs, including compliance with relevant guidance, the legality of activities and transactions, and for monitoring the adequacy of these arrangements. The Code requires auditors to review and report on the College's corporate governance arrangements as they relate to:

- the College's reviews of its systems of internal control, including reporting arrangements;
- the prevention and detection of fraud and irregularity;
- standards of conduct and arrangements for the prevention and detection of corruption; and
- its financial position.

Governance arrangements

The Board of Management comprises 17 members, including those with skills and expertise in finance. On 1 August 2009 there was a change in chairman and vice-chair of the Board of Management. The appointments were reviewed and recommended by the Board's nomination committee according to its guidelines.

The Board of Management is ultimately responsible for the College's governance arrangements, but some responsibility for these duties are delegated to various Board sub-committees.

Risk management

The Board of Management has continued to review the risk management process to ensure compliance with best practice by introducing a formalised risk management strategy during the period. This document represents an integral part of the College's internal control and corporate governance arrangements. The strategy formally documents the roles and responsibilities of the Board of Management, the College management team and other key parties in relation to risk management.

A risk register is maintained and is available to all staff. This register is reviewed and updated each term and reported to the Board of management for final approval. The audit committee also considers the risk register during its own meetings.

Governance and risk management (continued)

Corporate governance statement

The corporate governance statement for 2008-09 provides details on how the Board of Management has established processes and controls in order to comply with the combined code on corporate governance, issued in 2003. The statement highlights that the College is committed to exhibiting best practice in all aspects of corporate governance. The corporate governance statement is informed by the results of internal consideration of the arrangements that have been put in place by the Board of Management.

KPMG have reviewed the corporate governance statement and consider it consistent with our understanding of the processes followed by the College during the period.

Regularity

The Board of Management considers all incoming correspondence relevant to its strategic management role from the Scottish Funding Council and other regulatory or advisory bodies, such as Audit Scotland. The audit committee also considers any applicable correspondence. The College therefore considers all incoming guidance received from these bodies, and can demonstrate that they take appropriate action has been taken when required.

Internal audit

The approved internal audit programme for 2008-09 has been completed and the internal auditors have concluded that the College "*did have adequate and effective risk management, control and governance processes to manage its achievement of the College's objectives*". The internal audit programme included 24 days of work on various areas including treasury management, corporate governance, income collection and credit control.

Internal audit commented via their reporting to management that controls in all areas covered were either strong or substantial.

Internal controls

In accordance with our audit plan, we undertook testing in relation to both entity level and key financial controls. Testing of the design and operation of controls over significant risk points in terms of major financial systems confirms that controls are designed appropriately and operating effectively.

Governance and risk management (continued)

Prevention and detection of fraud and irregularity

The College has in place an over-arching fraud prevention policy, in addition to a specific whistle-blowing policy. Both policies are readily available to staff on the College's intranet. The fraud policy sets out procedures for the avoidance of fraud and corruption, while also detailing guidance for staff should such activities be suspected. The content of the policy meets the requirements and identifies responsibilities for the prevention and detection of fraud. The whistle-blowing policy provides guidance for those who wish to report suspected matters in confidence.

Management has not reported any frauds, material or otherwise, during 2008-09.

Standards of conduct

There are comprehensive policies and procedures in place at the College. All policies are readily accessible to staff via the College intranet. There are codes of conduct in place for general staff, senior management and members of the board of management. There is a formal register of interests for recording members of the Board of Management and senior managers' interests. This is considered to be best practice and assists in demonstrating consideration of independence in decision-making. The register of interests was updated fully on 1 August 2009 for the beginning of the new financial period.

Best Value / value for money

The 2008-09 planning guidance for further education colleges issued by Audit Scotland indicated that there was no requirement for auditors to undertake performance audit or other Best Value studies during the year.

Internal audit produced a report in relation to value for money for transport costs during the year. They concluded that the College has appropriate procedures in place to address value for money in its transport arrangements.

Scottish Funding Council enquiry

On 9 June 2009 the Scottish Funding Council issued an enquiry letter to all further education colleges in Scotland as a result of findings by the Scottish Funding Council's internal auditors. These asked Colleges to ensure that:

- all non-trivial contracts entered into by institutions are committed to writing;
- statutory child protection requirements in relation to Enhanced Disclosure checks are adhered to;
- Boards of Management avoids the prospect of any actual perceived conflicts of interest for board members at all times; and
- colleges are aware of and adhere to guidance issued in relation to provision provided in collaboration with other organisations.

The College replied to this enquiry in October 2009 with positive affirmations that it already complies with best practice in each of these areas.

Key findings

- We issued an audit report expressing unqualified opinions on the financial statements and the regularity of transactions of the College for 2008-09.
- Management provided draft financial statements and supporting papers, which were complete and of a high standard, in line with the agreed timetable.

Audit opinion

On 21 December 2009 we issued an audit report expressing an unqualified opinion on the financial statements for the year ended 31 July 2009 and on the regularity of transactions reflected therein.

Financial statements – compilation arrangements

Management provided draft financial statements on the first day of our final fieldwork visit, which were largely complete and of a high standard. The standard of documentation prepared by the finance staff to support the financial statements was of a high standard and made available quickly upon our request.

Corporation tax risk

As part of our audit of the financial statements of the College, we have performed a high-level review of the various potential corporation tax issues. We have involved our tax professionals in this to leverage their experience in the further education sector in this review.

There is always a risk when a charity has trading activities that this could expose them to a corporation tax charge from HM Revenue and Customs ("HMRC"). This could arise from generating a profit or a loss on an activity that is considered to be a non-primary purpose (NPP) trading activity. A NPP profit is subject to corporation tax. If a loss arises on NPP trading activities this creates a non-charitable expenditure charge which is equal to the loss. This non-charitable expenditure charge is subject to corporation tax. If the activities that this loss arose from are run on a commercial basis (with a view to making a profit) or the College itself is considered to be commercial (i.e. the College has a surplus in the year and in recent years) then the non-charitable expenditure charge can be sheltered by the corresponding loss thus self cancelling.

If there are NPP trading activities and the total income arising from these is less than £50,000 then normally this is covered by the small trading exemption available to charities.

The specific risks we have identified cover three areas and our findings are detailed below.

Farm trading activities

The College's activities include the running of a fish and a livestock farm which generate significant levels of income for the College each year. Management have stated that they aim to generate a profit from these activities to enable them to contribute to the rest of the College's activities. We have discussed these with management and have identified the following:

- the farm activities are run to allow student tuition and are in fact necessary due to the courses offered in the land based and animal care industries;
- the trading activities of the farm reduces the net cost of the activities to the College and ensures its financial viability; and
- The small net loss made by the farm is essentially part of the College's cost of delivering education.

On the basis that the farms are being run mainly by the beneficiaries of the charity (i.e. students) it is considered that these activities are primary purpose activities of the College.

From this, management believe the tax risk from the trading of the farms to be low.

Conferencing and sports facilities

The College offers the use of conferencing facilities to third parties, e.g. local businesses. This will include use of the College's rooms and equipment and can also include the provision of catering. As well as this, the College offers the use of the sports hall to third parties when not in use by the College, e.g. local sports teams. We noted the following in relation to these activities:

- College facilities are designed for primarily teaching and for the use of students;
- as the College already has these facilities, it makes financial sense to allow third parties to use them so that the College can generate further income for use in core activities; and

Provided the overall income arising from these activities (when taken together with any other NPP activities) is less that the £50,000 small trading threshold then management believe the tax risk from the offering of these services to be low.

Corporation tax risk (continued)

Closed courses

Closed or restricted courses are deemed to be a non-primary purpose activity. A closed course is broadly one where the attendees are drawn form a narrow range of the public, or the criteria for selection for the course exclude the wider general public, or the benefit is not to a sufficiently wide sector of the public. A typical example would be where a College provides a course or training specifically for a single business. We understand that it is very rare that the College receives enquiries about such courses and only a minimal amount of income is ever generated from such courses.

Provided the overall income arising from these activities (when taken together with any other NPP activities) is less that the £50,000 small trading threshold then we believe the tax risk from the offering of these services to be low.

Conclusion

Management believe that the activities we have identified represent low risks that the College will be exposed to a corporation tax charge on the assumption that these activities will fall within the small trading threshold of £50,000. However, there is always a risk to a charity that trading activities leave the organisation exposed to the risk of suffering a corporation tax charge.

Recommendations

We have identified a recommendation to improve the following area:

Area for development	Action plan reference
Management should review the various income streams of the College to identify any areas of potential tax risk. If the income arising on these activities exceeds the small trading exemption of £50,000 a corporation tax return and computation should be prepared and submitted to HMRC. If the income falls within the small trading exemption, supporting evidence should be prepared to detail and record management's analysis in case of any future enquiries by HMRC.	One

Appendix one – action plan

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 Board or systems under consideration. The weakness 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 controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.

No.	Issue and recommendation	Management response	Officer and due date
1	During our audit we have identified a number of areas where the College could be open to the risk of tax exposure. We recommend that management analyse the various income sources of the College to identify any areas of tax risk. A record should then be kept of this analysis to aid in any future tax enquiries. *(Grade three)*	Agreed. We are aware of the potential tax risks around trading activities and will prepare an analysis in due course.	Finance manager May 2010