The North Highland College

Annual Report for the Year Ended 31 July 2010
To the Board of Management and the Auditor General for Scotland

RSM Tenon

5 Kings Place
Perth
PH2 8AA

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This report is part of a continuing dialogue between the College and ourselves and is therefore not intended to cover every matter discussed during the course of the audit. For this reason, the report is intended for the sole use of the College, and of Audit Scotland. We do not accept responsibility to any officer or member of the College acting in an individual capacity, and do not accept responsibility for any reliance that third parties may place on the report.

It should be noted that the primary objective of our audit is to express an opinion on the truth and fairness of the College accounts as a whole. An audit does not examine every operating activity and accounting procedure in the College, nor does it provide a substitute for management's responsibility to maintain adequate controls over the College's activities. Our work is not designed therefore to provide a comprehensive statement of all weaknesses or inefficiencies that may exist in the College's systems and working practices, or of all improvements that could be made.

1. EXECUTIVE SUMMARY

1.1. Financial Review

- The college incurred a deficit of £635k (previous year £317k) due to an exceptional loss on demolition of fixed assets, redundancy costs, and various income streams not being delivered as expected.
- The college balance sheet has net assets (before deduction of deferred capital grants) of £8,415k (previous year £6,672k) although it has moved into a net current liability position of £2k (previous year £814k net current assets). Cash in hand has increased to £633k but this is due to receiving £830k of capital grants for year end 2011 in advance of related expenditure being incurred.
- The updated budget for 2010-11 based on the recovery plan predicts a deficit of £103k.

1.2 Financial statements

- Subject to the satisfactory resolution of the outstanding matters noted in section 2 we would intend to issue an unqualified audit opinion on the accounts of The North Highland College for the year ended 31 July 2010.

1.3 Corporate Governance

- In our fourth year of appointment our work in relation to Corporate Governance has been carried out in the light of extensive work carried out during the year by the College Audit & Risk Management Committee, the Internal Auditors, (Messrs Chiene & Tait) and consultants from the Further Education Development Directorate led by Malcolm Heaton.
- As a result of these reviews and recommendations made within the various reports, a number of actions have already been taken to improve the standards of Corporate Governance within North Highland College. We have no additional matters to bring to the attention of management in this respect.
- We also understand that investigations are continuing into certain matters identified by the Audit & Risk Management Committee and that reports have been made to the Commission for Ethical Standards in Public Life and to the Office of the Scottish Charity Regulator. However, having reviewed the substance and quantum of these matters, we are satisfied that there is no requirement for any recognition within the financial statements of any additional assets or liabilities nor any requirement to make amendments to the draft narrative sections of the annual report presented for review.

1.4 Action Plan

We make recommendations relating to:

- Compliance with loan covenants
- Fixed asset disposals
- Over-depreciation of fixed assets

- Accuracy of debtor/creditor balances
- Property depreciation accounting policies
- Authorisation of bank borrowing facilities

2 INTRODUCTION

This is the fourth year of our five-year audit appointment. The purpose of this report is to give a summary of our audit activity. It includes details of the more significant matters arising from the audit, sets out the respective responsibilities of management and external audit, and reports what action has been taken or is necessary by members or executive management.

Our audit of The North Highland College for the year ended 31 July 2010 has been carried out in accordance with statutory requirements and follows the practices prescribed by the Code of Audit Practice and guidance issued by the Auditing Practices Board (APB). The Code of Audit Practice sets out fully the responsibilities of the College and its officers in relation to financial probity, control, preparation of accounts and the achievement of value for money in the provision of services. We are required under the Code to give an independent assessment of how the College has discharged its stewardship of public funds. A summary of our responsibilities is contained in the appendices.

We have summarised the Key Issues arising from our audit in Section One. In providing the summary, it can be difficult to strike a balance between recognising good performance when achieved and highlighting scope for improvement. The items referred to represent Key Issues for management attention and should not be taken out of the context of the remainder of this report, or the detailed reports covering individual reviews.

We invite The North Highland College to receive this report and consider the recommendations we have made.

We would be grateful to receive the College's response to the issues we have raised.

3 FINANCIAL REVIEW

3.1 Introduction

The purpose of the financial review is to consider the general financial standing of The North Highland College by looking back at financial performance in 2009/10 and to look ahead to the future financial position. Our review is aimed at helping College members understand the financial position of The North Highland College at a particular point in time. It should not be regarded as definitive or comprehensive and the College should not seek to rely on this summary in isolation.

3.2 Financial Performance 2009-10

The financial statements reflect a deficit for the year of £635k (previous year £238k). This does not compare favourably to the budgeted £283k deficit.

The principal factors which we understand have given rise to the adverse variance against the budgeted deficit are:

- The loss on disposal of the demolished buildings during the year which totalled £156k
- A large deficit was made on other income generating activities this year due to income not being delivered as expected on the Maree project and Burghfield going live
- EMI commercial income was down in the year
- There was £58k of unbudgeted redundancy costs in the year

The college continues to maintain a positive overall balance sheet position, with net assets of £8,415k. However, this includes deferred capital grants of £7,660k. The college has fallen into a position of net current liabilities of £2k at year ended 31 July 2010 compared to a net current asset position of £814k in the prior year. Cash held is £633k at the year end, but £830k of this is income received in advance to pay for the capital projects post year-end so perhaps paints a false position of financial security.

3.3 Reserves

The college income and expenditure reserves have decreased to £1,043k at 31 July 2010, (previous year - £1,580k). On incorporation of the pension reserve and the revaluation reserve, total reserves have now fallen to £755k (previous year - £1,296k).

3.4 Financial Plan 2010-11

The forecast for 2010-11 predicts a deficit of £103k in line with the recovery plan. To achieve this target, the college needs to make £477k of savings in the year of which we have been advised that £360k have been made at the current date.

3.5 Capital expenditure plans

The College has incurred capital expenditure of £3,138k, principally on Burghfield, the Centre for Energy and the Environment and the Engineering Skills Centre. There will be further Estates related capital expenditure incurred in 2010/11 on the Centre for Energy and the Environment which will be finished in November 2010 and the Engineering Skills Centre which only started in summer 2010.

3.6 Recurrent grant allocation

The Scottish Funding Council (SFC) has confirmed recurrent grant income of £7,177k and fee waiver initial grant of £780k for the year to 31 July 2011. This compares favourably to the year to 31 July 2010 allocation of £6,826k of recurrent grant income and £629k of fee waiver initial grant.

4 FINANCIAL STATEMENTS

The respective responsibilities of the College and RSM Tenon Audit are summarised in the Appendix 2. The purpose of this section of our report is to highlight and explain our formal opinion on the financial statements, and to comment on the main issues arising from our audit of the financial statements.

4.1 Audit opinion

We have issued an unqualified audit opinion on the accounts of The North Highland College for the year ended 31 July 2010. A copy of our audit opinion is attached to this report in the appendices.

4.2 Independence

In accordance with auditing standards we can confirm that any relationships that may bear on the firm's independence and the objectivity of the audit engagement director and audit staff have been identified and assessed at the planning stage of our audit.

No independence issues have been identified that Board Members need to be aware of.

As per our planning memorandum, we carried out the audit of the student support funds for the college at a cost of £1,750 plus VAT.

4.3 Timetable and procedures

The College is required to submit audited accounts to the Scottish Funding Council (SFC) by 31 December following the year end.

In order to achieve this deadline the accounts preparation procedures require good planning, commitment, and resources.

We discussed plans for the preparation and audit of the accounts with the Director of Finance.

Due to weather condition affecting the postal service, accounts were delivered to Audit Scotland shortly after 31 December 2010. However, electronic copies were submitted to SFC in advance of the deadline date. We are grateful to all of those in the Finance and other departments who helped to achieve this, especially in light of increased workload generated from the development of the College Estates and the implementation of the recovery plan.

4.4 Audit approach and materiality

Our audit planning was carried out taking account of the issues highlighted through a planning meeting with you, and our knowledge and understanding of the business.

In our planning, we have taken account of the reliance that can be placed on the work of the internal auditors, the regulation within the sector, and the results of our own risk assessment made in accordance with the guidance set by International Standards on Auditing (UK and Ireland).

The level of materiality for making adjustments to the financial statements, as set out in the detailed planning memorandum, was calculated based on total income and the value of general reserves and was assessed at £99,000.

We are required to notify you of any potential adjustments identified during the course of our audit work unless they are clearly trifling. For the purposes of this report we have taken clearly trifling as being less than £2,000.

Significant matters were discussed with management during the course of the audit. This includes the audit outcome of the key risks identified within our audit planning memorandum.

4.5 Accounting policies and practices

In preparing the financial statements of the College, Members are required under FRS18 to review the College's accounting policies on an annual basis to ensure they remain appropriate to the College's circumstances and are being properly applied.

We have reviewed the accounting policies and practices selected by the College and are satisfied that the College operates acceptable accounting policies and practices for the purpose of determining whether the financial statements show a true and fair view.

This section of the report summarises the main accounting issues that we have discussed with management and records the adjustments that have been made to the draft accounts as a result of matters arising during the course of the audit. This section also summarises the errors identified during the course of the audit which remain unadjusted.

We draw the Members' attention to the following matters in particular:

Financial Covenants on Bank Loan

Under the terms of the College's bank loan with Lloyds TSB Scotland, the College is subject to a financial covenant stating that the annual deficit on the Income & Expenditure account will not exceed £150,000. If this covenant is breached, the bank has the right to declare the loan repayable on demand.

In such circumstances, UK GAAP requires that the non-current element of the bank loan be reclassified as a current liability. This adjustment has been reflected in the financial statements.

Although the bank is not recognising the breach of the loan covenants in the year, technically there was a breach according to the loan covenants. Also, the budget for 2010/11 is for a deficit which could possibly further breach the loan covenants.

Refer to Appendix 5 for further information on bank loan covenants.

As a result of the £635k deficit incurred during the financial year to 31 July 2010, the college's balance sheet position was weakened with reserves falling to £755k and the previous net current asset position falling to net current liabilities of £2k. Although a cash position of £633k is presented in the financial statements, this includes £830k of deferred income in relation to capital projects, the cost of which was incurred in the 2 months after the year-end. Also, the college continues to breach its bank loan covenants.

However, it is noted that the college are actively seeking to reduce costs. We have reviewed in detail The North Highland College Recovery Plan (1st August 2010 to 31st July 2013) which has been implemented and is now set being used as the budget for year ended 31 July 2011. From this document, the college has budgeted for a £103k deficit which should result in cash generation by the college. To achieve this deficit, the college will need to cut £709k from costs which will incur £232k of one-off costs and income loss, resulting in £477k of overall savings. We have been advised that £360k of these cost savings have been implemented at the current date.

Also, it is noted, from direct confirmation received, that Lloyds TSB are working on proposed revisions to the financial covenants within the loan agreement which should reduce the risk of future breaches, and we have received confirmation that Lloyds TSB are not proposing to take action as a result of the breach of covenants in the year ended 31 July 2010.

Based on the information available at this date, the college is taking appropriate steps to reduce risks to going concern, and there is evidence available that the college will be a going concern for the 12 months from the balance sheet date.

Consent for bank borrowings

In the course of our going concern review, we identified an inconsistency between the duration of the SFC consent for bank borrowing from the Clydesdale Bank and the duration of the facility envisaged within the facility agreed with the Colleges bankers. We would draw your attention to the recommendation made at section 6 in this regard.

The SFC letter of consent contains a backstop date by which all borrowings are to be repaid of 31 July 2011. That was consistent with cash flow budgets prepared around this time last year which were presented to the SFC as part of the business case for the overdraft facility but is significantly different from the current forecast, in which it is acknowledged that the College will require a facility of up to £1m at various dates throughout the 2011 - 2012 financial year.

The Clydesdale Bank have authorised an overdraft facility of £600k for operating purposes (from the total of £1.5m) to run until review in October 2011. They are mindful of the requirement for SFC approval of borrowings but do not appear to be aware there is a backstop date on the letter. If they do note the back stop date it could potentially change their ability to offer facilities.

This matter has been discussed with the SFC who have indicated that they are likely to grant consent if a proper business case for a short term extension is presented and, on that basis, and based on our review of the recovery plan, we have concluded that this issue does not indicate a material going concern risk which requires notification within our audit report.

Highland Council Pension Fund

The College will benefit from the change in the benefit structure of LGPS whereby future pension increases will be based on the Consumer Price Index rather than the Retail Price Index. Further details of this change are set out in Appendix 3. Before technical resolution, the £421k adjustment in relation to this change was included in the income and expenditure account but this has now been correctly reanalysed to the STRGL.

International Financial Reporting Standards

We would draw to your attention the information in Appendix 4 regarding potential conversion to the use of International Financial Reporting Standards. It is estimated that this will first impact the sector in the 2014/15 financial year.

Other less significant areas relating to errors identified during the audit process have been identified and are included as minor recommendations within the action plan.

The risk areas identified in our plan were satisfactorily dealt with as follows:

Issue	Audit risks	Planned audit approach	Outcome
Recognition of Funding Council Income			

Issue	**Audit risks**	**Planned audit approach**	**Outcome**
The audit of 2009/10 student activity data by Chiene & Tait may result in adjustments to the SUMS which may take the College below 97% threshold and leave them subject to clawback of these funds.	*Recurrent grant income may be overstated in the accounts.*	*Reconciliation to remittances from SFC and review the outcome of the student activity data audit.*	***Satisfactory***
FRS 17 Accounting for Pensions			

Issue	Audit risks	Planned audit approach	Outcome
The provisions of FRS17 apply to the accounting for and disclosure of pension assets and liabilities related to the defined benefit schemes. In prior years the College have included a pension fund liability in its accounts as it was able to identify its own share of the assets and liabilities in the Local Government Superannuation Scheme. This complies with the requirements of FRS17. Audit Scotland's note for guidance issued on further education financial statements for 2005/06 provided guidance on auditors' responsibilities in these cases.	Disclosures and the accounting for pension costs and liabilities may not comply with FRS17 and the SORP Accounting in Further and Higher Education Institutions.	We will: Review college correspondence with, and the report of the actuaries in relation to the scheme Review compliance with FRS17	***Satisfactory***
Capital Expenditure			

Issue	Audit risks	Planned audit approach	Outcome
The College is currently undertaking two significant Capital Projects and expects to have incurred expenditure of £2.3m out of a total budget of £11m during the year ended 31 July 2010.	Non – systematic transactions such as those incurred on capital projects can carry a higher risk of fraud and error than standard ongoing revenue items. The College may have financial exposure in the case of a cost over-run	We will review the work already carried out by Internal Audit in relation to the procurement process and specifically consider regularity of expenditure in relation to capital expenditure items tested as part of our audit, while reviewing the most up to date project plan and discuss with management the likely variances from budget. We will corroborate management representations in respect of the funding of adverse variances to documentation and report back to the Audit and Risk Management Committee on any concerns.	***Satisfactory***
Provisions			
Many FE colleges are looking at carrying out some level of restructuring at present or during the upcoming financial year. In such circumstances, Colleges may seek to make provision for certain costs of restructuring at 31 July 2010.	Provisions recognised in the draft financial statement my not meet the criteria set out in Financial Reporting Standard 12 for recognition. In principal, provisions for restructuring and redundancy where an entity can demonstrate that there was an irrevocable commitment to incur these costs by the financial year end. This will generally include communication of plans to the affected employees.	We will: Discuss with management at the planning stage whether any provisions have been included within the 2010 financial accounts Review the circumstances of any provisions made to ensure recognition is consistent with the requirements of FRS12	***Satisfactory***
Going Concern			

Issue	Audit risks	Planned audit approach	Outcome
The company has exceeded their budgeted deficit and there is limited cash at the y/e.	There may be going concern issues within the college.	Perform a detailed review of budgets and forecasts, latest management accounts, overdraft/loan agreements, and cash receipt post y/e.	***Cash flow forecasts indicate that the company will continue to be reliant on bank borrowings to be able to meet its liabilities as they fall due.***
Banking Facilities			
Projected results for the year indicate that the College is likely to be in breach of financial covenants attached to the Lloyds bank loan	If the breach is not formally waived by the College's bankers prior to the year end, the loan should be reclassified as current on the basis that they will have a technical right to repayment on demand.	We will review correspondence between College and Bank in order to ascertain the Bank's understanding of the financial position and discuss the relevant disclosure issues with management.	***Confirmation was received from Lloyds TSB that no action is intended based on the breach of covenants at 31 July 2010 and discussions are underway in respect of redrafting covenants such that they reflect the College's current financial position.***

ADJUSTED AND UNADJUSTED ERRORS

4.6 Actual Audit Adjustments

The following adjustments were processed during the course of our audit.

	£'000
Surplus / (Deficit) per accounts presented for audit	17
Adjustments:	
Adjust pension reserve through STRGL rather than I&E	(421)
Loss on fixed asset disposals – demolished buildings	(156)
Reverse depreciation on fully depreciated or disposed assets	47
Provision for monies due to West partners	(30)
Fee waiver provision	(88)
Increase Learn project income accrual	31
Income credit note provision	(24)
Write off bad debt provision error	(12)
Surplus / (Deficit) per final accounts	(636)

4.7 Potential Audit Adjustments

The following potential adjustments have been noted during the course of our audit but have not been actioned.

Potential adjustments:	*£'000*
VAT creditor included under incorrect heading (£10k)	Nil
Bank reconciliation difference	3
Reallocation of credit balances from trade debtors (£12k)	Nil
Reallocation of debit balances from trade creditors (£17k)	Nil
Net impact of potential adjustments	3

4.8 Accounting and financial control systems

We found that, in general, and except for the comments in 4.5 above, all aspects of the College's financial systems that were reviewed to be well controlled, providing a good basis for the preparation of accounts.

There were no significant matters of weakness identified during the audit that we wish to draw to your attention, other than those highlighted at 4.5 above and those included within our recommendations in 6.1.

4.9 Regularity audit

We have issued an unqualified regularity opinion and there are no significant issues that we wish to draw to the Board's attention.

5 CORPORATE GOVERNANCE

Corporate Governance is concerned with structures and processes for decision making, accountability, control and behaviour at the upper levels of the organisation. The respective responsibilities of The North Highland College and RSM Tenon Audit are summarised in Appendix 2. This section of our report comments on the main aspects of our work, and highlights particular issues which arose.

5.1 Statement on Corporate Governance

The College have included in their financial statements, a statement on Corporate Governance. The statement clearly sets out the College's arrangements under each aspect of the code, and is a valuable enhancement of public accountability.

Although we are not required to form an opinion on the adequacy and effectiveness of the College's Code of Corporate Governance, we are required to report where a statement does not comply with the requirements of SORP or other guidance, or if it is misleading or inconsistent with other information of which we are aware.

In our opinion the statement is not misleading or inconsistent with other information which we are aware of from our other audit work.

5.2 Risk Management

Although the term "Risk Management" has become relatively common recently, the underlying principles – of identifying and assessing risks and taking action to minimise their occurrence and impact, are well established. The College's Committee structure, Financial Regulations, and Internal Audit functions are all examples of policies and procedures which address potential risks. However, it is now generally recognised that this process needs to become explicitly established as part of a management culture, and requires the implementation of consistent best practice through formal policies and procedures. The College have in place a Risk Management policy, and a risk Register.

5.3 Internal Audit

We adopt a managed approach in planning our audit work at your College. This means that we work closely with Internal Audit and place formal reliance on their work. This avoids duplication of effort and means that we can both direct our resources where they are most needed.

Our relationship with Internal Audit is governed by the International Auditing Standard ISA610 "Considering the work of Internal Audit".

It is the responsibility of management to determine the extent of the internal control system required. Internal Audit is an important element of the internal control system. Chiene and Tait C.A. provide the colleges internal audit function.

Wherever possible we use the work of the internal auditor to assist us in our assessment of the effectiveness of the internal controls in the College's main financial systems. We review internal audit reports and use the work of the internal auditor to plan our work and to inform our own risk assessment. However, to enable us to rely on the work of Internal Audit, we need to be satisfied that the audit work has been properly planned, controlled, performed, recorded and reviewed in accordance with the Internal Audit Standards and ISA 610.

We are pleased to confirm that we were able to derive the planned assurance in the areas examined and that the Internal Audit Service was carried out generally in accordance with the SFC Code of Practice.

In 2009/10 we placed reliance on assignments carried out by Internal Audit in the following areas:-

- SUMS audit and audit of FES returns
- Corporate governance

5.4 Systems of Internal Control

The respective responsibilities of the College and ourselves as auditors are set out in Appendix 2.

Through the results of our own testing, and our reliance on areas examined by Internal Audit, we have concluded that the fundamental key financial systems of the College are operating satisfactorily.

5.5 Going Concern

The results for the year show a deficit of £636k after budgeting for a £219k deficit, while the budget for year ended 31 July 2011 predicts a deficit of £103k based on the recovery plan.

It is our understanding that Board meetings will be held early in 2011, in which it is hoped to address issues of sustainability with a view to not only satisfying the Scottish Funding Council but also to plan for the next five years. We would underline the importance of these meetings as decisions are required to be made in the near future, particularly in relation to staffing levels, course provision and Estates strategy, so that general reserves are not further eroded and sufficient cash is forecast to be generated to meet all recurring commitments.

5.6 Other Governance responsibilities

Prevention and Detection of Fraud and Irregularities

The respective responsibilities of the College and ourselves as auditors are set out in Appendix 2. During the year, we have reviewed the overall arrangements through our review of systems.

The College also has in place a Prevention of Fraud Policy as part of their Quality Management Handbook, and a Fraud Response Plan, as part of their Financial Regulations.

In overall terms, we are satisfied that these arrangements are adequate.

Legality/Propriety

Again, the respective responsibilities of the College and ourselves as auditors are set out in Appendix 2.

Our review of the College's transactions and arrangements has revealed no areas of concern.

Standards of Conduct, Integrity and Openness

We have reviewed the College's arrangements which include:-

- Standing Orders of the Board of Management
- A Register of Members' Interests
- Information regarding their appointment to outside bodies and organisations is disclosed in the financial statements.
- A Code of Conduct for members and a code of conduct for staff as part of the Financial Regulations.

In overall terms we are satisfied that these arrangements are adequate.

6 ACTION PLAN

6.1 Observations on the College's Regularity Framework and Overall Control Environment

	Subject	Grade
1	Compliance with bank loan covenants	**2**
2	Fixed asset disposals	**3**
3	Over-depreciation of fixed assets	**3**
4	Accuracy of debtors/creditors	**2**
5	Property depreciation accounting policy	**3**

We have used the following grading system to indicate the significance of the matters we have raised and the priority that we believe should be given to our recommendations:

We have used the following grading system to indicate the significance of the matters we have raised and the priority that we believe should be given to our recommendations:

Grade 1: We believe these observations are particularly significant and that management should take prompt action.

Grade 2: These observations are significant but of a less urgent nature than Grade 1 observations. We believe that action needs to be taken within the agreed timescale.

Grade 3: Observations that merit attention, but are less significant than Grade 1 and 2 observations.

Issues noted

1 Compliance with bank loan covenants		Grade 2
Issue Although the bank is not recognising the breach of the loan covenants in the year, technically there was a breach according to the loan covenants. Also, the budget for 2010/11 is for a deficit which could further breach the loan covenants.		
Recommendation Loan covenants should be reviewed regularly in line with financial information to ensure that these are not breached. To ensure compliance with FRS25, the bank should be contacted when the breaches are identified to obtain a waiver of breach of covenants, otherwise the debt may have to be disclosed as fully <1yr.	Management response The bank has been fully informed of the College's operating performance both in the past and the present, and outturn monitoring is now more formalised. Financial information being given to the bank is considered adequate It has been given full details of the capital expenditure engagements and been given regular cash flows since early 2010. Relationship with the bank remains sound and there has been no indication that the covenant breach clauses will be invoked apart from higher interest. Indeed the bank has indicated that it may provide a more lenient covenant.	Action by whom: Director of Finance Deadline: On-going
2 Fixed asset disposals		Grade 3

Issue Fixed asset disposals due to demolition of certain areas of the estate were not identified until the audit process had begun		
Recommendation The fixed asset register should be reviewed on a monthly basis for items which should be written off, particularly when capital expenditure results in the scrapping of old assets.	Management response At present fixed asset additions is the priority for Finance working on fixed assets, due to large estates work. The demolished assets were unusual one-offs and not likely to re-occur often. Current procedures are considered adequate	Action by whom: N/A Deadline: N/A
3 Over-depreciation of fixed assets		Grade 3
Issue Fixed assets were depreciated beyond their £nil NBV which resulted in an overstatement of depreciation within the financial statements.		
Recommendation A control should be implemented within the fixed asset register which does not allow assets to be depreciated after they have reached £nil NBV.	Management response This was human error and at present using spreadsheets there is no control able to be implemented. In check procedures this was not picked up by Director of Finance due to time pressures in getting draft accounts to auditors about three weeks earlier than previously done Current procedures are considered adequate	Action by whom: N/A Deadline: N/A
4 Accuracy of debtors/creditors		Grade 2

<table>
<tr><td colspan="3">Issue

During the audit process it was identified that a number of balances within prepayments/accrued income and accruals/deferred income had either been overstated or understated.</td></tr>
<tr><td>Recommendation

Each balance sheet item should be reviewed in detail for accuracy with adjustments made prior to the audit beginning.</td><td>Management response

Bad debt provision wrongly posted in drafts – this has been addressed. Credit notes to be reviewed.

Other adjustments were mostly putting accounts on to a more conservative basis</td><td>Action by whom:

Finance Supervisor and Director of Finance
Deadline: Mid-late September when doing year-end procedures</td></tr>
<tr><td>5 Property depreciation accounting policy</td><td></td><td>Grade 3</td></tr>
<tr><td colspan="3">Issue

Certain property continues to be depreciated over a lifespan of over 50 years which is not in accordance with FRS15.</td></tr>
<tr><td>Recommendation

Property should be depreciated over a maximum of 50 years.</td><td>Management response

With demolitions, this no longer relates to many college properties.

No further action proposed</td><td>Action by whom:

N/A

Deadline:
N/A</td></tr>
<tr><td>6 Consents for bank borrowings</td><td></td><td>Grade 1</td></tr>
</table>

<table>
<tr><td colspan="3">Issue

SFC consent for borrowings from Clydesdale Bank plc expires prior to the date indicated in the College recovery plan where such borrowings will be able to be repaid out of other resources.</td></tr>
<tr><td>Recommendation

North Highland College should submit a further application for consent covering a period consistent with the requirement indicated in the current financial projections.</td><td>Management response

Clydesdale Bank, Lloyds and SFC get quarterly updates together with cash flow projections. The issue of overdraft pressures has been flagged up well in advance for discussion, action and resolution with SFC and Clydesdale. Meeting with Clydesdale due end of March 11, and representations to SFC will be made for front-loaded SUMS to cover likely excess above current overdraft limit.</td><td>Action by whom:

Director of Finance

Deadline: On-going</td></tr>
</table>

The North Highland College

Annual Report for the Year Ended 31 July 2010

Appendices for Management Information

RSM Tenon

Appendix 1

Independent auditor's report to the members of the Board of Management of the North Highland College, the Auditor General for Scotland and the Scottish Parliament

We have audited the financial statements of The North Highland College for the year ended 31 July 2010 under the Further and Higher Education (Scotland) Act 1992. These comprise the Income and Expenditure Account, the Balance Sheet, the Cash Flow Statement and Statement of Total Recognised Gains and Losses and the related notes. These financial statements have been prepared under the accounting policies set out within them.

This report is made solely to North Highland College and to the Auditor General for Scotland the parties in accordance with sections 21 and 22 of the Public Finance and Accountability (Scotland) Act 2000. Our audit work has been undertaken so that we might state to those two parties those matters we are required to state to them in an auditor's report and for no other purpose. In accordance with the Code of Audit Practice approved by the Auditor General for Scotland, this report is also made to the Scottish Parliament, as a body. To the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than North Highland College or the Auditor General for Scotland, for this report or the opinions we have formed.

Respective responsibilities of the Board of Management, Principal and auditor

The Board of Management and the Principal are responsible for preparing the Annual Report and the financial statements in accordance with the Further and Higher Education (Scotland) Act 1992 and the Accounts Direction issued there under by the Scottish Funding Council which requires compliance with the Statement of Recommended Practice on Accounting in Further and Higher Education Institutions. They are also responsible for ensuring the regularity of expenditure and income. These responsibilities are set out in the Statement of the Board of Management's Responsibilities.

Our responsibility is to audit the financial statements 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.

We report our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Further and Higher Education (Scotland) Act 1992 and the Accounts Direction. We also report if, in our opinion, the Report of the Board of Management is not consistent with the financial statements, if the body has not kept proper accounting records, or if we have not received all the information and explanations we require for my audit. We also report whether in all material respects

- the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers;
- funds provided by the Scottish Funding Council have been applied in accordance with the Financial Memorandum dated 1 January 2006 and any other terms and conditions attached to them for the year ended 31 July 2010; and
- funds from whatever source administered by the college for specific purposes have been properly applied for the intended purposes.

We review whether the Corporate Governance Statement reflects the college's compliance with the requirements of the Scottish Funding Council. We report if, in our opinion, it does not comply with these requirements or if it is misleading or inconsistent with other information we am aware of from our audit of the financial statements. We are not required to consider, nor have we considered, whether the statement covers all risks and controls. Neither are we required to form an opinion on the effectiveness of the college's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. This other information comprises only the Report of the Board of Management and Statement of the Board of Management's Responsibilities for the Accounts .We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with the Public Finance and Accountability (Scotland) Act 2000 and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board as required by the Code of Audit Practice approved by the Auditor General for Scotland. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of expenditure and income included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Board of Management and Accountable Officer in the preparation of the financial statements, and of whether the accounting policies are appropriate to the college's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error, and that in all material respects the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

Financial statements

In our opinion

- the financial statements give a true and fair view, in accordance with the Further and Higher Education (Scotland) Act 1992 and the Accounts Direction, of the state of affairs of the college as at 31 July 2010 and of its surplus, total recognised gains and losses and cash flows for the year then ended; and

- the financial statements have been properly prepared in accordance with the Further and Higher Education (Scotland) Act 1992 and the Accounts Direction made thereunder.

Regularity

In our opinion in all material respects

- the expenditure and income shown in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by the Scottish Ministers
- funds provided by the Scottish Funding Council have been applied in accordance with the Financial Memorandum dated 1 January 2006 and any other terms and conditions attached to them for the year ended 31 July 2010; and
- funds from whatever source administered by the college for specific purposes have been properly applied for the intended purposes.

RSM Tenon Audit Limited
5 Kings Place

Perth
PH2 8AA

Date

<u>Appendix 2</u>

Our respective responsibilities

Financial Statements

It is the responsibility of the College to:-

- *Ensure the regularity of transactions by putting in place systems of internal control.*
- *Maintain proper accounting records.*
- *Prepare financial statements which present a true and fair view of the financial position of the* College *and its expenditure and income in accordance with the SORP.*

We are required to give an opinion on:-

- *Whether the accounts present a true and fair view of the financial position of the College and its expenditure and income for the period.*
- *Whether the accounts have been prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements.*

In carrying out this responsibility we provide reasonable assurance that, subject to the concept of materiality, the financial statements:-

- *Are free from material misstatements.*
- *Comply with the statutory and other requirements applicable.*
- *Comply with relevant requirements for accounting presentation and disclosure.*

Corporate Governance

Corporate Governance is concerned with structures and processes for decision making, accountability, control and behaviour at the upper levels of the organisation. Three fundamental principles apply:-

- *Openness*
- *Integrity*
- *Accountability*

We have a responsibility to review and, where appropriate, report findings on the College's corporate governance arrangements as they relate to:-

- *The College's review of its systems of internal control including its reporting arrangements.*
- *The prevention and detection of fraud and irregularity.*
- *Standards of conduct and arrangements in relation to the prevention and detection of corruption.*
- *The financial position of the College.*

Our work has focused upon our review of the College's Risk Management arrangements, systems of internal control, Internal Audit, consideration of the controls to prevent and detect fraud and corruption, and the audit of the final accounts.

In giving an opinion on the accounts our audit strategy requires us to ensure that the fundamental financial systems are adequately covered each year. Whenever possible, to avoid duplication of effort, we seek to rely on the work of Internal Audit.

However, our work cannot cover every financial activity and accounting procedure. We plan and perform our audit to give reasonable assurance that the financial statements are free from material misstatement and that they comply with statutory and other requirements.

Risk Management

The College's Responsibility

It is the responsibility of the College to identify and address its operational and financial risks and to develop and implement proper arrangements to manage them, including adequate and effective systems of Internal Control.

The Role of RSM Tenon Audit Limited
In planning our audit, we consider and assess your risk management arrangements as part of our assessment of audit risk. This helps us to tailor our audit plans so that they are both appropriate to your circumstances and directed to the areas of greatest risk.

Systems of Internal Control
The College's Responsibility
The College has a responsibility to develop and implement systems of internal control, including risk management, and systems of financial, operational and compliance controls.
Three components of a system of risk management are:-

- *Timely identification of key business risks.*
- *Consideration of the likelihood of the risks crystallising and the significance of the consequential financial or other impact.*
- *Establishment of priorities for the allocation of resources to control risk and the setting and communicating of key objectives.*

The monitoring of controls provides assurance that managers are assessing the existence of risk and the effectiveness of controls over the risks. The internal audit arrangements form an important part of management's monitoring and review of internal control arrangements, and in ensuring that appropriate monitoring of risks and controls takes place.

The role of RSM Tenon Audit Limited
In broad terms the external auditor is expected to assess the internal controls in the College's main financial systems and report on any significant control weaknesses identified. This does not absolve management from its responsibility for the maintenance of an adequate internal control system.

Prevention and Detection of Fraud and Irregularities
The College's Responsibility
It is the responsibility of the College to establish arrangements to prevent and detect fraud and other irregularity. It therefore needs to put in place proper arrangements for:-

- *Developing, promoting and monitoring compliance with standing orders and financial instructions.*
- *Developing and implementing strategies to prevent and detect fraud and other irregularity.*
- *Receiving and investigating allegations of breaches of proper standards of financial conduct or of fraud and irregularity.*

The Role of RSM Tenon Audit Limited
External audit is required to review the adequacy of the measures taken by the College, to test compliance, and to draw the attention of management to any weaknesses or omissions.

Legality
The responsibility for ensuring the legality of all activities and transactions rests with the College.

The responsibility of the external auditor is to review the legality of the College's transactions and to be aware of the requirements of statutory provisions.

Standards of Conduct, Integrity and Openness
Propriety is concerned with the way in which public business should be conducted. It is concerned with fairness and integrity. It must be recognised that the public view of propriety is as much about perception as reality.

The College's Responsibility

It is the responsibility of the College to ensure that its affairs are managed in accordance with proper standards of conduct. It needs therefore to put in place proper arrangements for:-

- *Implementing and monitoring compliance with appropriate guidance on standards of conduct.*
- *Expressing and promoting appropriate values and standards across the organisation.*
- *Developing, promoting and monitoring compliance with Codes of Conduct that advise Members, Officers or Managers of their personal responsibilities and expected standards of behaviour.*
- *Developing, promoting and monitoring compliance with standing orders and financial instructions.*

The Role of RSM Tenon Audit Limited
It is our role to consider whether the College has put in place adequate arrangements to maintain and promote proper standards of financial conduct and to prevent and detect corruption. We discharge this duty by reviewing and where appropriate examining evidence that is relevant to these arrangements.

Financial Position
The College's Responsibility
It is the responsibility of the College to conduct its affairs and put in place proper arrangements to ensure that the financial position is soundly based having regard to:-

- *Financial monitoring and reporting arrangements.*
- *Compliance with statutory financial requirements and achievement of financial targets.*
- *Levels of balances and reserves.*
- *The impact of planned future policies and known or foreseeable future developments.*

The Role of RSM Tenon Audit Limited
It is our role to consider whether the College has established adequate arrangements. We are also required to have regard to going concern as part of the audit of the financial statements. In carrying out this responsibility we consider:-

- *Financial performance in the year.*
- *Compliance with statutory financial requirements and financial targets.*
- *Ability to meet known statutory and other financial obligations actual or contingent.*
- *Responses to known developments which may have an impact on the College's financial position.*

Appendix 3

Accounting for pension liabilities – FRS 17

The Chancellor announced in his emergency budget on 22 June 2010 that, from April 2011, increases in public sector pensions will be linked to the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) which is currently used. The first pension increase based CPI will be effective at April 2011. Government has indicated that future pension increases will apply to both pensions earned to date and future accruals.

It is anticipated that CPI will be significantly lower than RPI and this will reduce the value of the pension liabilities and the provisions included within the financial statements.

Consumer Prices Index: The CPI is the main measure of consumer price inflation and is the basis for the government's inflation target that the Bank of England's Monetary Policy Committee is required to achieve. It is calculated according to European Regulations.

Retail Prices Index: The RPI is the most long standing measure of inflation in the UK and statistics are available from 1947. It is still used for a variety of purposes by both government and external users, including the indexation of various incomes and prices, index-linked gilts and, until this budget, indexing pensions and benefits.

Differences between indices: The main differences are as follows.

RPI includes elements of housing costs which make up to 25% of its constituents, including mortgage interest payments. The RPI can therefore be heavily influenced by the housing market, which dominated the periods when RPI fell below CPI in the early 90s and in 2009/10.

There is also a more persistent effect from a different method of calculation which biases RPI above CPI by around 0.5% pa. Historically RPI has been higher, mainly reflecting the importance of the formula effect. In the past 20 years RPI has exceeded CPI by 0.7% pa on average.

Accounting periods ending on or after 22 June 2010

For employers with an accounting period ending on or after 22 June 2010 (the date of the emergency budget) pension increases are assumed to be in line with CPI. The change, which represents a gain in the net pension reserve, is accounted for as a negative past service cost.

The rationale for treating the change as a negative past service cost is that this is a change to benefits – that is, pension scheme members will expect a lower benefit following the change than before the change.

However, the proposed accounting treatment has come under scrutiny from public sector organisations and auditors alike since there is no consensus over whether the change should be accounted through the Income and Expenditure Account (I&E) or through the Statement of Recognised Gains and Losses (STRGL). As a result the matter was referred to the Urgent Issues Task Force (UITF) to provide guidance.

UITF Draft Abstract Information Sheet 90 was issued on the 13 October and is available through the web link http://www.frc.org.uk/asb/uitf/pub2392.html. Responses are requested by 10 November. The Final Abstract is envisaged to be published before the end of 2010 and will be the final determinant as to the accounting treatment required it is hoped.

The draft Abstract proposes that where there is a change in the obligation to the member, there is a benefit change which is accounted for as a past service cost. Where the obligation to the member is not changed, any change in the Scheme liabilities arises from a change in assumptions applied to measure those liabilities. The key to the accounting is whether there is a change in the members' obligation.

The UITF are proposing an approach that reflects the following:

- If the pension scheme rules/trust deed explicitly link pension increases to RPI and the scheme rules then change this to CPI, this should be treated as a change of benefit and any past service credit arising posted to I&E. *This change should be recognised in the accounting period when necessary consultations have been concluded. Consultations are concluded when the change has been agreed and announced, likely to be 2011*;
- If the scheme rules are silent on specifying an index but where there is a general presumption of an annual cost of living increase any change in measurement of inflation such as the change from RPI to CPI should be treated as a change of assumption with the credit taken through the STRGL;
- If the scheme rules are silent on specifying the index but where there is a constructive obligation to pay pension increases linked to RPI then the change to CPI should be treated as a change of benefit and any past service credit arising booked to I&E.

The key judgmental area therefore, if the Abstract is finalised as drafted, will be whether there is a '**constructive obligation**' for the college to pay RPI for pension increases. The key clauses within the appendix to the draft Abstract that cover this are:

> *A9. The UITF noted that the distinction between changes in benefits arising when a trust deed is specifically linked to RPI, compared to changes in benefits with an unspecified measure of inflation, should be considered in terms of whether the obligation to the member is being changed.*
>
> *A10. The UITF noted that a constructive obligation to the member for pensions linked to RPI could exist where the RPI is not embedded into the trust deed but where associated literature made reference to the RPI or where the general understanding of scheme members was that increases would be calculated using the RPI. The nature of any constructive obligation to members could vary and would depend on a number of factors, including the nature and content of the communications with members.*
>
> *Consideration would need to be given to whether any associated literature made reference to the RPI or whether the general understanding of scheme members was that increases would be calculated using the RPI.* ***However, a feature of a constructive obligation would be that the agreement of scheme trustees and/or members would generally be needed before any change could be made.*** *This change should be recognised in the accounting period in which the agreement of the scheme trustees and/or members was obtained, which for many colleges is unlikely to be year ended 31 July 2010.*

Most if not all FE Colleges have their LGPS as the main scheme for providing non academic retirement benefits. These schemes in turn have the same legislative origin and share the same rules to all intents and purposes. These clearly do not have an explicit link to RPI but instead refer to the Pensions (Increase) Acts of 1971 and 1974 which ultimately lead to the annual Pensions Increase (Review) Orders issued by Statutory Instrument (SI) around the end of the year. It is these SIs that use the RPI at 30 September each year and are intended to use CPI hereafter.

The same cannot be said for the pension scheme literature that accompanies the LGPS in each area and which may form a key source of evidence for determining whether a constructive obligation has been created.

The criteria for a 'constructive obligation' are set out in Paragraph 20 of FRS17 which states:

"Defined benefit scheme liabilities should be measured on an actuarial basis using the projected unit method. The scheme liabilities comprise:

> (a) Any benefits promised under the formal terms of the scheme;
> and
> (b) Any constructive obligations for further benefits where a public statement or past practice by the employer has created a valid expectation in the employees that such benefits will be granted."

Based on a sample of LGPS literature reviewed to date there is clear reference made to RPI and therefore in accordance with FRS 17 a constructive obligation established that would in normal circumstances see the credit adjusted through the I&E.

However, based on the clarifying definition contained within the UITF Abstract (highlighted in bold above) the change does not meet these refined terms and therefore the adjustment would be expected to be made through the STRGL.

Each college will have to examine its own circumstances and draw a conclusion as to whether there is a constructive obligation or not and present that case to their auditors. What will be paramount is that whichever treatment is adopted, then the rationale for that treatment should be explicitly summarised in the accounts of the College.

At the date of these financial statements, the Urgent Issues Task Force (UITF) is in the process of consulting widely on the accounting treatment for this change and is expected to issue a final Abstract towards the end of 2010. Should the Abstract call for a different accounting treatment it may be necessary to reflect any change as a prior period adjustment in the financial statements for the following year.

Appendix 4

International Financial Reporting Standards (IFRS) in Further and Higher Education

The Statement of Recommended Practice (SORP) for Further and Higher education institutions is based on UK General Accepted Accounting Practice (GAAP). At the moment the SORP has assumed that the education convergence to IFRS will follow that of UK GAAP, although it should be noted that under international standards there is no equivalent sector specific guidance such as SORPs and therefore more emphasis may be placed on a governing body such as the SFC to provide sector interpretation.

Whilst the Government sector has moved towards full implementation of international standards, there is currently no indication as to the date from which they will apply to the FE sector. The latest indications suggest an implementation in 2014/15.

The possible timeline for IFRS in Further and Higher Education

Year to 31 July 2014	Year to 31 July 2015
↓	↓
Comparative IFRS year end	**First IFRS year end**
2013/14 comparatives will need to be calculated	2014/15 Annual report (+ 2013/14 comparatives)

What does moving to IFRS mean for Further and Higher Education?

Significant differences	Some differences	No significant differences
Fixed assets **Leases** **PFI** **Group accounts** **Format of accounts** **Employee benefits** **Financial instruments**	**Related party disclosures** **Impairment** **Intangible assets** **Investment properties** **Disclosure generally**	**Stocks** **Post balance sheet events** **Accounting for government grants** **Provisions**

Appendix 5

College Covenants

With diminishing public funds available and a limited opportunity to develop alternative funding streams, some colleges with external borrowings are likely to experience increasingly greater difficulties in complying with the covenants within their loan agreements, and some may indeed breach those covenants.

In the event that a breach has occurred which entitles the lender to demand repayment of the loan, then under Financial Reporting Standard 25, any amounts that have previously been classified in the accounts as falling due after more than one year will be reclassified as current liabilities.

This will be the case irrespective of whether the bank knows of the breach or has issued a notice of breach to the lender.

Colleges can avoid this reclassification if before the year end they obtain a waiver of the entitlement to demand repayment and are given a grace period of at least one year from the balance sheet date to correct the breach.

As a consequence, we recommend that colleges implement a monitoring system to ensure that before the year end any potential breaches are identified, and the lender is contacted either to:

- obtain a suitably worded waiver from their lender; or
- agree an amendment to the covenants in the loan agreement.

Our discussions with bankers to date have shown a willingness to be sympathetic to colleges who breach loan agreements, particularly those arising as the result of changes to accounting standards not foreseen when the loans were put in place. We will be happy to discuss with you what sort of monitoring procedure might be most appropriate for your college and - should a potential breach be identified - to discuss with you the best course of action to avoid the reclassification of your loans as current liabilities.