The North Highland College

Annual Report for the Year Ended 31 July 2011
To the Board of Management and the Auditor General for Scotland

RSM Tenon

160 Dundee Street
Edinburgh
EH11 1DQ
Issued: 7 March 2012

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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 £32k (previous year £635k). Additional costs in the previous year included an exceptional loss on demolition of fixed assets (£156K). In addition, it was reported that various budgeted income streams did not deliver as expected in that year.

- The college balance sheet has net assets of £15,132k (previous year £8,415k) and it has moved into a net current asset position of £240k (previous year £1,659k net current liabilities). The 2010 deficit on net current assets was caused by the reclassification of long term bank debt due to a breach of financial covenants, which has subsequently been rectified.

- Cash in hand has increased to £1,185k (previous year £633k).

- The budget for 2011-12 presented to the Board in Autumn 2011 predicted a deficit of £400k and a significant additional cash requirement in summer 2012. Approval of the financial statements was deferred at the December meeting of the Board of Management as it was considered unclear at that time whether the college would be in a position to meet it's liabilities as they fell due over the 12 month period following the meeting.

- A revised budget and cash flow projection has been prepared and was approved and adopted by the Finance and General Purposes Committee on 29 February 2012. As a result of cost savings and the recognition of certain items of income which were previously regarded as insufficiently certain for inclusion within the budget, the College is now projecting a break even position for 2011/12.

1.2 Financial statements

- It is our intention to issue an unqualified audit opinion on the accounts of The North Highland College for the year ended 31 July 2011.

1.3 Corporate Governance

- In our fifth year of appointment we have carried out an overall review of Corporate Governance arrangements in the year, and have no specific recommendations. There appears to be an adequate and appropriate system of Corporate Governance in place.

1.4 Action Plan

We make recommendations relating to:

- Fixed asset disposals

- Over-depreciation of fixed assets
- Accuracy of debtor/creditor balances
- Property depreciation accounting policies

2 INTRODUCTION

This is the fifth 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 2011 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 2010/11 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 2010-11

The financial statements reflect a deficit for the year of £32k (previous year £635k). This compares favourably to the budgeted £103k deficit.

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

- The cost savings achieved in line with the colleges recovery plan.

The college continues to maintain a positive overall balance sheet position, with net assets of £15,132k. However, this includes deferred capital grants of £15,055k. The college has a net current asset position of £240k at year ended 31 July 2011 compared to a net current liability position of £1,659k in the prior year. Cash held is £1,185k at the year end, but £1,000k was received in July from the SFC as a loan to the college to assist in the payment of invoices in respect of the two developments ongoing at the year where timing of funding and payment of expenses was not in line, therefore this high level of cash paints a false position of the College's cash position. The loan however is not due for repayment until 31 January 2012. A further loan of £1,000k was paid over in August 2011 and falls repayable in July 2012.

3.3 Reserves

The college income and expenditure reserves have increased to £1,169k at 31 July 2011, (previous year £1,043k). On incorporation of the pension reserve and the revaluation reserve, total reserves have now fallen to £77k (previous year £755k).

3.4 Financial Plan 2011-12

The forecast for 2011-12 approved by the Finance and General Purposes committee on 29 February 2012 predicts a surplus of £712.

The accompanying cash flow projection predicts a minimum cash balance at 31 July 2012 of £13,155, following repayment of the short term loan referred to at 3.2 above.

3.5 Capital expenditure plans

Estates related capital expenditure is expected in 2011/12 on the Engineering Skills Centre which started in summer 2010. At the year end £706,045 was committed to be spent on this project.

3.6 Recurrent grant allocation

The Scottish Funding Council (SFC) has confirmed recurrent grant income and fee waiver income of £7,887k for the year to 31 July 2012. This is a slight reduction in the amount received for the year to 31 July 2011 which was an allocation of £7,957k of recurrent grant income and 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 expect to issue an unqualified audit opinion on the accounts of The North Highland College for the year ended 31 July 2011. A copy of our proposed 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.

Whilst draft financial statements and a draft audit report were presented to the Board of Management in December 2011, following discussions between Board members, the Principal and ourselves as auditors, it was agreed that there was insufficient certainty over the College's going concern position to enable the financial statements, prepared on a going concern basis, to be approved at that time.

Following consultations with Scottish Funding Council and Audit Scotland, it was agreed that the Financial Statements would be represented for approval at the meeting of the Board of Management scheduled for 21 March 2012.

We are grateful to all of those in the Finance and other departments who helped us with our work, 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 £147,000.

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 £3,000.

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:

Going Concern

In the balance sheet for the year ended 31 July 2010, the College's bank borrowings were reclassified into Current Liabilities due to a breach of the financial covenants contained within the bank loan agreement at that time. Subsequently, bank covenants have been renegotiated and the College was not considered to be in breach of the new covenants at 31 July 2011.

The College has set a budget which predicts a £712 surplus for the year and a minimum cash balance of £13,155 in July 2012.

It is understood that the projected result for the year would put the College in compliance with the financial covenants attached to it's bank loan at the end of the 2011/12 financial year. The College is required to ensure that general reserves remain in excess of £900k. At 31 July 2011, general reserves were £1,169k

The Fiinance and General Purposes Committee have considered the College's budget and cash flow projections, together with information provided by the Chair and Principal in respect of

- Management accounts for the 6 months ending 31 January 2012 ;
- The terms and conditions of EU funding and the contribution this project funding is expected to make to the College's overhead costs during 2011/12 and 2012/13
- Cost savings compared to the December 2011 draft budget which have been identified by College management.

No specific disclosures have been included within the financial statements as to any potential grounds that North Highland College might not meet the criteria of a going concern.

Based on these considerations, the finance committee has recommended to the Board that they formally accept the Annual Report and Financial Statements.

International Financial Reporting Standards

We would draw to your attention the information in Appendix 3 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			
The audit of 2010/11 student activity data by Wyle & Bisset 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***

Issue	Audit risks	Planned audit approach	Outcome
FRS 17 Accounting for Pensions			
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***

Issue	Audit risks	Planned audit approach	Outcome
Capital Expenditure			
The College is currently undertaking two significant Capital Projects and expects to have incurred the majority of expenditure of budget of £11m during the year ended 31 July 2011.	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 2011.	Provisions recognised in the draft financial statement may 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 2011 financial accounts Review the circumstances of any provisions made to ensure recognition is consistent with the requirements of FRS12	***We have made recommendations based on the substance of certain provisions included within the draft statutory accounts and adjusting entries have been agreed with the College.***

Issue	Audit risks	Planned audit approach	Outcome
Going Concern			
The College are working through a Recovery Plan against a back – drop of SFC funding cuts	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.	***Satisfactory as outlined on page 7.***
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.	***Satisfactory.***

ADJUSTED AND UNADJUSTED ERRORS

4.6 Actual Audit Adjustments

Posted adjustments:	*£'000*
Reduction in provisions for restructuring costs	95
Correction of allocation of income received to deferred capital grants	(65)
Net impact of posted adjustments	30

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*
Reallocation of negative debtors in the trade debtors ledger	NIL
Trade debtor credit notes issued post year end	(11)
Subscription prepayment omitted	24
Error in the accrued income testing	13
Extrapolated error in the deferred income testing	21
Reclassification of VAT out of trade creditors balance	NIL
Difference in dilapidations accrual and balance provided	6
Removal of motor vehicles from the fixed asset register	NIL
Removal of SITS negative debtor account	9
Accruals in respect of cost provisions not compliant FRS 12	20
Net impact of potential adjustments	82

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. During the initial part of the period under review, Chiene and Tait C.A. provided the colleges internal audit function.

Wylie & Bisset were appointed as the College's new internal auditors in June 2011.

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. However, we note that due to the ending of the College's relationship with Chiene and Tait CA, the full, planned internal audit programme for the year was not completed. A new rolling programme of internal audit has been agreed with the incoming audit firm which, we understand, we take account of the areas planned for audit during 2010/11.

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

- SUMS audit and audit of FES returns

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 £62k after budgeting for a £103k deficit, while the budget for year ended 31 July 2012 predicts a deficit of £400k.

We have also examined the cash flow projections prepared by management which include repayment of short term borrowings from SFC and have discussed the conclusions from our review with the Audit and Risk Management Committee. (Refer also to Para 4.5 of this document)

We have briefed the Finance Committee and the Audit and Risk Management Committee (as set out in Appendix 3) regarding the factors they are required to consider in order to make an assessment as to the appropriateness of the going concern basis, and are satisfied that they have reviewed all available information in the light of our briefing.

It is our understanding that Board meetings will be held in 2012, 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	Fixed asset disposals	**3**
2	Scheduled internal audits not carried out	**2**
3	Accuracy of debtors/creditors	**2**
4	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 Fixed asset disposals		Grade 3
Issue Fixed asset disposals such as motor vehicles were not identified until the audit process had begun, no review had been carried out of assets in the fixed asset register for assets no longer in use.		
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 With the resources available in the Finance Department, the last few years has seen a focus on control of estates budgets re CFEE and ETEC projects. Once these are complete, then a more focused review of old assets will take place. No net financial effect on Balance Sheet	Action by whom: Director of Finance Deadline: No further adjustment proposed to accounts; for 2011-12 work

2 Scheduled internal audits not carried out		Grade 2
Issue During the year there are scheduled Internal audits which are required to be carried out, however due to issues with the college's internal auditors, they were not carried out leaving the college less compliant with corporate governance in this area.		
Recommendation A full programme of scheduled internal audits should be carried out to ensure the college stays compliant with best practice in the sector for corporate governance.	Management response Discussed with Wylie Bisset (College's new internal auditor) and plan in place for needs of College	Action by whom: Audit Committee Deadline: On-going
3 Accuracy of debtors/creditors		Grade 2
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.		
Recommendation Each balance sheet item should be reviewed in detail for accuracy with adjustments made prior to the audit beginning. Where provision is being made in respect of expected future cash outflows, management should ensure that the provisions being made meet the requirements for recognition set out in FRS12 (Provisions, Contingent Liabilities and Contingent Assets)	Management response Some provisions included due to financial uncertainty and possible further restructuring, and bank covenant position. In the College's view the financial outlook has to be balanced with prudence	Action by whom: Director of Finance Deadline: No further adjustment proposed for year-end accounts

4 Property depreciation accounting policy		Grade 3
Issue Certain property continues to be depreciated over a lifespan of over 50 years which is not in accordance with FRS15.		
Recommendation Property should be depreciated over a maximum of 50 years.	Management response For properties with a life > 50 years the annual depreciation charge for 2010-11 was based on 50 years. However no additional depreciation for previous years was included, and no additional adjustment proposed	Action by whom: Director of Finance Deadline: No further adjustment proposed. For on-going statutory accounts annual depreciation on properties is now based on 50 year life, but no intention to restate back-dated depreciation

The North Highland College

Annual Report for the Year Ended 31 July 2011

Appendices for Management Information

RSM Tenon

Appendix 1

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

We have audited the financial statements of North Highland College for the year ended 31 July 2011 under the Further and Higher Education (Scotland) Act 1992. The financial statements comprise the Income and Expenditure Account and Statement of Total Recognised Gains and Losses, the Balance Sheet, the Cash Flow Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the parties to whom it is addressed in accordance with the Public Finance and Accountability (Scotland) Act 2000 and for no other purpose. In accordance with paragraph 123 of the Code of Audit Practice approved by the Auditor General for Scotland, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Respective responsibilities of the Board of Management and auditor

As explained more fully in the Statement of Responsibilities of the Board of Management set out on pages 12-13, the Board of Management is responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and is also responsible for ensuring the regularity of expenditure and receipts. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Auditor General for Scotland. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We are also responsible for giving an opinion on the regularity of expenditure and receipts.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts, disclosures, and regularity of expenditure and receipts in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the body's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Board of Management; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on 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 directions made thereunder by the Scottish Funding Council of the state of the body's affairs as at (insert date) and of its surplus for the year then ended;

- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and

- have been prepared in accordance with the requirements of the Further and Higher Education (Scotland) Act 1992 and directions made thereunder by the Scottish Funding Council.

Opinion on regularity

In our opinion in all material respects:

- the expenditure and receipts 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 (insert date) and any other terms and conditions attached to them for the year ended (insert date); and

- funds from whatever source administered by the body for specific purposes have been properly applied for the intended purposes.

Opinion on other prescribed matters

In our opinion the information given in the Operating and Financial Review and the Statement of Corporate Governance included in the Annual Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We are required to report to you if, in our opinion:

- adequate accounting records have not been kept; or

- the financial statements are not in agreement with the accounting records; or

- we have not received all the information and explanations we require for our audit; or

- the Statement of Corporate Governance and Internal Control does not comply with Scottish Funding Council requirements.

We have nothing to report in respect of these matters.

RSM Tenon Audit Limited
160 Dundee Street
Edinburgh
EH11 1DQ

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

We have summarised below certain issues we have identified which we believe likely to impact on the Scottish College sector in the foreseeable future.and which the Board may wish to consider when discussing the College's current performance and future plans.

1 Going concern

With funding to the SFC under pressure from the Scottish Government we believe it is useful to set out for the Board a brief summary of issues surrounding the Going Concern assertion in relation to financial statements in the College Sector.

It is clear that SFC will continue to support colleges in financial difficulties and work with them to identify potential solutions. However, they are unable to simply refinance an institution through significant one-off revenue grants, or provide funds to support mergers.

Therefore, when preparing the year end financial statements there is a far greater focus, by both Board and auditors, on the appropriateness of adopting the going concern basis used in the preparation of financial statements.

It is the responsibility of the Board to assess the College's ability to continue as a going concern. It is our responsibility as auditors to consider whether that assessment is appropriate, and whether the financial statements include the disclosures necessary to show a true and fair view.

The Boards' assessment must cover a period of at least twelve months from the date of approval of the financial statements. Furthermore, when Governors are aware of material uncertainties related to events or conditions that may cast significant doubt upon the College's ability to continue as a going concern, those uncertainties shall be disclosed.

Some of the key matters to consider when making a decision are as follows:

- Available head room in bank facilities for the next 12 – 18 months and impact of any anticipated breach in bank covenants;
- The robustness of the assumptions used when preparing the cash flow, which need to be realistic;
- Reductions in funding body income both FE and HE;
- The expectation that colleges can increase and recover fee income charged to adults and employers;
- Increased competition for funding body income, especially from private training providers and academies;
- Accuracy of past forecasts and management accounts;
- The consistent application of accounting policies adopted;
- Appropriateness of disclosures made within the financial statements.

Cash flow assumptions: Are they robust?

The following are some questions you may wish to pose when assessing the college's cash flow projections and budgets in support of the going concern assessment:

Reducing funding body income

Under-performance – what will be the timing/quantum of clawback or adjustment to future funding allocation?

What is the impact from local demographics for 16-18 and position of the labour market on all age groups?

Funding rates per qualification are reducing; will this lead to an overall decrease in income, or will the college be able to increase delivery to compensate?

Impact from HE sector

How will reduced public funds to universities impact available income to the college, both direct and franchised?

What will be the effect on Consortium arrangements? (Note for instance that the consortium agreement may share costs and penalties arising from over-recruitment by a partner).

Tuition fees

Are the increases realistic compared to prior years?

Are the debts recoverable?

Restructuring

Accuracy of the payments/savings - Are the calculations accurate and is the list of staff impacted complete?

Potential litigation – What is the level of ongoing litigation and potential liability that may result? Have likely settlement payments been included?

Cashflow phasing - Is the phasing of the payments/savings correct?

Property costs

Capital projects & summer works – What is the timing of payments/works undertaken?

Backlog of maintenance works or position of planned maintenance programme – What is the latest position, cost and likely timing of corrective works?

Finance costs

Capital repayments – What is the timing of these payments or when does the payment holiday end?

Interest costs – What is the value and timing of interest costs and interest rate changes? Has any sensitivity analysis been completed?

Breach of bank covenants – Are the covenants monitored and has an appropriate value been included for an arrangement fee where a breach has occurred as well as the likely impact of an increased interest rate?

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

In the audit management letter for the year ended 31 July 2010 we commented on the likely implementation of International Financial Reporting Standards (IFRS) in the FE sector. Since then, some progress has been made. However, the final implementation arrangements remain unclear.

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.

The implementation date for IFRS had moved to 1 January 2014 so would not affect colleges until financial year 2014-15. However, if there is a need to consolidate the sector into the Whole of Government Accounts then this timetable is likely to be brought forward.

Financial Reporting Exposure Draft (FRED) 45 is the first step to the introduction of the Financial Reporting Standard for Public Benefit Entities (FRSPBE) it makes it quite clear that this is not to replace SORPS but to provide supplementary guidance on specific matters relevant to Public Benefit Entities.

It also clarifies that the FRSPBE applies in conjunction with the proposed Financial Reporting Standard for Small and Medium Sized Entities which is drafted essentially for commercial entities.

The FRED makes it clear that where there is a conflict between the FRSPBE and a SORP, the FRSPBE will take precedent so there will inevitably be updates to SORPS to bring their principles into line with the FRSME/FRSPBE.

3 Changes to student VISA system

The second set of changes to Immigration Rules affecting the student tier of the points based visa system came into effect on 4 July 2011. The first set of changes came into force on 21 April 2011 following the Home Secretary, Theresa May's, initial announcement regarding the amendments.

The changes have been introduced to address abuse of the immigration system and protect genuine students wishing to apply to study at legitimate colleges.

The changes, effective from 4 July, are:

- Work entitlements will be restricted to migrants studying at HEIs and publicly funded further education colleges only;
- The sponsorship of dependants will be restricted to those studying at postgraduate level at HEIs on courses lasting at least 12 months, and government sponsored students on courses lasting at least 6 months;
- Education providers will be required to vouch that a new course represents genuine academic progression;
- The Home Office will ensure that maintenance funds are genuinely available to the applicant, by introducing a declaration on the visa application form;
- The Home Office will commit to publish a list of financial institutions that it considers, on the basis of experience, not to satisfactorily verify financial statements in more than 50% of a sample of cases;
- A streamlined application process for low-risk nationals applying to attend courses with Highly Trusted Sponsors will be introduced;
- The list of courses for which students must receive ATAS clearance will be extended;
- The ability to deliver accountancy courses accredited by the Association of Chartered Certified Accountants (ACCA) to those sponsors accorded platinum or gold status by ACCA will be restricted; and
- The Home Office will clarify the position of overseas universities with campuses in the UK.

From 2012, institutions wishing to recruit overseas students will be required to demonstrate that they have 'current and satisfactory full inspection or audit' from the Quality Assurance Agency, Ofsted or the Independent Schools Inspectorate before applying to the UK Border Agency for Highly Trusted Sponsor Status.

4 Data protection

On 24 November 2010 the Information Commissioner issued the first financial penalties for data protection breaches under new regulatory powers granted in April this year. Hertfordshire County Council received a fine of £100,000 after a fax containing sensitive information on a child sex abuse case was misdirected to a member of the public in June 2010. Sheffield based advisory organisation A4e were also fined £60,000 for the loss of an unencrypted laptop containing the personal details of thousands of people.

These fines send a strong message to all organisations handling personal information and reflect that the Commissioner's office is committed to enforcing its new regulatory powers.