AUDITOR GENERAL

OVERVIEW REPORT

Overview of further education colleges in Scotland 2000/2001

PREPARED BY AUDIT SCOTLAND

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Overview of further education colleges in Scotland 2000/2001

A report to the Scottish Parliament by the Auditor General for Scotland

Auditor General for Scotland

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AGS/2002/2

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Exhibit 1: Sources of college income

Source of income	Percentage of total
SFEFC grants	68%
Education contracts and tuition fees	19%
Other income	13%

Source: SFEFC

2. This is my second overview report on the further education sector. The report has been prepared principally from information contained in reports prepared by the colleges' appointed auditors at the conclusion of their audits and from SFEFC's own work in monitoring the financial health of the sector.

Audit results

Auditors' opinions have drawn attention to the financial position of colleges

3. Auditors provided unqualified opinions on the 2000/01 accounts of 39 colleges. For the remaining colleges three of the auditors' opinions were qualified because individual colleges had not complied with accounting standards and one was qualified because the college had not complied with SFEFC's financial memorandum for colleges. Auditors of seven colleges drew attention to the fact that the accounts had been prepared on a going concern basis on the assumption that SFEFC's financial support to the colleges and access to bankers' overdraft facilities would continue.

[1] On 1 August 2001 Bell College of Technology became a higher education institution reducing the number of incorporated further education colleges from 43 to 42.

Overall financial control is generally good and any weaknesses are being addressed

4. Auditors generally found that the key financial systems in place at colleges were of a good standard. Where the auditors identified weaknesses they have agreed action plans with college boards of management to make the improvements necessary.

5. All colleges are required to provide statements in their accounts confirming that they have complied with the principles of the Combined Code on Corporate Governance and that the effectiveness of their internal financial controls has been reviewed. Each of the colleges complied with these requirements satisfactorily.

Colleges must continue to improve internal audit and accounting disclosure

6. SFEFC undertook a review of internal auditors' reports for 2000/01 and found that their content was variable and that some colleges had failed to meet the level of detail recommended in SFEFC's Code of Audit Practice. None of the annual internal audit reports recorded any material failure in the adequacy and effectiveness of internal controls operated by the colleges.

7. In August 2000 a steering committee drawn from representatives of the further and higher education sector and working under the auspices of the Accounting Standards Board issued a Statement Of Recommended Practice (SORP) Accounting for Further and Higher Education. The SORP was issued so that colleges should prepare their accounts on a comparable and consistent basis. The SORP applied fully from the 2000/01 financial statements. SFEFC found that the compliance rate with the SORP for the sector as a whole was 90% and that there was room from improvement in the level and quality of disclosures by colleges.

8. It is important that colleges address these issues. Internal audit is a key financial control and the presentation of good quality financial statements which meet the required standards provide audit assurance and can therefore reduce the audit burden on colleges.

Auditors have highlighted areas of college activity which require careful management

9. In my FE overview report for 1999/2000, I noted that changes to eligibility criteria for grants from the European Social Fund (ESF) and the European Regional Development Fund (ERDF) were likely to impact on colleges' future income. In 2000/01 41 colleges recorded income from EU grants. The total level of income from EU grants fell from £31 million (5.6% of total income recorded by colleges for the 16 months to July 2000) to £18 million (4.1% of income in the year to July 2001). Generally, colleges appear to have adapted well to the reduced level of EU income but have yet to develop their management accounting systems to support the additional information requirements of future EU grant payments.

10. The grant in aid paid to colleges is based on a formula linked to the level of further education activity in the college. A condition of the funding agreement between the college and SFEFC is that the grant may be reduced retrospectively if the level of activity in a college is less than agreed. In 2000/01 seven colleges failed to deliver forecast levels of activity and were consequently asked to repay grant.

SFEFC have reported progress on a number of Audit Committee recommendations and the Auditor General is to report on others

11. During 2001 the Scottish Parliament's Audit Committee took evidence on the Auditor General's reports on Governance and Financial Management at Moray College and the Overview of FE College Accounts for 1999/2000. The Committee's subsequent reports made a series of recommendations on accountability and financial control in the FE sector as a whole. The Scottish Executive has responded positively to each of the recommendations.

12. In the overview report for last year, I reported on progress made by SFEFC to address recommendations made by the Audit Committee in March 2000 on Managing Costs in the FE sector. These recommendations highlighted the need for SFEFC to complete a series of initiatives to address: the financial health of the sector; the provision of further education across Scotland; the condition of the FE estate; and performance management covering the FE sector. SFEFC is continuing to take forward each of the initiatives.

Financial health of the further education sector

13. In 2000/01 the total operating deficit in the FE sector was reduced to £13.8 million, some £2.2 million lower than in 1999/2000. But the ratio of deficit as a percentage of income rose from 2.7% to 2.9%. In the same period the sector recorded a historic cost deficit of £3.0 million, compared with the historic cost surplus of £2.4 million recorded in the 16 months to 31 July 2000 and the accumulated historic cost deficit for the sector as a whole rose by £2.5 million to £17.5 million.

14. SFEFC monitor the sector's performance against colleges' financial forecasts and in 2000/01 results for the sector as a whole were in line with the forecasts.

Overall financial results mask the large number of colleges experiencing financial difficulties

15. Thirty-four of the 43 incorporated colleges incurred operating deficits during 2000/01, three more than in 1999/2000, and 16 recorded deficits greater than forecast. At 31 July 2001, 22 colleges recorded accumulated deficits totalling over £30 million including ten colleges with individual deficits exceeding £1 million.

It may take up to ten years to eliminate some accumulated deficits

16. The 1999/2000 overview report noted that financial recovery plans were either in place or are at an advanced stage of preparation for colleges whose financial health SFEFC assessed as being of most concern. The recovery plans forecast that individual colleges will take three to ten years to eliminate their deficits. SFEFC comments on each recovery plan in draft and on the extent to which it is achievable. Recovery plans must be realistic but I am concerned at the length of time envisaged for achieving financial balance at some colleges.

Some colleges have been awarded additional funding to accelerate the pace of financial improvement

17. In my overview report on the 1999/2000 accounts I reported that the Minister had announced a one-off sum of £7 million to be made available for the specific purpose of accelerating the pace of turnaround for those colleges in most financial difficulty. In February 2002 SFEFC announced that the one-off sum had been distributed to nine colleges with one college receiving £2.5 million and the other eight receiving between £250,000 and £1 million.

SFEFC have introduced new procedures for identifying and monitoring those colleges with the greatest financial difficulties

18. SFEFC's system for assessing and categorising the financial health of each college was revised in 2001. Colleges are now assessed against criteria covering their current financial position and a risk analysis of their financial forecasts.

19. SFEFC's assessment of financial health for 2000/01 financial results categorised 36% of colleges as unsatisfactory, 33% as poor, 19% as stable and 2% as good. It is estimated that by 2003/04 the proportion of colleges categorised as unsatisfactory will be 5%, 52% will be poor, 38% will be stable and 5% will be good.

20. SFEFC has introduced further monitoring procedures for the 16 colleges whose financial health is of greatest concern through enhanced formal quarterly monitoring of the college's financial position.

Update on developments

SFEFC have reported progress in addressing a number of initiatives

21. In last year's overview report I highlighted a number of initiatives by SFEFC to address the adequacy and efficiency of the provision of further education in Scotland. Part 4 of this report includes an update of progress against each of the initiatives provided by SFEFC including:

    - details of action taken to further improve college management through implementing recommendations arising from a management review of the sector and reviews of the supply and demand for further education

    - further information on steps being taken to rationalise the provision of further education in Glasgow, including proposals to merge at least two groups of colleges

    - SFEFC proposals to develop capital funding models to focus capital investment decisions on the strategic needs of the sector

    - the level of funding for the sector in 2002/03.

Overall conclusion

25. This second overview report shows that SFEFC and FE colleges are continuing to make progress in addressing a wide range of important issues affecting performance within the sector. This is commendable but it is important that the wide range of initiatives are set in context so that a clearer picture can be presented of the expected impacts and the timescale over which they will be achieved.

26. This is particularly true of the efforts being made to introduce financial stability to the sector. Colleges now have increased levels of core funding and individual colleges have also been granted additional funds to tackle their financial difficulties. It is now important that realistic and plausible deadlines are set as soon as possible to achieve improvements in financial health expected by Ministers.

Part 1: Introduction

1.1 Further education colleges in Scotland provide education and training opportunities for a wide range of people from school-leaving age upwards. During 2000/01 there were 43[1] colleges incorporated as independent corporate bodies under the Further and Higher Education (Scotland) Act 1992 (the 1992 Act) to provide further education. Another four further education colleges operated under the control of local authorities or independently but not as bodies incorporated under the 1992 Act. This report covers the 43 incorporated colleges.

1.2 In the year to 31 July 2001 the 43 incorporated colleges recorded a total income of £458 million, about 70% of which was derived from grant in aid provided by the Scottish Executive Enterprise and Lifelong Learning Department (the Department) via the Scottish Further Education Funding Council (SFEFC). The remainder of college income was derived from a range of sources including European grants, tuition fees and income from the provision of consultancy and research services (Exhibit 2).

Exhibit 2: Sources of income as a percentage of total

Source of income	Percentage of total
SFEFC grants	68%
Education contracts and tuition fees	19%
Other income	13%

1.3 Under the terms of the Public Finance and Accountability (Scotland) Act 2000 (the 2000 Act) the Auditor General for Scotland is responsible for securing the audit of each incorporated college. This report, which I present under section 23 of the 2000 Act, is my second overview report on the further education sector. The report has been prepared principally from information contained in reports prepared by the colleges' appointed auditors at the conclusion of their audits and from SFEFC's own work in monitoring the financial health of the sector.

1.4 Part 2 of the report details the results of the audit of college accounts for 2000/01 and the main findings of auditors at individual colleges and records progress made by SFEFC in addressing recommendations made by the Scottish Parliament's Audit Committee. Part 3 reviews the financial position of the sector and the action SFEFC has taken and proposes to take in managing the financial health of individual colleges. Part 4 of the report reviews recent developments which are likely to affect the adequacy and efficiency of the provision of further education in Scotland in the future.

[1] On 1 August 2001 Bell College of Technology became a higher education institution reducing the number of incorporated further education colleges from 43 to 42.

Part 2: Audit results

2.1 This part of the report covers:

- completion of accounts and audits of the incorporated further education colleges
- governance and internal financial control
- other matters arising
- Audit Committee recommendations.

Completion of accounts and audit

2.2 Section 22 (5) of the Public Finance and Accountability (Scotland) Act 2000 (the PFA Act) requires Scottish Ministers to lay before Parliament a copy of every account and report sent to them via the Auditor General not later than nine months after the end of the financial period to which the account relates. In order to meet this requirement in the further education sector, the Auditor General set the colleges' appointed auditors audit certification and reporting deadlines of 31 December 2001 for the accounts covering year ending 31 July 2001. All of the colleges achieved these deadlines.

Auditors' opinions

2.3 Auditors provided unqualified opinions on the 2000/01 accounts of 39 colleges. For the remaining colleges three of the auditors' opinions were qualified because individual colleges had not complied with accounting standards either for retirement benefits (Clydebank College and Banff and Buchan College), or for matching expenditure with income (Reid Kerr College). The auditors' opinion on a fourth college (Ayr College) was qualified because the college had not complied with SFEFC's financial memorandum for colleges in relation to consent for increases in bank borrowings (Exhibit 3).

2.4 Auditors of seven colleges (Ayr College, Bell College of Technology, Clydebank College, Inverness College, Lews Castle College, Moray College and North Glasgow College) drew attention to the financial circumstances of the college. While the auditors did not qualify their opinions on the financial statements of any of the colleges, each of the auditors drew attention to the fact that the accounts had been prepared on a going concern basis on the assumption that SFEFC's financial support to the colleges and access to bankers' overdraft facilities would continue. In view of the comments made by the auditors, I presented a report to the Scottish Parliament under section 22(3) of the PFA Act on the circumstances of each of these colleges with the colleges' accounts.

2.5 Part 3 of my report considers the financial health of the further education sector as a whole in more detail.

Exhibit 3: Auditors' qualified opinions on college accounts

Ayr College
The audit opinion was qualified on grounds of the college's failure to comply with the terms of the *Financial Memorandum* in respect of seeking SFEFC consent for additional borrowing.

Banff and Buchan College
The audit opinion was qualified on grounds of the auditor's disagreement with the college's treatment of its liability arising under Financial Reporting Standard (FRS) 17 *Retirement Benefits*. In the main, the qualification related to the college's failure to make the disclosures required by the FRS.

Clydebank College
The audit opinion was qualified on two grounds: disagreement about accounting disclosure; and limitation in audit scope.

The disclosure disagreement arose as a result of the college's failure to comply fully with the requirements of FRS 17 *Retirement Benefits*. The limitation in audit scope was a result of the auditor taking the view that there was insufficient audit evidence to support the carrying value of fixed assets, as the board of management failed to carry out an impairment review as required by FRS 11 *Impairment of Fixed Assets and Goodwill.*

Reid Kerr College
The opinion was qualified due to the auditor disagreeing with the college's treatment of £160,000 of marketing expenditure incurred in the year which related to student income for the following year. This expenditure has been carried forward as a prepayment by the college rather than being charged to the income and expenditure account for the year. The auditors consider that expenditure of this nature fails to meet the definition of an asset and qualified the accounts on that basis. Had this expenditure been treated correctly the restated results would have indicated that the college incurred an operating deficit of £132,000 for 2000/01.

Source: Auditors' reports on college accounts

Action plans

2.6 Each of the auditors of the 43 colleges has produced reports on their findings. External auditors generally found that the key financial systems in place at colleges were of a good standard. Where the auditors identified weaknesses they have agreed action plans with respective boards of management to make the improvements necessary in response to their findings. As part of my responsibilities for the audit of further education colleges I shall require that implementation of the action plans is monitored and followed-up by the appointed auditors.

Governance and internal financial control

Governance

2.7 The board of management of each college is required to include in its financial statements a description of how the college has applied the principles of corporate governance set out in Section 1 of the Combined Code on Corporate Governance issued by the London Stock Exchange in June 1998.

2.8 All the colleges satisfied the requirement to provide a statement in their 2000/01 accounts confirming that they had complied with the principles of the Combined Code on Corporate Governance.

Internal financial control

2.9 Colleges are required to prepare an internal financial control statement (the IFC statement) in which they confirm that the effectiveness of the internal financial controls has been reviewed. The IFC statement is included in the report of the college's board of management accompanying the college's financial statements.

2.10 Auditors are required to review the IFC statement and provide an opinion which takes the form of 'negative assurance'. This means that provided weaknesses in internal control are disclosed appropriately in the IFC statement and the statement is not inconsistent with information arising from the audit, auditors are able to provide an unqualified opinion on the IFC statement. In 2000/01, none of the auditors' opinions on college IFC statements was qualified.

Management of Risk

2.11 The Turnbull Committee Report 'Internal Control: Guidance for Directors on the Combined Code' extends the scope of statements currently produced to cover all controls, including financial, operational, compliance and the management of risk.

2.12 In September 2001 SFEFC issued guidance to colleges on the statement of corporate governance following publication of the code (Appendix 1). The guidance noted that the nature of disclosures that any college would be able to make in future years on internal control would depend on the extent to which it had established the procedures necessary to implement the Turnbull guidance. It is expected that all colleges will be able to comply with the additional requirements in statements produced for accounts for the year ended July 2003.

2.13 Auditors of ten colleges (Anniesland College, Ayr College, Fife College, Glasgow College of Building & Printing, Glasgow College of Nautical Studies, Jewell and Esk Valley College, John Wheatley College, Kilmarnock College and Lauder College) referred to the need to prepare for Turnbull in their reports to college boards of management. The reports commented on the extent to which individual colleges had yet to undertake formal reviews of the risks facing the college and to ensure that individuals within the college were assigned responsibility for ensuring appropriate mechanisms were in place to manage identified risks.

Internal audit

2.14 SFEFC's financial memorandum to colleges requires each college to establish an internal audit function whose primary responsibility is to provide assurance on the adequacy and effectiveness of college's internal control systems and to produce an annual internal audit report for consideration by the college's audit committee. SFEFC undertook a review of internal auditors' reports covering internal controls operated by the colleges during 2000/01. The review found that, by February 2002, most colleges had submitted annual reports by 31 December 2001, a significant improvement on 1999/2000 when reports were not available for 11 of the 43 colleges. SFEFC's review found, however, that the content of annual internal audit reports was variable and that some colleges had failed to meet the level of detail recommended in SFEFC's Code of Audit Practice.

2.15 None of the annual internal audit reports recorded any material failure in the adequacy and effectiveness of internal controls operated by the colleges but SFEFC noted some limitations in the opinions provided by the internal auditors. For three colleges the internal auditor failed to give an overall opinion on internal controls and many of the opinions were subject to the implementation of audit recommendations. For three colleges the annual report suggested further limitations on the internal audit opinion.

2.16 SFEFC's review found a number of areas of weaknesses common to a number of colleges. These included controls over: purchasing and tendering, fixed assets debt collection and student records. SFEFC intends to follow up with colleges to ensure the necessary corrective action is being taken through ongoing monitoring visits to colleges by SFEFC's Financial Appraisal and Monitoring Service (FAMS) and through more direct action where this is considered necessary.

Other matters arising from the audits

Compliance with the Statement of Recommended Practice

2.17 In August 2000 a steering committee drawn from representatives of the further and higher education sector and working under the auspices of the Accounting Standards Board issued a Statement Of Recommended Practice (SORP) Accounting for Further and Higher Education. The SORP was produced after collaborative work between key stakeholders in further and higher education including college and university representative bodies, funding councils in Scotland, England and Wales and accounting practitioners and is applicable to all further and higher education institutions in the United Kingdom for accounting periods commencing on or after 1 August 1999. The SORP was issued so that, as far as possible, the financial statements of institutions should be prepared on a comparable and consistent basis. The SORP was fully applicable for the first time on the 2000/01 financial statements.

2.18 SFEFC reviewed individual college's financial statements to gauge the level of compliance with disclosure requirements of the SORP. SFEFC found that on average the sector had complied with 90% of the SORP requirements. SFEFC concluded that, although none of the failures to comply with the SORP had affected the results presented by colleges, there is still room for improvement in the level and quality of disclosures given by colleges and will highlight areas of non-compliance to the colleges so that compliance rates can be improved.

European funding issues

2.19 In my FE overview report for 1999/2000, I noted that changes to eligibility criteria for grants from the European Social Fund (ESF) and the European Regional Development Fund (ERDF) were likely to impact on future income for colleges. In 2000/01 41 colleges recorded income from EU grants. The total level of income from EU grants fell from £31 million (representing 5.6% of total income recorded by colleges in the 16 months to July 2000) to £18 million (4.1% of income for the 12 months to July 2001).

2.20 Auditors who provided an analysis of variations in college income between 1999/2000 and 2000/01 identified lower income from EU grants as having a significant impact on income levels. Auditors for three colleges (Dundee College, James Watt College and Kilmarnock College) also identified significant debtor balances arising from delays in payment of claims in relation to EU funding.

2.21 The Scottish Executive has issued revised guidance to colleges and higher education institutions likely to be applying for EU funds under the new programmes. The guidance covers: the need for applicants to identify clearly the added value that would result from training courses in receipt of ESF monies; and the need to clearly demonstrate that when a course contains both ESF supported students and other students, the ESF beneficiary receives additional support to mainstream trainees. The Scottish Executive's guidance also sets additional information requirements which the European Commission will apply from July 2003. To comply with the additional requirements many colleges will need to develop their existing management accounting systems.

Provisions for pensions and early retirements

2.22 My FE overview report for 1999/2000 described how colleges are expected to establish provisions in their balance sheets to meet the cost of enhanced pensions to former employees who have retired early. During 2000/01 all but one college had maintained a provision for enhanced pension liability and the total of the provision was £36 million (£36 million in 1999/2000).

2.23 Early retirement is a means by which college managers can restructure staffing levels to match future costs with income projections. Colleges are likely to continue to restructure as they pursue improvements in their financial stability. But they must recognise from the outset the likely impact such decisions may have on their financial position and continue to monitor the movement in provision levels to ensure they match pension liabilities over time.

2.24 Under the transitional requirements of FRS 17 – Retirement Benefits, colleges were required to disclose their share of pension fund assets and liabilities at the balance sheet date. Colleges generally have two defined benefit pension schemes, one of which is the Scottish Teachers Superannuation Scheme (STSS). None of the colleges was able to identify their share of the STSS assets and liabilities and consequently all have accounted for this on a defined contributions basis (ie the Income and Expenditure account reflects the contributions paid rather than the measurement of the assets and liabilities). This is permissible under FRS 17 for multi-employer schemes.

2.25 With respect to the pension schemes for non-teaching staff, 26 of the colleges were able to disclose details of their share of pension fund assets and liabilities, although these were not always updated to the balance sheet date.

2.26 For the remaining 17 colleges, some were unable to obtain the information this year but expect to comply in 2001/02. The remainder have opted for treating the schemes as defined contribution schemes. Two colleges had their accounts qualified for being unable to obtain the relevant details (paragraph 2.3).

2.27 Given that further disclosures are required for accounting periods ending on or after 22 June 2002, including performance statement information, colleges need to take steps to ensure the relevant information is made available on a timely basis.

Clawback

2.28 The level of grant in aid paid to cover core funding of colleges is based on a formula share of the total grant available linked to the level of further education activity in the college. The level of activity is measured in weighted SUMS[3] representing a combination of teaching hours and the mix of courses offered by the college.

2.29 SFEFC set the level of grant available to each college in annual funding agreements. A condition of the funding agreement is that SFEFC may reduce the level of grant in the event that the college delivers less weighted SUMS than that agreed. For 2000/01, SFEFC agreed that this clawback provision would be invoked where colleges underprovided by 3% or more of weighted SUMS.

2.30 For 2000/01 seven colleges (Borders College, Coatbridge College, Moray College, Inverness College, Motherwell College, North Highland College and Perth College) failed to deliver forecast levels of activity and have consequently been asked to repay grant under the clawback provision.

Audit Committee recommendations

2.31 During 2001 the Scottish Parliament's Audit Committee took evidence on two Auditor General reports and noted progress made by SFEFC in addressing recommendations contained in an earlier report issued by the Committee.

2.32 The Committee took evidence on the Auditor General's reports on Governance and Financial Management at Moray College and on the Overview of FE College Accounts for 1999/2000. The Committee's subsequent reports made a series of recommendations on accountability and financial control in the FE sector as a whole. The Scottish Executive has responded positively to each of the recommendations and has announced a review of governance and accountability arrangements within the sector which will cover, inter alia, SFEFC' s powers to intervene when colleges fall short of expected standards and the appointment and training of members of colleges' boards of management (Exhibit 4).

3 SUMS – Student Units of Measurement. A SUM is equal to 40 hours of directed teaching time. The weighting is given to reflect the different courses on offer and how they are achieved.

Exhibit 4: Audit Committee recommendations to improve governance and accountability in the further education sector

Audit Committee recommendation

"We support the Auditor General's suggestion that the Scottish Ministers review governance and accountability in the further education sector and further suggest that consideration is given to extending the powers of SFEFC to allow it to intervene directly where poor governance arrangements exist in further education colleges."

Scottish Executive response

The Scottish Executive recognised that issues emerged from both the Auditor General's and the Audit Committee's consideration of events at Moray College that warrant a review of aspects of governance and accountability in the FE sector. The review will cover: whether arrangements for the appointment of board members accord with the principles established by the Committee for Standards in Public Life; the scope of Scottish Ministers' powers to remove or replace board members; and the SFEFC Chief Executive's powers to ensure prosperity and value for money in the stewardship of funds allocated to individual colleges. The review will also cover whether current appointment procedures secure an appropriate skills mix on college boards, the training and induction of board members and whether SFEFC's powers should be extended to allow it to intervene directly in cases of poor governance.

Audit Committee recommendation

"The Department should, in conjunction with SFEFC and other appropriate bodies, bring forward recommendations to improve training and induction for members of college boards of management to ensure that members are aware of both their legal responsibilities and duties as members of the board."

Scottish Executive response

The Executive agreed with the Committee's assessment of the importance of good training and induction both for board members' understanding of their role and responsibilities and to ensure that board members' skills are applied and put to best use in the college context. Work is underway to review existing and prepare new comprehensive guidance for board members covering duties and responsibilities, standards, evaluation and best practice. The Scottish Executive and SFEFC are both represented on a project working group to consider this and draft guidance and self-evaluation frameworks have already been prepared. The review of governance and accountability is also intended to address this aspect of effective governance.

Audit Committee recommendation

"The events at Moray College should be used in discerning whether there are lessons for other colleges to ensure that similar problems are not allowed to happen in establishments with larger budgets."

Scottish Executive response

The Council published its Chief Executive's report on Moray College in November 2001 and drew it to the attention to the chair of the board and the principal of every college by way of a circular. Each college's accountable officer has been asked to compare their systems and procedures against the findings, conclusions and recommendations in the report. SFEFC intends that a report of the outcome of that process should be presented to each college's audit committee and board of management, and an action plan prepared. SFEFC intends to check on the action taken by all colleges through its regular programme of monitoring visits.

Audit Committee recommendation

"The problems at Moray College were compounded by a lack of sufficient and relevant skills on the board of management and we consider that the need for appropriate mix of skills must be recognised in nominating college boards of management."

Scottish Executive response

The review of governance and accountability will address how best both to ensure that the appointments framework and procedures for college boards does secure the right skills mix required for boards to function effectively. The work in preparing comprehensive new guidance for board members will also focus on the issue of board skills.

Source: Audit Committee 4th Report 2001:
Governance and financial management at Moray College: Scottish Executive response to principal recommendations

2.33 In the overview report for last year, I reported on progress made by SFEFC in addressing recommendations made by the Audit Committee in March 2000 on Managing Costs in the FE sector. These recommendations highlighted the need for SFEFC to complete a series of initiatives to address: the financial health of the sector; the provision of further education across Scotland; the condition of the FE estate; and performance management covering the FE sector.

2.34 SFEFC is continuing to take forward each of the initiatives noted by the Committee. Part three of this reports provides details of the action SFEFC are taking to address financial difficulties and part four provides details of progress on a number of initiatives to address the level of FE provision and the condition of the colleges estates. In addition I intend to produce a further report during 2002 setting out the arrangements SFEFC has in place to manage performance in the sector.

Part 3: Financial health of the further education sector

3.1 This part of the report covers:

- financial results for 2001/02
- college operating results
- SFEFC monitoring of the financial health of colleges.

Financial results in 2000/2001

Sector results

3.2 Exhibit 5 summarises the overall results recorded by the colleges and compares the results against those recorded for the 16 month period to 31 July 2000 and against the overall results anticipated in financial forecasts provided by colleges to SFEFC.

Exhibit 5: Summary of Income and Expenditure results recorded by colleges

Consolidated item	2000/01 Financial Statements £m	College financial forecasts 2000/01 £m	1999/00 Financial Statements £m
Total Income	458.3	457.9	553
Total Expenditure	471.8	471.9	570
Operating Surplus/(Deficit)	(13.8)	(14.0)	(16.0)
Historical Cost Surplus/ (Deficit)	(3.0)	(3.7)	2.4
Peformance indicators			
Historical Cost Surplus/ (Deficit) as % of income	(0.7%)	(1%)	(0.8%)
Operating Surplus/(Deficit) as % of income	(2.9%)	(3.1%)	(2.7%)

Source: SFEFC

3.3 The financial results provide two measures of sector performance. The operating surplus or deficit is the difference between income and expenditure including a depreciation charge to represent the costs incurred through the use of assets. The historic cost surplus or deficit is the operating surplus or deficit, after accounting for the impact of asset disposals and tax, adjusted for the transfer from the revaluation reserve, but excluding any transfers between designated or restricted reserves and the income and expenditure account.

3.4 Operating surpluses or deficits provide a more consistent base for monitoring the sector's ability to deliver services within the level of income generated. An operating deficit represents a shortfall between the level of expenditure and the availability of normal trading income, and current year deficits have to be repaid from subsequent years' income. By continuing to record annual deficits colleges are deferring the reductions or changes in services that are required to repay earlier years' overspends and restore financial balance. Whilst an operating deficit of income over expenditure may be endured in the short term, and indeed even be planned in one or more years, it cannot be sustained in the long term as eventually the college will become insolvent.

3.5 In 2000/01 the total operating deficit was reduced to £13.8 million – some £2.2 million lower than in 1999/2000. But the ratio of (deficit) as a percentage of income rose from 2.7% to 2.9%. The use of a 16-month accounting period in 1999/2000 may have partly contributed to this.

3.6 Historic cost surplus/deficit is influenced by the write-back of an appropriate amount of depreciation on revalued assets from the college's revaluation reserve. This movement is not part of the college's normal trading activities.

3.7 In 2000/01 the sector recorded a historic cost deficit of £3.0 million, compared with the historic cost surplus of £2.4 million recorded in the 16 months to 31 July 2000. The significant difference between the results for the two periods is due to:

- a reduction in the level of gains from property disposals
- reduced transfers from revaluation reserves due to the difference in the length of accounting periods
- reduced transfers from the revaluation reserve for one-off realisation of property revaluation gains.

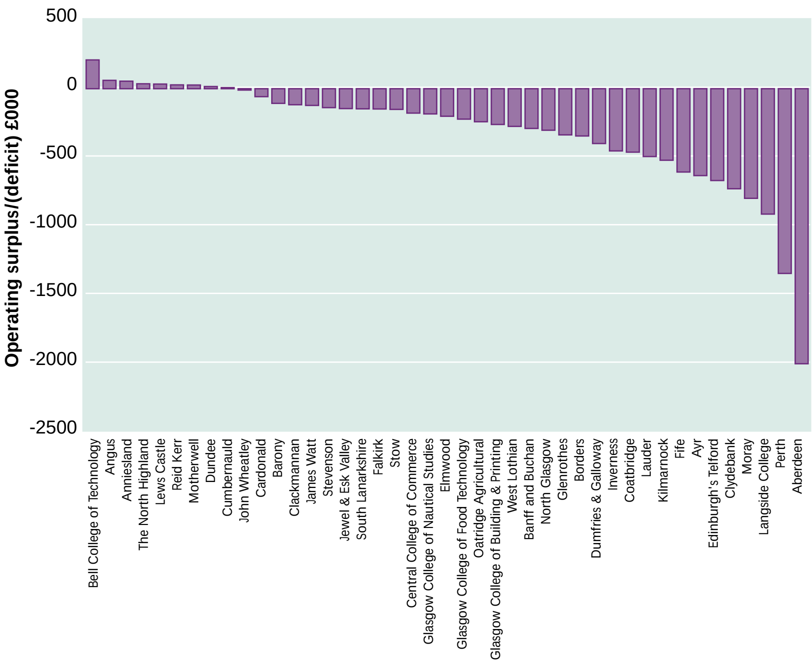
3.8 During the period the accumulated historic cost deficit for the sector as a whole rose by £2.5 million to £17.5 million.

3.9 The recorded results are in line with expectations. SFEFC monitor the sector's performance against financial forecasts which the colleges provide. For each of the measures of financial performance used by SFEFC the results recorded in 2000/01 are in line with the forecasts provided.

Deficits incurred by colleges

3.10 The financial results of the sector as a whole continue to mask the large number of colleges experiencing financial difficulties. The number of colleges incurring operating deficits in 2000/01 was 34, an increase of three on the number recording deficits in 1999/2000 (Exhibit 6). Although the level of operating deficit across the sector was better than that forecast, 16 individual colleges recorded deficits greater than that forecast.

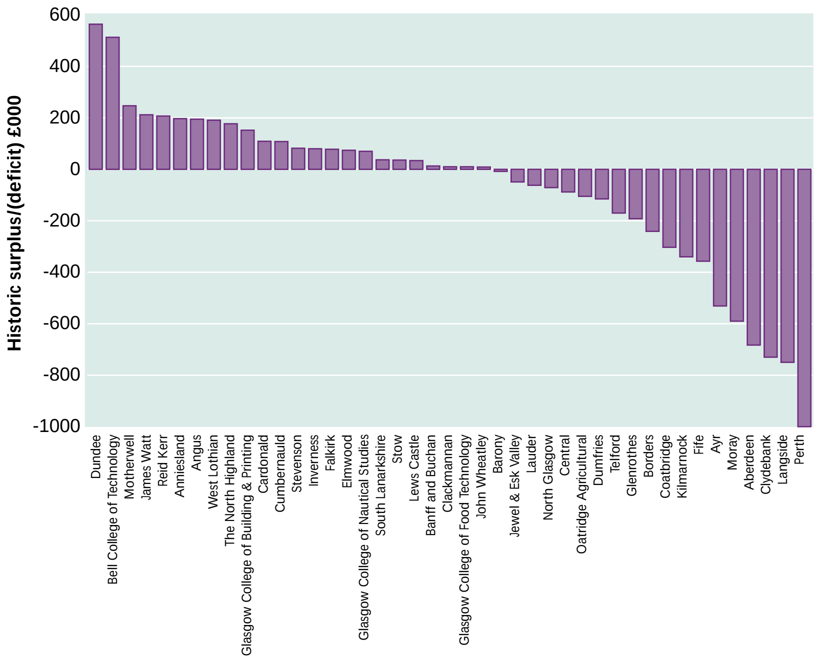
Exhibit 6: Colleges operating surpluses/(deficits) 2000/01



Source: Audit Scotland

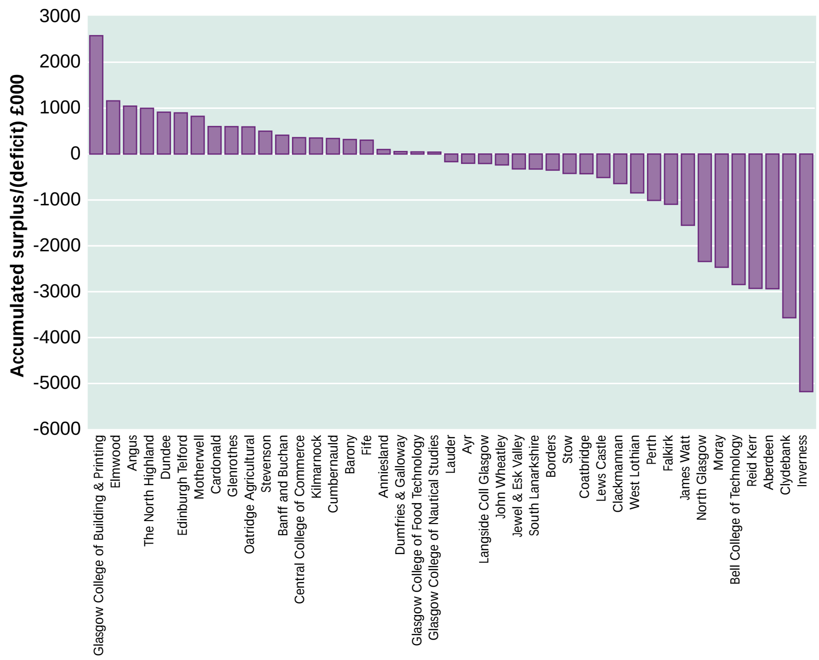
3.11 Historic cost results recorded by colleges also reveal considerable variation (Exhibit 7).

Exhibit 7: Colleges historic cost surpluses/(deficits) 2000/01



Source: Audit Scotland

Exhibit 8: Colleges accumulated historic cost surpluses/(deficits)



Source: Audit Scotland

Recovery plans

3.12 SFEFC's financial memorandum permits colleges to incur annual financial deficits where the deficits have the approval of college boards of management in accordance with their long-term strategic plans. SFEFC's financial memorandum states that it expects that any accumulated deficit on an income and expenditure account should normally be cleared by the end of the third accounting period after the year in which the deficit began to accumulate, unless an alternative timescale has been agreed with SFEFC. In practice, SFEFC looks to see that colleges have robust plans to recover a deficit within a reasonable and specified timescale.

3.13 By 31 July 2001 some 22 colleges were recording accumulated income and expenditure deficits (one more than at 31 July 2000) with ten colleges having accumulated deficits in excess of £1 million (Exhibit 8).

3.14 The 1999/2000 overview report noted that financial recovery plans were either in place or are at an advanced stage of preparation at 11 of the 19 colleges whose financial health SFEFC assessed as being of most concern at that time. For each of these colleges SFEFC was monitoring the achievement of recovery plans through regular reports and meetings with colleges' boards and management. In the remaining eight colleges no financial recovery plan had been prepared largely because action was already in hand or the financial position was forecast to improve in future years. In each of these colleges, SFEFC had informed the board of management of its concerns and is monitoring closely the position.

3.15 The recovery plans in place forecast that individual colleges will take between three and ten years to eliminate the deficits (Exhibit 9). The financial results for 2000/01 show that each of the colleges with recovery plans achieved the results they forecast in their recovery plans and remain on course to achieve their target dates for elimination of the deficit.

3.16 Recovery plans reflect the colleges' estimates of action necessary to eliminate their deficits and the timescale involved. In producing recovery plans colleges must seek to balance the need for speedy elimination of the deficit with the need for a reasonable plan of action to bring income in line with expenditure and recover accumulated deficits. SFEFC comments on each recovery plan in draft and on the extent to which it is achievable.

3.17 In my overview report on the 1999/2000 accounts I reported that the Minister had announced a one-off sum of £7 million to be made available for the specific purpose of accelerating the pace of turnaround for those colleges in most financial difficulty. In February 2002 SFEFC announced that special one-off payments had been awarded to nine colleges with one college receiving £2.5 million and the other eight receiving grants of between £250,000 and £1 million (Exhibit 10).

Exhibit 9: Estimated dates for elimination of deficits

College	Accumulated deficit July 2001 (£ million)	Plans for elimination of deficit
Colleges with recovery plans		
Bell College of Technology	2.711	Elimination of deficit by 2005
Clackmannan College	0.643	Reduce deficit by £0.5 million by July 2004
Clydebank College	3.567	Eliminate deficit by July 2008
Inverness College	5.177	Eliminate deficit within nine years from 2001/02
Langside College	0.206	Eliminate deficit by July 2002
Lews Castle College	0.511	Recovery plan still to be finalised
Moray college	2.467	Elimination of deficit by July 2007
North Glasgow College	2.341	Elimination of deficit by July 2007
Perth College	1.010	Elimination of deficit by July 2004
Reid Kerr College	2.927	Elimination of deficit by July 2006
South Lanarkshire College	0.327	Elimination of deficit by July 2003
Other colleges		
Dumfries & Galloway College	–	Accumulated surplus at July 2001
Glasgow College of Food Technology	–	Deficit eliminated by July 2001
Glenrothes College	–	No deficit, cause for concern due to size of college debt has now reduced.
James Watt College	1.552	Elimination of deficit by July 2003
John Wheatley College	0.237	Elimination of deficit by July 2005
Lauder College	0.166	Elimination of deficit by July 2005
Stow College	0.458	Elimination of deficit by July 2002
West Lothian College	0.846	No date yet set for elimination of deficit

Source: Audit Scotland

Exhibit 10: Additional funding to assist the recovery of colleges in serious difficulty

College	£ million
Clydebank College	2.565
Inverness College	1.084
Langside College	0.950
Moray College	0.850
North Glasgow College	0.500
Perth College	0.250
Reid Kerr College	0.350
South Lanarkshire College	0.250
Stevenson College	0.250
Total	**7.049**

Source: SFEFC

3.18 The allocation of additional support was decided by SFEFC using criteria established to reflect Ministerial objectives and SFEFC priorities for strengthening college management; assisting restructuring required to deliver recovery; and reducing short-term indebtedness. A specific condition of the additional support was that each of the colleges should continue to implement their financial recovery plans.

Indicative results for 2001/02

3.19 The audit of college accounts for the year ended 31 July 2002 are expected to be completed and passed to the Auditor General for Scotland by 31 December 2002. The full financial position of the colleges will not be available until the audit process is complete though in the interim SFEFC require colleges to provide regular financial forecasts which provide an interim assessment of changes in each college's financial position. The financial forecasts provided by the colleges to June 2001 forecast that the overall operating deficit for the sector was likely to be £7.3 million for 2001/02, £3.8 million for 2002/03 and £2.7 million for 2003/04. Twenty-nine colleges were likely to incur an operating deficit in 2001/02, 25 in 2002/03 and 24 in 2003/04. The overall accumulated deficit across the sector is expected to be £12 million in 2001/02 but an accumulated surplus exceeding £4 million is forecast by 2003/04.

SFEFC's approach to monitoring financial health

Monitoring financial arrangements

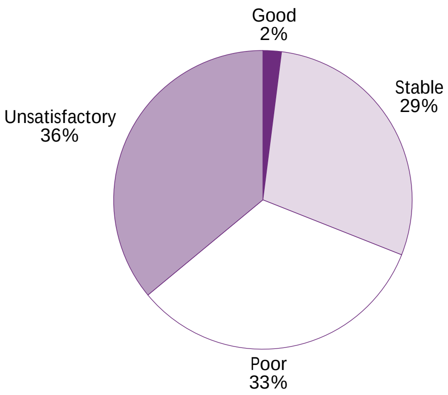
3.20 SFEFC has introduced a programme of visits to review the effectiveness of colleges' financial management, audit and governance arrangements by:

- assessing the financial health of colleges
- assessing the effectiveness of the financial and management framework in place at colleges
- confirming that colleges are complying with the financial memorandum and SFEFC's Code of Audit Practice
- assessing the effectiveness of colleges' processes for implementing or taking account of good practice, guidance on financial management and value for money and governance arrangements, including that published by the Department, SFEFC, Audit Scotland and the National Audit Office
- assessing the adequacy and effectiveness of colleges' audit arrangements.

3.21 The programme of visits is driven by SFEFC's assessment of the financial health of each college using a system for categorising colleges which was revised in 2001. The revised system replaces a previous assessment system based on a review of levels of financial surpluses or deficits and short-term solvency and borrowing levels, with a more systematic scoring and ranking mechanism. Colleges are now assessed against criteria covering their financial position (in terms of operating performance, liquidity and balance sheet strength) and a risk analysis (in terms of the outcome of SFEFC's financial management reviews, the accuracy of college financial forecasting, and the extent to which the college is judged to have responded to requests for documents and information from SFEFC).

3.22 Combining the results of both parts of the assessment allows SFEFC to make professional judgements to categorise the college's financial health in one of four categories: unsatisfactory, poor, stable or good. SFEFC's assessment of financial health using the 2000/01 financial results categorised 36% of colleges as unsatisfactory, 45% as poor, 19% as stable and 2% as good (Exhibit 11). These results show an improvement against the assessment based on forecast results and provide a clearer picture of those colleges with greatest financial challenges than that provided by the previous system. Using financial forecasts, SFEFC assess that by 2003/04, 5% of colleges will be unsatisfactory, 52% will be poor, 38% will be stable and 5% will be good.

Exhibit 11: SFEFC classification of college financial health 2000/01



Source: Audit Scotland

3.23 SFEFC has introduced further monitoring procedures for those colleges whose financial health is of greatest concern. For 16 colleges SFEFC has introduced a formal quarterly monitoring of the college's position. Monitoring requires colleges to report on three key areas in a standard format: Income and Expenditure performance for the quarter; operational cash flow for the quarter; movements in the college's balance sheet; and the future direction of Income and Expenditure and cash. Colleges are also expected to provide a commentary on any significant variances and the action being taken by the college to address these. SFEFC review the quarterly returns and hold meetings with the colleges to discuss progress.

Part 4: Recent developments

4.1 In last year's overview report I highlighted a number of initiatives which SFEFC had begun to address the adequacy and efficiency of the provision of further education in Scotland. The Scottish Parliament Audit Committee subsequently called on SFEFC to report progress made in relation to those initiatives in time for me to detail the progress made in this report. The following paragraphs record the information provided by SFEFC in response to the Committee's request.

Management review of further education colleges

4.2 In March 1999 Ministers asked SFEFC to undertake a major review of the management of Scotland's further education colleges and to report to them. SFEFC appointed consultants to undertake fieldwork for the study and to report their findings and conclusions arising from reviews of a sample of 12 colleges. Ministers subsequently endorsed SFEFC's report which was published in September 2000.

4.3 The report concluded that there was much good governance and management practice already in place in further education colleges although scope also existed for most colleges to learn from good practice and experiences in other colleges. Key messages included the need for greater involvement of board members in the formulation of the college vision, improved strategic and operational planning including the recognition of marketing as a strategic function, the need to develop significantly the financial management function particularly in relation to strategic financial planning and the need for colleges to develop comprehensive estate strategies.

4.4 As a result of the review SFEFC has asked colleges to prepare management action plans addressing how they intend to respond to the report's findings. Colleges were required to submit their action plans to SFEFC by the end of March 2001 and SFEFC engaged consultants to review the adequacy of action plans. Colleges were issued with individual feedback on their Management Action Plans (MAPs) in October 2001 and are expected to build in the impact of the MAPs into their strategic planning processes.

4.5 The management review has involved a number of stages and initiatives and SFEFC and the colleges are progressing the results. However, it is not clear when the impact of the management review will be realised by individual colleges.

Supply and demand

4.6 In summer 2000 SFEFC completed a review of links between the supply and demand for further education in Scotland. The review provided information on national trends in the provision of further education over the three year period 1996 to 1999, together with the relative contributions made by each college. The review also included maps of student participation, profile of each college, breakdown of participation by age, gender, mode of study, and subject of study.

4.7 The review was structured around the identification of each college’s provision and set against responses made by major stakeholders to structured questionnaires and interviews. The report concluded that on a national basis, provision of college based learning opportunities was broadly adequate. But the review recommended a further examination of the relative adequacy and efficiency of the provision in each area and for key industrial sectors. SFEFC has begun a comprehensive assessment of each geographical area and of key industrial sectors, due to complete by 31 March 2002. SFEFC intends to follow up each review with dialogue with the relevant colleges and stakeholders, in order to agree action plans to deliver the necessary changes identified.

The provision of further education in Glasgow

4.8 In September 2000 SFEFC and the Glasgow Colleges’ Group agreed to commission an external review to:

- generate and evaluate strategic options for consideration by the Glasgow Colleges Group and the council for the provision of further education in Glasgow in order to be efficient and effective in meeting the needs of learners and cost effective in the use of estates.

4.9 It was expected that options generated from the review would address: the future curricular requirements of Glasgow; the location of further education provision across the city; geographical features of participation and need; and the most effective organisational structures and configuration to support such provision. Options generated were also expected to provide the basis for decisions on the development of provision in Glasgow and, in particular, investment in estate and infrastructure. In addition each option was to be appraised against their impact on:

- current and future needs of students;
- current and future needs of employers and other sponsors;
- the needs of the city and its communities;
- quality of provision; and
- value for money.

4.10 The report was received by the council in March 2001 and considered to offer an acceptable basis against which to judge proposals for the development of FE provision (including appropriate estates provision) within the city. The Glasgow Colleges’ Group established a committee with representation from SFEFC to oversee and co-ordinate consultation with college boards and with other stakeholders.

4.11 The consultation was completed in September 2001. Although there was no overall consensus on the various options recommended for further discussion, there was no support for the status quo, and a broad acceptance of the main conclusion that strategic change and collaboration, including merger, should be actively pursued. The report stimulated discussions at Board level between groups of colleges on potential alliances and mergers. SFEFC's related strategy on requiring capital bids for funding to contain a robust analysis of the strategic options available to the college, has also acted as a lever for such discussions and actions.

4.12 Merger discussions are now taking place between the three Glasgow Cathedral Street colleges (College of Building and Printing, Central College of Commerce, and College of Food Technology) and between Stow and North Glasgow colleges. The Cathedral Street colleges commissioned consultants to undertake a merger feasibility study and the report will go to the respective Boards in April 2002. A Mergers Steering Group has been set up with Board and Executive membership from each college together with an independent chair. If the boards agree to proceed, a merger proposal is to be submitted to Ministers by autumn 2002.

4.13 Stow and North Glasgow colleges similarly commissioned a merger feasibility study which was positive about a potential merger. The two boards met in March 2002 and have agreed to proceed with a merger proposal. Again, this is due to be submitted to Ministers by autumn 2002.

Condition survey of college estates

4.14 In last year's report I noted that a condition survey of the FE estate across Scotland had concluded that £116 million was required to bring colleges' estates up to an operationally acceptable condition. I also reported that £60 million had been made available to colleges over the five years to 2003/04 to tackle the most pressing estates needs and that colleges had prepared estate strategies to support the allocation of funds.

4.15 SFEFC is developing a number of capital funding models to focus capital investment decisions on the strategic needs of the sector. One particular expectation for the models is that they will allow SFEFC to deliver needs at an area or city-wide level rather than a focus on individual colleges. SFEFC is due to consider this matter further in July 2002.

Future funding for the sector

4.16 In March 2002 the Scottish Ministers announced that the level of grant in aid available for discharging SFEFC's functions in 2002/03 would be £409 million. This sum is equivalent to the level of funding included in the 2000 spending review on which I reported in last year's overview report.

SFEFC organisational changes

4.17 In October 2001 the Department provided additional resources to SFEFC to enable it to establish a new FE Development Directorate. In December 2001 SFEFC decided to defer appointing a new director of FE Development until their outgoing chief executive was replaced in spring 2002.

Appendix 1

Guidance on the statement on corporate governance following the publication of the Turnbull report on the Combined Code

Maintaining a sound system of internal control

1 The Governing Body is responsible for the institution's system of internal control. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The Governing Body must further ensure that the system of internal control is effective in managing risks in the manner which it has approved.

2 In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the institution, the Governing Body's deliberations should include consideration of the following factors:

- the nature and extent of the risks facing the institution;
- the extent and categories of risk which it regards as acceptable for the institution to bear;
- the likelihood of the risks concerned materialising;
- the institution's ability to reduce the incidence and impact on the business of risks that do materialise; and
- the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

3 It is the role of management to implement the Governing Body's policies on risk and control. In fulfilling its responsibilities, management should identify and evaluate the risks faced by the institution for consideration by the Governing Body and design, operate and monitor a suitable system of internal control which implements the policies adopted by the Governing Body.

4 All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information and authority to establish, operate and monitor the system of internal control. This will require an understanding of the institution, its objectives, the environment in which it operates, and the risks it faces.

5 An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of an institution that, taken together:

- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the institution's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed;

- help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation.

- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.

6 An institution's system of internal control will reflect its control environment which encompasses its organisational structure. The system will include:

- control activities;

- information and communications processes; and

- processes for monitoring the continuing effectiveness of the system of internal control.

7 The system of internal control should:

- be embedded in the operations of the institution and form part of its culture;

- be capable of responding quickly to evolving risks to the business arising from factors within the institution and to changes in the higher education sector; and

- include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken.

8 A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.

9 A sound system of internal control therefore provides reasonable, but not absolute, assurance that an institution will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against an institution failing to meets its objectives or all material errors, losses, fraud, or breaches of laws or regulations.

Reviewing the effectiveness of internal control

10 Reviewing the effectiveness of internal control is an essential part of the Governing Body's responsibilities. The Governing Body will need to form its own view on effectiveness after due and careful enquiry based on the information and assurances provided to it. Management is accountable to the Governing Body for monitoring the system of internal control and for providing assurance to the Governing Body that it has done so.

11 The role of institutional committees in the review process, including that of the audit committee, is for the Governing Body to decide and will depend upon factors such as the nature of the significant risks that the institution

faces. To the extent that designated Governing Body committees carry out, on behalf of the Governing Body, tasks that are attributed in this guidance document to the Governing Body, the results of the relevant committees' work should be reported to, and considered by, the Governing Body. The Governing Body takes responsibility for the disclosure on internal control in the annual report and accounts.

12 Effective monitoring on a continuous basis is an essential component of a sound system of internal control. The Governing Body cannot, however, rely solely on the embedded monitoring processes within the institution to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the Governing Body should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered all significant aspects of internal control for the institution for the year under review and up to the date of approval of the annual report and accounts.

13 The reference to 'all controls' in Code Provision D.2.1 should not be taken to mean that the effectiveness of every internal control (including controls designed to manage immaterial risks) should be subject to review by the Governing Body. Rather it means that, for the purposes of this guidance, internal controls considered by the Governing Body should include all types of controls including those of an operational and compliance nature, as well as internal financial controls.

14 The Governing Body should define the process to be adopted for its review of the effectiveness of internal control. This should encompass both the scope and frequency of the reports it receives and reviews during the year, and also the process for its annual assessment, such that it will be provided with sound, appropriately documented, support for its statement on internal control in the institution's annual report and accounts.

15 The reports from management to the Governing Body should, in relation to the areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact that they have had, could have had, or may have, on the institution and the actions being taken to rectify them. It is essential that there be openness of communication by management with the Governing Body on matters relating to risk and control.

16 When reviewing reports during the year, the Governing Body should:

- consider what are the significant risks and assess how they have been identified, evaluated and managed;

- assess the effectiveness of the related system of internal control in managing the significant risks, having regard, in particular, to any significant failings or weaknesses in internal control that have been reported;

- consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and

- consider whether the findings indicate a need for more extensive monitoring of the system of internal control.

17 Additionally, the Governing Body should undertake an annual assessment for the purpose of making its public statement on internal control. The assessment should consider issues dealt with in reports reviewed by it during the year together with any additional information necessary to ensure that the Governing Body has taken account of all significant aspects of internal control for the institution for the year under review and up to the date of approval of the annual report and accounts.

18 The Governing Body's annual assessment should, in particular, consider:

- the changes since the last annual assessment in the nature and extent of significant risks, and the institution's ability to respond to changes in its business and the external environment;
- the scope and quality of management's ongoing monitoring of risks and of the system of internal control, and, where applicable, the work of its internal audit function and other providers of assurance;
- the extent and frequency of the communication of the results of the monitoring to the Governing Body (or Governing Body's committee(s)) which enables it to build up a cumulative assessment of the state of control in the institution and the effectiveness with which risk is being managed;
- the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the institution's financial performance or condition; and
- the effectiveness of the institution's public reporting processes.

19 Should the Governing Body become aware at any time of a significant failing or weakness in internal control it should determine how the failing or weakness arose and re-assess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

The Governing Body's statement of internal control

20 In its narrative statement of how the institution has applied Code principle D.2, the Governing Body should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the institution, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the Governing Body and accords with the Turnbull guidance.

21 The Governing Body may wish to provide additional information in the annual report and accounts to assist understanding of the institution's risk management processes and system of internal control.

22 The disclosure relating to the application of principle D.2 should include an acknowledgement by the Governing Body that it is responsible for the

institution's system of internal control and for reviewing its effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

23 In relation to Code provision D.2.1, the Governing Body should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.

24 Where a Governing Body cannot make one or more of the disclosures in paragraphs 5.20 and 5.23, it should state this fact and provide an explanation.

25 The Governing Body should ensure that its disclosures provide meaningful, high-level information and do not give a misleading impression.

26 Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying this guidance, this should be disclosed.

TIMETABLE FOR IMPLEMENTATION

27 The nature of the disclosures that an institution will be able to make on internal control will depend on the extent to which it has established the procedures necessary to implement the Turnbull guidance.

28 It is likely that initially an institution will wish to take advantage of transitional arrangements for the year ended 31st July 2001 and state that they are in the process of establishing the necessary processes to comply with the key principles of Corporate Governance. (A possible statement is shown at Annex A).

29 Once an institution is satisfied it has adopted the final guidance in full, it can make a full disclosure in its financial statements. (A possible statement is shown at Annex B). Some institutions will be in a position to make a full compliance statement by year ended 31st July 2002. All institutions must be in a position to make a full compliance statement by 31st July 2003.

AUDITOR GENERAL

110 GEORGE STREET   EDINBURGH   EH2 4LH

T. 0131 477 1234   F. 0131 477 4567

www.audit-scotland.gov.uk

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