

INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

The Adam Smith College, Fife

Annual audit report for 2005-06 to the Board of Management
and the Auditor General for Scotland

21 December 2006

AUDIT

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Notice: About this report

This report has been prepared in accordance with the responsibilities set out within Audit Scotland's *Code of Audit Practice* ('the Code') and *Statement of Responsibilities of Auditors and Audited Bodies*.

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

Nothing in this report constitutes a valuation or legal advice.

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

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Executive summary

Financial position

The financial statements reflect a consolidated surplus for the year of £376,000 after impairment of fixed assets of £217,000 and a transfer to a designated property reserve of £400,000. The group income and expenditure account shows a balance of £4,426,000 at 31 July 2006 (excluding net pension liabilities).

Full implementation of FRS 17 'retirement benefits' ("FRS 17") required a prior year adjustment to the comparative information for 2004-05, resulting in a reduction of £4,228,000 to opening reserves at 1 August 2005. During the year, the College's share of the liabilities of the Fife Council Pension Fund decreased from £4,377,000 to £3,851,000 at 31 July 2006.

The College received various ring-fenced funds during 2005-06, of which £1,135,000 was awarded to fund expenditure on property maintenance and College equipment and £900,508 was recognised in the year to assist the College in completing the merger of Fife and Glenrothes Colleges.

Corporate governance

During the 2005-06 financial statements audit our work has identified no significant weaknesses in the operation of financial controls and procedures.

In the year the College's internal auditor produced audit reports on budget management and control; network security and control; quality systems; estates management; and, commercial development. In each report, internal audit concluded that there was "substantial assurance" over the controls in place and summarised that "whilst there is a basically sound system, there are weaknesses that put some of the system objectives at risk".

The College's internal auditor's overall opinion for the year ended 31 July 2006 is one of "substantial assurance that the internal controls and governance frameworks which it operates are sufficient to ensure the efficient and effective operation of the organisation."

The 2005-06 corporate governance statement on the systems of internal control prepared by the College does not disclose any major weaknesses. However, the statement recognises that a number of internal control arrangements were not

fully developed for all of 2005-06 due to the ongoing finalisation of the College's corporate governance arrangements. The statement by management reports that "in the run up to merger, preparatory governance arrangements were put in place for key areas. However, during its first year of operation, the audit committee reviewed and improved the corporate governance arrangements, resulting in a stronger governance framework for the College."

We have not identified any significant control weaknesses in relation to fraud and irregularity, standards of conduct or prevention of corruption.

Financial statements

During 2004-05 the College obtained confirmation from the Scottish Ministers that Fife College would merge with Glenrothes College on 1 August 2005 to form Adam Smith College, Fife. The merger has been undertaken in compliance with FRS 6 'acquisitions and mergers', with prior year balances being restated to include the comparative balances of Fife and Glenrothes Colleges.

A number of adjustments were required to the draft financial statements during our audit, primarily in relation to opening balances, revaluation of fixed assets and full implementation of FRS 17.

On 21 December 2006 we issued an audit report expressing an unqualified opinion on the group and parent College financial statements for the year ended 31 July 2006 and on the regularity of the financial transactions reflected in those financial statements.

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Introduction

Audit framework

2005-06 was the first and indeed final year of our appointment as external auditors of The Adam Smith College, Fife ("the College"). This report summarises our opinion and conclusions and highlights significant issues arising from our work. While a requirement of Audit Scotland's *Code of Audit Practice*, this report, having been discussed in draft with the audit committee, also discharges our obligations under International Auditing Standard 260: *Communication of audit matters to those charged with governance*.

The framework under which we operate under appointment by Audit Scotland was outlined in the audit plan for the year discussed with the College's audit committee on 30 May 2006.

The scope of the audit was to:

- provide an opinion on, to the extent required by the relevant authorities, the financial statements and the regularity of transactions in accordance with the standards and guidance issued by the Auditing Practices Board;
- review and report on the College's corporate governance arrangements in relation to systems of internal control, the prevention and detection of fraud and irregularity, standards of conduct, and prevention and detection of corruption; and the College's financial position; and
- review and report on the College's arrangements to manage its performance, as they relate to the economy, efficiency and effectiveness in the use of resources.

Our audit planning process identified a number of other areas for specific attention:

- accounting for the merger between Fife and Glenrothes Colleges;
- full implementation of FRS 17;
- potential impact of the planned tangible fixed assets revaluation;

- accounting for ring fenced grant funding; and
- consideration of VAT schemes.

Basis of information

External auditors do not act as a substitute for the College's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

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

Acknowledgement

Our audit has brought us into contact with a range of College staff. We wish to place on record our appreciation of the co-operation and assistance extended to us by staff in the discharge of our responsibilities. It is our intention to minimise the disruption to the College from a change in auditor through briefing and liaison on unresolved issues with the incoming auditor's staff.

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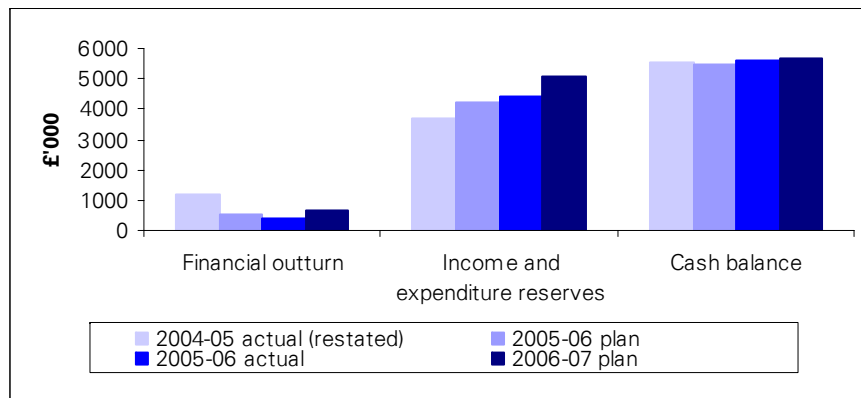
Financial position

Financial position

Funding Council circular FE/54/02, issued on 20 December 2002, defines a college that is financially secure as one that "on a continuing basis, is able to generate operating surpluses reliably and as planned, and through that accumulate a reasonable level of financial reserve. The college must also generate sufficient cash to finance its operations and meet its liabilities; regular operating surpluses would ensure this."

Figure 1 provides a summary of the College's planned and actual financial results, based on the formal returns submitted by the College to the Scottish Funding Council.

Figure 1: comparison of planned and actual results



The College has reported a consolidated surplus in 2005-06 of £376,000 after impairment of fixed assets of £217,000 and a transfer to a designated property reserve of £400,000. This has resulted in an accumulated group income and expenditure balance of £4,426,000 (excluding pension reserves) and group cash balances of £5,615,000 as at 31 July 2006.

The College surpassed its budgeted outturn for the year, before transfers to the designated property reserve, by £240,000 primarily due to additional unforeseen savings generated by the merger.

The College has reported a strong cash position for the past two years. After accounting for outstanding bank loans, net cash at 31 July 2006 was £3,778,000 (2005, £2,267,000). Management are delaying any decision to repay existing bank loans until finalisation of the future estates strategy, which is likely to identify a number of maintenance and redevelopment projects.

The College's annual surplus for 2005-06 included a number of non-recurring items as shown in figure 2. Management demonstrate consideration of non-recurring funding throughout the budget setting process, ensuring that such funding is used for non-recurring purposes.

Figure 2: recurring surplus in 2004-05 and 2005-06

Description	2005-06 £'000	2004-05 £'000
Reported surplus	376	1,161
Gain on disposal of fixed assets	-	(1,063)
Loss on impairment of fixed assets	217	-
Net impact of changes in accounting for pensions	146	252
Transfer to designated property reserve	400	-
Exceptional staff costs	566	354
Recurring surplus	1,705	704

Financial position (continued)

2006-07 budget

The College has budgeted for a surplus of £654,000 for the year ending 31 July 2007. The 2006-07 outturn will be significantly affected by the implementation of the College's estates strategy as well as other changes, including continued increases in energy costs and the known 1% increase (to 13.5%) in employer contributions to the Scottish Teachers' Superannuation Scheme from April 2007.

The College is budgeting for rolling annual surpluses of 3% of total revenues by 2007-08. Surpluses generated will mainly be used to support the College's estates strategy.

The financial outturn presented to the board of management in November 2006 reported a surplus of £11.9 million for the three months to 31 October 2006 against a budgeted surplus of £13.3 million for the same period. The year end forecast shows an expected surplus to 31 July 2007 of £0.6 million. We understand that management does not phase budgets on a month by month basis to avoid reliance on non-recurring funding, however, there is a risk that this may result in unnecessary financial volatility and exposure. While income is £1.8 million below budget outturn, expenditure is only £0.6 million below, which may indicate that one or more projects are proceeding on a loss-making basis.

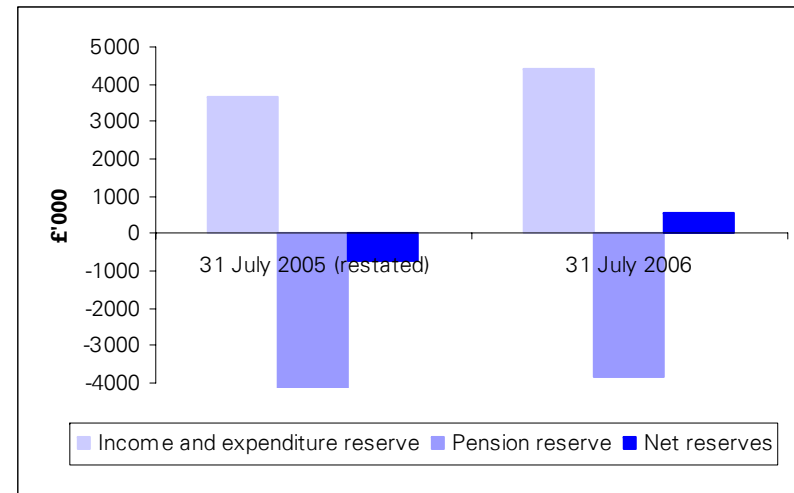
FRS 17 'retirement benefits' ("FRS 17")

The College fully implemented FRS 17 during the year ended 31 July 2006, resulting in inclusion of the College's share of Fife Council Pension Fund in the balance sheet for the first time. Full implementation of FRS 17 is a change of accounting policy and required a prior year adjustment in compliance with FRS 3 'reporting financial performance'. The restatement resulted in a reduction of £4,228,000 to previously reported reserves as at 1 August 2005. Implementation of FRS 17 resulted in the recognition of a net pension liability on the balance sheet of £3,851,000 as at 31 July 2006 (2005, £4,377,000).

The net impact on the income and expenditure account of recognising the net return/interest on pension assets and liabilities and the difference between pension contributions paid and the service cost was £146,000 (2004-05: £252,000).

Figure 3 highlights the impact of the College's share of the pension deficit on its income and expenditure reserves.

Figure 3: impact of FRS 17 pension deficit



Provisions

The College's enhanced pension provision is £2,510,000, based on previous actuarial valuations, which have been updated using discount tables issued by the Scottish Funding Council. Full implementation of FRS 17 resulted in reversal of the previously unfunded element of the provision of £121,000 relating to members of the Fife Council Pension Fund, which is now included in the pension liabilities recorded on the balance sheet.

Ring-fenced funding

The Scottish Funding Council allocated £3,626,000 of ring-fenced funding to the College during 2005-06, primarily for the capital programme, merger related costs and the funding of teachers' superannuation. The College's financial monitoring

Financial position (continued)

procedures include consideration of the use of this funding to ensure it is used for the purposes identified.

During 2004-05 the Scottish Funding Council had awarded additional funding to the former Fife College to be used to fund a number of merger-related costs. We reported that the level of funding recognised in the year ended 31 July 2005 was adjusted following the audit, resulting in £710,000 recognised during 2004-05. The balance (£740,000) carried forward into 2005-06 has been utilised during the year, with only £8,500 being carried forward into 2006-07.

Capital income and expenditure

The College has incurred capital expenditure of £222,000 in the year, relating to the purchase of a new telecommunications infrastructure system. This has been funded from ring-fenced grants, which have been capitalised in accordance with the College's accounting policies. Further capital expenditure has been postponed until the College's estates strategy has been finalised. There were no fixed asset disposals in the year.

2005-06 SUMS outturn

The College's outturn against its 2005-06 SUMS targets is shown in figure 4.

Figure 4: SUMS outturn

	2005-06
SUMS target	117,018
SUMS actual	113,953
Impact on recurring grant	Nil

The College's internal auditors have completed their work on the 2006-07 SUMS return to the Scottish Funding Council. Their audit certificate does not disclose any significant weaknesses in processes or errors in the return.

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Corporate governance

Introduction

Corporate governance is concerned with structures and processes for decision-making, control and behaviour at the upper levels of the College in accordance with the fundamental principles of openness, integrity and accountability. Management is responsible for establishing arrangements for the conduct of its affairs, including compliance with applicable guidance, ensure the legality of activities and transactions and to monitor the adequacy and effectiveness of these arrangements in practice. The *Code* requires auditors to review aspects of the corporate governance arrangements as they relate to:

- the board's review of its systems of internal control;
- the prevention and detection of fraud and irregularity; and
- standards of conduct, and the prevention and detection of corruption.

Framework

Following the merger on 1 August 2005, the board of management approved its corporate governance structure, establishing formal lines of reporting and accountability and a committee structure, supported by formal procedures.

The former Fife and Glenrothes Colleges undertook significant consideration of future strategies, policies and procedures during the preparation for the merger. As a result, the board of management successfully approved a number of policies at its first formal meeting on 1 August 2005, including:

- constitution and standing orders;
- compliance and health and safety policies; and
- register of interests.

During the year management continued to make good progress and demonstrate commitment to formalising the system of internal control, including risk management arrangements, the remit and terms of reference of standing committees, and internal quality and process review.

Monitoring the financial performance of the College has been a key focus of management and the board – through its finance committee – during the year. Management has taken steps to improve the robustness of the system of internal financial reporting during the year, but the following weaknesses have been identified:

- narrative commentary accompanying the monthly finance statements continue to record significant variances between actual and forecast results, primarily relating to European and other non-recurrent funding; and
- management accounts and budget statements are not formally circulated to budget holders for regular review and comment.

The frequency and nature of changes between forecast and actual results reported in the management accounts introduces a level of volatility and risk into the College's financial position.

As at 31 July 2006 the College was continuing the process of finalising some corporate governance documents, including:

- operational and departmental risk registers; and
- revised financial operating procedures.

Management should ensure that these documents are finalised during 2006-07.

Corporate governance statement

As part of the development of corporate governance, public sector bodies are required to make a statement of how they have applied the principles of corporate governance. We are required to review this to assess whether the description of the process adopted in reviewing the effectiveness of the system of internal control appropriately reflects the process. We are not required to provide an opinion on the College's systems of internal controls.

The 2005-06 corporate governance statement on the systems of internal control prepared by the College does not disclose any major weaknesses at 31 July 2006.

Corporate governance (continued)

However, the statement recognises that a number of internal control arrangements were not fully developed for all of 2005-06 due to the ongoing finalisation of the College's corporate governance arrangements.

The statement by management reports that *"in the run up to merger, preparatory governance arrangements were put in place for key areas. However, during its first year of operation, the audit committee reviewed and improved the corporate governance arrangements, resulting in a stronger governance framework for the College."*

Financial memorandum

We have discussed with management and the audit committee the revised financial memorandum, which took effect from 1 January 2006, in accordance with guidance issued by the Scottish Funding Council to assess the impact on financial regulations, standing orders and governance. The board of management formally considered the draft revised financial memorandum on 1 August 2005 and a number of recommendations were made to the Funding Council. The finalised financial memorandum was approved by the board on 26 October 2005.

Control environment

During the 2005-06 audit process we have identified some minor areas for improvement in the operation of financial controls and procedures, which have been included in the action plan in appendix one. We have made one significant recommendation to enhance the internal financial reporting processes.

Overall, our audit testing of the College's controls and procedures over cash income and banking, ordering and purchase invoice processing, sales invoice processing and payroll administration revealed no material weaknesses. The increasing demands of the College's finance function as a result of the ongoing estates strategy and the bedding down of merged systems and processes mean that strict financial controls and procedures are critical to the College's future success.

Oversight of the Council's internal control and reporting arrangements is provided through its audit committee. The audit committee does not currently include any members with formal accountancy qualifications. Two members of the board of management are qualified accountants, but serve on the finance committee. The board should reconsider its committee arrangements in line with good practice reflected in the Smith report.

Internal audit

During 2005-06, Chiene & Tait were contracted to provide internal audit services to the College. We have reviewed the scope and extent of work performed by internal audit during 2005-06 and considered the impact of their findings and conclusions on our work, where appropriate.

In the year the College's internal auditor produced audit reports on budget management and control, network security and control, quality systems, estates management, and commercial development. In each report, internal audit concluded that there was *"substantial assurance"* over the controls in place and summarised that *"whilst there is a basically sound system, there are weaknesses that put some of the system objectives at risk"*.

We reviewed the internal audit plan to identify areas where we could place reliance in order to dovetail the audit process and reduce duplication. However, similar to 2004-05 (at Fife College), we were unable to place formal reliance on the findings of internal audit due to the lack of coverage over key financial systems.

Fraud and irregularity, standards of conduct, and prevention and detection of corruption

Work in these areas has been addressed over the duration of our appointment. In relation to fraud, we have had regard to relevant auditing standards when completing our work. We also had regard to Statement of Auditing Standards 110: *Fraud and Error* and International Standards on Auditing 240: *The Auditor's Responsibility to Consider Fraud in the Audit of Financial Statements*.

Corporate governance (continued)

Performance audit

The terms of appointment from Audit Scotland include a requirement for a proportion of our audit time to be spent on performance audit work. Performance audit work covers a variety of areas, both financial and non-financial, including both Audit Scotland centrally directed studies and locally determined studies based on agreement between each organisation and their auditors.

No performance audit studies were identified by Audit Scotland for the College during 2005-06.

Reviews and inspections

Scottish Funding Council

The College was subject to a 'post merger' review by the Scottish Funding Council during the year. In its letter dated 11 July 2006, the Council noted that: *"We felt that progress with the merger was very positive. It was particularly good to hear that staff had been first-class, there were no major issues, that curriculum development was progressing well, and that the ASC name was well received in the college, sector, region and internationally."*

Investors in People ("IIP")

The College anticipates maintaining the IIP status previously held by the former Fife and Glenrothes Colleges. Whilst IIP reported in their interim review (February 2006) that *"Adam Smith College is not continuing to fully meet the Investors in People Standard at this time"*, the report also states that *"the pace of change at the College is relentless and senior management are congratulated on bringing people along with this whilst continuing to strive and achieve the objectives in their business of learning and development. The assessor is confident that, if the current level development continues Adam Smith College will come forward in spring 2007 strongly placed to satisfy the rigour of the Standard in full."* A full assessment is scheduled for spring 2007, which will confirm whether the College retains the IIP status.

Office of the Scottish Charity Regulator ("OSCR")

The Charities and Trustee Investment (Scotland) Act 2005 ("the Act") came into force in April 2006, introducing new duties and responsibilities for OSCR. Over time OSCR intends to undertake a rolling review of charities entered in the Scottish charity register to assess whether they meet, and continue to meet, the charity test: purposes will have to be charitable in the context of the charity test set out in Section 7 of the Charities and Trustee Investment (Scotland) Act 2005 and charities will have to show that they provide public benefit.

OSCR has recently proposed that the first phase of the rolling review should focus on those charities where uncertainty may exist regarding their ability to meet the new test, for example whether stated purposes are charitable, or where 'unduly restrictive conditions', such as fees, may exist. We understand that OSCR has written to parent organisations and umbrella bodies of such charities to inform them of the proposals and to invite comments.

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Financial statements

Audit opinion

On 21 December 2006 we issued an audit report expressing an unqualified opinion on the group and parent College financial statements for the year ended 31 July 2006 and on the regularity of the financial transactions reflected in those financial statements.

Audit completion

An important measure of proper financial control and accountability is the timely closure and publication of audited financial statements. Figure 5 summarises the key elements of the audit process with which we require management to engage.

Figure 5: key elements of the audit process

Completeness of draft financial statements
Although a set of draft financial statements were received at the start of the agreed audit visit on 31 October 2006, a number of presentational disclosures, including finalised comparatives, were not immediately available for review. This was mainly due to management's focus on accounting for pensions and the merger.
Quality of supporting working papers
In accordance with our normal practice, we issued a 'prepared by client' request that set out a number of documents required for our audit of the financial statements. Documentation provided was to a good standard and the College was at a reasonable standard of readiness for the start of the final audit visit on 31 October 2006.
Response to audit queries
We are pleased to report that our routine audit queries were dealt with in a timely manner.

Financial adjustments and confirmations

In figure 6 we draw attention to adjustments to the financial statements made by management as a result of the audit process.

Figure 6: financial statement adjustments

	Income and expenditure account £'000	Balance sheet £'000
Correction of categorisation of grants debtors	-	528
	-	(528)
Recognition of impairment	(217)	(217)
FRS 17 disclosures	Disclosure only	
Note 11: tangible fixed assets changed disclosure to separately identify constituent movements in year	Disclosure only	
Inconsistencies in disclosure of opening balances	Disclosure only	
Note 35: financial commitments changed to show payments due in next year analysed per expiry date rather than all future payments.	Disclosure only	
Net adjustment	(217)	(217)

Confirmations and representations

We confirm that as of 21 December 2006, in our professional judgement, KPMG LLP was independent within the meaning of regulatory and professional requirements and the objectivity of audit staff is not impaired. This has been confirmed separately in writing to the audit committee.

In accordance with auditing standards, we obtained representations from the board of management on material issues prior to signing our opinion. Management has adjusted all identified audit differences.

Financial statements (continued)

Significant accounting issues

Accounting policies

FRS 18 requires that new or revised accounting policies are considered to be appropriate to the College's circumstances and approved by the audit committee and board of management. The audit committee approved the College's accounting policies on 5 December 2006 in accordance with FRS 8. Management has reviewed the accounting policies which were in place for Fife and Glenrothes Colleges in 2004-05 and did not identify any significant differences in them, with the exception of the remaining lives of owned buildings, and no adjustments have been made to the 2004-05 comparative information. The professional valuation of buildings included an assessment of remaining lives, which have been applied prospectively from 1 August 2005.

FRS 6: acquisitions and mergers

The College was formed on 1 August 2005 by the transfer of activities, assets and liabilities from Fife and Glenrothes Colleges. Management considered the nature of this transaction with reference to FRS 6 'acquisitions and mergers' and determined to account for the transaction as a merger. The nature of the transaction is consistent with the requirements of FRS 6 and relevant financial statement adjustments and disclosures have been made, including the derivation of prior year comparatives to include the activities of Fife and Glenrothes Colleges.

The accuracy of the 2005-06 opening balances has been confirmed by reference to the 2004-05 financial ledger systems and signed financial statements of Fife and Glenrothes Colleges.

FRS 17: retirement benefits ("FRS 17")

In 2005-06 the College was required to make full disclosures in its financial statements, including amending comparatives and bringing in the effect of a prior year adjustment. This required information from the actuaries of the Fife Council Pension Fund.

In September 2006 the College's actuaries reported, in accordance with FRS 17, the College's share of the pension assets and liabilities of the Fife Council Pension Fund at 31 July 2006. Following our review of management's interpretation of the report, a revised actuarial report was subsequently received. Management prepared the majority of disclosures for audit, which were subject to a small number of presentational changes.

FRS 2: accounting for subsidiary undertakings

FRS 2 sets out the criteria under which legally owned entities should be consolidated into the group's financial statements. At 31 July 2006 the College had interests in two organisations: the Adam Smith Enterprise and Education Foundation ("ASEEF") and Oneviz Limited.

ASEEF is a registered charity, charged with securing funds to help the College pursue its corporate objectives. The results of ASEEF have been consolidated within the College's financial statements. We have been appointed auditors of ASEEF for the year ended 31 July 2006. However, due to the additional work required to ensure compliance with the updated Statement of Recommended Practice: Accounting and Reporting by Charities (revised 2005), management were unable to provide complete financial statements for audit within agreed timescales.

The College also has a 50% interest in Oneviz, a private company established by the former Glenrothes College that provides training, consultancy and facilities hire in Edinburgh. Management considered that the assets and liabilities of Oneviz and the results for the year ended 31 July 2006 are not material to the College and the financial results of Oneviz are not consolidated for the year ended 31 July 2006.

Financial statements (continued)

FRS 15: tangible fixed assets

FRS 15 'tangible fixed assets' ("FRS 15") requires that, for bodies adopting a policy of revaluation, land and buildings should be fully revalued every five years. The College formally commissioned DM Hall, Chartered Surveyors, to provide independent valuations of all land and buildings at 1 August 2005. Formal reports and associated working papers were presented in line with the original timetable. However, discrepancies in DM Hall's report were identified during the audit process and a revised report was received on 26 October 2006.

At our request, management reviewed the nature of the movements in asset values and have accounted for these movements in accordance with FRS 15. In total, £6,568,000 was credited to the revaluation reserve reflecting upward movements in land and buildings; an audit adjustment of £217,000 was processed in the income and expenditure account to recognise an impairment.

Estates strategy

We understand that the majority of capital expenditure has been delayed until the College's estates strategy has been finalised, which is planned for early 2007. We also understand that the College is in negotiations with the University of Dundee over the occupation and ownership of their Fife campus in Kirkcaldy and the provision of nursing training in Fife. We draw management's attention to the potential tax implications, including VAT, should the College transfer the provision of any nursing education activities into a subsidiary entity. Particular consideration will need to be given to transfer pricing legislation and the impact of this legislation on the College as a registered charity.

Treasury management

The College has a responsibility to ensure that public funds are administered in accordance with the College's financial memorandum and in a way that secures best value for money. At 31 July 2006, the College had bank loans outstanding of £1,837,000 (2005, £2,011,000) and cash balances of £5,617,000 (2005, £4,278,000).

The College intends to reschedule its loans portfolio to obtain more favourable terms and conditions and this has been disclosed as a post balance sheet event. Management has decided to delay the utilisation of its significant cash balances to repay loan balances until details of the College's estates strategy are finalised and costed.

Accounting for VAT

The St Brycedale campus redevelopment capital project was completed during 2004-05. As noted in our 2005-06 planning memorandum (issued 23 May 2006), management were considering entering into a Lennartz agreement with HM Revenue & Customs. The College would benefit by a refund of irrecoverable VAT relating to the project which will then be repaid over a ten year period. While an application for the Lennartz scheme has been made, the details of the scheme have yet to be finalised and there is no impact on the financial statements for the year ended 31 July 2006.

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Appendix I – action plan

This appendix summarises the performance improvement observations we have identified during the financial statements audit. Each of our observations has been allocated a risk rating, which is explained below.

	<p>Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the College or systems under consideration. The weakness may therefore give rise to loss or error.</p>		<p>Grade two (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.</p>		<p>Grade three (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.</p>
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Issue, risk and priority	Recommendation and benefit	Management response	Responsible officer and implementation timetable	
1	<p>Financial monitoring</p> <p>Management has improved the system of internal financial reporting during the year but the following areas have been identified for strengthening:</p> <ul style="list-style-type: none"> • the narrative commentary accompanying the monthly finance statements continues to reflect significant variances between actual and forecast results; and • management accounts and budget statements are not formally circulated to budget holders for regular review and comment. <p>The frequency and nature of changes between forecast and actual results reported in the management accounts introduces a level of volatility and risk into the College's financial position.</p>	<p>Increased attention should be given to phasing of income and expenditure at the budget stage.</p> <p>Thereafter, senior management should continue their focus on implementing a robust and timely system of financial review, including maintaining their focus on ownership of and accountability for financial results at institute level.</p>	<p>We are aware of the phasing issue and are addressing and agree with all the points raised. These will be implemented during 2006-07.</p>	<p>Finance manager 31 January 2007</p>

Appendix I – action plan (continued)

<p>2</p>	<p>Audit committee membership</p> <p>During 2005-06 there were no audit committee members with a professional accountancy qualification, as recommended by the Smith report. There is a risk that the audit committee is not suitably qualified to fulfil its role as an effective scrutiniser of the College's activities.</p>	<p>Whilst there are two qualified accountants on the College's finance committee, the board should reconsider its committee arrangements in line with good practice reflected in the Smith report.</p>	<p>We will raise this issue with the board.</p>	<p>Assistant principal & director of finance 31 July 2007</p>
<p>3</p>	<p>Fixed asset register</p> <p>During 2005-06 there have been a large number of adjustments to the value of land and buildings arising from:</p> <ul style="list-style-type: none"> • the merger process; • revaluation adjustments; • transfers between asset categories; and • reassessment of distinctions between buildings and associated land values. <p>The fixed asset register has not been updated to fully reflect these adjustments, which may impact the accuracy of management's fixed asset management in future accounting periods.</p>	<p>Management should review and update the fixed asset register and revaluation reserve for accuracy to reflect all adjustments in 2005-06. This will ensure that management has an accurate source of information on their fixed asset portfolio on which to base the estates strategy.</p>	<p>Many of these changes occurred during the audit process and the changes have since been made to the fixed asset register.</p>	<p>Not applicable – now implemented.</p>

Appendix I – action plan (continued)

<p>4</p>	<p>Financial controls</p> <p>Weaknesses exist in the operating effectiveness of the system of financial controls, particularly relating to the following key reconciliations:</p> <ul style="list-style-type: none"> • bank accounts; • supplier statements; and • control accounts. <p>In addition, there is no evidence of a routine system of review of the aged debt profile.</p> <p>There is a risk that fraud or error is not identified and rectified in a timely manner. In addition, the College may not maximise the recoverability of income due.</p>	<p>Management should ensure that there is evidence of preparation and review of all reconciliations on a regular basis to provide assurance over the operating effectiveness of these key controls.</p>	<p>The bank accounts in question were student funds accounts. These are now under control of the finance department and will therefore be subject to normal operating procedures and systems of internal control.</p> <p>Evidence will now be retained in respect of the aged debtors profile.</p> <p>We agree with other matters raised.</p>	<p>John Thompson 31 January 2007</p>
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Appendix II – follow-up of prior years' recommendations

In this section we provide a brief overview of the action taken to date against recommendations made in previous accounting periods. The following table contains a summary, by report, of the status of recommendations made in previous years. For the purposes of this report, we have considered only those recommendations made by external audit in the 2004-05 annual audit reports of Fife and Glenrothes Colleges. Management has indicated that recommendations preceding these reports have either been fully implemented or are no longer considered relevant.

Figure 2: follow-up of prior years' recommendations

	Fully implemented	Ongoing	Not implemented	Not yet due
Fife College annual audit report 2004-05	6	-	1	-
Glenrothes College annual audit report 2004-05	-	-	-	-
Total	6	-	1	-
% of total due	86%	-	14%	-

The one outstanding audit recommendation relates to the implementation of a programme of fixed asset physical verification. There were no significant recommendations specifically reported by Audit Scotland in their 2004-05 annual audit report for Glenrothes College.