

Members of the Board of Management  
James Watt College of Further and Higher Education  
Finnart Campus  
Finnart Street  
Greenock  
PA16 8HF

cc. Auditor General, Audit Scotland

2 March 2007

Dear Board of Management

**Report on the audit for the year ended 31 July 2006**

We have now completed our audit of the College's accounts for the year ended 31 July 2006.

As part of our responsibilities as external auditor to the College we are required to submit, at the conclusion of each year's audit, a final report addressed both to the members of the Board of Management and to the Auditor General.

This report aims to summarise all significant matters which have arisen during the course of the audit and which we feel are worthy of members' attention.

We have pleasure in attaching our final report on the College's audit for the year to 31 July 2006, which will be submitted to the Board of Management.

We should like to take this opportunity to thank the Acting Principal and his staff for their assistance during the course of the audit.

Yours faithfully

**Baker Tilly**

Enc

**James Watt College of Further and Higher Education**

**Draft Report to those charged with Governance**

**Year ended 31 July 2006**

**Presented to the Audit Committee  
on 28 February 2007**



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*This report has been prepared for the sole use of James Watt College and Audit Scotland and must not be disclosed to any third party, or quoted or referred to, with the exception of the Scottish Funding Council, without our written consent. No responsibility is assumed to any other person in respect of this report.*

## 1. Executive Summary

### Audit report

1. Our responsibilities and duties as auditor are summarised in Audit Scotland's Code of Audit Practice and are derived from the Public Finance and Accountability (Scotland) Act 2000. This report to the Board of Management and the Auditor General on the 2005/06 audit is a summary of audit activity for the year. The most significant issues identified by the audit are included in this Section with more detail provided in the body of the report.
2. Due to the significant deficit in the year and the College's current financial position, even with confirmation of ongoing funding from the SFC to meet the College's funding requirements for the next 12 months, we consider that our audit report requires an emphasis of matter on uncertainty over going concern resulting from the College's financial position. This is predominantly because the provision of SFCs funding is dependant on the College's agreement and adherence to a satisfactory recovery plan which is as yet uncertain because of the College's previous history of not achieving budget.
3. Apart from this, in our opinion, the financial statements give a true and fair view of the College's financial position and the income and expenditure for the year and funds received appear to have been applied for their intended purpose, although there have been several instances where value for money appears to be in question, it appears that the aim of the spend was to comply with the College's ongoing requirements.
4. We do have concerns over governance issues throughout the period as identified in our 2004/05 Report to Management, the subsequent Update Report and your Internal Audit Annual Report. We are pleased to note this is disclosed in your Governance statement but would recommend further disclosure of the issues identified and action taken.

### Financial Performance

5. The income and expenditure account shows a deficit of £3,872k on the year's operations. There were a number of adjustments made to the deficit in the accounts presented for audit, which had the effect of increasing the deficit by £919k. These are detailed in Section 11.
6. After adjusting for the difference between the actual depreciation charge for the year and depreciation based on historical cost and the realisation of a previous year's revaluation gain, a historical cost deficit of £3,320k is shown. The balance on the College's income and expenditure account reserve at 31 July 2006 is an accumulated deficit of £5,336k.

7. The College is in a very weak financial position from a cash flow point of view and the Board of Management will need to demonstrate that they have obtained confirmation that the College has a robust recovery plan and adequate financing to ensure the College continues to remain a going concern. The College is currently dependent on the continued financial support of the SFC following the withdrawal of overdraft facilities by the Bank of Scotland during September 2006. It is the Board's responsibility to ensure the College does not continue to trade if it is not in a position to meet its liabilities as they fall due.
8. A more detailed analysis of financial performance is undertaken at Appendix D.

### Prior year adjustments

9. The College has processed the following prior year adjustments (all figures in £000):-

	Opening reserves £'000	Creditors £'000
(a) Restatement of income deferral for local authority funding	(579)	579
(b) Recognition of creditor for SAAS fees for 2004/05 to be clawed back due to funding received where attendance targets were not achieved.	(196)	196
	<u>(775)</u>	<u>775</u>

In 2004/05 due to lack of contrary information the College recognised local authority funding on a time apportioned basis. This basis of recognition has now been amended to recognise income on the basis of costs incurred/milestones achieved resulting in a prior year adjustment delaying recognition of this income.

### Issues Arising

10. Due to governance issues noted earlier and the concerns raised by Internal Audit in their Annual Report, External audit placed no reliance on the work of internal audit in any areas on which they reported in 2005/06. Wylie & Bisset's internal audit report for the year ended 31 July 2006 concluded that "In their opinion James Watt College does not have adequate and effective risk management control and governance processes to manage its achievement of the College's objectives". The review for the year highlighted a number of high priority recommendations. The key issues highlighted were:

- Board meetings and finance sub-committee meetings were not held with sufficient regularity (NB no Board meetings were held between July 2005 and December 2005), although the requisite number of Board Meetings were held in the year there were no formal Board Meetings held in this period. While we accept this was due to a number of sub committee meetings being held on staffing and cashflow issues, we consider that it would have been more appropriate to hold 1 to 2 Board meetings in this period of change within the College;.
  - Lack of formalised policy on risk management;
  - Significant improvement required in the area of budgetary and financial controls. While action was taken by some members of the Board in requesting specific followup reports on Internal Control and future funding requirements, there was a failure to follow up on these reports with the update report requested in February only being reported to the Board in November;
  - Significant number of recommendations in the follow-up report had not been implemented.
11. In addition, the previous internal auditor's Deloitte had raised some issues in a report on lack of authorisation of international travel. This report does not appear to have been formally presented to the Audit Committee and Board.
12. Due to our concerns over controls and the conclusions of the Internal Audit Report significant additional audit costs have been incurred in completion of the 2005/06 audit.
13. This has been a difficult year for the College and its future trading recovery plan and governance framework needs to be resolved to allow the College to progress. The College currently does not currently appear to have sufficient detail of future funding requirements to meet its working capital requirements to confirm it is a going concern. We are aware that since 31 July 2006 the new Director of Finance and his team have been working with the rest of the Senior Management Team to improve the system of budgeting and planning to ensure it is robust and that clear action plans can be agreed with the Board to ensure achievement. However they have not had sufficient time to prove the success of the new proceedings, which appear more robust.
14. The key internal control issues identified by us for action by the College arising from the audit are set out in an action plan at Section 8.
15. There is a significant provision of £798k for potential claw back of Local Authority grant income, which may result in a repayment to funding providers in future accounting periods. This has arisen due to funding in excess of actual spend, however further spend in 2006/07 is forecast in this area.
16. Following various reports and queries, a Further Education Development Directorate (FEDD) team from SFC was asked by the Board and SFC to report on various governance issues. This report was finalised in December 2006. This supports our initial concerns over governance practices within the College.
17. The College had a restricted reserve of £16k for which there is no information as to the nature of the reserve, conditions attaching and expected timing and magnitude of future expenditure. Due to immateriality this has now been released to general reserves.
18. All other audit issues identified are noted, together with action taken to resolve these, at Section 6.

## Corporate Governance

19. Audit work has identified significant weaknesses in the College's corporate governance arrangements in terms of level of reporting on finances, number of Board meetings held and general control over the financial position of the College. This and proposed steps for improvement should be included in the Board's Report and Corporate Governance statement. At present, we do not feel that the Corporate Governance statement identifies the issues raised from our work and the work of internal audit and the FEDD team. We consider that it would be more appropriate to identify the main issues and the action that has been taken to address these.

## Concluding Remarks

20. We would like to take this opportunity to convey our thanks to the Vice Principal Financial Development, Associate Principal Finance, the Finance Team and other staff of the College with whom the audit team has had contact, and the FEDD team, for their courteous and helpful co-operation.



## 2. Introduction and coverage

1. This report summarises our key findings in connection with the audit of the financial statements of James Watt College in respect of the year ended 31 July 2006.
2. The scope of our work has already been communicated to you via our Audit Plan document.
3. Our audit has been carried out in accordance with statutory responsibilities under the Public Finance and Accountability (Scotland) Act 2000, and in accordance with the statements of International Auditing Standards (UK and Ireland) (“IAS”) issued by the Auditing Practices Board, and the wider responsibilities embodied in the *Code*. Under this *Code* auditors address and comment upon a number of objectives, together with complying with a number of obligations.

### *Financial statements*

4. We are required to provide an opinion on, to the extent required by the relevant authorities, the College’s financial statements and the regularity of transactions in accordance with the standards and guidance issued by the Auditing Practices Board.

### *Corporate governance*

5. We are required to review and report on, to the extent required by relevant legislation and requirements of the *Code*, the College’s corporate governance arrangements as they relate to the College’s review of its systems of internal control; the prevention and detection of fraud and irregularity, standards of conduct, prevention and detection of corruption and its financial position.

### *Performance audit*

6. We are required to review and report on, to the extent required by relevant legislation and requirements of the *Code*, aspects of the College arrangements to manage its performance, as they relate to the economy, efficiency and effectiveness in the use of resources. No specific performance audits were required to be carried out this year.
7. Audit Scotland has issued a document entitled *Statement of responsibilities of auditors and audited bodies* which accompanies the *Code*. This briefly summarises where the responsibilities of auditors begin and end and what is expected from the College, your attention is drawn to this document.

8. We have planned our work with a view to ensuring:
  - minimum disruption to your staff and operations;
  - that reports submitted to you are constructive and clear, focusing on the issues that matter;
  - that surprises are avoided and that good communications are maintained with you throughout the assignment.
9. A summary of adjusted and unadjusted misstatements identified during the audits has been prepared and is included in Section 11.
10. Additional services were provided to the College in the year by Baker Tilly. Details of these services are included in Appendix B.
11. We consider that the audit approach adopted will provide the Audit Committee with the required confidence that a thorough and robust audit has been carried out.

### 3. Financial Statements and Related Matters

#### Introduction

1. The financial statements of the College are the means by which it accounts for its stewardship of the resources made available to it and its financial performance in the use of these resources. In accordance with the Further and Higher Education (Scotland) Act 1992 and the Accounts Direction issued by the Scottish Further Education Funding Council (now SFC), it is the responsibility of the College to prepare financial statements, which give a true and fair view of the College's financial position and the income and expenditure for the year.
2. The Public Finance and Accountability (Scotland) Act 2000 requires that the auditor shall place on the abstract of accounts an audit report, which contains an opinion as to whether the College has fulfilled this responsibility. The format of the audit report directed by the Auditor General for Scotland clarifies the respective responsibilities of management and auditors in relation to the accounts and requires auditors to set out the basis on which they have formed their audit opinion.

#### Audit Report

3. Due to the significant deficit in the year and the College's current financial position, even with confirmation of ongoing funding from the SFC to meet the College's funding requirements for the next 12 months, we consider that our audit report requires an emphasis of matter on uncertainty over going concern resulting from the College's financial position. This is predominantly because the provision of SFCs funding is dependant on the College's agreement and adherence to a satisfactory recovery plan which is as yet uncertain because of the College's previous history of not achieving budget.
4. Apart from this, in our opinion, the financial statements give a true and fair view of the College's financial position and the income and expenditure for the year and funds received appear to have been applied for their intended purpose although there have been several instances where value for money appears to be in question, it appears that the aim of the spend was to comply with the College's ongoing requirements.
5. We do have concerns over governance issues throughout the period as identified in our 2004/05 Report to Management, the subsequent Update Report and your Internal Audit Annual Report. We are pleased to note this is disclosed in your Governance statement but would recommend further disclosure of the issues identified and action taken.

## Financial Performance

4. The income and expenditure account shows a deficit of £3,872k on the year's operations. There were a number of adjustments made to the deficit in the accounts presented for audit, which had the effect of increasing the deficit by £919k.
5. The deficit represents a deteriorating position from the prior year deficit (after prior year adjustments) of £1,330k. The declining position is due to a number of factors, including the costs of a voluntary severance scheme (£1.1 million provision) undertaken in a bid to improve the financial health of the College going forward. Further analysis is given in Appendix D to this report.
6. After adjusting for the difference between the actual depreciation charge for the year, which is based on the revalued assets, and depreciation based on historical cost and the realisation of a previous years' revaluation gain, a consolidated historical cost deficit of £3,320k is shown (£1,294k in 2004/05).
7. The balance brought forward on the income and expenditure reserve at 1 August 2005 taking account of the prior year adjustment was £2,016k deficit. A transfer of £552k was made from the revaluation and designated reserves to the income and expenditure reserve in relation to depreciation. This represents the release of the previous revaluation made on these assets over their useful life. After the deficit for the year of £3,872k is taken into account the balance on the College income and expenditure reserve at 31 July 2006 is a deficiency of (£5,336k).
8. The College has processed the following prior year adjustments (all figures in £000):-

	Opening reserves £'000	Creditors £'000
(a) Restatement of income deferral for local authority funding	(579)	579
(b) Recognition of creditor for SAAS fees for 2004/05 to be clawed back due to funding received where attendance targets were not achieved.	(196)	196
	<u>(775)</u>	<u>775</u>

In 2004/05 due to lack of contrary information the College recognised local authority funding on a time apportioned basis. This basis of recognition has now been amended to recognise income on the basis of costs incurred/milestones achieved resulting in a prior year adjustment delaying recognition of this income.

9. The College is in a very weak financial position, with the balance sheet showing a position of technical and practical insolvency, and will be dependent on confirmed external financing to remain a going concern. The Board of Management will need to provide evidence that the recovery plan that is currently being drafted by the College is robust and achievable. They should also be aware of their responsibilities regarding ensuring creditors can be met as they fall due.
10. A more detailed analysis of financial performance is undertaken at Appendix D.
11. In June 2006 the Scottish Funding Council (SFC) published a circular, which contained a series of performance indicators (PIs) assessing the financial performance of further education colleges for 2004/05. While it is accepted that there are some valid criticisms of the methods of identifying unit costs and the fact that each College has some specific geographically relevant factors that influence costs they are a useful indication of one basis on which external readers will assess the College.
12. The indicators show that in 2004/05 the College was generally operating below the sector average in a number of areas:
  - Operating deficit percentage of total income was (6.1)% compared to the sector average surplus of 1.0%.
  - Designated reserve plus income and expenditure reserve as a percentage of total income was a deficit of (3.7)% compared to the sector average of 7%.
  - Historical cost deficit as a percentage of total income was (1.6)% compared to the sector average of 3.1%.
  - Current assets over current liabilities of 0.7 compared to the sector average surplus of 1.3.
  - Interest cover of (2.5) compared to the sector average of 4.0.
  - Days cash to total expenditure of (5) compared to a sector average of 57.

### Submission of Accounts

13. The accounts were submitted for audit on 16 October 2006 in line with the agreed timetable. The accounts submitted for audit were incomplete, with the main areas of omission being the Board of Management's report and the Corporate Governance statement. Working papers provided have been of a reasonable standard and queries arising from the audit have generally been resolved although there has been a significant delay in receiving information to resolve outstanding queries and issues. Key staff were available for consultation throughout the audit process.
14. In order to obtain sufficient comfort on the College's future cashflow requirements over the next 12 months the Board decided at its December meeting to postpone signing the accounts until February until the recovery plan and related cashflow requirements could be received and presented to SFC for confirmation where possible that future funds will be available to meet their working capital requirements for at least 12 months.

## Issues Arising

15. During the course of the audit a number of issues arose which were resolved in discussion with, or formally reported to the Vice Principal Financial Development and the Associate Principal Finance. This practice is an established part of the audit process. The remainder of this report draws to the attention of the Board of Management and the Auditor General any matters of particular significance or interest which arose from the audit. The major concerns are in respect of ongoing funding and implementation of improved governance procedures.

### *Matters brought forward from the 2004/05 audit report*

#### *Recommendation 1*

It was noted that the College has made a further significant deficit in the year to 31 July 2005. In addition the College has a large deficiency of working capital at 31 July 2005. Whilst we are satisfied that the Board has reviewed evidence to support their assertion that the accountancy policy on going concern is reasonable, it is a key management area which could jeopardise the future of the College and the target for the College to be financially secure by 31 July 2006.

We would recommend the Board of Management continue to review all budgets, including balance sheet and cash flow and ensure all assumptions appear reasonable and achievable, as this has been an issue in the past. Performance against budget must be regularly reviewed and variances investigated. Medium to long term projected cashflow forecasts prepared and reviewed regularly.

**2005/06 update: The College has suffered another significant deficit during the year ended 31 July 2006 and has a deficiency in working capital of around £3.0m at the year-end. Budgetary and financial control does not appear to have improved during the year, contributing to an overall deterioration in the College's financial position. We noted in the post year end period that additional investment had been allocated to this issue to try to ensure more accurate budgets are prepared. The Board requested in early 2006 both an update report on the 2004/05 report to Management and a going concern report to assist them and management in addressing issues raised. Unfortunately the former report though completed in May 2006 was not presented to the Board until November 2006 and the latter report was not finalised and neither report was chased up by the Board.**

#### *Recommendation 2*

During the course of our audit we identified 32 material errors in the accounts, increasing the deficit by £626k. In addition, the information provided in the audit file did not contain all of our requirements per our deliverables list given at the initial planning meeting. This implies that the management accounts prepared during the year may not have been reliable. This also led to additional costs in completion of the audit. Whilst we appreciate preparation for the audit was hindered by the four-week downtime of the computer system, this does not appear to have been the only reason for the issues identified.

We would recommend the 2005/06 audit file be fully reviewed before the onsite audit work commences. Also on an ongoing basis throughout the year a clear analytical review of the monthly management accounts and journals should be carried out to identify any issues.

**2005/06 update: A number of errors were identified during the course of the audit, increasing the deficit by £919k. Whilst the standard of audit deliverables had improved, there was a lack of audit trail of prior year figures to facilitate an efficient analytical review of the movements year on year. In addition the audit trail for processing the above errors was not initially well documented. There has also been a delay in receiving outstanding information. However there has been a strengthening of senior staff within finance during the latter part of 2006 which should help better delivery by all finance staff.**

*Recommendation 3*

It was noted that the budgeted results and indeed the June forecast outturn varied significantly from the actual results for the year to 31 July 2005. This was also highlighted as a weakness in the Internal Audit review. This highlights a weakness in the information presented to the Board of Management on which decisions are being based.

We would recommend that the College review its budgeting process with a view to generating a more accurate budget and better monitoring of actual against budgeted results.

**2005/06 update: No significant improvement noted year on year. Original budgets and forecast outturns prepared throughout the year were significantly different to the actual results for the year. Issues over the quality of budgetary and financial control were also raised by the Internal Auditors during their review in 2006. The poor financial position and the issues which have arisen over negotiating severance programmes and pay scales for existing staff indicate a lack of effective financial control in the year. We would note that there appears to have been a more logical and detailed approach to the 2007/08 forecast, but this has not been audited or reviewed by us in any detail.**

*Recommendation 4*

The College has a control in place whereby journal sheets are meant to be signed off by the preparer and authoriser. It was found in a number of cases these sheets were being prepared and authorised by the same person. This highlights weak segregation of duties and it appears that a number of audit adjustments that were required to the financial statements might have been avoided if an independent authorisation of journals had taken place.

We would recommend that journal sheets are prepared and authorised by independent members of the finance team.

**2005/06 update: We noted that the majority of journals were signed as authorised however incidences of journals not being fully authorised were noted. Further strengthening of controls is required in this area.**

*Recommendation 5*

It was noted that the College still does not have a fixed asset register in place and there is no formal link between the deferred capital grants and the fixed assets the grants were used to purchase. This is important for the College to identify all owned assets and identify any disposed of assets that have not been removed from the accounting records.

We would recommend that a full audit of the College's fixed assets is carried out as soon as practically possible and that a fixed asset register is compiled. This should include a clear record between the deferred capital grants received and fixed assets they used to purchase.

**2005/06 update: No improvement noted year on year. Our recommendation is repeated in the current year.**

*Recommendation 6*

There has been an 85% increase in the bad debt provision from £215k to £397k during the year. The primary reason for this is the increase in provision for fees due from international students. Failure or delay in the chasing of these debts reduces both the income and cashflow available to the College. In addition, there remains a substantial amount of older balances within the provision as no formal write off of debt has been authorised in the year.

We would recommend the College review its procedures for the collection and chasing of international student fees. A full review of the bad debt provision should be undertaken and a write off of irrecoverable debts should take place.

**2005/06 update: No improvement noted year on year. The bad debt provision has increased by a further £363k with no significant improvement in the level of international student debt. In addition, there was no write off of irrecoverable debts during the year or at the year-end. Our recommendation is repeated in the current year.**

*Recommendation 7*

It was noted during our audit that expenditure in relation to a special event run by the music department had initially been included within the balance sheet and not expensed through the income and expenditure department. Although this has been adjusted statutory financial statements this expenditure was wrongly excluded in the management accounts during the year.

We would recommend that the College include all revenue expenditure within the income and expenditure account in the management accounts.

**2005/06 update: It was noted that a number of suspense accounts continued to be used for special College projects. Although the amounts involved were not material, finance staff appeared to have limited information as to what these were for, which could result in income and expenditure being excluded from both the management and financial accounts. This indicates a lack of overall governance controls.**



*New matters arising in 2005/06*

Recommendations arising from our audit of the 2005/06 financial statements are set out in Section 8.

## 4. Corporate Governance

### Introduction

1. Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviour at the upper levels of an organisation. The College has a responsibility to put in place arrangements for the conduct of its affairs, ensure the legality of activities and transactions and to monitor the adequacy and effectiveness of these arrangements in practice.
2. As auditors we have a responsibility to review on the College's corporate governance arrangements and consider whether the corporate governance statement in the financial statements appears consistent with the information of which we have become aware of during our audit.

### System of Internal Control

#### *General arrangements*

3. A review and assessment of the College's corporate governance arrangements was carried out. This assessment included a review of the College's Board and Committee minutes and completion of a number of standard checklists. The checklists cover issues relating to systems of internal control, arrangements for the prevention and detection of fraud and corruption, standards of conduct, issues of legality and the College's financial position. This work is intended to confirm that overall the College's corporate governance arrangements appear adequate and initiatives to strengthen any areas of weakness are continuing. We have seen some improvements but generally throughout 2005/06 there were significant weaknesses in corporate governance.
4. Both Internal and External Audit work, and the findings of the FEDD team, has identified significant weaknesses in the College's corporate governance arrangements in terms of the following:-
  - Level of reporting on finances;
  - Weaknesses in budgeting leading to inaccurate information available for decision making;
  - Frequency of Board meetings held. While the requested number of meetings were held, none were held between December 2005 and July 2006.
  - General control over the financial position of the College;
  - Lack of detailed information in minutes to give a full understanding as to the extent and nature of discussions held and action to be taken;
  - Significant time delay in presenting the findings of commissioned reports on the financial position/work of Internal Auditors to the Audit Committee. While the Board requested these reports, they failed to follow up in the revisions for delays in their presentations to the Board;
  - Lack of formal appraisal of the Principal;

- Lack of evidence of involvement by the Board in the development of College planning.
5. The Annual report from the Internal Auditors states the College “does not have adequate effective risk management, control and governance processes to manage its achievements of the College’s objectives.”

#### *Financial Systems*

6. It is the responsibility of management to maintain adequate financial systems and associated internal controls. The auditor evaluates the significant financial systems and the associated internal controls, both for the purpose of giving an opinion on the statement of accounts, and in order to report to the College on the adequacy of such systems and controls. Our Audit work confirmed that overall the financial systems are adequate for the purpose of producing the financial statements however the controls in place were not well documented and reporting to the Board of Management and interrogation and verification of budgeting assumptions was poor. Decision making processes for various projects did not always include sufficient financial analysis. This appears to be improving but further development is required. The most significant issues to be addressed are detailed at Section 8.
7. It is emphasised that the weaknesses identified are only those that have come to the attention of the auditor during the normal audit work in accordance with the Code of Audit Practice and, therefore, are not necessarily all the weaknesses which may exist.

#### Fraud and Corruption Arrangements

8. During 2005/06, no instances of fraud were identified by the College, although controls over approval of spend were less robust than should be expected just as financial implications and cost/benefit analysis of proposed projects were not always fully considered.
9. The College’s arrangements for preventing, detecting and identifying fraud and corruption were assessed during the audit. This assessment included a review of the College’s Board and committee minutes and completion of a standard checklist. The work confirms that overall the College’s fraud and corruption arrangements appear adequate, however further questioning of financial reports and requests for full details on costings and risks of proposed projects would add to overall governance controls.

#### Review of Internal Audit

10. Internal audit is a key element of the internal control system set up by management. A strong internal audit function is necessary to ensure the continuing effectiveness of the internal control systems established. The College, therefore, needs to have in place a properly resourced internal audit service of good quality. To maximise the reliance that may be placed on internal audit and to avoid duplication of effort, the adequacy of internal audit is assessed each year.

11. Internal audit services are provided by Wylie and Bisset who replaced Deloitte in the year. An assessment was made of the adequacy of the Internal Audit input and it was concluded that External Audit can place some formal reliance on the work of internal audit due to the findings in the Annual Report and reports during the year. Accordingly no reliance was placed on the work of Internal Audit in any areas on which they reported in 2005/06.
12. We would like to draw attention to the findings of Internal Audit during the year, where a significant number of high and medium priority recommendations were identified. These findings have been separately reported to the Audit Committee however we wish to stress the importance of addressing the recommendations made along with the control weaknesses identified from external audit (see section 8). The points raised included:-
  - Board meetings and finance sub-committee meetings were not held with sufficient regularity (no Board meetings were held between July 2005 and December 2005); (N.B the requisite number of meetings were held but the timing was not necessarily appropriate).
  - Lack of formalised policy on risk management;
  - Significant improvement required in the area of budgetary and financial controls;
  - Significant number of recommendations in the follow-up report had not been implemented.
13. In addition, the previous internal auditors Deloitte had raised some issues in a report on lack of authorisation of international travel. This report does not appear to have been formally presented to the Audit Committee or Board.
14. Due to our concerns over controls and the conclusions of the Internal Audit report significant additional audit costs have been incurred in the conclusion of the 2005/06 audit.

## 5. Performance Audit

1. It is the College's responsibility to ensure that proper arrangements are in place to secure the economy, efficiency and effectiveness in the use of its resources. As part of the auditor's statutory responsibilities we are required to satisfy ourselves that the College has made appropriate arrangements to fulfil its responsibilities
2. Throughout our five year audit appointment, the Performance Audit Section of Audit Scotland will, from time to time, require auditors to undertake field work on topics which form part of Audit Scotland's VFM centrally directed studies programme. **No such studies were included within the 2005/06 programme for the FE sector.**
3. SFC indicators: as reported in Section 3 of this report the SFC publishes performance indicators (PIs) which assess the financial performance of further education colleges. Also, the SFC publish student and staff performance indicators for further education colleges, which they use for benchmarking purposes. The College needs to keep the inter-college comparisons produced by SFC under review, to identify areas where current practices could be reviewed to further improve performance, by sharing and discussing good practice with other Colleges.

## 6. Audit and accounting issues identified at planning stage

Key area of audit focus	Our approach	Resolution
<p>The current outturn highlights that the College has made a large deficit in 2005/06 and has a weakening balance sheet. The budget for 2006/07 projects a deficit of £753k, net current liabilities of £4,089k and a deficiency of net assets of £1,427k. In addition, the cash flow projections to 31 July 2007 show the college requiring an overdraft of £3,648k at 31 July 2007, with the peak overdraft requirement at £4,500k in April 2007. We are aware that the bank has recently withdrawn the College's overdraft facility and the college has received advances of £3m on its 2006/07 main recurrent grant from SFC.</p> <p>All of these indicate that the College faces a significant going concern risk.</p>	<p>We will review the recovery plan that the College is currently drafting in addition to the plans as to the future financing of the College. We will also review projections for 2006/07 and in the medium and long term to assess the achievability of these budgets.</p> <p>We will also seek confirmation of continued support of the College from the Scottish Funding Council.</p>	<p>Our audit report has been modified to include an emphasis of matter paragraph. Our opinion is not qualified as we are satisfied with the level of disclosure in the financial statements.</p>
<p>The College have identified a number of potential prior year adjustments in relation to European income, SAAS clawback, impairment of fixed assets and marketing spend.</p>	<p>We will review the need for and calculations of any prior year adjustments and ensure these have been adequately disclosed in the financial statements. We also need confirmation that all liabilities have been properly notified to SAAS.</p>	<p>A detailed review of workings and terms and conditions of local authority funding and workings for the SAAS clawback has been performed and a prior year adjustment has been made to the comparative figures (see 1.9). Following review of the proposed prior year adjustments for impairment and marketing spend, it was concluded that these did not represent a fundamental error or a change in accounting policy, and as such should be recorded in the results in the current year.</p> <p>We have advised management of the importance of notifying SAAS of all amounts owed in respect of overpaid fees.</p>

Key area of audit focus	Our approach	Resolution
<p>Due to the financial difficulties of the College the intended capital spend programme has largely not been undertaken. The College have received £1.5m from the SFC towards this programme. The College has written to the funding council to amend the planned spend of this capital grant.</p>	<p>We will examine the nature of all spends from the capital grants received to ensure that are capital in nature and are within the terms of the grants given from the SFC. We will review all correspondence with the funding council concerning the virement of any capital grants.</p>	<p>An amount of £640k was unspent as at 31 July 2006 however the College has received confirmation from the SFC that these funds can be allocated against principal repayment of Waterfront loan and capital element of finance lease repayments.</p>
<p>We are aware that the College has been the subject of media reports and there have been accusations of financial mismanagement within the College. We are also aware that the SFC has asked a Further Education Development Directorate (FEDD) team to report on a number of issues.</p>	<p>We will focus our regularity audit on these risk areas and where possible place reliance on the review carried out by the FEDD team to highlight issues which need corroboration by us.</p>	<p>A review of the work performed by the FEDD team and the final report has been undertaken and considered in conjunction with the Corporate Governance statement. As noted in section 1.18, we do not feel that the Corporate Governance statement, at present, identifies the issues raised from our work and the work of internal audit and the FEDD team. We consider that it would be more appropriate to identify the main issues and the action that has been taken to address these.</p>
<p>£1.1m has been accrued for exceptional restructuring costs at the year end.</p>	<p>We will review whether this was a constructive obligation at the year end and if payments are in line with your severance policy.</p>	<p>Review undertaken in line with planned approach – no issues identified and severance accrual appears appropriate as a constructive obligation existed at the year-end.</p>
<p>A global £400 per head and £250 per head provision for salary increase for 2005/06 has been made, although this has not been agreed with the Union.</p>	<p>We will review whether or not this was a constructive obligation and the validity of the basis on which it was calculated.</p>	<p>We are satisfied that the accrual of £320k (post audit adjustment) represents the College's best estimate of the amounts required to settle this dispute and that a constructive obligation existed at 31 July 2006.</p>

Key area of audit focus	Our approach	Resolution
<p>International Auditing Standards, which came into effect on 1 January 2005, require us to document more fully the key controls within the College's systems, and consideration of key business and operational risk and the organisations culture, in relation to formal management.</p>	<p>Discussion and documentation of key controls over completeness of income, accuracy of payroll costs and validity and accuracy of other costs together with walk through tests.</p>	<p>Review carried out in accordance with planned approach – no significant areas of weakness were noted. Control weaknesses identified are adhered to in Section 3 (matters arising in 2005/06).</p>
<p>Calculation of the pension provision in line with SFC guidance. During the year this has increased by £900k due partly to some premature retirement costs being included as part of severance packages.</p>	<p>Our approach will be to review your calculations and satisfy ourselves that the provision has been calculated using a factor based on guidance issued by SFC and that it appears a reasonable provision based on information available. We will also consider if the pension payment is in line with your severance policy.</p>	<p>Review carried out in accordance with planned approach – no significant issues were identified.</p>
<p>The future decrease in European funding in the sector resulting in increased pressure on the College's recovery plan.</p>	<p>We will review the College's plans to replace this income in the face of the future loss of this income.</p>	<p>A review of the College's budget for 2006/07 has been undertaken. The assumptions made appear to be reasonable and the likelihood of future reduction in this income has been noted in the budget.</p>



## 7. Audit and accounting issues identified during the audit

Issue	Resolution
It was found that the College had capitalised costs of abortive projects within Fixed Assets. Although these had been fully depreciated in the year, both cost and depreciation were overstated.	This has now been adjusted in the financial statements to remove these costs from fixed assets and write them off to the income and expenditure as abortive capital costs.
Two prior year adjustments were processed that were not fundamental and therefore should have been charged against the income and expenditure account in the current year rather than restating opening reserves. The effect of these (for marketing costs and the Finnart impairment) is an increase in the current year deficit of £90k but no change in overall reserves.	Following review of the proposed prior year adjustments for impairment and marketing spend, it was concluded that these did not represent a fundamental error or a change in accounting policy, and as such should be recorded in the results in the current year.
SAAS fees clawback included in the draft financial statements was underaccrued by £103k, being the difference between the 04/05 element referred to above and amounts paid back to SAAS during the year.	This has now been adjusted in the financial statements and the creditor increased to reflect all SAAS fees repayable.
Bursary debts of £114k were incorrectly charged to the income and expenditure account of the College as part of the overall bad debt provision. These amounts should have been charged to the bursary accounts outwith the College's income and expenditure account.	This has now been adjusted in the financial statements. A recommendation for controls over review and authorisation of journal entries is included in Section 8.
The College has a restricted reserve of £16k for which there is no information as to the nature of the reserve, conditions attaching and expected timing and magnitude of future expenditure.	This has now been released to general reserves as part of the audit adjustments.
Further governance issues were identified during our review of Internal Audit Reports, Minutes, Budgeting and Financial Reporting.	As noted in section 1.18, we do not consider that the Corporate Governance statement, at present, identifies the issues raised from our work and the work of internal audit and the FEDD team. We consider that it would be more appropriate to identify the main issues and the action that has been taken to address these.

## 8. Internal control issues

### Matters arising in this year's audit

We have set out below those areas of internal control weakness that we consider should be brought to the attention of the Audit Committee which arose as a result of our audit work. This does not constitute a comprehensive statement of all weaknesses that may exist in internal controls or of all improvements which may be made.

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<p><b>Going Concern</b></p> <p>The College's financial position has deteriorated further during the year. A deficit of £3.0m was incurred during the year and net current liabilities amounted to £3.0m. A further deficit of £753k is forecast for the year to 31 July 2007. Due to this, the College is heavily dependent on the ongoing support of the SFC. Going concern continues to be a key management area which could jeopardise the future of the College. The target is for the College to be financially secure in the short-term, however, there have been significant weaknesses in this area during the year. At present there appears to be inadequate evidence to confirm that funding is available to meet liabilities as they fall due.</p>	<p><b>We would recommend</b> the Board of Management continue to review all budgets, including balance sheet and cash flow and ensure all assumptions appear reasonable and achievable, as this has been an issue in the past. Performance against budget must be regularly reviewed and variances investigated. Medium to long-term projected cashflow forecasts should be prepared and reviewed regularly.</p> <p>It is vital that the Board obtain confirmation that ongoing funding will be available to meet liabilities as they fall due.</p>	<p>The Board of Management will continue to review all budgets and monthly financial performance monitoring reports through the Finance &amp; Resources Committee. As part of this process the Committee will also continue to review the cashflow forecasts for the College.</p> <p>The Board has received a letter of assurance from SFC which meets the College requirements in order for it to continue as a going concern.</p>	<p>Finance &amp; Resources Committee Ongoing</p> <p>Board of Management Done</p>

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<b>Financial review</b>			
<p>The high level of deficit and issues on future funding do not appear to have been appropriately highlighted to the Board in a timeous manner nor have meetings been held with sufficient regularity. There also appears to have been a lack of questioning of proposed results and management results by those in a governance role. While reports on future going concern and follow up on the 2004/05 external audit management letter were requested by the Board, indicating they were concerned over the College's operations. They did not follow up on the reasons for the delay in obtaining these reports or in implementing recommendations.</p>	<p><b>We would recommend</b> that the Principal and Board need to ensure for the future that they receive clear reports of budgeted results, actual against budgeted results and assumptions. There should be sceptical and critical appraisal of any projects proposed. The need for this was highlighted in our 2004/05 Report to Management.</p>	<p>The Finance &amp; Resources Committee now receives a more detailed financial information pack showing all of the information recommended by audit. These reports are discussed in detail by the Committee with particular emphasis on variations from budget and questioning of forecast assumptions. The impact of this is that the forecast outturns prepared during the latter part of 2005/06 were in line with the actual results for the year.</p> <p>This process of increased scrutiny has continued into 2006/07.</p>	<p>Finance &amp; Resources Done</p>
<b>Financial procedures</b>			
<p>It was found during our review of internal controls that the limited financial procedures in place do not reflect the current operating environment, nor are they sophisticated enough to demonstrate the existence of the required level of financial control for an organisation of the College's nature and size.</p>	<p><b>We would recommend</b> that all current financial controls are documented in a formal financial procedures document. In addition, the College should undertake a review of current controls to identify any areas where internal controls require strengthening.</p>	<p>The College will draft revised Financial Regulations.</p> <p>An independent review of current systems and controls within the Finance Department was carried out by Internal Auditor Deloitte in 2004/05. The recommendations from that report have been implemented</p>	<p>AP Finance 31<sup>st</sup> March 2007</p>

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<p><b>Strategic Planning</b></p> <p>The Strategic Development Plan refers to the probability of operating surpluses not being achieved as low. In addition, the financial information does not appear to be consistent with the actual financial position of the College. The SDP has therefore been completed with significant factual errors.</p>	<p><b>We would recommend</b> that the College strengthens its practices in strategic planning and risk management in order to ensure that strategic plans in place are accurate, up to date and are consistent with the operating environment of the College.</p> <p>We have seen some indications of a more robust approach to forecasts for 2006/07 but this needs to be formalised and followed through.</p>	<p>The strategic planning processes must be closely linked and related to operational reality. Future strategic planning will take full account of the operating environment of the College.</p>	<p>Principal Ongoing</p>

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<p><b>Capitalisation of fixed assets</b></p> <p>It was found that costs for projects at Westbyrehill and the Learning Resource Centre of £240k had been capitalised in fixed assets however these projects were subsequently aborted. As such, the correct accounting treatment is to write these costs off directly to the income and expenditure account as opposed to capitalising and depreciating over 1 year. In addition, an invoice of £11k for estates work for had been capitalised twice, resulting in an overstatement of fixed assets. This is included in Section 11 on adjusted and unadjusted errors.</p>	<p><b>We would recommend</b> that the College reviews its procedures for capitalisation of costs in fixed assets to ensure these are in line with generally accepted accounting practice. Any significant abortive costs should be formally reported prior to write-off.</p>	<p>The projects in question were originally legitimate capital projects which were subsequently aborted. At the yearend advice was sought from the auditors as to the appropriate treatment of these costs as funding for them was to be via Capital Grant. The college followed the advice from Baker Tilly in this matter.</p>	<p>AP Finance            Done</p>

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<p><b>Bad debt provision</b></p> <p>It was noted that trade debtors includes £493k of invoices aged over 10 months. Although these are fully provided for in the financial statements, it is considered that these may be irrecoverable and should be reviewed and if relevant written off in the nominal ledger rather than being carried forward as part of the bad debt provision. It also highlights a major issue over recoverability of debtors.</p> <p>In addition, the bad debt provision included £114k of bursary bad debts which had been incorrectly charged to the College's income and expenditure account rather than the bursary account. This would have been identified by the college by a more thorough review process for journal entries.</p>	<p><b>We would recommend</b> that the College undertake a review of the bad debt provision and write off those debts which are irrecoverable leaving only doubtful debts in the provision. The procedures for chasing up recovery of debtors should also be reviewed and improved.</p> <p>In addition, we would recommend that further consideration be given to the adequacy of current authorisation and review controls for journal entries.</p>	<p>In December 2006 the Finance and Resources Committee approved the write off of old/irrecoverable debts. A paper on possible options for College debt collection went to the committee in 2006, this resulted in the approval of door step collection options via the College's debt collection agents for some debts. A further paper looking and additional options is to be drafted for the Committee in early 2007. The Committee will then agree a revised debt collection policy.</p>	<p>AP Finance          Finance &amp; Resources Committee          31<sup>st</sup> March 2007</p>

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<b>Other policies and procedures</b>			
<p>It was found during our review of policies and procedures that a number of key areas such as financial management, payroll and whistleblowing had not been updated for 7-8 years. As such, these may not reflect the current operating environment of the College.</p>	<p><b>We would recommend</b> that a review of current policies and procedures be carried out and any required amendments made to ensure that these reflect current practice. Following on from this, a formal review timetable should be put in place to ensure that policies and procedures are subject to more regular review and revision.</p>	<p>The Director of Quality is currently carrying out a review of all current policies and plans to bring in a new rolling programme of policy review to ensure that all policies are reviewed and updated on a regular basis.</p>	<p>Director of Quality                      31<sup>st</sup> March 2007</p>
<b>Bank reconciliations</b>			
<p>It was found during our review of internal controls that review of bank reconciliations by a responsible official was not always evident. This is a key control and any errors may not be identified if formal reviews are not taking place. In addition, the year-end bank reconciliation contained some cheques aged over six months. These should be written back to creditors as these cheques have now lapsed.</p>	<p><b>We would recommend</b> that all bank reconciliations are reviewed by a responsible official and appropriate adjustments made for cheques aged over six months.</p>	<p>Bank reconciliations are carried out by the Finance Manager and reviewed on a monthly basis by the management accountant. This process has been in place since early 2006. In addition the College has now appointed a dedicated cashier to increase Finance Department resources and enhance controls in this area.</p>	<p>AP Finance                      Done</p>





Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<b>Asset register</b>			
It was noted that the College still does not have a fixed asset register in place and there is no formal link between the deferred capital grants and the fixed assets the grants were used to purchase. It is important for the College to identify all owned assets and identify any disposed of assets that have not been removed from the accounting records.	<b>We would recommend</b> that a full audit of the College's fixed assets is carried out as soon as practically possible and that a fixed asset register is compiled. This should include a clear reconciliation between the deferred capital grants received and fixed assets they used to purchase.	The Audit Committee will consider this recommendation and determine when and how this audit will be carried out	Audit Committee By 31 <sup>st</sup> March 2007
<b>Internal recharge</b>			
It was noted during our review of income and expenditure that catering sales included an internal hospitality recharge of £64k. As a result, both income and expenditure were overstated by this amount.	<b>We would recommend</b> any internal recharges for management accounts purposes are removed when preparing the statutory accounts in order to ensure that overstatement does not occur.	Agreed. This was an oversight in the 05/06 accounts which will not recur in future years	AP Finance Done
<b>Fraud register</b>			
The College does not currently maintain a fraud register in line with best practice in the area of governance.	<b>We would recommend</b> that a fraud register is established to record an instances of actual, suspected or alleged fraud. This should be reviewed regularly by the Board of Management in order to strengthen governance practices.	The College has a Fraud Prevention Policy and Procedure which were adopted in June 2004. To date there have been no instances of actual, suspected or alleged fraud reported through the formal channels.	AP Finance On going

Fact and potential consequence	Recommendations	Management response	Timing of implementation and responsibility
<b>Accruals</b>			
<p>It was found that accruals of around £10k were double-counted as a result of being picked up by a post year-end end invoice review and from unmatched items from the purchase order system.</p>	<p><b>We would recommend</b> that procedures be strengthened to ensure that overstatements of this nature do not occur at future year-ends.</p>	<p>This was an oversight which should not reoccur.</p>	<p>AP Finance Done</p>
<b>Bursary accounts</b>			
<p>It was found that some payments of bursaries were made out of the College's main account or from petty cash rather than coming out of the designated bursary bank accounts. This increases the level of work required to reconcile the bursary accounts.</p>	<p><b>We would recommend</b> that all payments in respect of bursaries are made from the designated bursary accounts in future.</p>	<p>This is not a regular occurrence but is occasionally unavoidable if students are in extreme hardship and unable to access back accounts. The Bursary funds do not have a petty cash float and the College regards the creation of a float for this purpose unnecessary as it would involve more work than the current system does for the rare occasion when this occurs</p>	<p>No action required</p>

## 9. Significant accounting policies

### **Going concern**

The College's financial statements have been prepared on a going concern basis, which indicates that the College will continue as a going concern for the foreseeable future. In order to conclude that application of the going concern basis of accounting is appropriate, it was necessary for the Board to obtain confirmation of ongoing support from the SFC to meet liabilities and cash flow requirements for at least the next 12 months. This assurance is subject to agreement and adherence to a Recovery plan, the Board has been asked to confirm its comfort with the College's ability to agree and adhere to a recovery plan.

### **Recognition of Income**

Income from tuition fees is recognised in the period in which tuition is delivered and includes all fees payable by students or their sponsors.

Income from grants, contracts and other services rendered is included to the extent of the completion of the contract or service concerned ie for European grants it is matched to expenditure.

All income from short-term deposits is credited to the income and expenditure account in the period in which it is earned. The main recurrent allocation from SFC, which is intended to meet recurrent costs, is credited to the income and expenditure account equally over the accounting year. Non-recurrent grants from SFC or other bodies received in respect of the acquisition or construction of fixed assets are treated as deferred capital grants and amortised in line with depreciation over the life of the assets.

### **Bursary/EMA Funds**

Such grants received from the SFC are available solely for students; the College acts only as a paying agent. The grants and related disbursements are therefore excluded from the Income and Expenditure account and shown separately within the notes to the accounts.

### **Deferred PFI expenditure**

All costs incurred in relation to the development of the PFI scheme for the Kilwinning campus have been deferred and are being amortised over the period of the PFI agreement.

### **Carrying value of Finnart campus**

Following the decision not to vacate from the Finnart campus, a prior year adjustment has been processed to reverse the impairment loss recognised in the previous year. The Finnart building is now carried at depreciated replacement cost in line with the provisions for specialised buildings in FRS 15.

## 10. Uncertainties, risks, exposures, estimates and judgemental issues

Set out below are those matters that we have identified in respect of the above, during the course of our work, that we consider should be brought to the attention of the Audit Committee.

Key Issue	Audit Impact	Resolution
<b>Going concern</b>		
The College's financial position has deteriorated further during the year. A deficit of £3.0m was suffered during the year and net current liabilities amounted to £3.0m. A further deficit of £753k is forecast for the year to 31 July 2007. No confirmation of the availability of funding to meet the College's ongoing working capital requirements has been received.	The College is heavily dependent on the ongoing support of the SFC and confirmation of the SFC's ongoing support and the validity of current projections is crucial to the College's going concern status.	Our audit report has been modified to include an emphasis of matter paragraph. Our opinion is not e qualified as we are satisfied with the level of disclosure in the financial statements.
<b>Pay award accrual</b>		
The financial statements currently include an accrual of £320k for the staff pay increase due from 1 April 2006 until the year end. At present the pay award has not been accepted by staff and remains the College's best estimate of the likely cost to the College of making this pay award.	We appreciate the position regarding the pay award is uncertain. However, the cost of the increase is likely to be greater than the accrual included in the accounts.	We are satisfied that the accrual of £320k (post audit adjustment) represents the College's best estimate of the amounts required to settle this dispute and that a constructive obligation existed at 31 July 2006.

## 11. Unadjusted/adjusted misstatements

A summary of the unadjusted/adjusted errors identified during the course of our work is set out below, analysed between errors of fact and differences in judgement.

College	Adjusted misstatements		Unadjusted Misstatements Factual		Unadjusted Misstatements Judgemental	
	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £
Adjustment to tie bank schedule to bank statements - effect on I&E - effect on Bank	200	(200)				
Cheques over 6 months old written back - effect on bank - effect on creditors		1,022 (1,022)				
Reversal of asset capitalised twice - effect on I&E - effect on fixed assets net book value	8,921	(8,921)				
Refectory cleaning stock incorrectly treated as stock - effect on I&E - effect on stock	2,235	(2,235)				

College	Adjusted misstatements		Unadjusted Misstatements Factual		Unadjusted Misstatements Judgemental	
	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £
Journal to expense abortive project costs - effect on fixed assets additions - effect on fixed assets accumulated depreciation		(240,181) 240,181				
Write off of difference in FA balance between a/c's and nominal ledger - Depreciation - Fixed Assets	1,566	(1,566)				
Write off of difference in Accrued Income between a/c's and nominal ledger - effect on I&E - effect on Other Debtors	599	(599)				
Credit note misallocated to accrued income - effect on accrued income - effect on trade debtors		10,000 (10,000)				
Round 2 ESF overpayment netted off against Deferred Income - effect on accrued income - effect on deferred income		95,453 (95,453)				

College	Adjusted misstatements		Unadjusted Misstatements Factual		Unadjusted Misstatements Judgemental	
	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £
Unreconciled receipt per Bank still included in debtors - effect on bank - effect on debtors	9,398 (9,398)					
Write off of Euro Project suspense account - effect on I&E - effect on Other Debtors	1,000	(1,000)				
Write off of Design & Media and Allied Health suspense a/c's - effect on Other Creditors - effect on I&E	(10,314)	10,314				
Omitted accrual - effect on I&E (Other operating expenses) - effect on accruals	682	(682)				
Reallocation of FE Childcare clawback netted off - effect on Other debtors - effect on childcare funds (I&E)	(83,872)	83,872				

College	Adjusted misstatements		Unadjusted Misstatements		Unadjusted Misstatements	
			Factual		Judgemental	
	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £
Double counted accruals - effect on accruals - effect on restructuring costs	(9,839)	9,839				
SAAS clawback 04/05 not accrued - effect on income (SAAS) - effect on accruals	103,500	(103,500)				
Invoice not prepaid but relating to 06/07 - effect on prepayments - effect on operating expenses	(3,464)	3,464				
SAAS income offset against clawbck - effect on accrued income - effect on accruals and deferred income		19,950 (19,950)				
Overstated deferral of ESF income - effect on deferred income - effect on European income	(33,338)	33,338				
Removal of internal recharge income - effect on catering sales income - effect on Other operating expenses	64,356 (64,356)					



College	Adjusted misstatements		Unadjusted Misstatements		Unadjusted Misstatements	
			Factual		Judgemental	
	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £
Additional staff for pay award accrual - effect on staff costs - effect on accrual and deferred income	83,390	(83,390)				
Omitted prepayments for rates - effect on prepayments - effect on Other operating expenses	(6,528)	6,528				
Water rates accrued twice - effect on accruals and deferred income - effect on Other operating expenses	(13,144)	13,144				
Correction of error in bursary debtor - effect on Other debtors - effect on I&E – operating expenses	(114,190)	114,190				
Write off of car lease balance - effect on creditors - effect on I&E – interest payable	(14,518)	14,518				
Release of restricted reserve - effect on restricted reserves - effect on general reserves		15,583 (15,583)				

College	Adjusted misstatements		Unadjusted Misstatements		Unadjusted Misstatements	
	Income & Expenditure effect Dr/(Cr) £	Balance Sheet effect Dr/(Cr) £	Factual Income & Expenditure effect Dr/(Cr) £	Factual Balance Sheet effect Dr/(Cr) £	Judgemental Income & Expenditure effect Dr/(Cr) £	Judgemental Balance Sheet effect Dr/(Cr) £
Release marketing unspent grants to deferred capital grants - effect on creditors - effect on deferred capital grants		639,693 (639,693)				
Reversal of marketing PYA - effect on opening reserves - effect on I&E	90,006	(90,006)				
Reversal of impairment PYA - effect on opening reserves - effect on I&E	916,525	916,535				
Adjustment for understated deferral of BNSF etc. income - effect on Income - effect on deferred income			11,191	(11,191)		
Underaccrual of internal audit fees - effect on creditors - effect on I&E			3,525	(3,525)		
<b>Total</b>	<b>919,457</b>	<b>(919,457)</b>	<b>14,716</b>	<b>(14,716)</b>		

## 12. Concluding Remarks

1. We are pleased to be able to formally conclude the audit of the College's 2005/06 accounts.
2. The key issues for action by the College arising from the audit are set out in Section 8 internal control issues.
3. We would like to take this opportunity to convey our thanks to the Vice Principal Financial Development, Associate Principal Finance, the Finance Team and other staff of the College with whom the audit team has had contact, for their courteous and helpful co-operation.

**Baker Tilly**

**Date**

## Appendix A – Emerging issues

## Emerging issues

### Procurement policy

Over the next two years the FE sector is tasked to deliver a high level of savings. In order to achieve this all colleges will need to make significant changes in the way they manage procurement.

To achieve these savings the College will need to establish effective and consistent procedures and controls, and review its policy for procurement of goods and services to ensure that value for money is obtained on all contracts for goods and services and any areas where efficiencies and savings could be made. The College should review its purchasing strategy to consider whether savings could be achieved via:

- Price reduction
- Cost avoidance
- Added value
- Improvements to the purchasing process

### VAT on new building works

Colleges recognise that if they construct a building predominately for the use of grant funded students (e.g. those under 19) the construction of the building will not be subject to VAT. The position becomes more problematic the greater the business use of the new building. Business use can come in many forms, such as sales of meals to non-students, vending machines, photocopying charges and hire of premises as well as any charges to students by way of fees, even if heavily subsidised by the SFC. However greater opportunities are now available given the Court of Session judgement in Telford College that a further education college is a public body which provides non-business education, even to fee paying students. The College needs to determine whether it has paid VAT on the construction of new buildings, or parts of buildings in recent years. If so, retrospective claims can be made for VAT relief.

Certain VAT reliefs are available as follows:

- i) construction of new non-business charitable building (or parts thereof)
- ii) construction of new residential buildings
- iii) alterations to listed buildings providing the buildings qualify under (i) and (ii) above
- iv) 5% VAT rate for the creation of some types of residential building

The College should ensure that the project is structured in the most efficient way at the initial planning stage to ensure that maximum benefit is obtained for any reliefs that maybe available.

## Land disposals

There is a risk that certain profits from the disposal of land could be taxable under Section s776 of ICTA 1988. This Section applies where land is developed with the sole or main object of realising a gain from disposing of land when developed. In particular when the disposal proceeds are contingent on development, e.g. the deal involves a fixed sum, plus overages depending on how many houses the developer builds. Any proceeds in respect of the contingent element will be liable to s776 tax.

## ASB Convergence Plan

The ASB is pursuing a programme of convergence between UK Accounting standards and IFRS by issuing new UK standards that are based on IFRS. As a result, over time, all UK entities will be preparing their financial statements in accordance with standards based on the same core set of IFRS. The ASB remain at consultation stage in respect of this convergence, which may not impact on organisations in the UK other than plcs and larger entities.

## Draft Statement of Principles for Public Benefit Entities and the Charities SORP

It is possible that at some point in the future colleges will be required to comply with the Statement of Principles for Financial Reporting Proposed Interpretation for Public Benefit Entities (currently in draft) or the Charities SORP. The main impact of these two proposals would be the on recognition of deferred capital grants. Colleges currently recognise grants under SSAP 4, i.e. the grant is released to the income and expenditure account over the life of the assets acquired with the grant, whereas under the statement and the Charities SORP they would need to recognise all the income in the income and expenditure account on receipt.

## Members report

As best practice it is recommended that the college's members report should also be reviewed to more closely resemble the trustees report in the Statement of Recommended Practice "Accounting and Reporting by Charities" (SORP 2005).

## Financial Reporting Exposure Drafts (FRED)

(a) *Proposed Amendment to FRS 17: Retirement Benefits*

On 31 May 2006, the ASB published an exposure draft setting out proposals to amend FRS 17 'Retirement Benefits' and to issue a new Reporting Statement 'Retirement Benefits – Disclosures'.

The amendment achieves convergence on disclosure requirements between IAS 19 and FRS 17 by replacing the disclosure requirements in FRS 17 with those of IAS 19.

The FRED proposes the amendment to FRS 17 should be effective for accounting periods ending on or after 31 December 2006.

(b) *FRED 36: Business Combinations*

FRED 36 sets out proposals for how the IFRS3 business Combinations could be implemented into UK accounting standards, and sets out consequential amendments to several UK accounting standards.

The amendments proposed will require all business combinations to be accounted for using the acquisition method. Merger accounting will not be permitted, which will impact on colleges accounting for mergers.

It should be noted that currently when the combination has the characteristics of an acquisition, for example a larger college acquiring the assets and liabilities of a smaller college in financial difficulty, then that combination should be accounted for as an acquisition. As there is no consideration for the acquisition a significant level of negative good will would arise when comparing cost (nil) to the fair value of assets acquired. In this situation the LSC have suggested a true and fair override over the treatment of negative goodwill.

Effective date: Periods commencing on or after 1 January 2007.

(c) *FRED 37 and 38: Intangible assets and impairment of assets*

Intangible assets comprise an increasing proportion of the assets of many entities, including colleges. The FRED reconsiders the definition of intangible assets. They are (FRS10 Goodwill and Intangible assets) currently recognised when they are capable of being separately disposed of, without disposing of a business of the undertaking. The new proposals change the identification criterion to include the fact that the asset is *separable*, i.e. is capable of being separated or divided from the entity and sold either individually or together with a related asset or liability.

The most significant changes arising as a result of this are likely to result from the potential capitalisation of both Computer Software and Development costs (e.g. website costs).

The exposure draft FRED 38 will require the recoverable amount of an intangible asset with an indefinite useful life to be measured annually, irrespective of whether there is any indication that it may be impaired.

Effective date: Periods commencing on or after 1 January 2007.

(d) *FRED 39: Amendments to FRS12*

The Exposure Draft no longer uses the term 'provision' but refers to 'non-financial' liabilities, and no longer applies the terms 'contingent liabilities and assets'. A non-financial liability is a liability other than a financial liability, i.e. any financial liability that is not a contractual obligation that gives rise to a financial asset of one enterprise and a financial liability/equity instrument of another.

The Exposure Draft uses the term 'contingency' to refer to an uncertainty about the amount that will be required to settle the liability, rather than uncertainty as to whether the liability exists. It also distinguishes between conditional and unconditional obligations, whereby all unconditional obligations that meet the definition of a liability are considered for recognition.

The probability criterion is moved from recognition to measurement of the liability which will lead to more liabilities being recognised, e.g. if a college was being sued for damages of £5 million, with a 25% chance of losing the case, under the new proposals a non financial liability would be provided for of £1.25 million, rather than disclosure as a contingent liability under FRS12.

Effective date: Periods commencing on or after 1 January 2007.



## Updated Combined Code on Corporate Governance

On 27 June 2006 the Financial Reporting Council (“FRC”) published an updated version of the Combined Code on Corporate Governance (“Combined Code”). The Listing Rules will not formally apply to the revised Combined Code until a consultation exercise, which is expected to start in September 2006, has been carried out by the Financial Services Authority. However, the FRC have indicated that in view of the limited nature of the changes and the strong support they had received, they would encourage listed companies and their investors to adopt the updated Combined Code on a voluntary basis for reporting years commencing on or after 1 November 2006.

The college currently applies the principles set out in the revised Combined Code on Corporate Governance issued by the London Stock Exchange in July 2003, and will be required to comply with the updated Combined Code. As best practice the college should consider adopting the updated Combined Code on a voluntary basis for the year ended 31 July 2007.

## Financial Memorandum

A new Financial Memorandum is in place from January 2006, in order to reflect the current financial relationships between Colleges and the SFC, as well as the requirements on Government and the SFC and good practice that has emerged over the years.

Appendix B – Additional services

## Additional Services

Under the interim Audit Code of Practice we are required to report to the audit committee any services we performed for the college in addition to the external audit of the financial statements. In the year to 31 July 2006 we provided the following additional services:

- Follow up investigation and report to management on the issues raised in our 2004/05 report on the audit;
- Investigation and report on significant variances between the forecast outturn at February 2006 compared with the original 2005/06 budget.
- Review of governance process followed by the Board in considering possible severance process (no comment has been made on quantum).

Appendix C – Letter of representation

Dear Sirs

## AUDIT OF FINANCIAL STATEMENTS – YEAR ENDED 31 JULY 2006

We confirm, to the best of our knowledge and belief, and having made appropriate enquiries of other officials of the college, the following representations given to you in connection with your audit of the college's financial statements for the year ended 31 July 2006.

1. We acknowledge as governors our responsibility for the fair presentation of the financial statements in accordance with United Kingdom Generally Accepted Accounting practice. All the accounting records have been made available to you for the purpose of your audit and all transactions undertaken by the college have been properly reflected and recorded in the accounting records. All other records and related information and explanations, including minutes of all meetings of governors, committees of governors and management held between the beginning of the accounting period and the date of this letter, have been made available to you. We confirm that as far as we are aware, there is no relevant audit information of which the auditors are unaware.
2. We confirm that:
  - a. We acknowledge responsibility for the design and implementation of internal control to prevent and detect fraud;
  - b. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud;
  - c. To the best of our knowledge there have been no allegations of fraud or suspected fraud, affecting the college involving:
    - i. Management;
    - ii. Employees who have significant roles in internal control; and
    - iii. Others where the fraud could have a material effect on the financial statements;and
  - d. To the best of our knowledge there have been no allegations of fraud, or suspected fraud, affecting the college's financial statements communicated by employees, former employees, analysts, regulators or others.
3. We have not adjusted the following misstatements, which were drawn to our attention by the auditors, because they are immaterial to the financial statements as a whole:

4.

	Value (£)	I&E effect (£)
Underaccrual of internal audit fees	3,525	(3,525)
Understated deferral of local authority funding	11,191	<u>(11,191)</u>
Net effect on deficit - understatement		<u>(14,716)</u>

5. We confirm that full disclosure is made in the financial statements of:-
- a. any arrangement, transaction or agreement to provide credit facilities (including loans, quasi-loans, or credit transactions) for senior post holders;
  - b. Transactions and balances with related parties (including members of the corporation and senior post holders) including:-
    - i. the names of the transacting parties;
    - ii. a description of the relationship between the parties;
    - iii. a description of the transactions;
    - iv. the amounts involved (even if nil);
    - v. any other elements of the transactions necessary for an understanding of the financial statements;
    - vi. the amounts due to or from related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
    - vii. amounts written off in the period in respect of debts due to or from related parties;
  - c. outstanding capital commitments contracted for at the balance sheet date;
  - d. all contingent liabilities including details of pending litigation and material claims against the college;
  - e. all guarantees or warranties or other financial commitments.
6. We have disclosed all events of which we are aware which involve possible non-compliance with those laws and regulations which provide a legal framework within which the college conducts its business and which are central to its ability to conduct that business. We have also notified you of the actual or contingent consequences which may arise from such non-compliance.
7. We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.

*Fixed assets*

8. *Disposal*

Buildings, plant and equipment, which have been disposed of, scrapped, or otherwise taken out of use, have been eliminated from the financial statements or have been fully depreciated.

9. *Depreciation*

The rates and method of providing for depreciation and anticipated obsolescence of buildings, plant and equipment are sufficient to reduce the book amount of each asset to its residual value by the end of its probable useful life in the college's business.

*Internal Audit*

10. To the best of our knowledge and belief all internal audit reports and reports from Deloitte and Wylie Bisset have been made available to you.

*Income sources/initiatives*

11. To the best of our knowledge and belief the college has complied with the terms and conditions attached to all income brought into the financial statements, including meeting non-financial targets and outcomes as required, and has provided you with details of all income sources.
12. The college has carried out appropriate procedures to ensure that it has not claimed double funding for blocks of provision or individual students.

*European Structural Funds*

13. To the best of our knowledge and belief we have made available to you details of any involvement in activity funded from European Structural Funds (ERDF and ESF and other as appropriate) and income received in respect of that activity and the college has complied with any terms and conditions attached to that income.
14. We have made available to you copies of any audit reports relating to claims for European Structural Funds.

*Continuing operations*

15. In our opinion, the college will have adequate cash resources available to finance its trading and other obligations during the course of the twelve months from the date of this letter.

*Going concern*

16. We have received assurance from the Scottish Funding Council (SFC) that sufficient funding will be provided to enable the College to meet its ongoing cash flow requirements. The Board of Management are satisfied that the agreed recovery plan is sufficient to meet the requirements set down by SFC and as such, the going concern basis of accounting is considered to be appropriate.
17. We confirm that there are currently no plans to relocate any of the College's operations from the Finnart Street campus.
18. We confirm that the accrual for the staff pay award from April 2006 not granted of £320,030 represents our best estimate of the cost to the College of settling this dispute.
19. We are satisfied that the College continues to act within its Charitable Objects and as such is not liable to Corporation Tax.

20. There have been no events (other than those already disclosed in the financial statements) since the balance sheet date, which necessitate revision of the figures included in the financial statements or inclusion of a note thereto. Should such further material events occur prior to your signature of the audit report we will advise you accordingly.

We confirm that the above representations are made on the basis of enquiries of management and staff with relevant knowledge and experience (and, where appropriate, of inspection of supporting documentation) sufficient to satisfy ourselves that we can properly make each of the above representations to you.

The contents of this letter were considered and approved by the board at its meeting on .....  
2007.

Yours faithfully

Signed on behalf of the Board of Management of the James Watt College

Chairman .....

Acting Principal .....

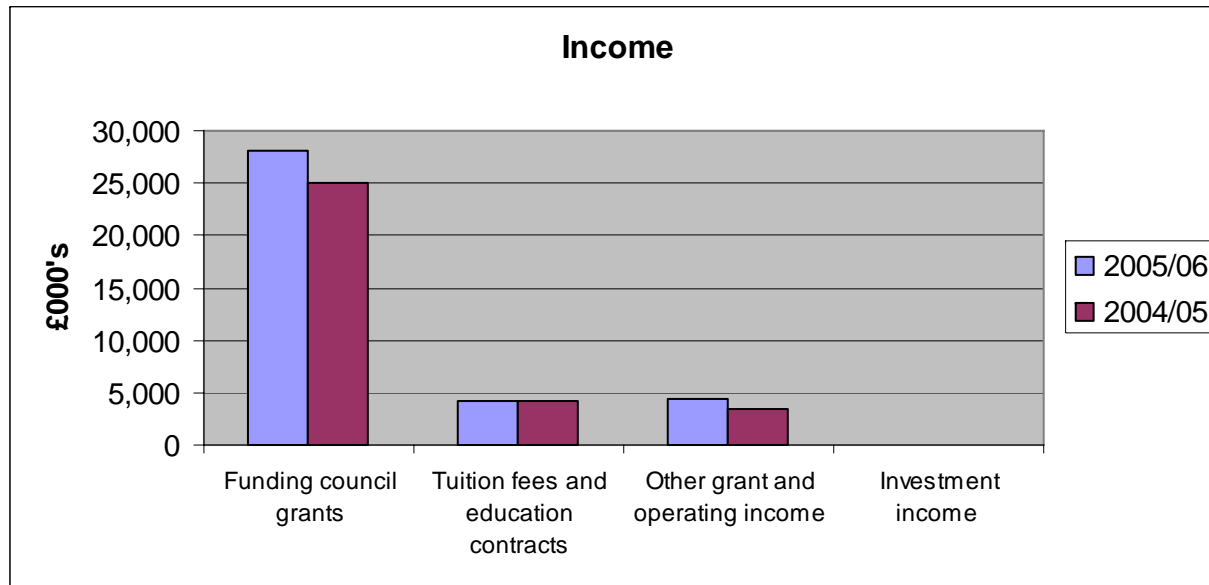
Date .....2007



## Appendix D – Analysis of Financial Performance

## Detailed analysis of financial performance

### Income



Source: Audited financial statements

## Funding council grants

Funding council grants have increased by £3,032k from £25,062k to £28,094k, the major reasons for the increase are as follows;

- Grant in Aid has increased by £1,474k;
- Fee waiver income has decreased by £77k or 2%;
- There has been a £23k increase in the teachers superannuation grant to reflect the increased pension contributions required by the College as set by STSS;
- The College received £617k in additional one off resources compared to £274k in 2004/05.
- The SFC also gave the College £342k grant for the School/College partnership programme in to assist in the implementation of lifelong partners.
- There has been an increase in the release of deferred capital grants of £874k due to increase in assets funded by funding council grants.

## Tuition fees and education contracts

Income from tuition fees and education contracts has increased by £83k from £4,170k to £4,253k, the major reasons for the increase are as follow;

- Local Enterprise Company (LEC) income has fallen by £100k largely due to a non renewal of the “New Deal” contract with Jobcentre plus as the College found it was not cost effective to continue to run this programme. An invitation to tender was declined.
- Overseas income has decreased by £124k largely as a result in a drop in full time student numbers form 82 to 34, this has been partially offset by a rise of 17 part time students and a new contract in Egypt for £23k.
- HE and FE fee income has increased by £306k due to an increase in student numbers and an increase in the fees charged for these courses.

## Other grants and other operating income

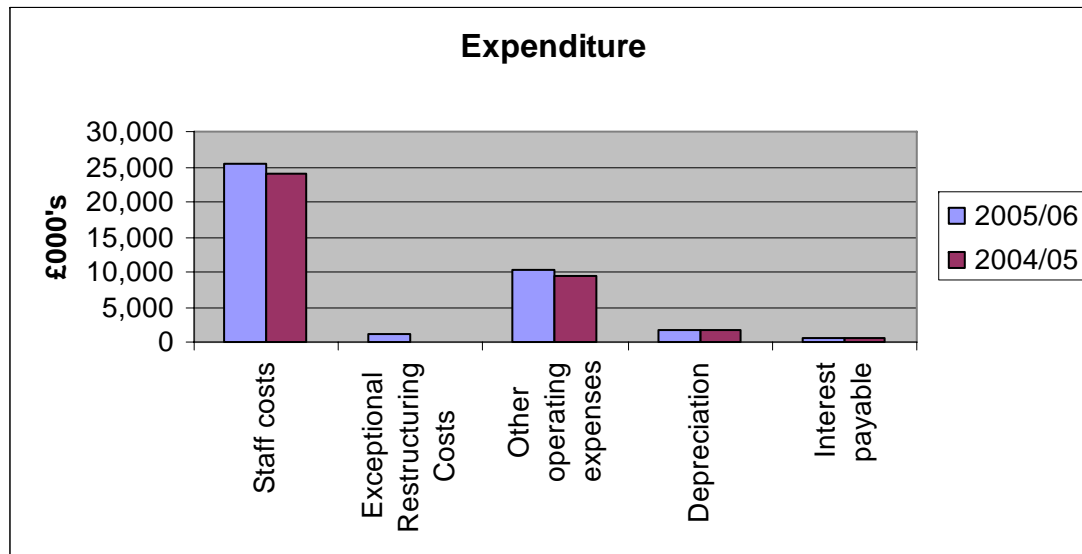
Other grants and other operating income has increased by £1,035k from £3,421k to £4,456k, the major reasons for the increase are as follow;

- ESF income has increased by £530k largely due to a new round of ESF Objective 2 funding being introduced affecting the College’s geographical area.
- Local authority grant income has increased by £422k largely due to increased Community Regeneration Fund funding which is replacing Better Neighbourhood Social Fund income.

## Investment income

Investment income has remained static at £9k year-on-year.

## Expenditure



Source: Audited financial statements

## Staff costs

Staff costs have increased by £1,391k from £23,888k to £25,279k this has largely been a result of the following;

- There has been an average increase in staff pay of 2.15%. As noted previously, the pay award to staff in April 2006 was not made and an accrual of £2320k is included in the financial statements at present.
- There has been an increase in the pension provision as a result of the voluntary redundancies the College has undertaken in the year.

## Exceptional Restructuring Cost

The exceptional restructuring costs of £1,258k have arisen due to the Voluntary Severance Scheme that the College have undertaken in the year.

## Other operating expenditure

Other operating expenditure has increased by £1,023k from £9,386k to £10,409k. The major movements in this balance are as follows;

- There has been an £160k increase in rental costs as a result of additional facilities being used at Largs, Melvin House, Nethermains and Westbyrehill.
- PFI costs have increased by £75k largely as a result of the inflationary increase in the contract and some additional capital works being carried out, thereby increasing the quarterly charge from the PFI company.
- There has been a £112k increase in SQA exam fees due to a higher number of SQA students and the student mix.
- The bad debt charge has increased by £113k;
- Beneficiary costs for ESF and BNSF have increased by £226k due to an increase in the number of projects run by the College. This also ties to the increase in income.

## **Depreciation**

Depreciation has increased by £65k to £1,623k. This is largely due to accelerated depreciation charge on the abortive costs of Westbyrehill and the Learning resource centre.

## **Interest payable**

Interest payable has increased by £7k. Although interest payable on bank loans and finance leases has decreased, these have been offset by an increase on the pension interest charge.