INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Lews Castle College
(Colaisde a' Chaisteil)

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

29 December 2006

AUDIT

Contents

Notice: About this report

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

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

Nothing in this report constitutes a valuation or legal advice.

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

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

Contents

Executive summary

Financial position

The financial statements reflect a consolidated surplus for the year of £89,000, after £86,500 release of the capital goods scheme provision during 2005-06. The College has reduced its negative reserve position (excluding pension liabilities) to £922,000 at 31 July 2006.

The financial statements are prepared on the going concern basis, which provides that an entity will continue in operational existence for the foreseeable future. This is not withstanding the accumulated deficit on the general reserve, including pension liabilities, of £1,130,000 at 31 July 2006. Management document their consideration of the appropriateness of the going concern assumption in note one to the financial statements.

Full implementation of FRS 17 'retirement benefits' required a prior year adjustment to the 2004-05 comparatives, resulting in a further reduction of £535,000 to opening reserves at 1 August 2005. During the year, the College's share of the net liabilities of the Highland Council Pension Fund decreased from £535,000 to £203,000 at 31 July 2006.

Corporate governance

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

In the year the College's internal auditor completed audits over the cash & bank, payroll, purchasing, financial accounting, financial regulations and income systems. The internal audit annual reported concluded that "the College has a sound framework of controls which is sufficient to provide reasonable assurance regarding the effective and efficient achievement of Lews Castle College's objectives."

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

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

Financial statements

On 29 December 2006 we issued an audit report expressing an unqualified opinion on the group and parent College financial statements for the year ended 31 July 2006 and on the regularity of the financial transactions reflected in those financial statements.

Contents

Introduction

Audit framework

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

The framework under which we operate under appointment by Audit Scotland was outlined in the audit plan for the year submitted to the College's audit committee.

The scope of the audit was to:

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

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

- full implementation of FRS 17;
- valuation of the capital goods scheme provision
- inclusion of Lews Castle College Trading in the group accounts; and
- recognition of income by the College in respect of recurrent and non-recurrent income streams.

Basis of information

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

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

Acknowledgement

Our audit has continued to bring us into contact with a range of College staff. We wish to place on record our appreciation of the continued co-operation and assistance extended to us by staff in the discharge of our responsibilities.

Since this is the final year of our audit appointment it is our intention to minimise the disruption to the College from a change in auditor through briefing and liaison on unresolved issues with the incoming auditor's staff.

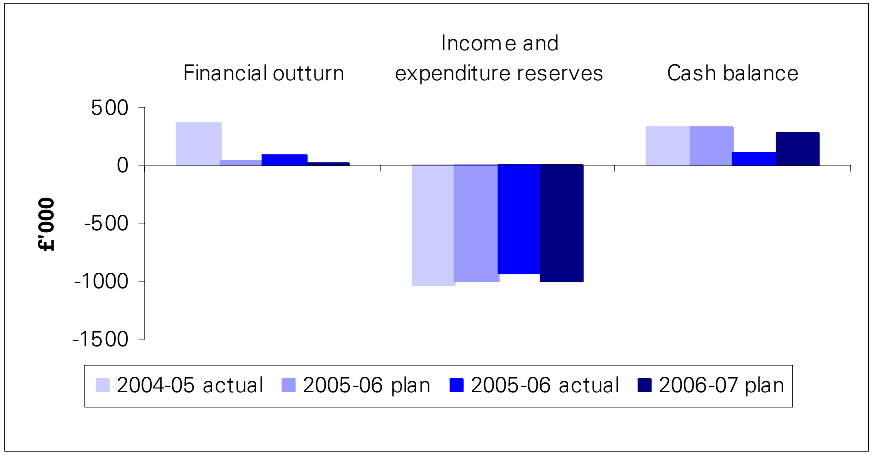
Contents

Financial position

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

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

Figure 1: comparison of planned and actual results



The College has reported a surplus in 2005-06 of £89,000, surpassing the budgeted out-turn for the year. This is primarily due to the non-recurring reduction of the capital goods scheme provision on the advice of independent VAT experts. The College budgets for a breakeven outturn each year. This has reduced the accumulated income and expenditure reserve deficit to £922,000 (excluding pension reserves). The College holds cash balances of £101,000, as at 31 July 2006.

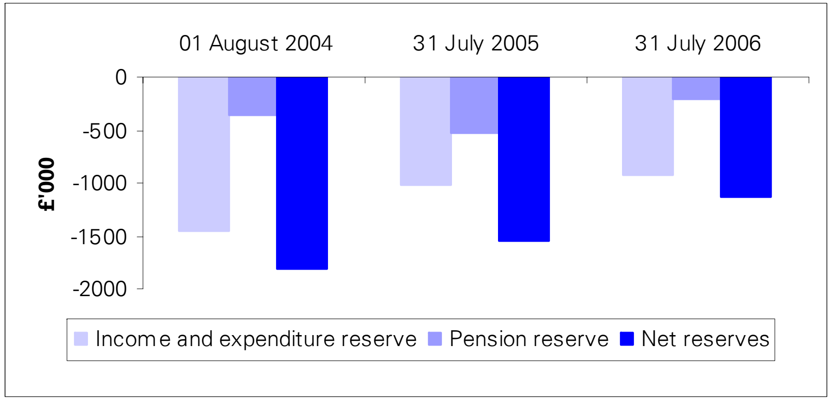
Cash in hand and at bank balances have decreased significantly in the year; the College now has a balance of £101,000, down from £338,000 in 2004-05. There is therefore a net decrease in cash balances that is primarily due to income due to the College from external bodies at the year end.

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

The College fully implemented FRS 17 during the year ended 31 July 2006, resulting in inclusion of the College's share of Highland Council Pension Scheme in the balance sheet for the first time.

Full implementation of FRS 17 'retirement benefits' is a change of accounting policy and required a prior year adjustment in compliance with FRS 3 'reporting financial performance'. The 2004-05 comparatives have been restated, resulting in a reduction of £364,000 in previously reported reserves as at 1 August 2004. Implementation of FRS 17 resulted in the recognition of a net pension liability on the balance sheet of £203,000 as at 31 July 2006 (2005: £535,000). Figure 2 highlights the impact of the College's share of the pension deficit on its income and expenditure reserves.

Figure 2: impact of FRS 17 pension deficit



Ring-fenced funding

The Scottish Funding Council allocated £393,000 of ring fenced funding to the College during 2005-06, primarily for the estates redevelopment and the funding of teachers superannuation. The College received £70,000 of ring fenced funding from the UHI Millennium Institute and £41,000 from the European Social Fund (ESF) for the provision of academic courses. The college also undertook new research projects for which specific funding of £165,000 was received. The College's financial monitoring procedures include consideration of the use of this funding to ensure it is used for the purposes identified.

Capital income and expenditure

The College has incurred capital expenditure with a value of £118,000 in the year, primarily relating to the completion of the 2004/05 capital programme and upgrade of teaching equipment. These have been funded mainly from Scottish Funding Council grants, which have been capitalised in accordance with the College's accounting policies.

Provisions

The College's enhanced pension provision is £768,000, based on an actuarial valuation as at 31 July 2005, which has been updated using discount tables issued by the Scottish Funding Council. Full implementation of FRS 17 resulted in reversal of the previously unfunded element of the provision of £16,000 relating to members of the Highland Council Fund Pension Scheme, which is now included in the pension liabilities disclosed on the face of the balance sheet.

The College, in response to our recommendation raised in prior years, received an independent expert valuation of the provision required on capital goods scheme operated by the College. The provision has been adjusted from £89,000 to £2,500 as a result of this process. Other operating income has therefore been increased by £86,500 for 2005-06 as a result of reducing the provision.

2005-06 SUMS outturn

The College's outturn against its 2004-05 and 2005-06 SUMS targets are shown in Figure 3.

Figure 3: SUMS outturn

	2004-05	**2005-06**
SUMS target	8,593	8,432
SUMS actual	9,277	8,415
Impact on recurring grant	**Nil**	**Nil**

2006-07 budget

The College has budgeted for a £19,000 surplus for the year ended 31 July 2007. The 2006-07 out-turn may be significantly affected by changes such as continued increases in energy costs and the known 1% increase, to 13.5% in employer contributions to the Scottish Teachers' Superannuation Scheme from April 2007.

Research projects

During 2005-06, the College undertook two significant research projects, the Greenspace and Hydrogen Lab projects. Both these projects derive significant funding from European Regional Development Fund and ESF and are operated in conjunction with Comhairle nan Eilean Siar (Western Isles Council). These projects resulted in additional income in 2005-06 of £165,063 of which £70,926 has been included within debtors as accrued income to be received from the funding bodies.

Contents

Introduction

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

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

Control environment

During the 2005-06 audit process our work has identified some minor areas for improvement in the operation of financial controls and procedures, which have been included in the action plan in appendix one. There are no priority one recommendations.

Overall our audit testing of the College's controls and procedures over cash income and banking, ordering and purchase invoice processing and sales invoice processing revealed no material weaknesses. However, management has not actioned a number of recommendations reported as part of our 2004-05 audit.

As part of our planning process we tested whether the College has an appropriate system of high level College wide financial and corporate governance controls. It was found that the College has in place such a system which includes a staff code of conduct per the constitution and articles of governance, Board of Management register of interests, scheme of delegation, whistle-blowing policy, human resources policies and a risk register.

Internal audit

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

In the year the College's internal auditor completed audits over the cash & bank, payroll, purchasing, financial accounting, financial regulations and income systems. The internal audit annual reported concluded that "the College has a sound framework of controls which is sufficient to provide reasonable assurance regarding the effective and efficient achievement of Lews Castle College's objectives."

Corporate governance statement

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

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

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

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

Performance audit

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

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

Reviews and inspections

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

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

There have been no other external inspections in the year.

Contents

Financial statements

Audit opinion

On 29 December 2006 we issued an audit report expressing an unqualified opinion on the group and parent College financial statements and of its group for the year ended 31 July 2006 and on the regularity of the financial transactions reflected in those financial statements.

Audit completion

An important measure of proper financial control and accountability is the timely closure and publication of audited financial statements. Figure 4 summarises the key elements of the audit process with which we require management to engage.

Figure 4: key elements of the audit process

Completeness of draft financial statements
Although a set of draft financial statements was received prior to the start of the final audit visit on 30 October 2006, a number of presentational changes were required including the inclusion of FRS 17 adjustments.
Quality of supporting working papers
In accordance with our normal practice, we issued a 'prepared by client' request that set out a number of documents required for our audit of the financial statements. Documentation provided was to a high standard and the College was at a good standard of readiness for the start of the final audit visit on 30 October 2006.
Response to audit queries
Our routine audit queries were dealt with in a timely manner.

Financial adjustments and confirmations

In Figure 5 we draw attention to adjustments to the financial statements made by management as a result of the audit process.

Figure 5: financial statement adjustments

	Income and expenditure account £'000	Balance sheet £'000
Lews Castle College Trading reported net in 2004-05 but gross in 2005-06	Presentational adjustment only	
Room hire included as grant income	Presentational adjustment only	
Audit fees under accrued	12	-12
Trade creditors included as accruals	Presentational adjustment only	
Credit balances in debtors	Presentational adjustment only	
Capital goods provision overstated	-87	87
Operating lease disclosure	Presentational adjustment only	
Net adjustment	**-75**	**75**

Confirmations and representations

We confirm that as of 4 December 2006, in our professional judgement, KPMG LLP was independent within the meaning of regulatory and professional requirements and the objectivity of audit staff is not impaired. This has been confirmed separately in writing to the audit committee.

In accordance with auditing standards, we obtained representations from the Board's directors on material issues prior to signing our opinion. Management has adjusted all audit differences.

Significant accounting issues

FRS 17: Retirement benefits

In 2005-06 the College was required to make full disclosures in its financial statements including amending comparatives and bringing in the effect of a prior year adjustment. This required information from the actuaries of the College's pension fund.

In September 2006 the College's actuaries reported, in accordance with FRS 17, the College's year end position for the College's participation in the local government pension scheme. The financial statements reflect the actuaries' valuation of the net pension liability at 31 July 2005 and 2006.

Valuation of the capital goods scheme provision

In previous years the College elected to benefit from the capital goods scheme offered by the former HM Customs and Excise (HMC&E). This created a provision for repayment of VAT to HMC&E. The College obtained a professional valuation of the provision and found it to be overprovided.

An adjustment of £86,500 to reduce the provision was processed by management during the audit process.

Group accounting

During 2005-06, the College produced group financial statements for the first time, following managements' consideration of the significance of Lews Castle College Trading Limited's results and balances. The College initially included the subsidiary as net income in 2004-05 but gross income and expenditure for 2005-06. This was corrected to ensure comparability with no impact on the financial outturn.

Income recognition

The College receives income in the form of recurrent grants and recurrent grants from a variety of funding bodies. A number of these are required to be expended in accordance with terms and conditions. During 2005-06 two significant research projects were undertaken by the College. The nature of research projects requires the recognition of income in line with actual expenditure. The College monitored expenditure against such grants and recognised income accordingly.

Contents

Appendix I – action plan

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

	Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the College or systems under consideration. The weakness may therefore give rise to loss or error.		**Grade two (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future.** The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.		**Grade three (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors.** The weakness does not appear to affect the availability of the controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.

Issue, risk and priority		Recommendation and benefit	Management response	Responsible officer and implementation timetable
1	A number of recommendations reported during 2004-05 in our report 'systems and controls review: high level controls' (17 May 2005) have not been fully implemented. There is a risk that fraud and error is not identified and rectified in a timely manner.	Management should ensure that they implement a process to monitor action against external and internal audit recommendations. In line with good practice this should be reported to the audit committee on a regular basis.	We will review all audit recommendations (internal and external) as part of the induction process for the College's new internal audit arrangements.	Director of finance & corporate services 28 February 2007
2	Purchase requisition forms are not completed for the ordering of all goods & services. There is a risk that goods and services are ordered without appropriate authorisation	All orders for goods and services should be made using a standard purchase requisition form	We will review the impact of financial procedures issued in 2006 and check for compliance.	Director of finance & corporate services 28 February 2007

Appendix II – action plan (continued)

Issue, risk and priority		Recommendation and benefit	Management response	Responsible officer and implementation timetable
3	On a periodic basis class lists from the student records are reconciled to income records to ensure fees are received from all students, but, this process is not formally documented. There is a risk that fees are not received from all students.	The process of reconciling student records to the records maintained by finance should be formally documented and reviewed.	A new member of staff will support course leaders and take responsibility for fees. Processes are being streamlined to ensure effective fee collection.	Director of finance & corporate services 28 February 2007
4	Nursery fee forms requesting the raising of an invoice are not signed or dated. There is a risk that invoices are raised without the correct authorisation.	Nursery fee forms requesting the raising of an invoice should be signed and dated by the person requesting the raising of the invoice.	Instructions will be issued to remind staff of authorisation procedures.	Director of finance & corporate services 31 December 2006

Appendix II – follow-up of prior years' recommendations

In this section we provide a brief overview of the action taken to date against recommendations made in previous accounting periods. The following table contains a summary, by report, of the status of recommendations made in previous years.

Figure 6: follow-up of prior years' recommendations

	Fully implemented	**Ongoing**	**Not implemented**	**Not yet due**
Systems and controls review: high level controls (17 May 2005)	3	9	1	-
Annual audit report for 2004-05 to the Board of Management and the Auditor General for Scotland	2	1	0	-
Total	**5**	**10**	**1**	**-**
% of total due	**31%**	**63%**	**6%**	**-**

Management should ensure that recommendations are monitored to ensure full implementation in a timely manner.