INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

Reid Kerr College

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

18 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 Reid Kerr 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.

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Executive summary

Financial position

The financial statements reflect a surplus for the year of £50,000 and a deficit on the income and expenditure account of £578,000 at 31 July 2006 (excluding pension liabilities). Full implementation of FRS 17 'retirement benefits' required a prior year adjustment to previously reported information for 2004-05, resulting in a reduction of £1,631,000 to opening reserves as at 1 August 2005. During the year, the College's share of the net liabilities in the Strathclyde local government pension scheme decreased from £1.8 million to £1.6 million at 31 July 2006.

Corporate governance

Our audit work for 2005-06 has identified no significant weaknesses in the operation of the College's financial controls and procedures and has not identified any significant control weaknesses in relation to fraud and irregularity, standards of conduct or prevention of corruption.

During the year the College's internal auditor produced audit reports on income collection and credit control, purchasing and payments, personnel and payroll, and fixed assets, estates management and inventories. For these areas, it was reported that 'the College has strong procedures and controls appropriate to its operations'. In some areas it was reported that there are 'weaknesses or areas for potential improvement'.

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

Financial statements

On 15 December 2006 we issued an audit report expressing an unqualified opinion on the financial statements of the College for the year ended 31 July 2006 and on the regularity of the financial transactions reflected in those financial statements.

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Introduction

Audit framework

2005-06 was the final year of our five-year appointment as external auditors of Reid Kerr 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 discussed with the College's audit committee on 25 April 2006.

The scope of the audit was to:

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

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

- impact of full implementation of FRS 17;
- the effect of the revised Scottish Funding Council financial memorandum;
- financial security;
- accounting for fixed assets in respect of the College's ongoing estates redevelopment; and the
- the regularity of transactions.

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.

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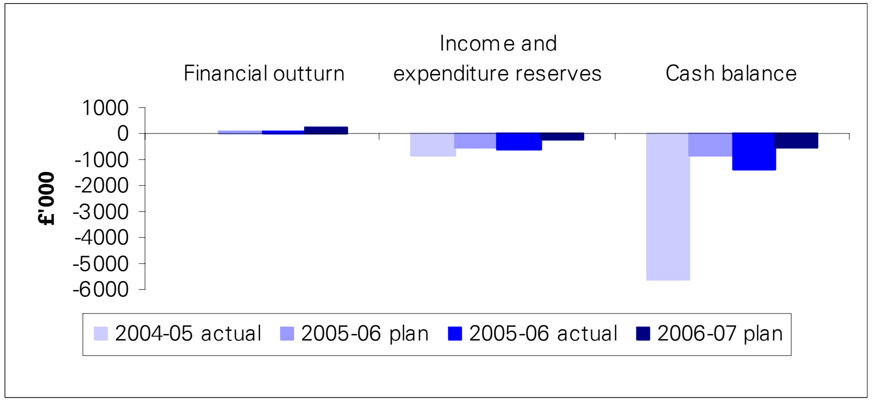
Financial position

Financial position

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

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

Figure 1: comparison of planned and actual results



The College has reported a surplus on continuing operations after depreciation in 2005-06 of £50,000 (2004-05, £33,000), against a budgeted outturn for the year of £53,000. On an historical cost basis, the surplus for the year was £243,000 (2004-05, £215,000). This has reduced the accumulated deficit on the income and expenditure balance to £578,000.

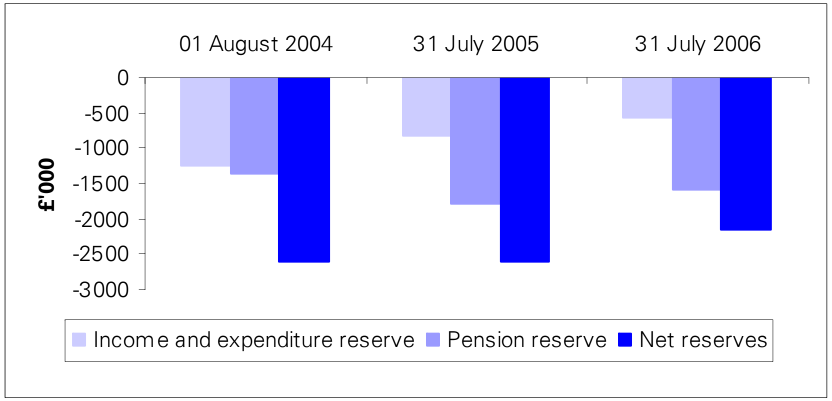
At 31 July 2006 short term overdrafts and loans were £1,616,000 (2005, £5,706,000), with cash at bank and in hand of £1,000 (2005, £8,000). In addition, at 31 July 2006 there were long term loans and finance lease debt of £6,534,000 (2005, £1,500,000). Bank overdrafts have reduced over the year as a result of a restructuring to a secured bank loan in the early part of the year following the completion of the College's new teaching block. The bank overdrafts and loans are secured over specific areas of land and buildings, including the new teaching block.

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 the Strathclyde local government 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 £1,631,000 to opening reserves as at 1 August 2005. Implementation of FRS 17 resulted in the recognition of net pension liabilities on the balance sheet of £1.6 million at 31 July 2006 (2005, £1.8 million). 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



Financial position (continued)

Ring-fenced funding

The Scottish Funding Council allocated £1,491,000 of ring-fenced funding to the College during 2005-06, primarily for the estates redevelopment, financial security, childcare assistance costs and the funding of teachers' superannuation. 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 £2.4 million in the year. The most significant areas of expenditure were completion the new teaching block and also salon equipment and IT equipment for the current and new teaching facilities. These have been funded from bank loans and Scottish Funding Council grants, which have been capitalised in accordance with the College's accounting policies.

Provisions

The College has a pension provision for £1,371,000 relating to pension costs arising from the early retirements awarded to former employees who are members of the Scottish teachers' superannuation scheme. After consulting with an actuary, the College revalued this provision as at 31 July 2006 using the assumptions and measurement basis from the prior year updated to reflect 2005-06.

Implementation of FRS 17 resulted in an element of the prior year adjustment (£157,000) for release of an element of the provision for members of the Strathclyde local government pension scheme. This is now included in the pension liabilities disclosed on the face of the balance sheet.

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	78,588	**77,118**
SUMS actual	80,311	**81,663**
Impact on recurring grant	£Nil	**Nil**

2006-07 budget

The College has budgeted for a balanced position in the year ending 31 July 2007, consistent with the overall breakeven targets in prior years. The 2006-07 outturn will be significantly affected by a full year's depreciation charge in respect to the new teaching block, financing costs for the estates programme, costs such energy which show continuing volatility and the known increase to 13.5% in employer contributions to the Scottish Teachers' Superannuation Scheme from April 2007. The College has recognised a likely reduction in local enterprise company income and European grant income over the next three years.

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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 reported separately to management. There were no priority one recommendations.

Overall, our audit testing of the College's controls and procedures over cash income and banking, payroll starters and leavers, ordering and purchase invoice processing, and sales invoice processing revealed no material weaknesses. The College faces increasing demands on its finance function as a result of ongoing commitments and pressures on income streams.

The College's financial forecasting return indicates that the educational contracts income will be reduced over the years to 2008-09 and that there will be a significant reduction in European income. Increasing costs on salaries and pension costs necessitates that reductions in temporary staff costs as well as non-staff costs are required. The College is planning further estates redevelopment from 2008-09 onwards and, as a result, continued strict financial controls and procedures are critical to the success of the College's medium and long term plans.

The College system of high level financial and corporate governance controls includes the committee and Board structures, a code of conduct per the constitution and articles of governance, a Board of Management register of interests, a scheme of delegation and a risk management strategy which includes an up to date risk register. It was noted that in the year to 31 July 2006 all of these documents were updated to take into consideration changes to the senior management team and to reflect the recent major changes in the College's estate.

Scottish Funding Council circular FE/35/05 requested that its revised draft financial memorandum should be formally considered by each college's board of management during late 2005 to allow timely and efficient adoption from 1 January 2006. The Scottish Funding Council financial memorandum was agreed by the Board of Management in September 2005.

Oversight of the Council's internal control and reporting arrangements is provided through its audit committee.

Figure 4 contains a summary of the implementation status of recommendations made in the annual audit report for 2004-05.

Figure 4: follow-up of prior years' recommendations

	Fully implemented	**Ongoing**	**Not implemented**	**Not longer relevant**
Annual audit report for 2004-05	6	2	-	2
Total	**6**	**2**	**-**	**2**
% of total due	**60%**	**20%**	**-**	**20%**

Corporate governance (continued)

The two recommendations which remain 'ongoing' relate to the need to ensure that journal entries are appropriately authorised prior to being input to the financial ledger and that bank reconciliations are evidenced by the preparer and reviewer by being signed and dated. Management should continue to ensure that recommendations are monitored to ensure full implementation.

Internal audit

During 2005-06, Wylie & Bisset 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 produced audit reports on income collection and credit control, purchasing and payments, personnel and payroll, and fixed assets, estates management and inventories. For the areas reviewed, it was reported that 'the College has strong procedures and controls appropriate to its operations'. In some areas, it was reported that there are 'weaknesses or areas for potential improvement'.

It is noted that in the internal audit report 'student funding, revisit previous reports' (September 2006) no outstanding 'high risk' recommendations were reported as being outstanding or partially implemented. The March 2006 report highlighted one 'high risk' recommendation in respect to the College not having a fixed assets procedures manual.

In September 2006 internal audit reported on their review of the IT systems and procedures. A number of significant recommendations were identified and noted by the audit committee as having been incorporated as part of the College's IT development plan for 2006-07.

Corporate governance statement

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

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

Fraud and irregularity, standards of conduct, and the 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 College has not been subject to any external inspections in the year impacting on the financial or governance arrangements of the College.

The College is due for an inspection by the HM Inspectorate of Education in late 2006 which will be published in 2007. The areas of assessment are likely to include the College's learning and teaching processes, the progression of learners and the achievement of appropriate outcomes, including learner self-evaluation, the College's retention and recruitment of learners, and the College's overall management, its operational planning and its progress towards improving the quality of its services for learners.

Corporate governance (continued)

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.

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Audit opinion

On 15 December 2006 we issued an audit report expressing an unqualified opinion on the financial statements of the College for the year ended 31 July 2006 and on the regularity of the financial transactions reflected in those financial statements.

Audit completion

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

Figure 5: key elements of the audit process

Completeness of draft financial statements
A set of draft financial statements were received at the start of the final audit visit. Several disclosure sections (including FRS 17) were incomplete and number of presentational adjustments were required.
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 reasonable standard. We acknowledge the improvements made by the finance department since the 2004-05 financial statements process in this area.
Response to audit queries
Our routine audit queries were dealt with in a timely and effective manner.

Financial adjustments and confirmations

In Figure 6 we draw attention to adjustments to the financial statements made by management during the course of the audit process.

Figure 6: financial statement adjustments

	Income and expenditure account £'000	Balance sheet £'000
Reclassification of stock balance to prepayments.	- -	38 (38)
The unfunded pension provision for local government scheme members had to be reversed on implementation of FRS 17.	- -	157 (157)
Net adjustment	Nil	Nil

A number of disclosure and clarification adjustments were made to the financial statements to ensure SORP compliance and improve the overall presentation.

Confirmations and representations

We confirmed that as of 15 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. A summary of all material audit differences not processed by management was considered by the audit committee and formed part of the representation letter.

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 by means of a prior year adjustment, of its participation in the Strathclyde Pension Fund. This required information from the actuaries of the College's interests. College management took the view that the information regarding its interests was sufficiently robust for it to account for its participation on a defined benefit basis.

Unfunded pension liabilities

Following discussions with the actuary, a discount rate of 7% (2005, 6.7%) has been used by College management in determining the appropriate carrying value for the provision as at 31 July 2006. This is based on an assumed level of return from bonds and equities and is acceptable in terms of SSAP 24, although in some circumstances may be considered optimistic given that the liabilities are shorter term (i.e. for pensioners rather than active members). Given that there are no assets associated with these liabilities, there is some justification for the use of a discount rate which is consistent with the rate of borrowings the College has given that these liabilities are effectively debt.

The actuary's calculations also use an assumed rate of increase in pensions of 2.44% (2005, 2.28%), the historical average rate. In our view this assumption is too weak and has the effect of understating the provision level. In our opinion an assumed rate of 2.95% (2005, 2.8%) for future increases is more appropriate. Using this, the computed minimum provision level is £1,430,000, a difference of £58,000 (2005, £35,000) against the current carrying value. This difference has been included on the statement of unadjusted audit differences agreed with the audit committee.

Estates redevelopment

During earlier years the College's estates re-developments plans have been progressed in terms of a new teaching block. Formal completion was obtained in three phases commencing early in the 2005-06 financial year, with the third phase in January 2006.

The College contracted Graham & Sibbald, Chartered Surveyors to conduct a revaluation at of the College's land and buildings as at the date of completion (26 January 2006). The effect was to uplift the carrying value of the land and buildings by £204,000. As part of our audit work we reviewed the valuation report and confirmed that the valuation approach was reasonable and on a consistent basis with the College's accounting policies. As the valuation report was not obtained until after the year end, College management computed depreciation based on historical costs, but without reflecting the phased approach to the introduction of the new facilities. As result, the depreciation charge for the year was overstated by £54,000. This difference has been included on the statement of unadjusted audit differences agreed with the audit committee.

In accordance with Financial Reporting Standard (FRS) 11 we reviewed the carrying value of the College's other buildings in the light of ongoing consideration by management of development options. FRS 11 requires the carrying value of fixed assets to be at least equal to the lower of their value in use or recoverable amount, i.e. if sold. The St Mirin building and surrounding site may be sold in coming years, but no decisions were taken with regard to the development or sale of this site during 2005-06.