Key Issues Memorandum

Barony College

For the 14 month period ended 30 September 2012

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To the Audit Committee of SRUC and the Auditor General for Scotland

The purpose of this memorandum is to highlight the key issues affecting the results of Barony College (the College) and the preparation of the College's financial statements for the 14 month period ended 30 September 2012. It is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We take responsibility for this memorandum, which has been prepared on the basis of the limitations set out in 'The small print' (Section 11).

We would like to take this opportunity to record our appreciation for the kind assistance provided by the finance team and other staff during our audit.

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1 Executive Summary

Financial reporting issues	
Audit opinion	• The key issues impacting on the audit opinion this year have related to the merger of Barony College, Elmwood College and Oatridge College with the Scottish Agricultural College (SAC) to form SRUC. • We have issued an unqualified true and fair view opinion on the financial statements for the period ended 30 September 2012.

Governance issues	
	• The merger of Barony College with SAC to form SRUC has gone well. Our audit has not identified any material weakness in governance or internal control during the merger process. • We have identified one low risk control matter from our testing which is detailed at Section 8 of this report.

Performance issues	
Key areas of audit risk	• Our audit has not identified any material performance issues at Barony College. • We note that Barony College was facing potentially significant financial challenges in relation to its long term financial sustainability in response to reductions in grant funding, however, these challenges are largely subsumed by the merger process.
Audit adjustments	• We identified one potential adjustment with a net effect on the Income and Expenditure Account of a £7k reduction in the reported surplus. This item has not been adjusted as it is not material.

2 Financial Results

2.1 Income and expenditure account

Table 1: Income and Expenditure account

	2011-12* £	2010-11 £'000
Income	6,300,832	5,463,261
Expenditure	6,455,281	5,682,193
Gain on disposal of assets	10,817	11,889
Deficit for the year	**(143,632)**	**(207,043)**

Source: 2011-12 financial statements
***Please note that due to the change in accounting period, figures for 2011-12 capture a 14 month period in comparison to 2010-11, which is for 12 months. As such the figures are not directly comparable.**

For the period ended 30 September 2012, the College reported a deficit of £143,632 (2011: £207,043). Table 1 above highlights the financial results for the year.

The College originally budgeted for a surplus of £92,574. However, against the back drop of funding cuts it should be recognised that achieving any surplus is a challenge and the current financial position reflects the monitoring processes in place within the College.

Income
Income has increased overall by £838k (15%), however it should be noted that the figures for 2011/12 cover a fourteen month period, opposed to twelve months covered by 2010/11.

SFC grant income increased by £895k in the period ended 30 September 2012. However, when only the first 12 months are used for comparative purposes this shows a reduction in SFC grant income of £241k. The decrease in SFC funding of 8% reflects a decrease in the main recurrent teaching grant as a result in a cut in funding by the Scottish Government.

Tuition fee income has increased in the period mainly due to FE EU fees. This increase is the result of additional short courses being delivered in 2011/12, and increased Skill seekers activity resulting in milestone payments being achieved.

Overall other operating income has increased by£359k in the period, this is mainly driven by the milk sales.

Expenditure
Expenditure has increased by £773k million (14%), mainly due to an increase in other operating expenses of £968k and an increase in depreciation of £33k, offset by a decrease in staff costs of £229k.

Within other operating expenses there have been significant one off costs of £90k incurred on repairs to the biomass heating system, together with increased farm expenditure of £200k on items including feed and fertiliser.

Overall average staff numbers have decreased by 13, with the number of academic and teaching support staff having decreased by 9. Staff costs have decreased accordingly, with redundancy costs significantly down on the high of £294,598 in 2010/11 (£8,332 in 2011/12).

2.2 Balance sheet

Table 3: Balance Sheet

	2011-12* £	2010-11 £
Fixed assets	6,665,059	6,790,453
Current assets	1,069,730	1,157,563
Current liabilities	(1,463,871)	(1,220,735)
Non-current liabilities	(266,940)	(515,323)
Pension Liability	(753,000)	(521,000)
Net Assets	**5,250,978**	**5,690,958**
Deferred capital grants	1,424,989	1,390,337
General Reserve	1,088,403	1,191,537
Pension Reserve	(753,000)	(521,000)
Revaluation Reserve	3,490,586	3,630,084
Total Funds	**5,250,978**	**5,690,958**

Source: 2011-12 financial statements
***Please note that due to the change in accounting period, figures for 2011-12 capture a 14 month period in comparison to 2010-11, which is for 12 months.**

For the year ending 30 September 2012, the College held net funds of £5.3 million (2011: £5.7 million). Table 2 highlights the key balance sheet items for the year.

Fixed assets
The decrease in the value of fixed assets was mainly attributable to the depreciation charge of £277k. This was offset by a net investment in assets of £95k (£167k of additions and £72k of disposals).

Current Assets
Debtors have increased by £117k over the prior period due to the timing of payments. The main reason for this is the timing difference between the period end being moved from 31 July to 30 September. This resulted in a number of payments which usually take place after the year end and relate to balances apportioned over the period from August to July. This has resulted in an increased prepayments figure.

Stocks have decreased by £158k, due to a reduction in the level of livestock.

Cash balances have reduced during the period from a positive balance of £60k to a net overdrawn position of £260k, this is driven by the operational results of the College.

Current liabilities
Current liabilities have increased by £243k, mainly due to the recognition of student fees which were paid in September for a full year course. The creditors balances recognise the liability the College has to deliver tuition to the students. This was not an issue in the prior year as the year end coincided with the end of the academic year.

Further as noted above, the College is utilising its overdraft facility at the period end.

Pension Liability
The pension deficit of £753k reflects the College's share of the assets and liabilities in the Local Government Pension Scheme (LGPS), which is accounted for as a defined benefit scheme under FRS 17.

3 Key audit issues

In this section we present our findings in respect of matters and risks identified at the planning stage of the audit and we provide details of additional matters that arose during the course of our work.

3.1 Status of audit

Our audit is complete following discussions with management.

3.2 Matters identified at the planning stage

In the conduct of our audit, we have had to alter or change our audit plan, to reflect the change in the accounting period. This change was communicated to you in a revised Audit Approach Memorandum which was issued on 20 December 2012. The revised audit plan did not identify any additional risks. Our responses to the matters identified at the planning stage are detailed below.

3.3 Matters identified at the planning stage

	Issue	Auditor commentary
1	**Merger** The Griggs report on the Review of Further Education Governance in Scotland proposes a new governance structure for the further education sector. In response to this report, the College merged with Scottish Agricultural College, Oatridge College and Elmwood College to form SRUC, with effect from 1 October 2012. As a result the College has required the audit to now cover the 14 month period from 1 August 2011 to 30 September 2012. Furthermore, we have been informed that the Board of SRUC now represent those charged with governance of the College in relation to this final financial statements period ended 30 September 2012. Mergers of this type are, by their nature, complex and challenging undertakings impacting on all aspects of the College's operations, students and staff. Preparations for the merger will be a natural focus for the Board and senior management but does introduce a risk that operations of the College in the lead up to the merger may not be fully effective.	We have conducted on the audit of the financial statements for the 14 month period to 30 September 2012. The disclosures in the accounts were evaluated against accounting standards, the requirements of the SFC accounts direction and guidance issued by Audit Scotland. Additional disclosures were required outlining the results of the merger and in particular in relation to the going concern principal. We have reviewed the disclosures in the accounts and discussed the appropriateness with the Finance Manager. **Management Commentary** Comments have been noted.

2	**Property, plant and equipment** In advance of the merger the College should review its estate and consider if valuation was necessary. Assets should be identified which become obsolete as a result of the merger and impairment reviews may have been carried out.	SRUC had a professional valuation undertaken on the land and buildings of the former Barony College on 1October 2012. The results of this valuation have been provided to us and represent a material change in the value of the assets as reported in the college financial statements for the period ended 30 September 2012. However, it should be noted that the basis of the October 2012 valuation was Depreciated Replacement Cost. The previous professional interim valuation on 31 July 2011, carried out on behalf of the college had been undertaken on a Market Value basis. Given the differing valuation basis we have not recommended any uplift in the fixed assets as reported in the financial statements for the period ended 30 September 2012. Management have not identified impairment indicators following their review of assets, and our audit confirms this assessment. **Management Commentary** No adjustment was proposed to the carrying value of fixed assets at 30 September 2012 and we are not aware of any indicators of impairment.
3	**Financial planning and monitoring** The 2010-11 income and expenditure account showed an operating deficit of £207,043. The key financial ratios were also challenging with current assets to current liabilities at 0.9:1 and cash balances for 4 days' operations, a significant reduction from previous years. The College was also required to utilise its cash overdraft. The 2011-12 SFC revenue grant allocation is £2.2 million. The approved 2011-12 budget forecasts a £27,342 surplus, excluding any redundancy costs.	Monthly financial reporting has been in place at the College and continues to be provided to the SRUC post- merger. The College reported a final deficit of £144k against a budgeted surplus of £27k. However, the events that brought this underachievement against projected surplus have been clearly identified by the College and were reported to the Finance Committee throughout the year. Remedial action was taken throughout the financial year to reduce operating costs where possible. **Management Commentary** Monthly results continue to be carefully monitored. Budgets for the year to 31March 2014 are underway.

4	**Financial statements key risks** The two key areas of audit risk in relation to the financial statements are in other operating income and employee remuneration.	There was increased testing on both the employee remuneration and income systems including performance of walkthroughs tests of the control systems in place. There was one low risk control weaknesses found within the systems, which we bring to your attention at section 8. There were no weaknesses which were so significant that the system could not be relied upon for our audit of the financial statements. We performed analytical review of both income and employee remuneration combined with detailed sample testing of the key balances with no significant issues noted. Based on the results of our testing we are satisfied that income and employee remuneration are not materially misstated. **Management Commentary** Noted

3.4 Matters identified during the course of the audit

Other than the matters highlighted at the planning stage, there were no additional significant audit issues which arose through the course of our fieldwork.

4 Governance

4.1 Introduction

The Board are responsible for establishing arrangements for ensuring the proper conduct of its affairs, including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. The Audit Committee has a role in monitoring these arrangements.

	Issue	Auditor commentary
1	**Merger** The college merger is by its nature, a complex and challenging undertaking which will have impacted on all aspects of the College's operations, students and staff. Preparations for the merger will have been a natural focus for the Board and senior management, but it does introduce a risk that the operations of the College in the lead up to the merger may not have been fully effective. We have identified the following risks in relation to the 2011-12 accounts: • arrangements need to be in place to allow the new board to approve the 2011-12 accounts and receive the Annual Report • there may have been an impact on capacity of senior staff as time has been required on merger • key staff may have left the organisation during the transition • governance arrangements for 2011-12 may not be fully effective • risk management arrangements may need to be reviewed to account for the merger transition.	We have undertaken a review of governance arrangements in place at the College as part of our audit work. Our audit found that good arrangements were in place to facilitate the merger process. There were some weaknesses in the entity level controls identified. Further detail on the identified issues are outlined at section 8. From our review of committee minutes it was evident that significant consideration had been given to the merger and the governance structures which would be in place following the merger. **Management Commentary** An internal audit review has been completed for the post-merger period and procedures were found to be satisfactory.

5 Performance

5.1 Introduction

All public bodies in Scotland have a duty to secure Best Value and continuous improvement. Barony College and SRUC continues to work with the Scottish Government to identify further areas of efficiencies and savings.

	Issue	Auditor commentary
1	**Audit Scotland national reports** In August 2010, Audit Scotland published a national report on how public bodies are beginning to respond to the challenge of a significant reduction in budget. The report provides an overview of budgeting issues across the public sector and there is some key commentary on the reduction of the funding to the Further and Higher Education sector and the impact of the removal of the cap on tuition fees in England and Wales. In September 2010, Audit Scotland published a national report on the governance arrangements across the public sector. The report focused on three areas and provided recommendations on the following: • the role and accountability of boards • the skills and expertise of board members • how boards operate.	During 2011/12 there was no review of the Audit Scotland Reports by the College Board of Management. This is reasonable due to the uncertainty of the College's position going forward and the limited impact any action could have in the event of the merger. The merger has now taken place and there will be significant challenges concerning both budgeting and the governance arrangements. It is recommended that the Audit Scotland reports are considered by the Board of the SRUC to identify areas of good practice and evaluate the merged bodies performance against the findings of the national reports. **Management Commentary** Noted – these will be reviewed.

6 Financial reporting matters

6.1 Commentary on key judgements and estimates

Going concern

Barony College has ceased to be a separate entity following a merger with other Land Based Colleges and therefore increased disclosures have been required regarding going concern. The disclosures have been subject to review, and are deemed to reflect the circumstances of the College accurately.

6.2 Review of principal accounting policies

We have reviewed the financial statements and have noted no significant issues in relation to the key accounting policies, judgements and estimates.

6.3 Disclosure omissions

Our review found no material omissions in the financial statements.

7 Audit adjustments

7.1 Misstatements

We are required to communicate all uncorrected misstatements to you, other than those considered to be clearly trivial. We have requested that management correct these misstatements and have included (where applicable) the reasons given by them as to why the misstatements remain uncorrected.

7.2 Impact of misstatements

All unadjusted misstatements are set out in detail in section 7.3 below. In summary, the impact of adjustments is:

Income & Expenditure Account	Increase/ (Decrease) in deficit
	£'000
Deficit per trial balance	(144)
Auditor-proposed adjustments posted	(7)
Final deficit per financial statements	**(151)**

There is no impact on the audit report as a result of these unadjusted misstatements.

Misstatements in relation to the prior year

During the course of our audit we obtained audit evidence that the opening balances in relation to deferred accrued income contained misstatements.

The impact of these misstatements on this year's income and expenditure account is £nil. There is no impact on our audit report as a consequence of these misstatements.

7.3 Unadjusted misstatements

Journal reference	Detail	Balance sheet		Profit and loss		Profit effect	Reason for not adjusting
		Dr	Cr	Dr	Cr		
1	Dr Expenditure			7,065		7,065	
	Cr Creditors		(7,065)				
	Being the recognition of legal expenses						Immaterial effect on the financial statements for the period
Impact - reduction on reported surplus of						**7,065**	

8 Design effectiveness of internal controls

8.1 Accounting system and internal control

Our audit is not designed to identify all significant weaknesses in the College's internal controls but is designed primarily for the purpose of expressing our opinion on the financial statements of the College. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

In consequence, our work did not encompass a detailed review of all aspects of the internal controls and cannot be relied upon necessarily to disclose all defalcations or other irregularities or to include all possible improvements in internal control.

See 'The small print' for further details of our approach in respect of internal controls.

8.2 Key findings

Key to assessment of internal control deficiencies

● (red)	Material weakness - risk of material misstatement
● (yellow)	Significant deficiency - risk of significant misstatement
● (green)	Deficiency - risk of inconsequential misstatement

	Assessment	Issue and risk	Recommendation
1	● (green)	**Authorised Starters and Leavers Forms** From our sample testing we noted that 3 forms were not signed off by the authorised signatory. However, we understand the monthly payroll differences report was signed by either the Principal of Deputy Principal throughout the period. Poorly-controlled employee starter and leaver processes mean that errors or fraud can occur and go undetected. With the heightened risk of fraud caused by the current economic conditions, improving controls over this area should be a focus for the Board.	We would recommend that going forward all starters and leavers forms should be signed by the HR manager or an alternative member of the senior management team **Management response:** There are procedures in place to ensure that the approval is appropriately documented.

9 Financial reporting and legislative developments

UK GAAP

Improvements to FRSs

What is proposed?
As we have noted in previous years the Accounting Council is planning to replace all current UK financial reporting standards with a new framework, incorporating two new standards. The standards are "The FRS", a 300 page standard which will be applied by the majority of UK companies, and the Reduced Disclosure Framework, an option of IFRS with reduced disclosures available for subsidiaries and parent company individual accounts.

For more information on the proposals and their implications, visit our website, http://www.grant-thornton.co.uk/services/audit_and_assurance/the_future_of_uk_gaap.aspx.

What would this mean for SRUC?
Under the proposals, SRUC would be considered to be a public benefit entity, as its main purpose is not the generation of profit. The FRS includes supplementary paragraphs which address issues specific to public benefit entities, for example non-reciprocal transactions such as donations.

SRUC will be required to undergo transition to The FRS, as will any subsidiary companies. When undergoing transition to the new financial reporting regime, there are likely to be recognition and measurement differences on transition, for example the requirement to accrue for unused holiday balances. These differences are likely to impact on the reported profit and also on the balance sheet.

As a consequence, there may be an impact on:

- the amount payable under any employee bonus arrangements SRUC might put in place.

What other issues do I need to consider?
There are also operational issues which may need to be addressed in preparing for transition, such as:

- training requirements
- possible systems changes to ensure all information is captured
- education of stakeholders
- potential need for additional resources.

What about the not-for-profit SORPs?
The Accounting Council intends to retain the three not-for-profit SORPs, for Charities, Registered Social Landlords and Higher and Further Education Establishments. However as stated above these SORPs will need to be updated to reflect the requirements of The FRS.

How should I plan for the transition?
From our experience in helping other entities transition between frameworks we note that the key to managing the process successfully is thorough planning and ensuring the time and resource commitments are not underestimated.

Although the final standards will not be published until the end of 2012, and will not be effective until accounting periods beginning on or after 1 January 2015 at the earliest, it is not too soon to start considering how you will address the transition process.

For SRUC this will mean the first reporting period is likely to be the year ended 31 March 2016, which will mean comparative balance sheets will be required for 31 March 2015 and 31 March 2014.

Timely actions and the right support will ensure that the process goes as smoothly as possible.

We would be pleased to discuss this matter further and provide detailed guidance in regard to this transition.

Real Time Information (RTI)

The introduction of Real Time Information (RTI) will significantly change the way that employers report PAYE deductions from April 2013. Instead of notifying HM Revenue & Customs (HMRC) of pay and deductions made from employees' wages at the end of the tax year, employers will be required to do this each and every time that any payment is made to an employee, on or before the time the payment is made.

Employers with fewer than 5,000 employees must start filing RTI returns from 6 April 2013.

Non-compliance with the new rules could lead to payroll processing failures, reputational damage with HMRC and employees, and potential penalties by HMRC for late or incorrect submission of data. All employers will need to review their policies, processes and systems to make sure that they are robust enough, and contain the correct data, to enable them to file in real time.

We would be pleased to discuss this matter further and provide detailed guidance in regard to this transition.

Disguised remuneration

The new disguised remuneration legislation results in an upfront income tax charge and National Insurance contributions where a reward or sum of money is earmarked for or loaned to an employee by a third party as part of an arrangement in connection with employment.

The original draft of the legislation was very wide ranging and caught many commercial arrangements with no tax avoidance element. Although the latest changes to the legislation do address many of the anomalies, there are still key issues which need to be considered when a company is to introduce any reward, benefit or incentive arrangement which includes a party other than the employee and employer in the structure

10 Independence

Ethical standards require us to give you full and fair disclosure of matters relating to our independence.

We confirm that there are no significant facts or matters that impact on our independence as auditors that we are required or wish to draw to your attention. We have complied with the Auditing Practices Board's Ethical Standards and therefore we confirm that we are independent and are able to express an objective opinion on the financial statements.

In accordance with best practice, we analyse our fees below:

	£
Audit of College	15,000
Total audit	**15,000**

11 The small print

Purpose of memorandum

This Key Issues Memorandum has been prepared for the benefit of discussions between Grant Thornton, the of SRUC and the Auditor General for Scotland.

The purpose of this memorandum is to highlight the key issues affecting the results of the College and the preparation of the College's financial statements for the period ended 30 September 2012.

This document is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We would point out that the matters dealt with in this report came to our attention during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements of the College.

This memorandum is strictly confidential and although it has been made available to management to facilitate discussions, it may not be taken as altering our responsibilities to the College arising under our audit engagement letter.

The contents of this memorandum should not be disclosed to third parties without our prior written consent.

Responsibilities of the Board of Management and auditors

The Board of Management are responsible for the preparation of the financial statements and for making available to us all of the information and explanations we consider necessary. Therefore, it is essential that the Board of Management confirm that our understanding of all the matters in this memorandum is appropriate, having regard to their knowledge of the particular circumstances.

Clarification of roles and responsibilities with respect to internal controls

The College's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the that it has done so.

The is required to review the College's internal financial controls. In addition, the are required to review all other internal controls and approve the statements included in the annual report in relation to internal control and the management of risk.

The should receive reports from management as to the effectiveness of the systems they have established as well as the conclusions of any testing conducted by internal audit or ourselves.

We have applied our audit approach to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

In consequence, our work cannot be relied upon to disclose defalcations or other irregularities, or to include all possible improvements in internal control that a more extensive special examination might identify.

We would be pleased to discuss any further work in this regard with the .

ISAUK 260 requires communication of:

- relationships that have a bearing on the independence of the audit firm and the integrity and objectivity of the engagement team
- nature and scope of the audit work
- significant findings from the audit