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Ayrshire College

Annual audit report to the Board of Management of Ayrshire College and the Auditor General for Scotland

Period ended 31 March 2014

3 October 2014

Contents

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About this report

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

This report is for the benefit of the Board of Management of Ayrshire College and is made available to Audit Scotland and the Auditor General for Scotland (together "the Beneficiaries"). This report has not been designed to be of benefit to anyone except the Beneficiaries. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

Nothing in this report constitutes an opinion on 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 (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) 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.

Headlines

This annual audit report summarises our work at Ayrshire College for the eight month period ended 31 March 2014. Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* and guidance issued by Audit Scotland.

This report also includes those matters specified by ISA (UK and Ireland) 260: *Communication with those charged with governance* in relation to the financial statements for the period ended 31 March 2014.

We wish to record our appreciation of the co-operation and assistance extended to us by Ayrshire College staff during the course of our work.

Area	Summary observations	Analysis
Strategic overview and use of resources		
Business issues	Management has developed a strategic vision for the College based on the principles in the business case for the establishment of the College. Continuing reductions in Scottish Government real-time funding continue to present challenges. Colleges in Scotland have been reclassified as public bodies from April 2014. One consequence has been the change in accounting reference date away from one which matched academic activity.	Pages 6-7
Financial position	The College generated a deficit of £11.5 million (2012-13: £1 million surplus), against a budgeted £43,000 surplus. The deficit against budget relates to exceptional items including the impairment of the current Kilmarnock campus and donation of monies to the Ayrshire College Foundation. Without these exceptional items, the surplus for the period was £700,000. Income reduced, primarily as a result of a reduction in Scottish Funding Council grant income and a provision for potential claw back against wSUMS activity. The balance sheet reflects a decrease in net assets of £15.2 million, corresponding to the deficit for the period and the actuarial loss on the defined benefit pension scheme.	Pages 8-9
Financial statements and accounting		
Audit conclusions	We have issued unqualified audit opinions on the financial statements and on the regularity of financial transactions.	Page 11
Significant risks and audit focus areas	We have considered inherent significant risks that International Standards on Auditing require us to address covering risks in relation to revenue recognition and management override of controls and have satisfactorily concluded our work in these areas. We have also satisfactorily concluded work identified at the planning stage in relation to retirement benefits valuation, merger accounting, accounting for PFI, new campus development and the establishment of a charitable foundation.	Pages 11-15
Period end process	The complexities of the various accounting requirements and issues in the period presented a range of challenges for College management. These were handled well, with good interaction between the College's finance team and ourselves to address and resolve matters in an appropriate timeframe.	Page 18

Headlines (continued)

Financial statements and accounting (continued)		
Control observations	Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are in the main designed appropriately and operating effectively. We have raised a number of recommendations over the operation of controls.	Page 18
Governance and narrative reporting		
Governance arrangements	The statement of corporate governance and internal control identifies no major weaknesses in governance or internal control arrangements. We have reviewed the statement of corporate governance and consider it consistent with our understanding of the process followed by the College during the period. Management has identified no significant fraud or irregularities.	Pages 20-21
Performance management		
Performance management	The College produces management accounts which compare actual expenditure to budget and has a procurement strategy which seeks to use the most advantageous supplier that is available. Efficiency savings are planned and ongoing as part of the merger business case.	Page 23

Scope and responsibilities

Purpose of this report

The Auditor General for Scotland ("the Auditor General") has appointed KPMG LLP as auditor of the Board of Management of Ayrshire College ("Ayrshire College") under the Public Finance and Accountability (Scotland) Act 2000 ("the Act"). The period of appointment is 2013-14 to 2015-16, inclusive.

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at Ayrshire College and the Auditor General for Scotland. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit committee at the outset of our audit.

Responsibilities

Audit Scotland's *Code of Audit Practice* ("the Code") sets out Ayrshire College's responsibilities in respect of:

- preparation of financial statements;
- systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- financial position; and
- Best Value.

This report reflects our overall responsibility to carry out an audit in accordance with our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the Code.

The Code sets out the wider dimensions of public sector audit which involves not only the audit of the financial statements, but also consideration of areas such as financial performance and corporate governance.

An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. Weaknesses or risks identified are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260 *Communication with those charged with governance*, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity.

This annual audit report to members and our presentation to the audit committee, together with our audit strategy and plan for the period discussed with the audit committee, discharges the requirements of ISA 260.

Service overview

Our perspective on on key business issues
and the financial position of the College

Key business issues

Ayrshire College was established on 1 August 2013 through the merger of Ayr and Kilmarnock Colleges and the North Ayrshire campuses of James Watt College.

Sector organisational and structure changes

During 2011-12 the process of regionalisation of colleges began, with the goal of creating 13 college regions across Scotland, to be completed in 2013-14. As part of this change, Ayrshire College was created as at 1 August 2013, being the merger of Ayr and Kilmarnock college and James Watt College North Ayrshire campuses.

The Board expects that the new regional arrangement will help address the significant funding challenges faced by the college sector in light of reduced levels of Scottish Funding Council recurrent and specific grant funding.

Through the merger, the College has developed an institution of greater reach and scale. The establishment of the College has enabled continued delivery of a broad and balanced curriculum at a time of economic stringency. The scale and regional coherence of the College will help to mitigate the impact of future reductions in public investment.

Outcome agreement

The Ayrshire College outcome agreement with the Scottish Ministers has been agreed for 2014-17.

The College's aim for 2014-15 is to lay foundations for a sector leading college for the whole of Ayrshire, and retaining roots in the local communities it serves across the region. The College's vision is to raise aspirations, inspire achievement and increase opportunities.

The college plans to deliver both economic growth and social cohesion through enhanced education and training opportunities.

The College has aligned its vision, mission and values with the ambitions of their strategic partners. The College has also committed to the overarching visions of the three Community Planning Partnerships in Ayrshire. The outcome agreement 2014-17 sets out seven key ambitions for the College and is linked to the draft strategic plan 2014-17 which outlines strategic goals and key objectives of the college.

Ambitions

- To deliver excellence in learning and teaching
- To have an excellent reputation locally, regionally and nationally
- To nurture new and further develop excellent partnership working with employers and Community Planning Partners
- To recruit and retain excellent staff and enable learning to flourish in excellent learning environments
- To be the college of first choice for students
- To be the training partner of choice for employers
- To demonstrate excellence in financial sustainability

The College seeks to meet its mission and progress towards the ambitions of the future through planning and achieving a balanced set of outcomes and results that meet both the short and long term needs of the College and its key stakeholders.

Key business issues (continued)

Funding for the college sector has decreased in recent years and the Scottish Government expects continued efficiencies from the merger programme and wider reforms to allow further real-term reductions in funding.

Colleges have been re-classified as public bodies from April 2014, restricting the scope to build up financial reserves. The accounting reference date has been altered as a consequence.

Management approved 58 voluntary severance applications, supported and mostly funded by Scottish Funding Council merger support grants.

Voluntary severance

A voluntary severance scheme across the campuses was ongoing in 2013-14, funded by Scottish Funding Council merger support grants.

Management approved 58 voluntary severance applications with a total cost of £1.9 million in 2013-14. The voluntary severance was supported by a total grant of £4.15 million from the Scottish Funding Council to be recognised in line with the severance programme over several financial periods. The remaining SFC funding available for future schemes is £480,000, with any remaining costs to be met by the College directly.

Future funding challenges

In its latest review of the college sector, Audit Scotland reported that, while the overall financial standing of the sector continued to be generally sound, the sector faces an overall 11 per cent real-terms reduction in revenue grant funding from the Scottish Government in the period to 2014-15. Some college regions will see larger reductions in grant funding than others meaning that they face greater challenges in reducing costs. Reducing staff numbers is likely to be the main way in which savings will be delivered, but that presents risks in terms of retaining skills and experience required to maintain quality of learning.

Colleges in Scotland have been re-classified as public bodies from April 2014 and this will require them to operate within the same annual budget limits as other Scottish Government bodies. This will restrict the scope to build up financial reserves.

A number of colleges – including Ayrshire – have established separate charitable foundations as a means of minimising some of the impact of this change. One consequence of the re-classification has been the change in accounting reference date to 31 March from 2014.

Financial position

The College generated an overall deficit of £11.5 million in the eight month period (2012-13: £1 million surplus).

Income reduced on the prior year mainly as a result of the year end change meaning the figures were only for an eight month period this year.

The increased expenditure is mainly in respect of exceptional items relating to the impairment of the Kilmarnock campus and cash donation to Ayrshire College Foundation.

The College is reporting a deficit for the eight month period to 31 March 2014 of £11.5 million. This compares to a surplus of £1 million in the previous 12 month period.

- Total income decreased by £8.4 million when compared to 2012-13, but this has been largely as a result of the change in accounting periods.
- Scottish Funding Council grants recognised in 2013-14 decreased by £7.2 million mainly as a result of shorter accounting period; when the adjustment for potential claw back based on targeted WSUMs is taken into account, recurrent grant income is in line with prior year. Overall, there was an increase in Funding Council grant income of £4.3 million due to exceptional items of grant income, including transformation grant funding received (£1.2 million increase compare to prior year), release of deferred capital grant in relation to the impairment (£1.65 million) and the release of £1.2 million unspent capital grant to revenue.
- Tuition fees and education grants have remained broadly consistent when considering the reduction in the accounting period from 12 to eight months.
- Other operating income increased by £600,000 in absolute terms mainly due to the donation of gifted land for the new campus development, valued at £800,000.
- Expenditure increased by £4.1 million when compared to 2012-13. However, this has been largely as a result of exceptional items (impairment of the current Kilmarnock campus building and a cash donation to the Ayrshire College Foundation).
- Staff costs reduced by £8.1 million in absolute terms, but have remained largely consistent when considering the shorter accounting period. The staff costs include a £400,000 expense for a backdated pay award for curriculum staff. In line with expectations, exceptional restructuring costs have increased by £500,000 due to the voluntary severance programme.
- Other operating expenses decreased by £2.5 million in absolute terms. This is primarily due to the reduced months in the accounting period rather than significant savings achieved by the College.

31 March / 31 July	2014 £'000	2013 £'000
Income		
Funding Council grants	27,418	34,600
Tuition fees and education grants	3,158	4,829
Other grant income	134	222
Other operating income	2,738	2,130
Endowment and investment income	153	203
Total	**33,601**	**41,984**
Expenditure		
Staff costs	(17,827)	(25,960)
Exceptional restructuring costs	(1,867)	(1,550)
Exceptional new build and college merger costs	-	-
PFI deferred expenditure release to I&E	(429)	-
Impairment of building and asset write down	(8,765)	(104)
Transfer to ACF	(6,611)	-
Other operating expenses	(8,033)	(10,762)
Depreciation	(1,569)	(2,496)
Interest payable	-	(103)
Total	**(45,101)**	**(40,975)**
(Deficit)/surplus	(11,500)	1,009

Source: 2013-14 financial statements

Financial position (continued)

The balance sheet shows a decrease in net assets of £15.2 million, arising from the increase in the net pensions liability and the operating deficit in the current period. Period end comparisons have been impacted by the change in accounting reference date.

The balance sheet shows a decrease in net assets of £15.2 million.

- Fixed assets have decreased £8 million as a result of the impairment of the current Kilmarnock campus due to a reduction in the useful life of the current campus to two years, reflecting the anticipated completion of the new campus in May 2016.
- Cash at bank and in hand decreased by £4.4 million. This is primarily the result of timing differences and the donation to the Ayrshire College Foundation established in the period.
- Debtors increased by £2 million due a £2.5 million increase in amounts owed by the Scottish Funding Council as a result of the change in accounting period and a decrease of £800,000 in prepayments and accrued income balances in the period for the same reason.
- Creditors due within one year have increased by £2.3 million, primarily arising from an increase in deferred income for SAAS tuition fees of £1 million as a result of the change in accounting period and a £1.3 million severance pay accrual at year end and £400,000 for a backdated pay award for curriculum staff.
- Net pension liabilities in respect of participation in the Strathclyde Pension Fund increased by £2.8 million as a result of market conditions and assumption changes.

Budget 2014-15

The approved a budget for 2014-15 reflects a £300,000 surplus for the year. From normal operations, the College is forecasting a breakeven position.

31 March / 31 July	2014 £'000	2013 £'000
Fixed assets		
Tangible assets	51,002	59,048
Current assets		
Stocks	13	8
Debtors: Amounts falling due within 1 year	4,024	2,028
Debtors: Amounts falling due after 1 year	-	393
Cash at bank and in hand	3,013	7,421
Creditors: Amounts falling due within 1 year	(6,573)	(4,271)
Net current assets	**477**	**5,579**
Creditors: Amounts falling due after 1 year	(10,253)	(11,002)
Provisions for liabilities and charges	(1,701)	(1,750)
Net pensions liability	(7,298)	(4,455)
Net assets including pension liability	**32,227**	**47,420**
Deferred capital grants	10,094	10,983
Reserves		
Income and expenditure reserve (including pension reserve)	(1,858)	4,844
Restricted Reserve	470	470
Capital reserve	6,057	6,057
Revaluation reserve	17,464	25,066
Total funds	**32,227**	**47,420**

Source: 2013-14 financial statements

Financial statements and accounting

Our perspective on the preparation of the financial statements and key accounting judgements made by management

Audit conclusions

We have issued an unqualified audit opinion on the financial statements and the regularity of transactions reflected in those financial statements.

International Standards on Auditing require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk and that management override of controls is a significant risk.

We have satisfactorily carried out audit work to address these risks.

Audit conclusions

We have issued an unqualified opinion on the truth and fairness of the state of the affairs of the College as at 31 March 2014 and of the College's income and expenditure, recognised gains and losses and cash flows for the period then ended. We have also issued an unqualified opinion on the regularity of the transactions reflected in those financial statements. There are no matters identified on which we require to report by exception.

In gathering the evidence for our opinion we have:

- performed a mixture of substantive and controls testing to ensure an efficient approach that covers all the key risks;
- reviewed internal audit reports to ensure all key risk areas having a potential financial statements impact have been considered;
- reviewed assumptions and judgements made by management and considered these for appropriateness;
- considered if the financial statements may be affected by fraud through discussions with senior management and internal audit to gain a better understanding of their work in relation to the prevention and detection of fraud with the potential to impact on the financial statements;
- held discussions with senior management; and
- attended meetings with those charged with governance to communicate our findings, but also to update our understanding of the key governance processes and obtain key stakeholder insights.

Significant risks

Revenue recognition	While fraud risk associated with grant income would ordinarily be rebutted, the change in accounting reference date to 31 March introduced a degree of judgement as to underlying activity measures and compliance with funding conditions. This included whether underlying activity was such that provision should be made for anticipated clawback of grant funding. We found that management had considered the variables impacting recognition of grants and had arrived at an appropriate basis. We consider management's judgement to have been balanced. We did not identify any errors requiring adjustment in the financial statements or evidence of bias in determining income to be recognised.
Management override of controls	To address this risk, we have performed testing of journal entries during the period and at the period end, undertaken a review of unusual transactions in the period, made enquiries with employees outside the finance department, incorporated audit tests of an unpredictable nature and undertaken testing of controls, including 'higher level' controls and reviewed management's accounting estimates for bias. Our work did not identify any matters that required adjustment in the financial statements or which require to be brought to your attention.

Audit conclusions (continued)

In addition to the significant risks which International Standards on Auditing require us to address, our audit planning also identified areas of audit focus around:

- **accounting for the combination;**
- **retirement benefits valuation;**
- **PFI accounting;**
- **new campus development; and**
- **establishment of a charitable foundation.**

Our work in each of these areas has been satisfactorily concluded.

Audit focus areas	
Accounting for the combination	Following the combination of the three colleges through transfer to Ayr College, management considered the accounting treatment for the formation of the combined entity. Management have concluded that the terms of the agreement and structure of the College's governance arrangements result in merger accounting being applicable. The key feature of merger accounting is that no party is viewed as the acquiring entity and the combined results and balances are presented as if the merged entity existed in the comparative periods. Merger accounting is applicable for the formation of a new reporting entity which is a substantially equal partnership where no party is dominant. Audit committee approval was received for the adoption of this accounting treatment, following consideration of the five criteria of FRS 6: *Acquisitions and mergers*: ■ the way the roles of each party are portrayed; ■ the involvement of each party to the combination in the selection of management of the combined entity; ■ the relative sizes of the parties to the combination; ■ whether shareholders receive any consideration; and ■ whether shareholders of the combined entities retain an interest in the performance of only part of the combined entity. At an early stage, we reviewed management's paper which sets out the assessment against each of the three principal criteria of FRS 6 and consider the appropriateness of merger accounting. In our view, the proposed treatment was appropriate and met the definitions of a merger in line with FRS 6: *Acquisitions and mergers*. We reviewed management's calculations and assumptions in determining the combined financial statements, including the impact on comparative amounts following the alignment of accounting policies across the predecessor colleges. The capitalisation thresholds for fixed assets varied across the predecessor colleges. In aligning accounting policies, management considered appropriate thresholds for the College as a single entity. Management conducted a review of the inherited fixed asset base and set new thresholds for capitalisation of £5,000 and £10,000 for groups of assets consequently equipment at both Ayr and Kilmarnock campuses with a cost less than the set threshold for the College was written off. This did not have a significant impact on the income and expenditure account.

Audit conclusions (continued)

Audit focus areas	
Accounting for the combination (continued)	As at 31 July 2013, different actuarial assumptions were used for accounting for the predecessor colleges' participation in the Strathclyde Pension Fund. To ensure the pension liability as at 31 July 2013 was consistently valued in the financial statements, a revised FRS 17 report was obtained as at that date under consistent assumptions. We consider that management have been thorough in their consideration of the accounting impact of the merger. We concur with the accounting adjustments in respect of the alignment of the capitalisation policy for fixed assets and also the treatment of actuarial assumptions. We did not identify any further alignment adjustments following our review of the accounting policies for the merged college or through the course of our audit work in the period.
Accounting policies	The financial statements have been as set out in the Statement of Recommended Practice: *Accounting for Further and Higher Education* (2007) ("the SORP"). There have been no substantive changes to this financial reporting framework compared to previous year. We reviewed accounting policies across the three pre-merger colleges to ensure they were consistent with those to of the host entity. We suggested minor changes in the accounting policies and notes to the financial statements which have been updated by management.

Audit conclusions (continued)

Audit focus areas	
Retirement benefits valuation	The College accounts for its participation in the Strathclyde Pension Fund in accordance with FRS 17: *Retirement benefits* on a defined benefits basis using valuation information prepared by actuarial consultants. Our audit of the accounting for retirement benefits includes evaluation of the actuarial consultants as a third party expert, consideration of the data underlying the actuarial report, including the level of contributions made during the period, the financial assumptions and membership data provided to the actuary by the College, and estimates of the College's share of the pension fund assets. We found that the actuarial consultant as a third party expert was objective and had the appropriate experience and expertise to provide the information for use by the College. The level of contributions made by the College in the period is estimated based on data prior to the period end. It is important that this number is accurate as it is used to inform the calculation of the liabilities at the period end. Our testing included review of actual data against that used in the actuarial calculations. No issues were identified. Contribution estimates for the period included the accrued costs of voluntary severance payments made in the period. For the Strathclyde Pension Fund, the actuaries use a number of assumptions in their calculations based on market conditions at the period end, including a discount rate to derive the anticipated future liabilities back to the period end date and assumptions on future salary increases. Using our own actuarial specialists, we have reviewed the assumptions and concluded that the overall assumptions proposed are in line with our expectations and fall within our acceptable range. The rate of salary increases is set taking into account the College's expected long-term rate of salary increases, including incremental drift. Following agreement with management, the rate assumed in 2013-14 is 1% followed by RPI + 1.5% from 2015 onwards. The increases assumed in the period 2014-15 to 2015-16 represent management's estimation of the most likely increases taking into account a variety of factors including harmonisation and headcount changes. Management should ensure that in setting this assumption it reflects the College's long-term plans and strategy.

Audit conclusions (continued)

Audit focus areas	
PFI accounting	During 1999-2000 James Watt College entered into a 25 year partnership with KE Projects Limited for the provision of a college campus and the associated facility management at Kilwinning. Following the merger, the contract transferred to Ayrshire College. James Watt College accounted for the contract off-balance sheet. We found that, consistent with the requirement to consider and harmonise accounting policies, management had reviewed the accounting treatment and evaluated the arrangement to ensure it was accounted for in line with current accounting standards. The College is subject to the majority of the potential variations in property related profits or losses and has access to the risks and rewards of ownership (which is assessed having regard, in particular, to the quantum of finance provided by the private sector that is, in fact, at risk to the performance of the project) and management considered that the College should recognise an asset and a corresponding liability for amounts due to the scheme operator to pay for the asset on balance sheet. We are in agreement with this treatment. As a result of the review, the Kilwinning campus has been recognised on the College's balance sheet and has been revalued and depreciated in the same way as tangible fixed assets owned by the College. A corresponding liability has been recognised on balance sheet for the capital element due to the PFI operator which will be written out over the remainder of the contract. The adjustment made by management following the issue of draft financial statements is documented at Appendix two.
Fixed asset valuations	To align the valuation basis for all tangible fixed assets Ayrshire College carried out a valuation as at 31 July 2013 and engaged the District Valuer to perform the valuation of the Ayr and Kilmarnock campuses, with Rydens undertaking the valuation for Kilwinning. We found that the valuers as a third party experts were objective and had the appropriate experience and expertise to provide the information for use by the College. We reviewed the valuation reports, the basis upon which they were prepared, related accounting entries and disclosures. We are satisfied with the assumptions applied by the valuers and that the valuers' instructions were in line with the requirements of the SORP. From our audit testing, we concur with the amounts presented in the financial statements, related accounting entries and disclosures.

Audit conclusions (continued)

Audit focus areas	
New campus development	Management concluded arrangements to procure a new £50 million campus at Hill Street in Kilmarnock with a building contract entered into in June 2014. As a result of this development, we found that management had considered the potential impairment of the existing Kilmarnock campus at Holehouse Road and its anticipated useful life. This resulted in an impairment of the current campus of £8.765 million and a corresponding release of £6.9 million from the revaluation reserve and £1.7 million released from deferred capital grant into Funding Council grant income. At an early stage, management considered and discussed with us the accounting treatment for the new campus. The gifted land was valued by the District Valuer at £800,000. Consequently, this has been recognised as an exceptional item of income. We are in agreement with this treatment. Management will need to consider treatment for the new campus buildings prior to the first year of operation in 2016-17, and how these should be reflected on the College's balance sheet.
Charitable foundation	As a result of the college reclassification, colleges' abilities to spend existing reserves, eg. by operating at a deficit in a given year, will be restricted due to the Scottish Government funding mechanisms. In order to protect existing reserves levels, Ayrshire College Foundation has been established as a company limited by guarantee and registered with the Office of the Scottish Charity Regulator. We considered the status of the Foundation against the relevant accounting requirements which determine whether it should be consolidated in the College's financial statements. This requires consideration of whether: ■ there is direct ownership or control of the Foundation; and ■ there is evidence of indirect control through established practices or other means. Following consideration of the Foundation's constitution and associated documentation, we have agreed with management's intention that the Foundation will not require to be consolidated at 31 March 2014. In so doing, we note, that there are a number of risks that should be considered by management where future actions may indicate that consolidation is required. £6.6 million was gifted to the Foundation during 2013-14.

Accounting framework; application of accounting policies

There have been no substantive changes to the financial reporting framework as set out in the *Statement of Recommended Practice: Accounting for Further and Higher Education (2007)* ("the SORP").

Accounting policies have been applied consistently with those introduced in the previous year following the establishment of the College.

A new SORP, that draws on the principles of FRS 102, will be applied in respect of the year ending 31 March 2016. The College will need to prepare a transitional balance sheet as at 1 April 2014.

The financial statements have been prepared on a going concern basis.

Statement of Recommended Practice: *Accounting for Further and Higher Education* (2007) ("the SORP")	■ The 2013-14 financial statements have been prepared in accordance with the SORP. ■ There have been no substantive changes to this financial reporting framework. ■ Management reviewed accounting policies across the three pre-merger colleges to ensure they were consistent with those of the host entity. In line with FRS 6 *Acquisitions and mergers*, management adjusted opening balances to ensure alignment of accounting policies between all entities. The key difference was in relation to tangible assets, as the Colleges all applied different capitalisation thresholds. ■ The financial statements have been prepared on a going concern basis.
Impact of revised accounting standards	■ There are no newly effective accounting standards which are considered to have a material impact on the College's financial statements for 2013-14. ■ In March 2013, the Financial Report Council issued FRS 102, the Financial Reporting Standard applicable in the UK and Republic of Ireland. This is the main part of the new UK GAAP regime and follows the issue in November 2012 of FRS 100 (overview of the framework) and FRS 101 (reduced disclosure framework). ■ FRS 102 is applicable for accounting periods beginning on or after 1 January 2015. In response, the Further and Higher Education SORP Board has recently completed the development of a new SORP. Management will need to consider the accounting and reporting implications of the revised SORP and prepare a transitional balance sheet as at 1 April 2014. ■ There are key differences to the existing SORP, particularly in respect of grant accounting, recognition of obligations arising from funding past deficits of multi-employer pension schemes, service concession arrangements and in respect of financial statement disclosures. Each of these will need careful consideration.
Going concern	■ Management has considered the funding available to the College in 2014-15 and consider it appropriate to adopt a going concern basis for the preparation of these financial statements. ■ We are satisfied that the going concern basis of preparation of the financial statements is appropriate. At 31 March 2014, the College had £3 million cash and £1 million net current assets. We note that the impact of the reclassification of Further Education institutions will impact on the College's ability to utilise surplus reserves reflected in cash balances and this should be factored into future financial forecasting.

Period end process; internal control; other matters

The unaudited financial statements were made available on a timely basis.

Ayrshire College was still operating on separate systems until the current period. During 2013-14, the merged college moved away from systems reflecting the predecessor colleges onto one unified system.

Financial statements preparation	■ Working papers and draft financial statements in Excel were provided on 23 June 2014 in line with the agreed timetable, with the operating and financial review and statement or corporate governance and internal control provided separately on 28 August 2014 following substantive conclusion to audit work and confirmation that no adjustments were required. The complexities of the merger accounting process in this shortened period presented a range of challenges for the College's finance team and it is notable that, outwith the adjustments for the accounting recognition of the Kilwinning campus, the reported outturn for the period is in line with management accounts prepared as at 31 March 2014. ■ There are no material unadjusted audit differences; there were three adjusted audit differences warranting disclosure. There were a number of amendments during the audit, as management worked through the accounting and related disclosure consequences arising from the merger.
Systems of internal control	Management successfully merged finance systems with effect from 1 August 2013. We satisfactorily tested the transfer of data from the individual systems at each campus onto the finance system at Kilmarnock, through our review of opening balances. Our testing, combined with that of internal audit, of the design and operation of financial controls established over significant risk points confirms that controls are designed appropriately and operating effectively over the following financial processes: ■ income and expenditure; ■ staff costs; and ■ cash and bank. We have identified a number of control improvement opportunities. These are set out in the action plan at Appendix three.
Other matters	Mandatory communications required by International Standards on Auditing are given in Appendix one. There are no significant matters in respect of (i) audit differences; (ii) auditor independence and non-audit fees; and (iii) management representation letter content.

Governance and narrative reporting

Update on your governance arrangements

Our overall perspective on your narrative reporting

Corporate governance arrangements

The statement of corporate governance and internal control identifies no major weaknesses in governance or internal control arrangements.

We have reviewed the statement of corporate governance and consider it consistent with our understanding of the process followed by the College during the period.

Management has identified no significant fraud or irregularities.

Corporate governance and internal control arrangements	The College has made a compliant corporate governance and internal control statement. We are required to review this to assess whether the description of the process adopted by the College in reviewing the effectiveness of the system of internal control is consistent with our understanding of the process and report any inconsistencies. We are not required to provide an opinion on the College's system of internal control. The statement of corporate governance and internal control provides detail on the governance framework, the system of internal control, internal audit, internal financial controls and risk management arrangements, and analyses the effectiveness of these elements of the framework. It describes a number of sources of assurance for the accountable officer. We have reviewed the statement of corporate governance and internal control and consider it consistent with our understanding of the process followed by the College during the period.
Internal audit	As set out in our audit plan and strategy, we have evaluated the work of internal audit in the period, both to enhance our understanding of the key risks and issues facing the College and to rely on the work of internal audit where possible to avoid duplication. The content of the internal audit plan is in line with our expectations. We placed reliance on internal audit work in the period as part of our work interim audit over systems and controls due to the change in the systems during the current period. Internal audit reported that: "Ayrshire College has a framework of controls in place that provides assurance regarding the effective and efficient achievement of the College's objectives and the management of key risks. Proper arrangements are in place, in the areas we have reviewed, to promote value for money, deliver best value and secure regularity and propriety in the administration and operation of the College."
Regularity	As part of our audit of the College's financial statements, we are required by the Public Finance and Accountability (Scotland) Act 2000 to give an opinion on the regularity of expenditure and receipts shown in the financial statements. The executive team considers all incoming correspondence relevant to its strategic management role from the Scottish Funding Council and other regulatory or advisory bodies, such as Audit Scotland to ensure it is appropriately aware of sector issues and developments and that it complies with the terms and conditions of funding. Our review of expenditure throughout the course of our audit did not identify weaknesses in the control environment over regularity of expenditure and receipts, or instances of non-compliance with Scottish Funding Council terms and conditions.

Corporate governance arrangements (continued)

Prevention and detection of fraud	A key mechanism in the allocation of authority, accountability and responsibility and the prevention and detection of fraud is the existence and maintenance of strategic and financial documentation. We consider that the College has established appropriate processes for the prevention and detection of fraud. During 2013-14, management identified no significant fraud or irregularities.
Maintaining standards of conduct and the prevention and detection of corruption	The College has appropriate policies and codes of conduct for staff and members, including the use of a register of members' interests. These appear proportionate for the College's purposes.
Corporation Tax	Where colleges undertake non-primary purpose ("NPP") activities, they may be liable for corporation tax. Colleges are exempt from corporation tax on these activities (such activities might include conferences, non-student residences, consultancy) provided they do not exceed the threshold of £50,000, as a small trading exemption. In the case of a recently merged college, as all the various strands of NPP activity for the previously individual colleges will be consolidated, there is an increased risk of breaching the £50,000 small trading exemption threshold. It is therefore important management continue to consider these activities in more detail to determine whether the limit is breached each year and if so whether an overall profit or loss arises from these activities. If profitable, the College would have a corporation tax liability, however it is more likely there will be an overall loss once an allocation of overheads has been taken into account. Calculations should be retained as evidence that no corporation tax return requires to be submitted. Tax specialist assistance may be required to assist consideration of NPP activities and have a process going forward for identifying NPP activities and calculate whether a profit arises on those activities
Senior post-holders' emoluments	The Scottish Funding Council's Accounts Direction sets out certain disclosures required in respect of senior post-holders' emoluments. We tested these disclosures to ensure that they were prepared in accordance with the requirements of the Accounts Direction. We identified one adjusted audit misstatement in relation to the disclosures which was subsequently corrected.

Performance management

Our perspective on the performance management arrangements

Performance management

The College produces monthly management accounts which compare actual expenditure to budget.

Performance against sector indicators is measured by the College.

Best value	In April 2002 the Scottish Ministers introduced a non-statutory duty on accountable officers to ensure arrangements exist to secure Best Value. Audit Scotland has been committed to extending the Best Value audit regime across the whole public sector for some time. Using the Scottish Executive's nine Best Value principles as a basis for audit activity, Audit Scotland previously selected five areas as priority development areas (use of resources, governance and risk management, accountability, review and option appraisal, and joint working). The merger has enabled efficiencies in support services through the creation of centralised Finance and HR functions and the staff savings in these areas have been reinvested into curriculum areas and new service areas to support the college, such as learner services.
Performance indicators	In accordance with Scottish Funding Council requirements, the College is required to publish and report progress against national priorities. These indicators monitor the implementation of the College's financial objectives.

KPI	Actual 2013-14	Actual 2012-13
Recurring operator surplus as a % total income	2.5%	2.4%
Non-SFC income as a % of income	19.2%	17.6%
Gearing	Nil	Nil
Current assets : current liabilities	1.1:1	2.1:1
Days' cash	27	66

The activity target set by Scottish Funding Council for 2013-14 was 183,269 wSUMs. As at 31 March 2014, the College delivered around 178,424 wSUMs in 2013-14.

As the accounting period of the College has changed, it is important that the College considers the range of performance indicators that are relevant to be measured on an ongoing basis. These should include value for money indicators and annual targets or limits and should be agreed with the board of management.

Appendices

Mandatory communications

Mandatory communications regarding audit adjustments, auditor independence and representation letter content are given here.

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were three audit adjustments required to the draft financial statements. A small number of numerical and presentational adjustments were required to some of the financial statements notes; these have been adjusted by management.	Appendix 2
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences identified above our materiality thresholds agreed with the audit committee.	-
Confirmation of Independence Letter issued by KPMG LLP to the audit committee	We have considered and confirmed our independence as auditor and our quality procedures, together with the objectivity of our audit Director and audit staff.	Appendix 4
Schedule of Fees Fees charged by KPMG for audit and non-audit services	The audit fee payable in respect of 2014-15 has been agreed with reference to Audit Scotland guidance, but adjusted to recognise the specific features of the College in the period. There were no non-audit services in 2013-14.	-
Draft management representation letter Proposed draft of letter to be issued by the College to KPMG prior to audit sign-off	There are no specific representations required for our audit to draw to your attention.	-

Audit differences

There are no unadjusted audited differences and three adjusted audit difference to the financial statements.

Adjusted and unadjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all corrected and uncorrected misstatements, other than those which are trivial, to you. There are three adjusted audit difference and no unadjusted audit differences.

		Balance sheet		Statement of financial activities	
Caption	Nature of adjustment	DR £'000	CR £'000	DR £'000	CR £'000
Income	Adjustment of severance payment for senior post holder	-	-	181	-
Staff costs		-	-	-	181
Deferred capital grants	Items included in fixed asset additions that should have been categorised as repair and maintenance and the expenditure to ensure that a tangible fixed asset maintains its previously recognised standard of performance should be recognised in the income and expenditure account in the period in which it was incurred.	101	-		
SFC grant (release deferred capital grant)		4	105		
Tangible fixed assets		-	101		
Depreciation		-	4		
Other operating expenses		105	-		
Net impact		**-**	**-**	**-**	**-**

Audit differences (continued)

There are no unadjusted audited differences and three adjusted audit difference to the financial statements.

Adjusted and unadjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all corrected and uncorrected misstatements, other than those which are trivial, to you. There are three adjusted audit difference and no unadjusted audit differences.

		Balance sheet		Statement of financial activities	
Caption	**Nature of adjustment**	**DR £'000**	**CR £'000**	**DR £'000**	**CR £'000**
Prior year (2012-13)	A prior year adjustment has been agreed to recognise the PFI contract for Kilwinning Campus on the College's balance sheet and has been revalued and depreciated in the same way as tangible fixed assets owned by the College and a corresponding liability for amounts due to the scheme operator to pay for the asset. A capital reserve has been created to account for the difference between the value of the asset and the corresponding liability. The PFI payment previously recognised in other operating expenses has been decreased by the capital element which is now applied to write down the balance sheet liability towards the PFI operator. The fair value of the services received during the year and interest charged are still recognised through the income and expenditure account.				
Tangible fixed assets		17,833			
Depreciation				390	
Creditor – amounts due within one year			(481)		
Creditor – amounts falling due after more than one year			(11,001)		
Capital reserve			(6,057)		
PFI payment					(684)
Net impact 2012-13		**294**	**-**	**-**	**(294)**
2013-14 adjustment	With the PFI contract recognised on balance sheet, adjustment was required to the 2013-14 financial statements Kilwinning campus has to be depreciated in the same way as tangible fixed assets owned by the College and the liability is written down. The PFI payment recognised in 2013-14 has been decreased by the capital element, which is now applied to write down the balance sheet liability towards the PFI operator.				
Tangible fixed assets			(260)		
Depreciation				260	
Creditor amount falling due within one year		481	(749)		
Creditor – amounts falling due after more than one year		749			
PFI payment					(481)
Net impact 2013-14		**221**	**-**	**-**	**(221)**

Action plan

The action plan summarises specific recommendations arising from our audit work, together with related risks and management's responses.

Priority rating for recommendations		
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 organisation or systems under consideration. The weaknesses 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 control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
1 HR policies		**Grade three**
It was noted during the course of the audit that individual HR policies for the predecessor colleges have not been aligned for Ayrshire College. There is a risk that the HR policies are no longer appropriate for the new staffing structure of Ayrshire College.	Management should ensure HR policies are updated for the new Ayrshire College structure.	**Responsible officer:** Director of HR 2014
2 Journal entries		**Grade three**
We found that there is no formal control in place for the review of manual journals. There is a risk that without appropriate management review and authorisation of manual journals inaccurate or inappropriate journals may be posted without management knowledge.	Management should ensure all manual journals are reviewed and approved by management as appropriate. This could be approached with a risk based methodology, with individual approval of significant or material journals, and monthly review of all other manual journals.	The College is in the process of formalising monthly review of manual journals by way of review and sign off by the Head of Financial Services. **Responsible officer:** Head of Financial Services **Implementation date:** 2014

Action plan (continued)

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
3 Purchase invoices		**Grade three**
Before the implementation of new systems for the merger at the beginning of the period, purchase invoices were not processed onto the ledger on a timely basis. Processing delays give rise to a risk that liabilities are not captured correctly.	Management should ensure purchase invoices are posted to the ledger on a timely basis as operations become more streamlined between the different campuses. While revised systems arrangements should mitigate this risk, management should monitor arrangements to record and process purchase invoices.	**Responsible officer:** Head of Financial Services **Implementation date:** 2014

Auditor independence and non-audit fees

Auditing Standards require us to consider and confirm formally our independence and related matters in our dealings with the College.

We have appropriate procedures and safeguards in place to enable us to make the formal confirmation in our letter included opposite.

Professional ethical standards require us to provide to you at the conclusion of an audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed. This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence.

We have considered the fees paid to us by the College and its related entities for professional services provided by us during the reporting period. We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Directors and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Regular communications
- Internal accountability
- Risk management
- Independent reviews

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the board of management.

Confirmation of audit independence

We confirm that as of 30 September 2014, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This report is intended solely for the information of audit committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

KPMG

cutting through complexity™