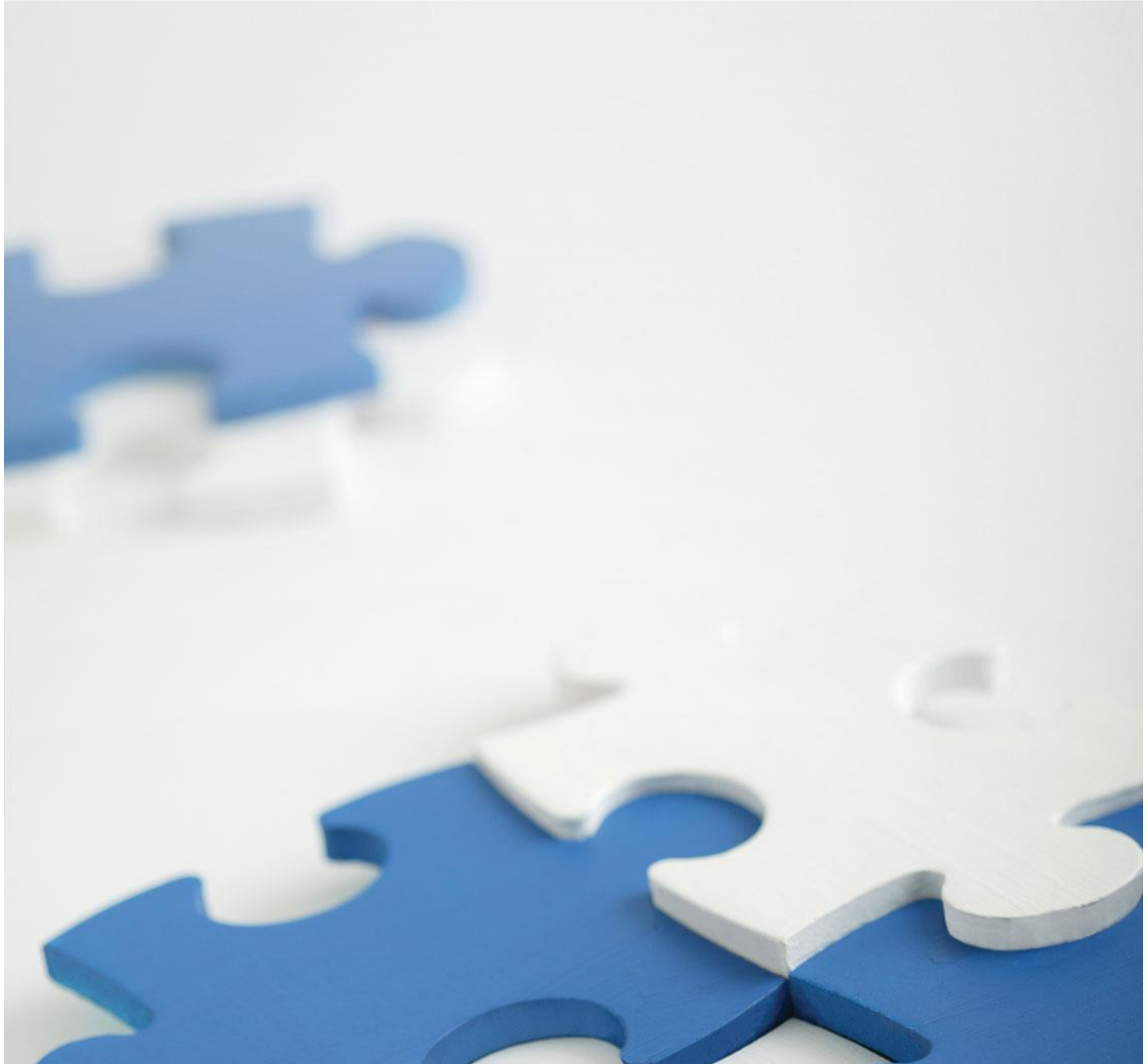

North East Scotland College

Report on the 2014/15 Audit

Prepared for the Board of Management of North East Scotland College and the Auditor General for Scotland

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This report has been prepared for the use of North East Scotland College and no responsibility to any member or officer in their individual capacity or any third party is accepted.

This report will be published on our website after it has been considered by the Board of Management. The information in this report may be used for the Auditor General's annual overview report on further education audits published on its website and presented to the Public Audit Committee of the Scottish Parliament.

Contents

Key messages

Audit of financial statements	• The independent auditor's report on the 2014/15 financial statements for North East Scotland College and its group is unqualified. • With the application of the Government Financial Reporting Manual, the accounts include a remuneration report for the first time. This has been prepared in accordance with the Accounts Direction.
Financial management and sustainability	• While the college reported a deficit in respect of 2014/15, this is an accounting deficit which has arisen due to the treatment of funding for non-cash depreciation. This was an expected outcome in line with guidance and consequently, there is no impact on the audit opinion. • The college has sound financial arrangements including financial regulations that are regularly reviewed and detailed monthly accounts which are considered by the Board.
Governance	• In general, the college had strong systems of internal control operating during the period, however a number of weaknesses were reported in respect of arrangements within human resources. Steps have been taken to review and strengthen procedures and these should be kept under review by the Audit Committee.
Performance	• The college continued to offer a voluntary severance scheme. Arrangements around the operation of the scheme were strengthened during the period and these were largely found to operate satisfactorily.

Introduction

1. This report is a summary of our findings arising from the 2014/15 audit of North East Scotland College. It was a 16 month accounting period covering 1 April 2014 to 31 July 2015. The report is divided into sections which reflect our public sector audit model.

2. The management of North East Scotland College is responsible for:
   - preparing financial statements which give a true and fair view
   - implementing appropriate internal control systems and maintaining proper accounting records
   - putting in place proper arrangements for the conduct of its affairs
   - ensuring that the financial position is soundly based.

3. Our responsibility, as the external auditor of North East Scotland College, is to undertake our audit in accordance with Auditing Standards, the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011 and the ethical standards issued by the Auditing Practices Board.

4. An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements; this does not relieve management of their responsibility for the preparation of financial statements which give a true and fair view.

5. **Appendix I** is an action plan setting out our recommendations to address the high level risks we have identified during the course of the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response". We recognise that not all risks can be eliminated or even minimised. What is important is that North East Scotland College understands its risks and has arrangements in place to manage these risks. The board and senior management team should ensure that they are satisfied with proposed action and have a mechanism in place to assess progress and monitor outcomes.

6. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures; consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.

7. We are grateful for the cooperation and assistance we received during the course of the audit.

Audit of the 2014/15 financial statements

Audit opinion	• We have completed our audit and issued an unqualified independent auditor's report.
Going concern	• The financial statements of the college and its group have been prepared on the going concern basis. We are unaware of any events or conditions that may cast significant doubt on the college and its group to continue as a going concern.
Other information	• We review and report on other information published with the financial statements, including the operating and financial review by the Board of Management, statement of corporate governance and internal control and the remuneration report. We have nothing to report in respect of these statements.
Group accounts	• North East Scotland College has accounted for the financial results of its subsidiary in its group accounts for 2014/15. The overall effect of consolidating the balances on the group balance sheet was to reduce total reserves and net assets by £57,000.

Submission of financial statements for audit

8. From 1 April 2014, further education colleges were reclassified as public bodies and consequently, were brought within the central government framework. The year end was changed from 31 July to 31 March for financial year 2013/14 but following further consideration, the Scottish Funding Council (SFC) and the Scottish Government decided to revert to a financial year aligned to the academic year for colleges. This meant that North East Scotland College was required to prepare accounts for a 16 month period covering 1 April 2014 to 31 July 2015.

9. From 2014/15, while colleges are required to use the Government Financial Reporting Manual (FReM), the 2007 Statement of Recommended Practice: Accounting for Further and Higher Education (the SORP) is still in place and largely takes precedence over the FReM if there is a conflicting matter.

10. The introduction of reclassification and the FReM has impacted on the college's accounts in the following ways:

- colleges must break even in each Scottish Government financial year
- the ability to use accumulated reserves to fund future spending is no longer possible
- grant in aid can only be drawn down when needed
- mechanisms to access capital funding and commercial borrowing have changed
- for the first time, colleges are required to include a remuneration report within their annual accounts.

11. We received the unaudited financial statements on 1 October 2015. At that point, a remuneration report and a planned revaluation of fixed assets had not been completed. A final remuneration report was received on 4 December 2015 but otherwise, the accounts were complete on 9 November 2015.

Overview of the scope of the audit of the financial statements

12. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in our Annual Audit Plan presented to the Audit Committee on 17 March 2015.

13. As part of the requirement to provide full and fair disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. As such, the agreed fee for the 2014/15 audit which was set out in the Annual Audit Plan remains unchanged.

14. The concept of audit risk is of central importance to our audit approach. During the planning stage of our audit we identified a number of key audit risks which involved the highest level of judgement and impact on the financial statements and consequently had the greatest effect on the audit strategy, resources and effort. We set out the audit work we proposed to undertake to secure appropriate levels of assurance.

15. Our audit involved obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Materiality

16. Materiality can be defined as the maximum amount by which auditors believe the financial statements could be misstated and still not be expected to affect the decisions of users of financial statements. A misstatement or omission, which would not normally be regarded as material by amount, may be important for other reasons (for example, an item contrary to law).

17. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

18. We summarised our approach to materiality in our 2014/15 Annual Audit Plan. Based on our knowledge and understanding of North East Scotland College, we set planning materiality at £680,000 (1% of gross expenditure). We report all misstatements greater than £10,000. Performance materiality was calculated at £136,000 to reduce to an acceptable level the probability of uncorrected and undetected audit differences exceeding our materiality level.

19. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels and concluded that they remained appropriate and no change was required to our approach.

Evaluation of misstatements

20. All misstatements identified during the audit have been amended in the financial statements. The impact of these was to increase the deficit on the Consolidated Income and Expenditure Account by £128,000 and increase Net Assets by £10.172m. Tangible fixed assets were increased by £10.3m to reflect the outcome of the property revaluation and to include assets purchased with funding provided by the arm's length foundation. These amendments also impacted on the revaluation reserve and deferred capital grants respectively. Other adjustments to the balance sheet resulted in a reduction in net assets of £128,000.

21. In addition, we identified a number of presentational adjustments within the financial statements during the course of our audit. These were discussed with the Finance team who agreed to amend the unaudited financial statements accordingly.

Significant findings from the audit

22. International Standard on Auditing 260 requires us to communicate to you significant findings from the audit, including:
    - the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures
    - significant difficulties encountered during the audit

- significant matters arising from the audit that were discussed, or subject to correspondence with management
- written representations requested by the auditor
- other matters which in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

23. During the course of the audit we identified the following significant issues that, in our view, require to be communicated to you.

Issue	Resolution
1. Remuneration Report In accordance with FReM, a remuneration report disclosing pay and pension information for the college's management team was required for the first time in 2014/15. In addition to salary and pension benefit information, there was a requirement to provide accrued pension information and cash equivalent transfer values (CETVs). With the exception of CETVs, the college had provided all the necessary information. A request was made to the North East Scotland Pension Fund (NESPF) to provide the outstanding information. At the date of the Audit Committee (17 November 2015), the pension fund were awaiting a software update to enable them calculate the information requested. In the absence of this information, the college would not have complied with the Accounts Direction and the requirements of FReM in respect of the remuneration report and this would have resulted in a qualification of the opinion on the remuneration report.	NESPF provided the information on 3 December 2015 which we were able to verify. The college has therefore provided all the information required by the Accounts Direction and an unqualified opinion has been provided.

Issue	Resolution
2. Revaluation of assets including componentisation The college's estate has been revalued at 31 July 2015 for the purposes of the accounts. At the date of the Audit Committee, we had only recently received the valuation report and the associated accounting entries from the finance team and consequently, we were still reviewing the relevant working papers.	We concluded our review of the working papers satisfactorily and there are no matters to report.
3. Holiday pay accrual The Accounts Direction requires colleges to recognise an accrual for the untaken element at 31 July 2015 of short-term accumulating paid absences. This is also in accordance *with IAS 19 Employee Benefits*. Paid absences are periods during which an employee does not provide services to the employer, but benefits continue to be paid. Accumulating absences known as the untaken holiday accrual are those that are carried forward and used in future periods if the current period entitlement is not used in full, e.g. annual leave and flexitime balances. Only the movement of £62,598 between the current and previous year had been accrued at 31 July 2015, rather than the full amount (£623,218). This item also requires a prior year adjustment of £560,620 to reflect a comparative figure for 2013/14.	The revised accounts were amended to reflect this matter.

Future accounting and auditing developments

24. A new Further and Higher Education SORP was approved in March 2014. While 2015/16 will be the first reporting year, comparative figures for 2014/15 and a restated opening balance sheet at 1 August 2014 will be required.

25. This SORP will bring college accounts into line with International Financial Reporting Standards and consequently, there will be significant changes in the primary statements with the introduction of a statement of comprehensive income and expenditure, changes to reserves and funds and a statement of financial position (i.e. a balance sheet).

Financial management and sustainability

Financial management

26. In this section we comment on the college's financial outcomes and assess the financial management arrangements.

Financial outcomes

27. North East Scotland College and its Group reported a deficit of £0.888m at 31 July 2015. More widely, the sector continues to face a variety of financial challenges in the year ahead, including the impact on pay and conditions if National Collective Bargaining is implemented. There will also be a need to address property and other insurance arrangements within the sector. On reclassification, this matter was put on hold for an interim period but under government requirements, the sector should move to self-insurance arrangements which will potentially have a significant financial impact.

28. As part of the government's budgeting and accounting requirements, the college is required to provide a monthly cash flow and deliver against resource requirements. Included in this year's funding colleges received cash funding in respect of depreciation which is a non-cash item. For North East Scotland College, this amounted to £854,000. The cash had to be spent by 31 March which put the college into an accounting deficit position once net depreciation was taken into account. As this was an expected outcome and in line with SFC guidance, there was no impact on the audit opinion. The SFC did however provide guidance on how the cash received in respect of depreciation could be spent. As North East Scotland College did not need the cash for any of the specified categories, it was permitted to use the funds to make an advance payment to the North East Scotland Pension Fund in respect of the college's share of deficit funding.

Financial management arrangements

29. As auditors, we need to consider whether colleges have established adequate financial management arrangements. We do this by considering a number of factors, including whether:

- the finance officer has sufficient status within the college to be able to deliver good financial management
- financial regulations are comprehensive, current and promoted within the college
- reports monitoring performance against budgets are accurate and provided regularly to budget holders
- board members provide a good level of challenge and question budget holders on significant variances.

30. Based on our observations during the course of the 2014/15 audit, we drew the following conclusions:

- The Vice Principal, Finance is a member of the college's senior management team and provides regular support to the Board of Management and both the Finance and Audit Committees. He therefore holds sufficient status.
- We reviewed the college's Governance Manual which includes standing orders, scheme of delegation and code of conduct; and the Financial Regulations. We concluded that both documents were comprehensive, current and subject to regular review.
- Monthly management accounts comprising an income and expenditure account, student support funds statement, a balance sheet and a major capital projects statement is prepared and considered by the Finance and General Purposes Committee and the Board on a regular basis. Reports contain robust information on variances and provide actual and budgeted spend to date with the full year forecast position.
- Based on our observations at the Audit Committee, there is a good level of challenge and questioning and this was particularly noted in relation to financial matters.

Governance

31. The board of management is responsible for establishing arrangements to ensure that its business is conducted in accordance with the law and proper standards, that public money is safeguarded and for monitoring the adequacy and effectiveness of these arrangements.

Corporate governance

32. In November 2013, North East Scotland College was formed. Over the following months, a new board and management team came into place. While there was significant continuity in the senior team, the severance scheme enabled a significant amount of experience to leave the college. During 2014/15, the new arrangements continued to become embedded and in terms of finance, systems from the former colleges were merged during the year.

Governance and internal control systems

33. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their board members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

34. Through its accountable officer or equivalent, each body is 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. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

35. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:

- corporate governance and systems of internal control
- the prevention and detection of fraud and irregularity.

36. It is a requirement of the college's funding that they sign a Financial Memorandum with the SFC. The financial memorandum was refreshed during the year and the new terms and conditions were applied to colleges from December 2014. One of the conditions within the memorandum is that colleges are expected to comply with the principles of good governance as set out in the 2014 *Code of Good Governance for Scotland's Colleges*. With respect to section C of the Code covering accountability, we are satisfied that the college meets the requirements set out in the good practice.

Audit Committee

37. Scrutiny of the effectiveness of the internal control processes within North East Scotland College is undertaken by the Audit Committee. The terms of reference for the Committee are in line with the UK Corporate Governance Code 2010 (the Code).

38. The Code and the Accounts Direction from the SFC require colleges to include a governance statement within their financial statements. The 2014/15 statement confirmed that in the opinion of the Board of Management, the college complied with the Code throughout the period ended 31 July 2015. We have reviewed the governance statement and have confirmed it is in line with the content required by the Accounts Direction and it reflects our understanding of North East Scotland College.

Internal control

39. The auditor evaluates significant financial systems and associated internal controls for the purpose of giving an opinion on the financial statements and as part of the review of the adequacy of governance arrangements. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.

40. Internal audit for the college is provided by Wylie & Bisset LLP. Generally, we seek to rely on the work of internal audit wherever possible and in respect of 2014/15, we concluded that reliance could be placed on their work. In their annual report for 2014/15, Wylie & Bisset LLP provided their opinion that based on the internal audit work undertaken during the year, the college had adequate and effective risk management, control and governance processes to manage its achievement of the college objectives.

41. However, internal audit reported significant concerns during the year in relation to internal audit work undertaken on Human Resource activities. The main areas were:

- An absence of documentation to support the calculation of a severance payment (this is covered in more detail on page 16)
- Seven payroll overpayments amounting to approx. £9,600 which had arisen due to the relevant changes not being passed by Human Resources to the payroll team. The amounts involved had been recovered or appropriate recovery plans were in place.
- Sixty six errors in pay grades had been identified and while there was no impact on the amounts paid, there was a lack of confidence in the records held by Human Resources. As a result, internal audit were commissioned to undertake a full data verification exercise which identified around 500 errors across spinal points and job grades. This also identified a number of salary overpayments. Human resources have agreed to undertake a self check in advance of further work by internal audit as part of their 2015/16 audit programme.

42. On receipt of the relevant internal audit reports, the Audit Committee sought explanations from the head of human resources and requested further reports from the service when queries could be clarified. In addition, related papers were considered by the Finance and General Purposes Committee and the Human Resources Committee, and also by the Board. In our opinion, the Audit Committee gave these matters the priority they deserved and we note that the Board of Management have also made appropriate disclosures on these matters in the 2014/15 governance statement.

Refer Action Plan, Recommendation 1

43. We placed reliance on the work of internal audit around human resources and pay related matters and are satisfied that appropriate action is being taken to address the areas of concern. Otherwise, we did not identify any material weaknesses in the accounting and internal control systems during the audit which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

Risk Management

44. The college's risk management strategy, processes and risk register were kept under regular review by the Board of Management and the Audit Committee to ensure that risks were adequately managed by the college.

Prevention and detection of fraud and irregularities

45. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. We noted for example, standing orders, a prevention of fraud policy, whistle blowing policy and codes of conduct for board members and staff. Combined, these are the standard suite of policies and procedures we would expect to find in an organisation with satisfactory arrangements in place.

Arm's-length foundation

46. By bringing further education colleges within the central government framework, certain restrictions were put on aspects of existing financial management arrangements, including:

- the ability to generate and retain income and reserves
- use of existing reserves
- access to capital funding and commercial borrowing.

47. In order to protect existing reserves and minimise the impact of reclassification on colleges' finances, a solution was reached with SFC in the form of arm's-length foundations. Across the further education sector, colleges have either established their own foundation as arm's-length vehicles or have opted to join a national foundation.

48. NES FE Foundation was constituted as a Scottish Charitable Incorporated Organisation which was approved by the Office of the Scottish Regulator (OSCR) in February 2014. The Foundation has 7 members, 4 of which are independent trustees, including the chair.

49. The college approved the transfer of funds to the Foundation and by 31 July 2015, a total amount of £14m had been transferred. During 2014/15, the college applied and received an award of £4.5m from the Foundation to develop the estate.

Performance

50. A college should have systems and processes to ensure that it can demonstrate that it is delivering value for money by assessing and reporting on the economy, efficiency, effectiveness and equality in service provision.

Severance payments

51. At 31 July 2015, the financial statements showed that the college incurred £3.1m in respect of exceptional restructuring staff costs. On conclusion of the 2013/14 audit, guidance notes in respect of the college's voluntary severance scheme were refreshed to ensure that appropriate evidence was considered and retained in respect of each case and that a clear audit trail was provided for cases where payments, including any 'strain on the fund' payments, were made which exceeded the value of a standard award under the voluntary severance scheme regulations.

52. The scheme required senior staff applications to be considered by the Board of Management. In reality, this was delegated to the Remuneration Committee. One senior staff application was received and we confirmed that it had been approved by the Remuneration Committee and that it was supported by a detailed business case setting out the cost implications. Other staff applications were to be considered by the senior management team (SMT) and we were able confirm approval to SMT minutes in all cases.

53. Internal audit undertook a review of severance payments. Following their initial difficulty in obtaining a complete list of severance payments made in the period, the auditors examined a sample of 42 payments. With one exception, they confirmed that these had been calculated in accordance with regulations. There was no supporting evidence in respect of one case where an amount of £9,561 had been paid. In general, severance is restricted to a maximum of one year's salary which amounted to £5,531 in this case. The Audit Committee requested an explanation for the apparent increased payment and subsequently received a detailed report setting out the history of salary payments in respect of this case and a re-working of the calculation of the severance payment. In the absence of the original documentation, this piece of work sufficiently resolved the matter.

54. In our opinion, the Audit Committee acted promptly to pursue an explanation for the case where internal audit reported an absence of evidence. Based on the above actions and management representations, we are satisfied that the payment was appropriate and in accordance with regulations.

55. The college's current severance scheme is open until December 2015. It is critical that every step is taken by the Board to ensure the prescribed evidence is submitted when a case is being considered and retained afterwards to demonstrate the necessary audit trail.

Refer Action Plan, Recommendation 2

Budget and cash flow returns

56. With reclassification, colleges are required to submit monthly cash flow forecast returns to the SFC. These set out the cash requirement for the next month and therefore the allocation of grant, the college is seeking to draw down. Over the period since April 2014, the format, timing and information requirement of these returns has changed several times making it difficult for colleges to settle into a routine for completion. This has had resource implications for the college.

Appendix I - Action plan

No/para	Issue/Risk/Recommendation	Management action/response	Responsible officer	Target date
1/42	**Human Resources** Following recent internal audit reports, HR have agreed to carry out self-checks to confirm arrangements are operating correctly. ***Risk: incorrect payroll payments are made.*** Recommendation: the Audit Committee continue to receive update reports until they are confident HR processes are operating effectively.	Internal audit are carrying out a follow up audit in this area as part of the 2015/16 audit plan. This will be considered by the Audit Committee on 26 January 2016.	Principal and Chief Executive	January 2016
2/55	**Voluntary Severance Payments** It is critical that every step is taken by the Board to ensure the prescribed evidence is submitted when a case is being considered and retained afterwards to demonstrate the necessary audit trail. ***Risk: it is not possible to demonstrate that payments comply with the college's approved severance scheme.*** Recommendation: checks are put in place to ensure that the appropriate paperwork is submitted and retained to provide the audit trail.	Procedures have been established and operate to ensure that the appropriate paperwork is submitted and retained to provide the audit trail.	Principal and Chief Executive	In place