HENDERSON LOGGIE
Chartered Accountants

# The North Highland College

## Annual Audit Report for 2014/15 to the Board of Management and the Auditor General for Scotland

## External Audit Report No: 2015/02

**Draft issued: 4 December 2015**
**Final issued: 17 December 2015**

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## Notice: About this report

This report has been prepared in accordance with our responsibilities under International Standards on Auditing (ISAs) and those set out within Audit Scotland's Code of Audit Practice ('the Code') and Statement of Responsibilities of Auditors and Audited Bodies.

This report is for the benefit of only The North Highland College and is made available to Audit Scotland (together with the beneficiaries), and has been released to the beneficiaries on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without prior written consent.

Nothing in this report constitutes a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than 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 Henderson Loggie CA (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law Henderson Loggie CA does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

# Executive Summary

## Financial Statements

- On 16 December 2015 we issued an audit report with an unqualified opinion on the financial statements of the College for the year to 31 July 2015 and on the regularity of the financial transactions reflected in those financial statements. Although there are projected deficits in the periods 2015/16 and 2016/17, as a result of action being taken to address the position Board members have concluded that the financial statements should be prepared on a going concern basis. We concluded that the position is adequately disclosed in the financial statements and as a result have included an 'emphasis of matter' paragraph in our audit opinion drawing attention to the going concern issues identified in the financial statements and noting that we have not modified our opinion in respect of these matters. These issues are discussed at paragraphs 8, 31 and 84 of this report.

- The annual financial statements of the College comply with the Accounts Direction issued by the Scottish Funding Council (SFC), the Statement of Recommended Practice (SORP) on Accounting for Further and Higher Education and, as far as applicable, the Government Financial Reporting Manual 2014/15 ('the FReM').

- There were a number of audit and accounting adjustments made to the financial statements. The overall effect of adjusting for these items was to increase the deficit for the year by £0.065 million. It was agreed not to amend the financial statements for a further four non-trivial potential adjustments on the grounds that the overall impact of these on the financial statements is not material.

- A prior period adjustment was made to reflect the introduction of valuation basis for land and buildings in accordance with the FReM. Changes in useful economic life of the fixed assets were incorporated as part of the prior period adjustment. The effect of this change in accounting policy was to increase the previously reported deficit for the year ended 31 July 2014 by £0.086 million. The cumulative effect on the Income and Expenditure Account reserve at 31 July 2014 was a reduction of £1.488 million. As a result of making this adjustment there was an overall reduction of £4.377 million in the net book value of land and buildings at 31 July 2015 from the original financial statements received for audit, deferred capital grants on the balance sheet decreased by £3.427 million and the revaluation reserve increased by £0.539 million. In addition, a prior period adjustment was made to incorporate an accrual for untaken annual leave, as required by the FReM. The cumulative effect of this on the Income and Expenditure Account reserve at 31 July 2014 was a reduction of £0.083 million.

- A number of minor disclosure and clarification adjustments were also made to the financial statements to ensure compliance with the SORP, FReM and Accounts Direction and improve the overall presentation of the financial statements. These mainly related to presentation and disclosure around the revaluation of land and buildings.

- The College's position is a deficit for the year of £0.592 million (2013/14 – deficit £1.309 million (as restated) after a transfer to The North Highland College Foundation of £1.300 million), and an Income and Expenditure Account balance of £(0.730) million at 31 July 2015 (31/07/14 - £(0.730) million (as restated)).

## Corporate Governance

- The College's Corporate Governance Statement confirms that the College complies with all of the provisions of the 2014 Code of Good Governance for Scotland's Colleges, and it has complied throughout the year ended 31 July 2015.

- No material weaknesses in the accounting and internal control systems were identified during the 2014/15 financial statements audit which would 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.

- We did not identify any matters of concern relating to the College's corporate governance arrangements regarding the prevention and detection of fraud, or standards of conduct and the prevention and detection of corruption.

- The College has an on-going process for identifying, evaluating and managing its significant risks.

## Performance

- The College management and committee structure clearly includes robust mechanisms to monitor and manage financial and non-financial performance. This appears to work well in practice.

- In relation to Shared Services, University of the Highlands and Islands (UHI) Academic Partners continue to consider the potential for optimising efficiencies and achieving best practice across the Partnership including the development of shared Learning and Information Services (LIS). There have been delays with implementation of this shared service, mainly due to outstanding issues with pensions and VAT. At the date of this report the shared services project was again experiencing delays.

## Outlook

- Three new accounting standards (Financial Reporting Standard (FRS) 100, 101 and 102) come into force for accounting periods commencing on or after 1 January 2015 which means that 2015/16 will be the first reporting year. However, comparative figures for 2014/15 will be required. In addition, a new Education SORP has been developed following the publication of the new FRSs, which will also be effective from 2015/16.

- The College has identified a challenging financial position for 2015/16 and 2016/17. Board members have been pro-active in taking steps to address this and to work with the Regional Strategic Body to secure the financial future of the College.

# Introduction

## Background

1. 2014/15 was the fourth year of our five year appointment as external auditors of The North Highland College ('the College'). This report summarises our opinion and conclusions and highlights significant issues arising from our work. It covers the communication of findings from the audit required by International Standard on Auditing (ISA) (UK and Ireland) 260: Communication of Audit Matters with Those Charged with Governance.

2. The audit framework is outlined in our Strategic Planning Memorandum and 2014/15 Annual Audit Plan issued on 18 May 2015 and considered by the Audit Committee on 15 June 2015. The scope of the audit was to:

   - provide an opinion on, to the extent required by the relevant authorities, the financial statements and the regularity of transactions in accordance with the standards and guidance issued by the Financial Reporting Council;

   - review and report on the College's corporate governance arrangements in relation to systems of internal control, the prevention and detection of fraud and irregularity, standards of conduct, and prevention and detection of corruption; and the College's financial position; and

   - review and report on the College's arrangements to manage its performance, as they relate to the economy, efficiency and effectiveness in the use of resources.

3. Our audit approach focused on the identification of the significant risk areas facing the College and the significant classes of transactions, estimates, other account balances and disclosures impacting upon the financial statements. These include;

   - compliance with legislation and financial regulations

   - fixed assets transactions, including the revaluation of land and buildings; the estates development strategy implementation; on-going estate improvements and maintenance; and compliance with relevant financial reporting standards

   - recoverability of debtors

   - recognition of funding provided for specific purposes and the regularity of corresponding expenditure

   - compliance with FRS 17 – Retirement Benefits and provision for pension liabilities for early retirals

   - compliance with the SORP on Accounting for Further and Higher Education, FReM and Accounts Direction. In particular, the additional disclosures required this year where the FReM requirements go beyond the SORP.

## Basis of Information

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

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

6. As our audit is designed primarily to enable us to form an opinion on the financial statements taken as a whole, our report cannot be expected to include all the possible comments and recommendations that a more extensive special examination would bring to light.

## Acknowledgement

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

# Financial Statements

## Audit Opinion

8. On 16 December 2015 we issued an audit report with an unqualified opinion on the financial statements of the College for the year to 31 July 2015; on the regularity of the financial transactions reflected in those financial statements; and on other prescribed matters, being the part of the Remuneration Report to be audited and the consistency of the information in the Operating and Financial Review with the financial statements. The opinion includes the following 'emphasis of matter' paragraph, drawing attention to Going Concern issues noted in the financial statements. These issues are discussed at paragraphs 31 and 84 of this report.

**'Emphasis of matter – Going Concern**
We draw attention to the going concern disclosures made in note 1 to the financial statements on page 33 and on page 19 concerning the projected deficit outturn for 2015/16; its impact on loan covenant conditions; the budget position for 2016/17; the Deficit Action Plan being implemented by the College; and assurances received from the Regional Strategic Body, The University of the Highlands and Islands, to work with the College to resolve the overall financial position; and the preparation of the accounts on a going concern basis as a result of the action being taken. These circumstances indicate the existence of material uncertainty that may cast significant doubt on the College's ability to continue as a going concern. The financial statements do not include adjustments that would result if the College was unable to continue as a going concern. Our opinion is not modified in respect of these matters.'

9. We are required to undertake audit work from the Balance Sheet date up to the date of signing the financial statements and this was undertaken in the period up to 16 December 2015. No post balance sheet events were identified that required adjustment to be made to the financial statements or additional disclosure in a note thereto.

## Audit Completion

10. An important measure of proper financial control and accountability is the timely closure and publication of audited financial statements. Table 1 summarises the three key elements of the audit process.

**Table 1: Key elements of the audit process**

### Completeness of draft financial statements

A set of draft financial statements was received in advance of the final audit visit however these did not incorporate the revaluation of land and buildings, the remuneration report and certain corporate governance disclosures. An updated draft of the financial statements incorporating these was received on 3 December 2015. Additional work was required to help identify the adjustment, including for the prior period, for the revaluation of assets. Otherwise the financial statements were of a high standard and required minimal presentational changes as part of the audit process.

### Quality of supporting working papers

Other than in relation to the revaluation of land and buildings and the remuneration report a full set of supporting working papers was provided from the outset of the audit and were of a suitably high standard.

### Response to audit queries

We are pleased to note that all audit queries were dealt with in a timely manner.

## Corporate Governance Statement

11. Colleges are required to include a statement on their corporate governance arrangements within their annual financial statements. The statement describes the ways in which the College has complied with good practice in corporate governance, including the arrangements for risk management.

12. We are required to review the statement to assess whether the description of the process adopted in reviewing the effectiveness of the system of internal control appropriately reflects the process and report where statements are not consistent with our knowledge of the body and report if the statement does not comply with SFC requirements. We are not required to provide an opinion on the College's systems of internal controls.

13. The College's corporate governance statement for 2014/15 states the College complies with all of the provisions of the 2014 Code of Good Governance for Scotland's Colleges, and it has complied throughout the year ended 31 July 2015.

14. Our audit opinion on the statement is covered by our auditor's report and is unqualified in this respect.

## Remuneration Report

15. 2014/15 is the first time a Remuneration Report has been required in college financial statements. The information to be included is prescribed by the FReM.

16. We are required to audit part of the Remuneration Report and review the remainder as part of our review of the Operating and Financial Review. We express a specific opinion on whether the audited part has been properly prepared.

17. We received the draft Remuneration Report for audit on 6 November 2015. From the work done we were satisfied that we could give an unqualified opinion. More information about the work undertaken is provided at paragraphs 60 and 61.

## Operating and Financial Review

18. The SORP sets out the requirements for an Operating and Financial Review to be included in the financial statements. The content is prescribed through the Accounts Direction from the SORP and the FReM. We review the information provided in the Operating and Financial Review and consider whether or not it is consistent with the financial statements and other information we have gathered in the course of our audit. We are not required to verify, or report on, the completeness of the information in the Operating and Financial Review, with the exception of the audited element of the Remuneration Report.

19. We received the final Operating and Financial Review on 3 December 2015 and concluded that an unqualified opinion could be provided for this.

## Audit and Accounting Adjustments and Confirmation

20. In Table 2 we draw attention to the adjustments identified during the course of the audit. The overall effect of adjusting for these items was to increase the deficit for the year by £0.065 million. The major adjustment related to the revaluation of land and buildings (refer paragraphs 37 to 42 below). No change was made to the materiality figures we told you at the planning stage: materiality £0.130 million, performance materiality £0.091 million, and the amount below which items were deemed to be clearly trivial £0.009 million.

**Table 2: Audit adjustments – impact on the financial statements**

| | Description | I&E DR £000 | I&E CR £000 | B/Sheet DR £000 | B/Sheet CR £000 |
|---|---|---|---|---|---|
| 1 | Other grant income | 26 | | | |
| | Accrued income | | | | 26 |
| | *Being reduction in accrued income for Turnkey project* | | | | |
| 2 | Bad debts | 20 | | | |
| | Trade debtors | | | | 20 |
| | *Being increase required in bad debt provision following review of after date cash and outstanding debts* | | | | |
| 3 | Accruals | | | 306 | |
| | Income and Expenditure Account reserve | | | | 306 |
| | *Being reduction in untaken annual leave accrual, which was originally calculated at 31 March 2015 rather than 31 July 2015 and was not robust. This has been posted as a prior period adjustment.* | | | | |
| 4 | Other operating expenses | 52 | | | |
| | SFC grants | | 52 | | |
| | *Being gross up of SFC FE recurrent grant for amount top sliced by UHI.* | | | | |
| 5 | SFC grants – HE/FE Childcare | 19 | | | |
| | HE/FE Childcare expenditure | | 19 | | |
| | *Being correction to Childcare disclosure.* | | | | |
| 6 | Early retirement provision | | | 46 | |
| | Other operating expenses | | 46 | | |
| | *Being correction to valuation of provision based on latest SFC actuarial tables.* | | | | |
| 7 | Trade creditors | | | 99 | |
| | Other creditors | | | | 99 |
| | *Being reallocation of pension creditor and union dues.* | | | | |

## Audit and Accounting Adjustments and Confirmation (Continued)

**Table 2: Audit adjustments – impact on the financial statements (continued)**

| | | | | | |
|---|---|---|---|---|---|
| 8 | Deferred capital grants | | | 3,427 | |
| | Income and Expenditure Account reserve | | | 1,424 | |
| | Depreciation – Land & Buildings | 66 | | | |
| | Loss on Revaluation of Fixed Assets | 250 | | | |
| | Release of Deferred Capital Grants – Other | 40 | | | |
| | Land and Buildings – Aggregate Depreciation | | | 4,355 | |
| | Land and Buildings – Cost | | | | 8,732 |
| | Revaluation reserve | | | | 539 |
| | Release of Deferred Capital Grants – SFC | | 291 | | |
| | *Being accounting for the revaluation of land and buildings including prior period adjustment.* | | | | |
| | **Total** | **473** | **408** | **9,657** | **9,722** |
| | | ====== | ===== | ======= | ======= |
| | **Net impact on Income and Expenditure Account deficit** | | **65** | | |
| | | | ====== | | |

21. A number of disclosure and clarification adjustments were made to the financial statements to ensure SORP, FReM and Accounts Direction compliance and improve the overall presentation of the financial statements. These mainly related to presentation and disclosure around the revaluation of land and buildings.

22. A number of potential audit adjustments were identified which management decided not to adjust. Non-trivial adjustments have been listed in Table 3 below and the total of these items is below our materiality level of £0.130 million. The effect of adjusting for these items would be to decrease the deficit for the year by £0.003 million.

**Table 3: Unadjusted audit differences – impact on the financial statements**

| | Description | I&E DR £000 | I&E CR £000 | B/Sheet DR £000 | B/Sheet CR £000 |
|---|---|---|---|---|---|
| 1 | Cash at bank | | | 49 | |
| | Other creditors | | | | 49 |
| | *Being unpresented payments added back to the bank balance as they were not processed until August 2015.* | | | | |
| 2 | Trade debtors | | | 7 | |
| | Trade creditors | | | | 7 |
| | *Being reallocation of credit balances on the year-end sales ledger.* | | | | |
| 3 | Trade debtors | | | 12 | |
| | Other operating expenses | 6 | | | |
| | Trade creditors | | | | 18 |
| | *Being adjustment required for debit balances on the year-end purchase ledger.* | | | | |

# Audit and Accounting Adjustments and Confirmation (Continued)

**Table 3: Unadjusted audit differences – impact on the financial statements (continued)**

| | | | | | |
|---|---|---|---|---|---|
| 4 | Stock | | | 9 | |
| | Other operating expenses | | 9 | | |
| | *Being adjustment required to correct under-statement of Engineering stock.* | | | | |
| | **Total** | **6** | **9** | **77** | **74** |
| | | ====== | ===== | ===== | ===== |
| | **Net impact on Income and Expenditure Account deficit** | **3** | | | |
| | | ====== | | | |

## Confirmations and Representations

23. We confirm that as at the date of this report, in our professional judgement, Henderson Loggie CA was independent within the meaning of regulatory and professional requirements and the objectivity of audit staff was not impaired.

24. In accordance with auditing standards, we obtained representations from the College on material issues.

# Financial Reporting

25. Scottish colleges were reclassified as Government Bodies from 1 April 2014 although UHI colleges were allowed to retain 31 July as their financial year-end date. From 1 April 2014 Incorporated Colleges and Regional Boards were required to comply with the Scottish Public Finance Manual (SPFM), except where directed by SFC's Accountable Officer. Financial reporting is now undertaken in accordance with HM Treasury's FReM 2014/15 in addition to the SORP on Accounting for Further and Higher Education and the SFC's Accounts Direction. As a result:

- Despite the 31 July financial year-end date colleges are still required to meet HM Treasury annual budgeting and reporting requirements at March.

- In April 2015 the College submitted the required Resource and other returns for 31 March 2015 to the SFC. In September, as allowed, an update was submitted which made the following adjustments:

  - Depreciation increase £0.017 million
  - Deferred grant release increase £0.017 million
  - Pension liability accrual (as at 31 July 2015) £1.019 million

## Financial Reporting (Continued)

26. Inclusion of the Accounts Direction as an appendix to the financial statements was required this year. The application of the FReM also results in some changes and additional disclosure:

- Valuation of assets - the College has not carried land and buildings at current value in the past and is now required to do so. This has resulted in a prior period adjustment to the financial statements. Further information is include at paragraphs 37 to 42
- Untaken annual leave accrual. The College has included an accrual for untaken annual leave of £0.083 million in the financial statements at 31 July 2015. As this is a change in accounting policy the accrual has been reflected in the financial statements as a prior period adjustment
- Estates strategy information included in the Operating and Financial Review
- Remuneration Report included in the Operating and Financial Review

## Financial Position

27. Colleges are required to break even in line with their agreed spending budgets each year to 31 March. Updated returns at 31 March show a resource underspend of £0.157 million (excluding pension liability). For 2014/15, the SFC has allowed colleges to treat the depreciation allocation of their budgets as if it was a cash resource, thereby resulting in a deficit in the Income and Expenditure Account however The North Highland College did not make use of this facility. There are also a number of other non-cash items impacting on the deficit position. Table 4 provides a summary of the College's planned and actual financial results, based on the audited financial statements and the College budgets.

**Table 4: Comparison of planned and actual financial results**

| | 2013/14 Actual (Restated) £000 | 2014/15 Planned £000 | 2014/15 Actual £000 | 2015/16 Planned £000 |
|---|---|---|---|---|
| Financial outturn Surplus/(deficit) | (1,309) | 0 | (592) | 0 |
| Income and expenditure reserves | (730) | 841 | (730) | (730) |
| Cash balances | 1,239 | 584 | 588 | 588 |

Source: Audited financial statements and College budgets

The deficit of £0.592 million includes the following non-cash items:

| | £'000 |
|---|---|
| Early retirement pension revaluation | 464 |

## Financial Position (Continued)

28. Overall, College income in 2014/15 has decreased by £0.183 million (1.4%) over 2013/14 to £13.258 million. There was an increase of £0.106 million (1.4%) in SFC grants to £7.702 million, which mainly relates to an increase in SFC deferred capital grants released partially offset by a decrease in estates grant and other SFC grants. Education contracts income has decreased by £0.095 million (57.9%) over 2013/14 to £0.069 million, mainly due to a fall in income at the Environmental Research Institute. Other grant income has decreased by £0.221 million (11.3%) on 2013/14 to £1.733 million largely as a result of a major EU project finishing during 2013/14. Overall, other operating income has increased by £0.070 million (6.1%) over 2013/14 to £1.212 million. This includes a £0.247 million insurance payout received to cover the cost of storm damage repairs to the College roof. Overall, College expenditure has decreased by £0.900 million (6.1%) over 2013/14 to £13.850 million. This is mainly due to the transfer of £1.300 million made to The North Highland College Foundation in 2013/14. No transfer was made in 2014/15. The loss in revaluation of fixed assets of £0.250 million is offset by the release of deferred capital grants.

### Loan Covenants

29. The transfer to the Foundation in 2013/14, together with the reduction in Income and Expenditure Account reserves as a result of the prior period adjustment made to the financial statements in 2014/15 to account for the revaluation of land and buildings (refer paragraph 40) means that the College is technically in breach of financial covenants with Lloyds. We reported last year that the bank recognised why the transfer to the Foundation was required and had agreed to take this into consideration and adjust the transfer when calculating the minimum Income and Expenditure reserve and annual surplus / deficit. No further progress has however been made in formally amending the loan agreement and there has been no discussion with the bank as yet in relation to the revaluation adjustment.

### Going Concern

30. The financial environment for 2014/15 continued to be challenging. Financial challenges will continue for the foreseeable future. The College has budget setting and monitoring arrangements in place that should ensure close scrutiny that will in turn allow close and timely management of the position.

31. From our review of the results for the year and other available information we required further assurances from the Board of Management regarding going concern for the 2014/15 financial statements. This was discussed with the Audit & Risk Management Committee on 7 December 2015. Following the meeting, and further discussions with the Director of Finance and Estates and the Principal, further information regarding the action taken and the support of the University of the Highlands and Islands (UHI) was received and we undertook further audit work on this area. As a result of this work and further discussion with management an accounting policy on going concern has been included in the financial statements. We are content that the note properly describes the current position. The budget for 2015/16 shows a break-even position although the outturn currently being projected is a significant loss of around £0.600 million for the year and a loss of £0.588 million is forecast for 2016/17 unless major changes are made. The College conducted a full curriculum review in autumn 2015, along with a review of support staff and an action plan is in place to address the issues leading to the projected deficits. Discussions have taken place at Board level, and with the SFC and the UHI, which has agreed to work with the College to resolve the budget difficulties. Applications have been made to the Foundation for financial support. Paragraph 8 records the impact on our audit opinion in relation to these matters.

# Financial Position (Continued)

### 2014/15 FTEs / SUMs outturn

32. The College's outturn against its 2014/15 FTEs / WSUMs targets is shown in Table 5.

**Table 5: 2014/15 FTE / SUMs outturn**

| | HE 2014/15 | HE 2013/14 | FE 2014/15 | FE 2013/14 |
|---|---|---|---|---|
| FTE / WSUMS target | 414.5 | 425 | 26,826 | 26,826 |
| FTE / WSUMS actual | 377 | 390 | 27,445 | 28,378 |
| Excess / (deficit) | (37.5) | (35) | 619 | 1,552 |

Source: College records / audited SUMs returns

33. The audit of the SUMs return for 2014/15 was carried out by Wylie and Bisset LLP who concluded that the student data returns have been compiled in accordance with all relevant guidance, that adequate procedures are in place to ensure the accurate collection and recording of data; and, on the basis of testing, reasonable assurance can be taken that the FES return contained no material mis-statement.

### FRS 17 Retirement Benefits

34. In 2014/15 the College accounted for its participation in the local government pension scheme as a defined benefit scheme. This is consistent with the accounting treatment adopted in previous years.

### Capital Income and Expenditure

35. During 2014/15 the main capital project undertaken by the College was the reconstruction of a wall and new windows fitted at Burghfield House, Dornoch, which were considered to meet the criteria for capitalisation under FRS 15 – Tangible Fixed Assets. The cost of this work was approximately £0.337 million, which was financed using SFC capital grants.

36. From review of the fixed asset register it was noted that there are a significant number of items of computer equipment and plant and equipment that are fully written down. From discussion with Finance staff it was noted that it is possible that some of these items are no longer held as they have been replaced by more recent fixed asset additions. As these items are fully written down there is no overall impact on the financial statements however an exercise should be conducted to identify those no longer held and remove the cost and accumulated depreciation. The Director of Finance and Estates advised that such an exercise will be undertaken in 2015/16. This has been included in the action plan at **R1** to ensure it is followed up next year.

# Financial Position (Continued)

### Valuation of Land and Buildings

37. Following the reclassification of incorporated colleges in Scotland as Central Government bodies from 1 April 2014 the College is required to follow applicable requirements of the FReM. While the Education SORP allows colleges to: (a) adopt a policy of revaluation; or (b) hold tangible fixed assets at historical cost; or (c) hold tangible fixed assets at their book amount on transition to FRS 15, the FReM requires a current valuation to be used.

38. The College applied the transitional rules set out in FRS 15 on implementing FRS 15 for the purposes of the 1993/94 financial statements. Accordingly the book values of tangible fixed assets on implementation were retained. Inherited land and buildings were valued at depreciated replacement cost, in line with the requirements of FRS 15 for specialised properties. The College did not adopt a policy of revaluation.

39. For the purposes of the 2014/15 financial statements the College was therefore required to move to a policy of revaluation (i.e. current value basis). Audit Scotland Technical Guidance states that as this is a change in accounting policy, the move should be accounted for as a prior period adjustment in accordance with FRS 3 – Reporting Financial Performance. This required a restatement of the opening balances at the start of the previous year (i.e. 1 August 2013).

40. The FReM states that entities should value their land and buildings using the most appropriate valuation methodology. Such methods might include:

- a quinquennial valuation supplemented by annual indexation and no interim professional valuation;
- annual valuations; or
- a rolling programme of valuations of properties (whether specialised or non-specialised).

The College obtained a professional depreciated replacement cost valuation of its land and buildings at September 2014 and indexed this back to 31 July 2013 in order to restate opening balances and indexed forward to 31 July 2015 to comply with the FReM. Changes in useful economic life of the fixed assets were incorporated as part of the prior period adjustment. The effect of this change in accounting policy was to increase the previously reported deficit for the year ended 31 July 2014 by £0.086 million. The cumulative effect on the Income and Expenditure Account reserve at 31 July 2014 was a reduction of £1.488 million. As a result of making this adjustment there was an overall reduction of £4.377 million in the net book value of land and buildings at 31 July 2015 from the original financial statements received for audit, deferred capital grants on the balance sheet decreased by £3.427 million and the revaluation reserve increased by £0.539 million.

41. The FReM states that where depreciated replacement cost is used as the valuation methodology entities should normally value a modern equivalent asset in line with Royal Institution of Chartered Surveyors standards. This contributed to the loss on revaluation as the value of a reproduction of College properties such as Burghfield House, Dornoch would be significantly higher than a modern equivalent.

42. Entities may elect to adopt a depreciated historical cost basis as a proxy for fair value for non-property assets that have short useful lives or low values (or both). The College has valued computer equipment, plant and equipment and motor vehicles on this basis.

## Financial Position (Continued)

43. We have previously commented on the fact that although it is a requirement of the SORP not all of the College's assets are split into major components to recognise the different useful lives of each component. The new SORP for 2015/16 still requires this. The valuation discussed above did not componentise fixed assets although the College reflected previous information on major components for the ETEC and CFEE buildings in its calculations. This still needs to be addressed in future and has been included in the action plan at Appendix II.

### Arms-Length Foundation

44. An arms-length foundation, The North Highland College Foundation, was set up during 2013/14 into which the College transferred £1.300 million by way of a donation in March 2014. No transfer has been made to the Foundation during 2014/15. No applications for funds were made to the Foundation during 2014/15 and consequently no income has been received from the Foundation during the year. Applications have been made to the Foundation during 2015/16 and are still being considered at the date of this report.

45. The objects of the Foundation are *'to advance and promote further education, higher education and / or research in North Highland by the support of The North Highland College, or any successor bodies thereto; and to promote such similar charitable purposes in such proportions and manner as the directors will think fit'*. The main reason for setting up the Foundation was that the Central Government budget mechanisms mean that the ability to use College reserves and surpluses is restricted.

46. To ensure that the Foundation is not consolidated into the College's financial results, thereby most likely losing the ability to spend the money, it requires to be independent of the College. For 2014/15 we concur with the College management assessment that the Foundation is an arms-length organisation and does not require to be consolidated into the college accounts in terms of the requirements of FRS 2 – Accounting for Subsidiary Undertakings.

### Post-16 Education (Scotland) Act 2013 – assigned college of UHI

47. The Post-16 Education (Scotland) Act 2013 makes provision about the support for, and the governance of, further and higher education institutions, including provision for the regionalisation of colleges. Under the Act, the University of the Highlands and Islands is the Regional Strategic Body for the Highlands and Islands. The Assigned Colleges (University of the Highlands and Islands) Order 2014 came into force on 1 August 2014. The order assigns the Board of Management of The North Highland College to UHI.

48. UHI has established a Further Education Committee of Court (the Further Educational Regional Board) to carry out its functions as a Regional Strategic Body.

49. From 1 April 2015 UHI achieved fully operational fundable body status in relation to further education funding from the SFC for the Highlands and Islands region. In practical terms however, funding has continued to be paid directly to the assigned colleges by the SFC. UHI has determined that for the year ended 31 July 2015 consolidated accounts for the region will not be required.

# Financial Position (Continued)

### SFC Financial Memorandum with Colleges

50. A new Financial Memorandum with colleges was issued by the SFC in December 2014 following a period of consultation. This sets out the formal relationship between the SFC and fundable bodies in the college sector, and the requirements with which fundable bodies are expected to comply in return for payment of grant by the SFC. The Financial Memorandum shows a significant number of changes from the previous version, reflecting all the recent governance changes in the sector and the reclassification of incorporated colleges in Scotland as Central Government bodies.

51. In the Highlands and Islands region the UHI has signed the Financial Memorandum with the SFC, as the Regional Strategic Body, and in turn requires its assigned colleges to sign up to a Financial Memorandum with it. At the time of this report this has not been signed by The North Highland College and there are ongoing discussions regarding the additional conditions placed on the colleges by UHI. The College continues to comply with the Financial Memorandum with the SFC.

# Corporate Governance

52. The College is responsible for ensuring that governance arrangements follow the three fundamental principles of openness, integrity and accountability and that arrangements are in place to ensure the proper conduct of its affairs. Mechanisms to monitor the adequacy and effectiveness of these arrangements should also be in place.

53. Our responsibility, as noted in the Code of Audit Practice, is to review and report on audited bodies' corporate governance arrangements as they relate to:

- Bodies' reviews of corporate governance and systems of internal control, including reporting arrangements
- The prevention and detection of fraud and irregularity
- Standards of conduct and arrangements for the prevention and detection of corruption
- The financial position of audited bodies

54. Comments on the financial position and the College's Corporate Governance Statement are covered in the Financial Statement section of this report. The Corporate Governance Statement does not identify any significant areas for improvement.

55. The Post-16 Education (Scotland) Act 2013 includes provisions in relation to the identification of principles of good governance practice for the college sector. A new 'Code of Good Governance for Scotland's Colleges' was published in December 2014 following a consultation process. The Code sets out the principles of good governance across five main areas: Leadership and Strategy; Quality of the Student Experience; Accountability; Effectiveness; and Relationships and Collaboration. Colleges are expected to comply with the new Code as a condition of grant from the SFC or their regional strategic body.

56. Incorporated colleges and Regional Boards are also required to comply with the requirements of the SPFM, except where directed by SFC's Accountable Officer.

57. Regional College arrangements required the Board to be re-appointed during 2015/16. Existing members were asked if they wanted to remain on the Board and recruitment was undertaken for new non-executive members, replacement staff members and new student members. The process followed the 2014 Ministerial Guidance on college sector Board appointments. The Regional Board has approved the majority of non-executive appointments, with the remaining appointments due to be approved on 16 December 2015. The process for the appointment of staff and student members is still underway. Two existing members of the Board stood down, but the net effect of the process once complete will be an increase of four new board members.

58. We have considered the College's governance arrangements through formal review of documents and procedures and informal observation of the operation of committee arrangements and the relationships between Board members and staff. In particular we have considered the arrangements for risk management and reporting to committees. We did not identify any areas of concern regarding the College governance arrangements other than we did note that at the June 2015 Audit & Risk Management Committee meeting concerns were raised about the membership of the Committee and the lack of numbers. It was noted that the Chairman had been unable to attend recent meetings and the Committee instructed the Secretary to raise this issue with the Chairman in the first instance. The scheduled date for the Audit & Risk Management Committee was again put back in November 2015 due to lack of numbers. Following the appointment of new members, as discussed above, revised committee membership, which should address quorum issues, were on the agenda for the Board meeting on 16 December 2015. The final version of this report will include the decision from the meeting.

59. The College's internal auditors reviewed the College's compliance with the SPFM as part of their work for 2014/15. They concluded that policies and procedures and current arrangements were compliant with the requirements of the SPFM, subject to two medium and two low grade recommendations. The internal auditors highlighted that there was no member of the Audit & Risk Management Committee with an accountancy or financial background. The College noted that it has always actively attempted to attract and recruit Board members with a background in accountancy or finance. Two members of the Audit & Risk Management Committee have some financial experience through their work (budget planning and monitoring) although there was no-one on the Board with actual accountancy experience. The College advised that it would continue to try and address this in conjunction with the UHI Court who technically now have formal responsibility for appointing Board members to partner college Boards.

60. The 2014/15 SFC Accounts Direction requires the preparation of a Remuneration Report in accordance with the FReM. The FReM requires a Remuneration Report to show the remuneration and pension benefits of senior officials. We are required by the Audit Scotland Code of Audit Practice to audit the remuneration and pension benefit disclosures and express a separate opinion within our independent auditor's report on whether they have been properly prepared in accordance with the Accounts Direction. Other narrative disclosures included in the Remuneration Report are not specifically covered by our audit opinion.

61. We reviewed the draft Remuneration Report prepared by the College against the requirements of the Accounts Direction and agreed the remuneration and pension benefit disclosures to the payroll, and pension information provided by the Local Government Pension Scheme administrators. This testing proved satisfactory other than for the fact that the College has disclosed posts of senior officials rather than names against remuneration and pension benefit disclosures. The reason for this was that some post holders did not give permission for their names to be disclosed. This did not affect our audit opinion.

# Systems of Internal Control

### Control environment

62. No material weaknesses in the accounting and internal control systems were identified during the 2014/15 financial statements audit which would 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.

63. Following our interim visit in July 2015, and the subsequent testing we performed during the year-end audit to update our findings, we concluded that the key controls for the main financial systems tested were in place and operating as expected. No weaknesses or issues were found that would impact adversely on the financial statements or our year-end audit.

### Internal Audit

64. Audit Scotland's Code of Audit Practice directs us to maintain effective co-ordination with internal audit and place the maximum possible reliance on their work. Wylie and Bisset LLP provided internal audit services to the College in 2014/15. We have reviewed the scope and extent of work performed by internal audit during the year and considered the impact of their findings and conclusions on our work, where appropriate. We have also considered the adequacy of the provision and are content that the audit service is of good quality.

65. The annual internal audit report issued in July 2015 did not identify any issues that affect our audit conclusions. Previous years' reports have highlighted weaknesses in relation to IT, primarily as a result of UHI-wide issues that the College could not resolve itself, and the lack of a comprehensive asset inventory. Some further progress was noted in resolving these issues although some work was ongoing at the time of the internal audit follow-up review in April 2015.

### Risk Management

66. Risk management is important for the development and on-going review of systems of internal control.

67. The College has a Risk Management Policy and Strategy and risk management procedures are in place that are actively monitored and reported on. This includes an on-going process for identifying, evaluating and managing its significant risks.

68. Risk management is seen as a Board matter, with the key strategic risks being identified and reported to the Board. We noted that there are clear links drawn between the key risks in the Strategic Risk Register and the College's Strategic Plan.

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

69. During 2014/15 we had regard to ISA 240: The Auditor's Responsibility to Consider Fraud in the Audit of Financial Statements.

70. The College has appropriate arrangements in place to deter fraud and irregularity, including its Financial Regulations and a Governance Manual including Standing Orders and a Fraud & Corruption Policy. These documents are reviewed and updated regularly although need to be brought up-to-date for recent changes such as the new Governance Code, new Financial Memorandum and SPFM. The last full review was during 2011 and both documents were approved by the Board in October 2011.

71. No frauds were identified during 2014/15 or in the period since 31 July 2015 to the date of this report.

72. The College has in place the following procedures / policies in relation to standards of conduct and prevention and detection of corruption. These are incorporated in the Governance Manual and are reviewed and updated regularly:

- Code of Conduct for Board Members
- Register of Board Members' and Senior Staff Interests
- Fraud & Corruption Policy
- Public Interest Disclosure (Whistleblowing) Policy and Procedures
- Anti-bribery policy.

73. The arrangements for maintaining standards of conduct and the prevention and detection of corruption are considered to be appropriate.

# Performance

## Performance Audit

### Introduction

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

75. No mandatory performance audit studies were identified by Audit Scotland for the College during 2014/15 although Audit Scotland has requested auditors to provide information in a data set for use in a sector report. In particular it has requested information about voluntary severance schemes and payments. The College made payments totalling £0.035 million under a voluntary severance arrangement during 2014/15 and, in addition, there were a small number of redundancy payments made, totalling £0.015 million, as a result of reductions required to staff numbers in areas of the College where, for example, there has been a decrease in funding or a reduction of schools support. The College does not have a current voluntary severance scheme.

### College performance arrangements

76. Audit Scotland reports are considered by management upon receipt and thereafter brought to the attention of the Board committee responsible, if appropriate.

77. Arrangements for financial and non-financial management are well established in the College, through the operation of the Senior Management Team and the Board and its various Committees. The Governance Manual clearly records the management responsibilities of the Board and each Committee, and how these interact with each other. Discussion with managers and our review of meeting papers and minutes confirms these responsibilities appear to be undertaken in an appropriate manner.

### Education Scotland Review

78. We are required by Audit Scotland's Code of Audit Practice to contribute to the 'whole organisation' approach to inspection through co-ordination amongst auditors, inspectors and other scrutiny bodies. We therefore place reliance on the reported results of the work of statutory inspectorates in relation to corporate or service performance.

79. Education Scotland published a report on the education provision of the College in its annual engagement review issued in May 2015. The report noted that the College had made good progress in delivering improvement in the themes reported during the previous year's annual engagement visit and, to secure additional revenue, the College was actively considering creation of a stand-alone Business Development Unit. The College is scheduled for a full external review by Education Scotland during February 2016.

# Outlook

## 2015/16 and beyond

### Regional Outcome Agreement

80. A Regional Outcome Agreement with the SFC has been finalised and the regional allocation of funding agreed for 2015/16.

81. The College's allocations for academic year 2015/16 are teaching grant of £6.368 million (2014/15 – £6.420 million). The College's credits target for 2015/16 is 12,400.

82. The level of recurrent grant budgeted from UHI for the 2015/16 academic year is £1.510 million (2014/15 – £1.426 million).

83. In June 2015 the Director of Finance and Estates presented a draft budget for 2015/16 to the Finance & General Purposes Committee for approval. This showed a break-even position. Latest projections show a deficit position of £0.600 million and as discussed earlier in the report action is currently underway to address this.

84. The financial environment will continue to be challenging. The impact of national pay bargaining proposals are of significant concern for the College. The use of depreciation allocations as if they were a cash allocation is allowed again in 2015/16, resulting in a further deficit in the financial statements if the money is spent. As noted in the financial statements and at paragraphs 8 and 31 of this report the College is currently implementing an action plan to address projected deficits in 2015/16 and 2016/17 and is working with the Regional Strategic Body to secure the College's future financial position.

### ONS Reclassification

85. Arrangements between colleges, regional bodies and the SFC to manage the revised funding mechanisms are likely to develop further as lessons are learned from the initial period of change.

### FRS 102 'The Financial Reporting Standard' and new Education SORP

86. The Financial Reporting Council has been implementing a convergence programme aligning UK Generally Accepted Accounting Practice (GAAP) to International Financial Reporting Standards (IFRS) and published three new FRSs (FRS 100, 101 and 102) with the substantive FRS 102 'The Financial Reporting Standard' representing the final step towards IFRS convergence. These three new FRS' become the new UK GAAP, which is fully IFRS-based. The new accounting standards come into force for accounting periods commencing on or after 1 January 2015 which means that 2015/16 will be the first reporting year. However, comparative figures for 2014/15 will be required.

87. In addition, a new Education SORP has been developed following the publication of the new FRSs and this received final approval from the FRC on 26 March 2014 following an extensive consultation process. This will also be effective from 2015/16. The new SORP was formally published in May 2014 and is available on www.fehesorp.ac.uk.

### Consolidated regional accounts

88. The College is assigned to UHI as part of the Highlands and Islands Region. Consolidated regional accounts may be required in future; at which point the College's audit timetable will require to be revised to accommodate this additional element in the finalisation process.

# Appendix I - Audited Bodies' Responsibilities

## Extracts from the Audit Scotland Code of Audit Practice

The Scottish ministers, elected members, governing bodies, boards, accountable officers, managers and officials have primary responsibility for ensuring that public business is conducted in accordance with the law and proper standards, and that public money is handled with integrity and spent appropriately. Public bodies and those responsible for conducting their affairs must discharge this accountability by establishing and maintaining proper governance arrangements and effective stewardship of the resources at their disposal.

### Financial statements

Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources. Audited bodies are responsible for:

- ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority
- maintaining proper accounting records
- preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the relevant financial reporting framework (eg, the Financial Reporting Manual or an Accounting Code of Practice)
- preparing and publishing with their financial statements an annual governance statement, statement on internal control or statement on internal financial control and a remuneration report
- preparing consolidation packs and, in larger bodies, preparing a Whole of Government Accounts return.

Many audited bodies publish other information, such as an annual report, alongside the financial statements.

Audited bodies should prepare financial statements in accordance with statutory timescales or in good time to allow audits to be completed by any dates specified by sponsoring directorates or other bodies (eg, the relevant Scottish Government Health Directorate for NHS bodies). Financial statements should be prepared in accordance with all relevant regulatory requirements and be supported by accounting records and working papers prepared to an acceptable professional standard.

### Corporate governance arrangements

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

Through its chief executive or accountable officer, 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.

### Systems of internal control

Audited bodies are responsible for developing and implementing systems of internal control, including risk management, financial, operational and compliance controls.

They are required to conduct annual reviews of the effectiveness of their governance, systems of internal control, or internal financial control, and report publicly that they have done so. Such reviews should take account of the work of internal audit and be carried out by those charged with governance, usually through bodies' audit committees.

Rigorous self-evaluation should be a central part of audited bodies' performance management to support continuous improvement.

### Prevention and detection of fraud and irregularities

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity.
This includes:

- developing, promoting and monitoring compliance with standing orders and financial instructions
- developing and implementing strategies to prevent and detect fraud and other irregularity
- receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity
- participating, when required, in data matching exercises carried out by Audit Scotland.

### Standards of conduct and arrangements for the prevention and detection of bribery and corruption

Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and should put proper arrangements in place for:

- implementing and monitoring compliance with appropriate guidance on standards of conduct and codes of conduct for members and officers
- promoting appropriate values and standards
- developing, promoting and monitoring compliance with standing orders and financial instructions

### Financial position of audited bodies

Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:

- such financial monitoring and reporting arrangements as may be specified
- compliance with any statutory financial requirements and achievement of financial targets
- balances and reserves, including strategies about levels and future use
- the impact of planned future policies and foreseeable developments on their financial position.

### Best Value

The Scottish Public Finance Manual explains that accountable officers appointed by the Principal Accountable Officer for the Scottish Administration have a specific responsibility to ensure that arrangements have been made to secure Best Value. Best Value is defined as the continuous improvement in the performance of functions. This includes having regard to the concepts of economy, efficiency and effectiveness and the need to meet equal opportunity requirements, and contributing to the achievement of sustainable development.

Achievement of Best Value or value for money depends on the existence of sound management arrangements for services, including procedures for planning, appraisal, authorisation and control accountability and evaluation of the use of resources. Audited bodies are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily.

# Appendix II – Action Plan

| Observation | Recommendation | Management comment | |
|---|---|---|---|
| **Fixed Asset Register –fully written off items**<br><br>**Paragraph 36**<br>From review of the fixed asset register it was noted that there are a significant number of items of computer equipment and plant and equipment that are fully written down. From discussion with Finance staff it was noted that it is possible that some of these items are no longer held as they have been replaced by more recent fixed asset additions. As these items are fully written down there is no overall impact on the financial statements. | **R1** An exercise should be conducted to identify assets no longer held and remove the cost and accumulated depreciation from the register and accounts. | **Responsible officer:** Director of Finance and Estates<br><br>**To be completed by:** 31 July 2016 | |
| | | **Grade** | **C** |

| Observation | Recommendation | Management comment |
|---|---|---|
| **Capital Income and Expenditure**<br><br>We previously recommended that plans to obtain information from the College's professional advisors, to identify major components within the new buildings with substantially different useful economic lives should be taken forward with a view to accounting separately for depreciation purposes for each component and depreciating each over its individual useful economic life. This has been discussed at length and last year we noted the following:<br><br>• ***Management comment*** – after further consideration and consultation on this issue during 2013/14 the Director of Finance and Estates made the decision not to apply componentisation retrospectively. However efforts will be made to ensure that the College complies with any changes in accounting standards and legislation that may mean retrospective componentisation work has to be done.<br><br>• **Further auditor comment** Componentisation is a requirement of the current SORP and is also included in the new SORP applicable from 2015/16. Future guidance on implementation of the new SORP and the application of the FReM should be considered in due course and full componentisation reconsidered at that time.<br><br>We note that although a valuation of assets has been obtained to comply with part of the FReM requirements for the accounts to July 2015 this did not require component parts to be valued separately. | **R2** In order to comply fully with the requirements of the SORP and FReM at the next asset revaluation the College should obtain componentised valuations for all relevant assets. | **Responsible officer:** Director of Finance and Estates<br><br>**To be completed by:** Next valuation by an independent valuer<br><br>**Grade** **B** |

**Grade**

| | |
|---|---|
| A | Fundamental issues which require the consideration of the Board of Management or one of its committees. |
| B | Significant matters which the appropriate members of the Senior Management Team can resolve. |
| C | Less significant matters, which do not require urgent attention but which should be followed up within a reasonable timescale. |