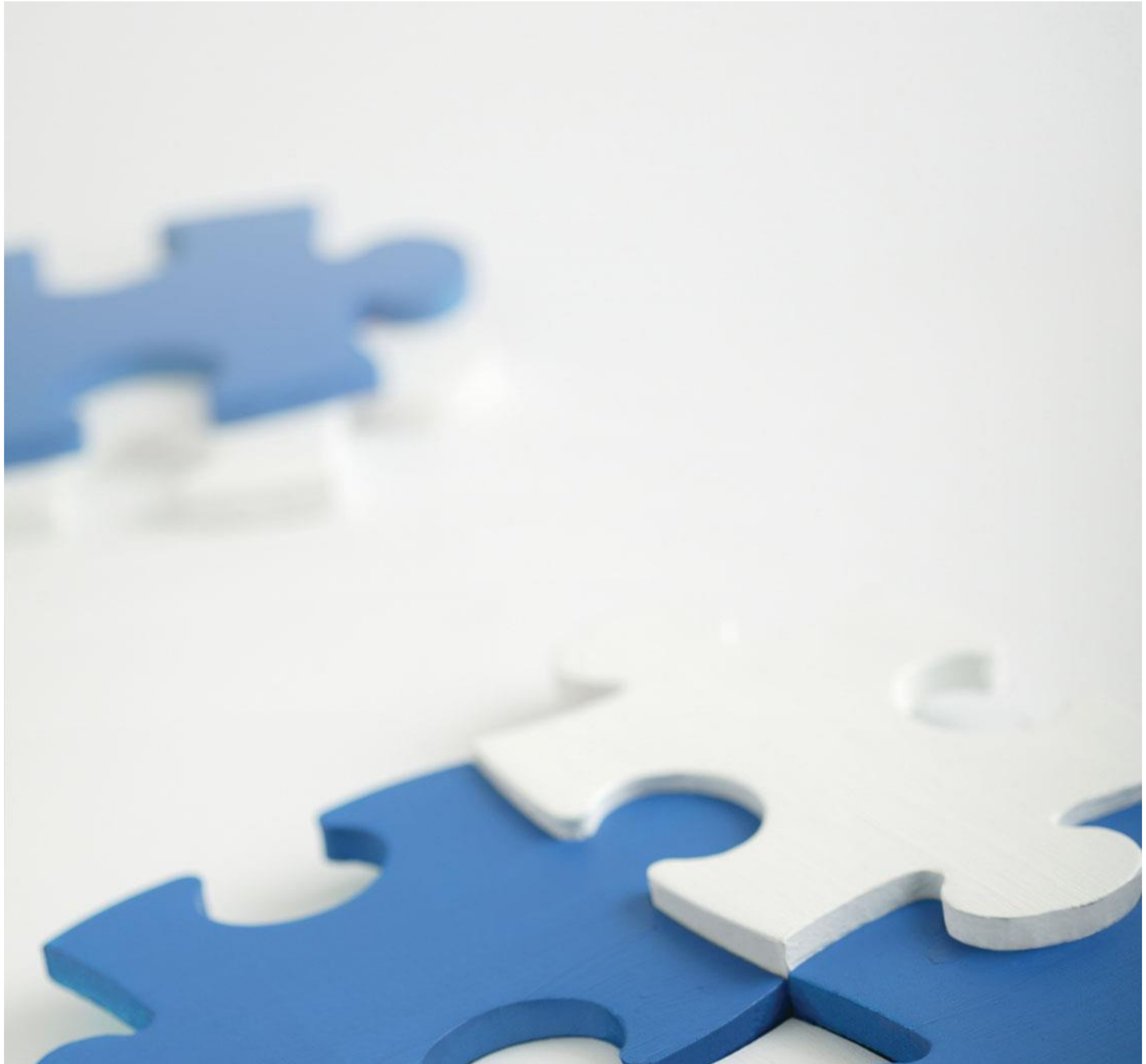

North East Scotland College

Report on the 2015/16 Audit

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

December 2016

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively (www.audit-scotland.gov.uk/about/).

Anne MacDonald is the engagement lead for the audit of North East Scotland College for the period 2011/12 to 2015/16.

This report has been prepared for the use of North East Scotland College and no responsibility to any board 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.

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Key messages

Audit of financial statements	• The independent auditor's report on the 2015/16 financial statements for North East Scotland College and its group is unqualified. • With the application of the 2015 Statement of Recommended Practice: Accounting for Further and Higher Education (SORP) alongside the Government Financial Reporting Manual (FReM), there were changes in the presentation of the primary financial statements, different options were available for accounting for capital grants and the Board of Management's Operating and Financial Review was replaced by Performance and Accountability Reports. These matters have all been addressed in line with the requirements of the Scottish Funding Council's 2015-16 Accounts Direction. • In order to comply with FReM, a prior year adjustment has been included to reflect the Balgownie site in the revised accounts at market value. With the downturn in the local economy, market values have fallen over the last year and consequently, the consolidated statement of comprehensive income and expenditure includes a deficit on revaluation of £4.4m to reflect the impact of the downward valuation for the year to 31 July 2016.
Financial management and sustainability	• While the college reported a deficit in respect of 2015/16, this is an accounting deficit which has arisen due to the treatment of funding for non-cash depreciation. In line with guidance, this was an expected outcome which also occurred in 2014/15 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, strong systems of internal control operated during the year although a number of weaknesses were reported in respect of payroll arrangements. Steps have been taken to review and strengthen procedures and these are being kept under review by the Audit and Risk Committee.
Performance	• The college offered a voluntary severance scheme during 2015/16 and the operation of this scheme was found to operate satisfactorily. A sample of payments made during the year were examined by internal audit and were found to have sound audit trails and appropriate supporting evidence.

Introduction

1. This report is a summary of our findings arising from the 2015/16 audit of North East Scotland College. 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. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged.

Our audit appointment

8. Audit Scotland is responsible for public sector audit in Scotland with audit appointments generally covering a five year cycle. The financial year 2015/16 is the final year of the current cycle. From 2016/17, the auditor of North East Scotland College will be Ernst and Young. In accordance with agreed protocols and International Standards on Auditing we will be liaising with the incoming auditors as part of this transition.

Audit of the 2015/16 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 a going concern basis. While there are significant financial challenges ahead, we are unaware of any events or conditions that may cast significant doubt on the college and its group's ability to continue as a going concern.
Other information	• We review and report on other information published with the financial statements. In line with the 2015 SORP and FReM, this includes a performance report and accountability reports by the Principal and/or the Board of Management. These reports contain a governance statement and a remuneration report. We have no major concerns 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 2015/16. The overall effect of consolidating the balances on the group balance sheet was to increase total reserves and net assets by £113,000.

Submission of financial statements for audit

9. In 2015/16, the 2015 SORP applied for the first time. It is based on FRS 102, the Financial Reporting Standard applicable in the UK and Republic of Ireland

10. The main change related to the classification and accounting of deferred capital grants. The 2007 SORP required capital grants to be deferred on the balance sheet while the 2015 SORP provides an alternative option of crediting capital grant to the consolidated statement of comprehensive income and expenditure. Consequently, grants received from the North East Scotland Further Education (NES FE) Foundation are now shown as income in the year of receipt rather than as deferred grants within creditors.

11. Changes in accounting treatment arising from implementation of the new SORP also affect comparative figures. It has therefore been necessary to make prior year adjustments which means the balance sheet for 2014/15 and the closing reserves for 2013/14 have been revised where appropriate. The impact of these changes on the financial statements has been explained in the accounting policies supported by note 33 to the financial statements.

12. In addition to the prior year adjustments, changes were made to the organisation of the financial statements, with, for example, the former Statement of Historical Cost Surpluses and Deficits and the Statement of Total Recognised Gains and Losses being replaced by the Statement of Changes in Reserves.

13. There were also significant changes to the other information contained within the accounts. The Accounts Direction required the inclusion of performance and accountability reports in accordance with FReM which replace the former Operating and Financial Review by the Board of Management and the Statement of Corporate Governance and Internal Control. These reports contain a range of information including a summary of the college's performance against strategic objectives, a governance statement and a remuneration and staff report.

Overview of the scope of the audit of the financial statements

14. 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 and Risk Committee on 15 March 2016.

15. 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 2015/16 audit which was set out in the Annual Audit Plan remains unchanged.

16. 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 in our Annual Audit Plan the audit work we proposed to

undertake to secure appropriate levels of assurance. The audit risks identified at the planning stage have been addressed and our findings and conclusions in respect of these risks are contained within the body of this report.

17. 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

18. 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).

19. 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.

20. We summarised our approach to materiality in our 2015/16 Annual Audit Plan. Based on our knowledge and understanding of North East Scotland College, we set planning materiality at 1% of gross expenditure. On receipt of the financial statements and following completion of audit testing we reviewed our materiality levels and concluded that no major change was required to our approach.

21. In respect of the 2015/16 financial statements, materiality was set at £603,000. We report all misstatements greater than £30,000. Performance materiality was calculated at £301,000 to reduce to an acceptable level the probability of uncorrected and undetected audit differences exceeding our materiality level.

Evaluation of misstatements

22. Other than the amendments for the Balgownie site and the holiday pay accrual which have been reflected in the audited accounts and are explained in the table at paragraph 25, there were no significant changes to the financial statements.

23. We identified a number of presentational adjustments within the financial statements during the course of our audit. These were discussed with the Finance team and amended accordingly.

Significant findings from the audit

24. 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.

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

Issue
1. Revaluation of Balgownie site The Balgownie site has been vacant and awaiting disposal for some time and was shown in the draft accounts as a current asset held for sale. At 31 July 2016, it was recorded at a book value of £1.075m. This accounting treatment complied with the 2007 SORP but FReM requires such assets to be carried at market value. FReM also sets out a range of criteria to assist in determining if an asset is available for sale including an expectation that the sale be completed within 12 months. With the downturn in the local economy, a potential date for the disposal of the Balgownie site is unknown. **Resolution:** A valuation at market value was obtained and the centre is reflected in the revised accounts at £5.6m for the current year and following a prior year adjustment, the previous year market value is included as £10m. We are satisfied with these adjustments.
2. Holiday pay accrual The Accounts Direction requires colleges to recognise an accrual for the untaken element at 31 July 2016 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 £21,842 between the current and previous year had been accrued at 31 July 2016, rather than the full amount of £601,376. **Resolution:** The revised accounts have been amended to reflect the full amount.

Issue
3. Finance lease liability The college entered into a finance lease for a facility in Ellon with Aberdeenshire Council. The lease is for 60 years, however the associated costs have been allocated over a 5 year period. The difference in charge between the current amount and one based on the college's policy of allocating costs over the life of the lease is £76,450. Fixed Assets are therefore understated by £76,450, and expenses overstated by the same amount. **Resolution:** The lease has a break period after 5 years which was the reason the shorter write off period was used. The accounting policy has been amended to reflect that this finance lease is being accounted for over a shorter period. As the amount involved is not material, we are satisfied with this approach.
4. Implementation of the 2015 SORP Note 33 to the financial statements sets out the impact on the college's prior year opening balances after implementing the new SORP. The main change has been the reclassification of £4.4m grants received from the NES FE Foundation as income received in the year rather than as a deferred grant to be used over the life of the relevant asset. In addition, the face of the balance sheet has changed significantly as total deferred grants of £46.7m which had previously appeared separately before reserves are (with the exception of foundation income above) included within creditors. **Resolution:** We are satisfied with the accounting treatment in the audited accounts following implementation of the new SORP.
5. Income and hardship funds The college receives a range of funding from the Scottish Funding Council which we were able to reconcile with monthly cash flows and budget information. Due to the risk of material misstatement, we also felt it was appropriate to seek management representation on the matter to ensure no significant income had been omitted from the accounts . Also, in 2014/15, we found that balances in respect of hardship accounts had not been cleared since the new ledger was set up following the merger. **Resolution:** Management representations have been obtained with regard to completeness of income and in respect of hardship funds, we confirmed that relevant balances were addressed appropriately during the year and were no longer an issue.

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 £2m for 2015/16. After taking actuarial losses in respect of pension liabilities and the deficit on revaluation of the Balgownie site, the overall deficit for the year was £11.1m. Additional challenges experienced during the year included increased demand for student support funds and the impact on pay and conditions following the implementation of National Collective Bargaining.

28. In the past the college received sufficient funding to cover student support but this year, expenditure exceeded the funding allocation and therefore the college was required to meet the additional cost.

29. Changes to pay and conditions continue to impact on the college. While a two year pay deal has been agreed with lecturers, there is ongoing negotiation to resolve the dispute with support staff. In overall, terms the additional cost of the agreed and proposed pay offers is currently around £400k.

30. The government's budgeting and accounting arrangements require the college to provide a monthly cash flow and break even against resource requirements. At 31 March 2016, the college reported an overspend of £577k against its resource limits.

31. As in the previous year, colleges received cash funding in respect of depreciation, a non-cash item, which has to be spent by 31 March and this puts colleges into an accounting deficit position once net depreciation is taken into account. In respect of 2015/16, this amounted to £1.009m for North East Scotland College but in line with Scottish Funding Council guidance, the deficit does not impact on our audit opinion as the outcome is the result of a technical accounting matter which was anticipated.

32. The Scottish Funding Council did however provide guidance on how the cash received in respect of depreciation could be spent and subsequently, the college was permitted to use it to meet additional student support funds and contribute towards the pay award and increased pension contributions.

33. In May 2016, the college received the first notification of its funding allocation for 2016/17. This was lower than expected especially when compared with other colleges and consequently, there is ongoing correspondence with the Funding Council. In the summer, the college agreed a balanced budget for 2016/17 on the basis that significant savings need to be delivered. While the college recognises that the current cost base and service delivery models are not sustainable, an estimate of the shortfall over the next 3 years assuming no change in current operations and funding is at least £6.5m.

34. Since reclassification the college has reduced costs across a number of areas. There is work ongoing with the two universities in the city to identify potential options for shared services. Early results have identified more opportunities for the universities than for the college. It will therefore be difficult to continue to deliver savings against a backdrop of reduced funding unless there is fundamental change. These matters are the focus of the Board's next planning day in November 2016.

Financial management arrangements

35. 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.

36. Based on our observations during the course of the 2015/16 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 General Purposes and Audit and Risk 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.
- With increasing financial challenges, the Board has recognised the need for longer term financial planning. There is some evidence of three year revenue plans and longer term costings for the estates strategy. Within its current self-evaluation action plan, the Board identified an aim to work towards developing 10-year financial plans. Recent Board planning days have also focused on the 'college in 10 years' time'.
- Based on our observations at the Audit and Risk Committee, there is a good level of challenge and questioning and this was particularly noted in relation to financial matters.

Governance

37. 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

38. During the year, there were some changes in board membership and in July 2016, membership of the Board's committees was reviewed. There was however continuity in the Chair and Vice Chair of the Board and the college's Senior Management Team. The Principal did however announce his retirement in spring 2016 and following a successful recruitment campaign in the summer, the new principal takes up her post in December 2016.

Governance and internal control systems

39. 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.

40. 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.

41. 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.

42. It is a requirement of the college's funding that they sign a Financial Memorandum with the Scottish Funding Council. 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 regard to section C of the Code covering accountability, we were satisfied that the college continued to meet the requirements set out in the good practice.

43. In June 2015, the college established a Governance Steering Group to support the Board in maintaining high standards of governance. The steering group met regularly during 2015/16 to consider a range of issues including responses to sector papers on governance, updates to the Board's governance manual, the Board's self-evaluation action plan and how the college might approach the external board evaluation required to be undertaken by March 2017 under the terms of the new Code of Good Governance for Scotland's Colleges. The new code applies from July 2016.

Audit and Risk Committee

44. Scrutiny of the effectiveness of the internal control processes within North East Scotland College is undertaken by the Audit and Risk Committee. The terms of reference for the Committee were extended during the year to include risk.

45. The Accounts Direction requires colleges to include a governance statement within their financial statements. We have reviewed the governance statement and have confirmed it is in line with the Accounts Direction.

46. As outlined earlier, a Performance Report is required as part of the financial statements in 2015/16 for the first time. Having considered the requirements of the Accounts Direction, we are satisfied there are no major omissions in the Performance Report. While detailed curriculum information has been included, there is, however, scope to provide more narrative on the results. It would also be helpful to include key performance measures monitored by the Board during the year.

Refer Action Plan, Recommendation 1

Internal control

47. 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.

48. 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 2015/16, we concluded that reliance could be placed on their work. In their annual report for 2015/16, Wylie & Bisset LLP provided their opinion that based on the internal audit work undertaken during the year, they were satisfied that sufficient internal audit work has been undertaken to allow them to draw a conclusion as to the adequacy and effectiveness of the college's risk management, control and governance processes.

49. In their opinion, North East Scotland College did have adequate and effective risk management, control and governance processes to manage its achievement of the college's objectives at the time of the audit work they carried out. It was also felt that the college had proper arrangements to promote and secure value for money. However, internal audit's annual report also drew attention to a 'weak' conclusion which had been reported following payroll work undertaken during the year. On receipt of the relevant internal audit report, the Audit and Risk Committee received an update from Human Resources and a further internal audit visit was agreed.

50. In 2014/15, a number of weaknesses in controls were reported by internal audit in respect of human resources and payroll functions. At that time the issues related to overpayments arising because appropriate documentation had not been passed to the human resources team. In addition, a range of errors had been identified in the pay grades recorded in college records. These matters were resolved and corrective action taken to improve internal controls.

The matters now reported in respect of 2015/16 payroll matters related to different weaknesses and internal controls.

51. We considered the potential impact of internal audit's findings on our audit of the college's financial statements. Having considered the work of internal audit, we were satisfied that the areas of concern could be restricted to:

- overtime payments
- expense claims
- sick pay and maternity pay calculations.

52. In respect of overtime and expenses, manual adjustments had been made to documentation by the finance team as part of processing rather than returning the relevant paperwork to the appropriate line managers for correction. This generally meant there was an absence of appropriate audit trails and weaknesses in the relevant internal controls. We also noted that the payroll system could not deal with sick pay and maternity pay calculations properly and therefore manual workarounds were required. We carry out substantive testing as part of our audit approach and in respect of 2015/16, a sample of 30 payroll transactions was examined. While internal audit reported on significant weaknesses in internal control, we concluded that the scale of the amounts involved were not material to our overall audit opinion on the financial statements.

53. We placed reliance on the work of internal audit in respect of payroll 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

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

Prevention and detection of fraud and irregularities

55. 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, whistleblowing policy and codes of conduct for board members and staff. Combined, these represent the standard suite of policies and procedures we would expect to find in an organisation with satisfactory arrangements in place.

Performance

56. 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

57. 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.

58. The scheme required senior staff applications to be considered by the Board of Management. In reality, this was delegated to the Remuneration Committee. Other staff applications were to be considered by the senior management team.

59. The college ran a severance scheme between August and December 2015. Internal audit undertook a review of the scheme and examined a sample of 10 payments. No matters were identified and in all cases, an appropriate audit trail existed including evidence of consideration by the colleges' senior management team.

College post-merger evaluation report

60. In Autumn 2015, the Scottish Funding Council began a round of post-merger evaluations. Each college was required to submit a self-evaluation which was considered alongside other Funding Council engagement with colleges including the outcome agreement process and financial health and quality monitoring.

61. In May 2015, the evaluation for North East Scotland College was published. It concluded that the merger could be regarded as 'very successful, particularly in terms of progress made by the college in creating a 'one college' culture'.

Transparency

62. Agenda papers and minutes for board and standing committee meetings are posted on the college's website on a timely basis. While the minutes of the Audit and Risk Committee are included in the board papers, the committee agenda papers are regarded as reserved business and do not appear on the website. Overall, this demonstrates a good level of transparency with regard to the college's decision making processes.

Appendix I - Action plan

No/para	Issue/Risk/Recommendation	Management action/response	Responsible officer	Target date
1/46	**Performance** The Performance Report includes detailed analysis of curriculum information but provides little explanatory narrative. ***Risk: The information may not fully meet the expectations of the Accounts Direction.*** **Recommendation:** there is scope to provide more narrative on the results for the year and to provide a summary of the key performance measures monitored by the Board during the year.	The amount of narrative shall be increased in the Performance Report for the year to 31 July 2017.	Vice Principal Finance	December 2017