HENDERSON LOGGIE
Chartered Accountants

The North Highland College

Annual Audit Report for 2015/16 to the Board of Management and the Auditor General for Scotland

External Audit Report No: 2016/02

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Contents

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.

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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.

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Executive Summary

Financial Statements

- On 14 December 2016 we issued an audit report with an unqualified opinion on the financial statements of the College for the year to 31 July 2016 and on the regularity of the financial transactions reflected in those financial statements.

- Three new accounting standards (Financial Reporting Standard (FRS) 100, 101 and 102) came into force in 2015/16, with comparative figures for 2014/15 restated using these new standards. In addition, a new Education Statement of Recommended Practice (SORP) has been implemented for the 2015/16 financial statements.

- The College's position is a deficit for the year ended 31 July 2016 (before 'other comprehensive income') of £0.607 million (2014/15 - deficit £0.828 million (as restated)). The College has an Income and Expenditure Reserve balance of £(7.974) million at 31 July 2016 (including pension reserve of £(7.380) million) (31/07/15 - £(6.517) million (including pension reserve of £(5.787) million).

- The College did not meet its Credits target for the academic year to 31 July 2016 however the overall target for the region was met.

- The College's Local Government Pension Scheme (LGPS) pension liability increased in total by £1.593 million during the year to £7.380 million at 31 July 2016, which was largely due to changes in key actuarial assumptions relating to discount rates, along with net interest on the increased pension liability.

- There were a number of audit and accounting adjustments made to the financial statements. The overall effect of adjusting for these items was to reduce the deficit for the year by £0.577 million. It was agreed not to amend the financial statements for a further three non-trivial potential adjustments on the grounds that the overall impact of these on the financial statements is not material.

- A significant number of disclosure and clarification adjustments were also made to the financial statements to ensure compliance with FRS 102, the new SORP on Accounting for Further and Higher Education, the Government Financial Reporting Manual 2015/16 ('the FReM') and the Accounts Direction issued by the Scottish Funding Council (SFC), and improve the overall presentation of the financial statements.

Corporate Governance

- The College's Governance Statement confirms that the College complies with all of the provisions of the Code of Good Governance for Scotland's Colleges, and it has complied throughout the year ended 31 July 2016.

- A Performance Report and Accountability Report (including a Governance Statement and Remuneration and Staff Report) are included in the annual report, replacing the Operating and Financial Review that was included in previous years.

- No material weaknesses in the accounting and internal control systems were identified during the 2015/16 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.

Outlook

- The College has identified a challenging financial position for 2016/17 and beyond. 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.

- Draft budgets have been prepared for the next three years which show an improving financial position, however achievement of the budgets is dependent on several key funding assumptions being realised.

Introduction

Background

1. 2015/16 was the fifth and final 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 2015/16 Annual Audit Plan issued on 17 May 2016 and considered by the Audit Committee on 27 May 2016. 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 (FRC);

   - 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;

   - audit specific parts of the Remuneration and Staff Report;

   - read and express an opinion on whether the Performance and Accountability Reports are consistent with the financial statements; 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 consideration of any impairment as a result of revaluation or asset conditions, 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 102 including regarding the provision for pension liabilities and provision for early retirals; and
   - compliance with the new SORP on Accounting for Further and Higher Education, FReM and Accounts Direction.

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. Weaknesses or risks identified by us are only those that have come to our attention during our normal audit work in accordance with the Audit Scotland Code of Audit Practice, and may not be all that exist.

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 14 December 2016 we issued an audit report with an unqualified opinion on:
- the financial statements of the College for the year to 31 July 2016;
- on the regularity of the financial transactions reflected in those financial statements; and
- other prescribed matters, being the part of the Remuneration and Staff Report to be audited and the consistency of the information in the Performance and Accountability Reports, governance statement and other annual report sections with the financial statements.

Last year we included the following Emphasis of Matter paragraph in our audit 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.'

We have concluded for 2015/16 that a similar statement is not required. Whilst the funding position remains challenging, support from UHI, the current projected outturn for 2016/17 showing an improved deficit position against budget, and projected budgets to July 2018 and 2019 showing a surplus position, demonstrate that it is appropriate for the financial statements to be prepared on a going concern basis.

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 14 December 2016. No post balance sheet events were identified that required adjustment to be made to the financial statements or additional disclosure in a note thereto.

Identified Risks of Material Misstatement and Materiality

10. At the planning stage of the audit we identified some key areas of focus which we considered had the greatest effect on the overall audit strategy, the allocation of resources in the audit, and directing the efforts of the audit team. The findings from our audit work on these items are set out below. Management override of controls and income recognition are included below as there is a presumption within international auditing standards for all audits to take account of these areas.

Key audit area	Our planned approach	Our findings
Completeness of income	We planned to review all significant revenue streams and transactions and, through a combination of analytical review, compliance testing of key controls and detailed substantive testing, obtain comfort that these transactions appear reasonable based on our knowledge of the College.	Our review of key income streams did not identify any items which had been omitted or accounted for incorrectly.
Management override of controls.	Our approach was to review any significant unusual transactions to ensure that they appeared reasonable in the context of our knowledge of the business.	We did not identify any significant unusual transactions or manual postings that did not have adequate back-up or management explanations.
The College may not comply with legislation and financial regulations.	We planned to identify major areas of legislation and financial regulations that the College is required to comply with, consider the risk of non-compliance of each, and consider whether there may be a material financial impact from these. We then planned to discuss with management what key controls are in place to ensure compliance and asked whether any actual, suspected or known instances of non-compliance had been noted.	Results from our testing were satisfactory.
The College may not properly account for its capital projects expenditure and related funding.	We planned to review a sample of capital expenditure items to ensure it was appropriate to capitalise this. We then reviewed significant accounts of a repairs and maintenance nature to determine whether it was appropriate to expense these items. Our approach regarding impairment was to discuss this with management, identify all significant assets, and consider whether there were any conditions that might give rise to an impairment, and check that any impairments made had been correctly treated.	Overall, results from our testing were satisfactory.

Key audit area	Our planned approach	Our findings
The College may fail to recognise funding provided for specific purposes appropriately.	Our approach was to review all significant ring fenced funds and check whether grant terms and conditions had been met before recognising income.	Results from our testing were satisfactory.
The College may not achieve its planned budget resulting in a deterioration of the financial position, non-compliance with financial covenants and going concern issues.	We considered the process undertaken by management to satisfy themselves that the going concern basis of preparation of the financial statements was appropriate. We also reviewed relevant evidence available, including management accounts and the Forecast Financial Return.	As part of auditing procedures, auditors must consider whether an entity can continue to operate for a period of twelve months from the date of signing the financial statements. This needs to be considered on an annual basis. Based on our review we consider the College is a going concern.
The College may not apply the new accounting requirements properly	We planned to check whether disclosures and accounting treatment was in line with FRS 102, the SORP, FReM and Accounts Direction through reviewing the requirements and completing checklists to ensure that the requirements were being met.	Our review found a significant number of items requiring amendment, with several of these being finalised late in the audit process. The College has amended these for the final version of the financial statements.

11. We told you materiality at the planning stage was £0.124 million, performance materiality set at £0.087 million, and the amount below which items were deemed to be clearly trivial was £0.009 million. We determined materiality based on the College's annual income. There was no change to our materiality calculation during the course of the audit.

Audit Completion

12. 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.

Audit Completion (Continued)

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 on 26 September however these did not incorporate all of the financial statement figures or required disclosures. An updated draft of the financial statements incorporating FRS 102 adjustments and additional disclosures was received on 17 November 2016. Further work was required to help with FRS 102 transitional adjustments and fully comply with the SFC Accounts Direction, and several versions of the financial statements were received, with the final substantial changes received on 9 December 2016, and minor corrections on 12 and 13 December 2016. Refer R1 in action plan at Appendix III.
Quality of supporting working papers Other than in relation to the transition to FRS 102 workings, 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

13. 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.

14. 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.

15. The College's corporate governance statement for 2015/16 states the College complies with all of the provisions of the Code of Good Governance for Scotland's Colleges, and it has complied throughout the year ended 31 July 2016.

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

Remuneration and Staff Report

17. 2015/16 is the second time a Remuneration Report has been required in college financial statements and this has been expanded for 2015/16 to include additional information in a Staff Report. The information to be included is prescribed by the FReM.

18. We are required to audit part of the Remuneration and Staff Report and review the remainder as part of our review of the Performance and Accountability Reports. We express a specific opinion on whether the audited part has been properly prepared.

Remuneration and Staff Report (Continued)

19. This is an area where the draft financial statements received for audit required to be updated. We received the draft Remuneration and Staff Report for audit on 17 November 2016 and agreed the remuneration and pension benefit disclosures to the payroll, and pension information provided by the Local Government Pension Scheme administrators. From the work done we noted a number of areas where further disclosure was required and after requested disclosures were added we were satisfied that we could give an unqualified opinion.

Performance Report and Accountability Report

20. The SORP sets out the requirements for a Performance Report and Accountability Report (which replaces the Operating and Financial Review prepared in previous years) to be included in the financial statements. The content is prescribed through the Accounts Direction from the SORP and the FReM.

21. We review the information provided in the Performance Report and Accountability Report 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 Performance Report and Accountability Report, with the exception of the audited element of the Remuneration and Staff Report.

22. This is an area where the draft financial statements received for audit required to be updated. We received the draft Performance Report and Accountability Report on 17 November 2016, and following a number of amendments up to receipt of the final Performance Report and Accountability Report on 12 December 2016, concluded that an unqualified opinion could be provided for this.

Audit and Accounting Adjustments and Confirmation

23. 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 reduce the deficit for the year by £0.577 million.

Audit and Accounting Adjustments and Confirmation (Continued)

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	Release of deferred capital grants – SFC	86			
	Release of deferred capital grants – Non-SFC	180			
	Deferred capital grants			10,075	
	Creditors due within one year – capital grants				764
	Creditors due after one year – capital grants				9,577
	Being reallocation of deferred capital grants to creditors in line with FRS 102, and College adjustment to release				
2	Creditors due after one year – capital grants			70	
	Release of deferred capital grants – SFC		11		
	Release of deferred capital grants – Non-SFC		59		
	Being additional release of grants re Ross House				
3	Cash at bank			195	
	Other creditors				91
	Other taxation and social security				104
	Being add back of payments not presented at year end				
4	Other pension costs		1,105		
	Net interest charge on pension scheme	213			
	Income and expenditure reserve			892	
	Being correction to posting of adjustments made for LGPS from actuary report. Actuarial loss posted to Staff costs, rather than through other comprehensive income, and net interest charge omitted				
5	Wages and salaries		43		
	Income and expenditure reserve			43	
	Being correction to treatment of reduction in holiday pay accrual originally posted as prior period adjustment				
6	Revaluation of fixed assets	162			
	Revaluation reserve				129
	Income and expenditure reserve				33
	Being College adjustments to revaluation entries				
7	Revaluation reserve			94	
	Income and expenditure reserve				94
	Being additional transfer for depreciation on revalued assets				
	Total	**641**	**1,218**	**11,369**	**10,792**
	Net impact on deficit for the year		**577 Cr**		

Audit and Accounting Adjustments and Confirmation (Continued)

24. A significant number of disclosure and clarification adjustments were made to the financial statements to ensure FRS 102, SORP, FReM and Accounts Direction compliance and improve the overall presentation of the financial statements.

25. A number of potential audit adjustments were identified which management decided not to adjust. These included an amount for additional audit fee due to the work required to ensure the financial statements were FRS 102, SORP, FReM and Accounts Direction compliant. Non-trivial adjustments have been listed in Table 3 below and the total of these items is below our materiality level of £0.124 million. The effect of adjusting for these items would be to decrease the deficit for the year by £0.030 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	Prepayments and accrued income			30	
	European funds		30		
	Being under-accrual for ERI EU projects				
2	Revaluation reserve			16	
	Land & Buildings - revaluation				16
	Being reversal of revaluation adjustment on Biomass Plant				
3	Income and expenditure reserve			17	
	Revaluation reserve				17
	Being correction to transfer for depreciation on revalued assets				
	Total	**-**	**30**	**63**	**33**
		======	=====	=====	=====
	Net impact on deficit for the year	**30 Cr**			
		=======			

Confirmations and Representations

26. 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.

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

Financial Reporting

28. 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 2015/16 in addition to the SORP on Accounting for Further and Higher Education and the SFC's Accounts Direction. As a result:

Financial Reporting (Continued)

- 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 2016 the College submitted the required Resource and other returns for 31 March 2016 to the SFC. In September, as allowed, an update was submitted which made a small number of adjustments to the previously submitted figures.

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

29. The FRC 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' became the new UK GAAP, which is fully IFRS-based. The new accounting standards came into force in the 2015/16 financial statements, which included comparative figures for 2014/15 being restated in the 2015/16 financial statements.

30. In addition, a new Education SORP was effective for 2015/16 which follows FRS 102, and provides specific details on disclosure of the main statements. The new SORP is available at www.fehesorp.ac.uk.

Financial Position

31. 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 break-even resource position. There are a number of non-cash items impacting on the deficit position for the year ended 31 July 2016. 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

	2014/15 Actual £000	2015/16 Planned £000	2015/16 Actual £000	2016/17 Planned £000
Financial outturn Deficit (before 'other comprehensive income')	(828) restated	0	(607)	(259)
Income and expenditure reserve (excluding pension reserve)	(730)	(730)	(594)	(753)
Cash balances	588	588	553	294

Source: Audited financial statements and College budgets

Financial Position (Continued)

32. Overall, College income in 2015/16 has decreased by £0.962 million (7.3%) over 2014/15 to £12.296 million. This included the following major movements:

- There was an decrease of £0.503 million (6.5%) in SFC grants to £7.199 million, which mainly relates to the decrease in Estates Maintenance Grant (down £0.108 million) and the release of Deferred Capital Grants (down £0.348 million); and
- Other operating income has decreased by £0.427 million (35.2%) over 2014/15 to £0.785 million. This is because the 2014/15 figure included a £0.247 million insurance payout received to cover the cost of storm damage repairs to the College roof and there has also been a reduction in activity at Burghfield House.

33. Overall, College expenditure in 2015/16 has decreased by £1.183 million (8.4%) over 2014/15 to £12.903 million. This included the following major movements:

- Staff costs have decreased by £0.409 million (6.1%) on 2014/15 to £6.333 million largely as a result of a £0.206 million reduction in the FRS 102 pension adjustment compared to last year, and a reduction in staff levels and associated costs. Strict vacancy management was implemented as part of a Deficit Action Plan;
- Other operating costs have decreased by £0.231 million (4.3%) on 2014/15 to £5.128 million largely as a result of the expenditure related to the roof replacement in 2014/15 not recurring and cost reduction measures introduced as part of the Deficit Action Plan;
- Depreciation has decreased by £0.284 million (20.0%) on 2014/15 to £1.137 million largely as a result of more fixed asset items becoming fully depreciated; and
- There was no net gain / loss on revaluation of fixed assets through the Statement of Comprehensive Income in 2015/16 (2014/15: loss of £0.250 million).

Loan Covenants

34. Changes in presentation due to FRS 102 mean that the College is technically in breach of financial covenants with Lloyds. Technical breaches have also arisen in previous years due to the transfer of funds to the Foundation and revaluations of land and buildings. We have reported previously that the bank had agreed to take the circumstances into consideration and adjust the figures when calculating the minimum Income and Expenditure reserve and annual surplus / deficit. No further progress has been made in formally amending the loan agreement however there is sufficient evidence to suggest the bank will continue to make appropriate adjustments when calculating the covenant cover.

Financial Position (Continued)

2015/16 FTEs / Credits/SUMs outturn

35. The College's outturn against its FTEs / Credits / WSUMs targets is shown in Table 5.

Table 5: 2015/16 FTE / SUMs outturn

	HE 2015/16	HE 2014/15	FE 2015/16	FE 2014/15
	FTE	FTE	Credits	WSUMs
FTE / Credits / WSUMS target	428	414.5	19,017	26,826
FTE / Credits / WSUMS actual	363	377	18,756	27,445
Excess / (deficit)	(65)	(37.5)	(261)	619

Source: College records / audited Credits/SUMs returns

36. The audit of the Credits return for 2015/16 was carried out by Wylie and Bisset LLP who concluded the College has reasonable procedures and controls over the collection of data for the Credits return and assurance can be provided that the Credits count for the College is not materially mis-stated, with the systems used by the College satisfactory in all areas tested.

Debtors

37. At 31 July 2016 the balance for Trade debtors and other receivables was £0.211 million down on 31 July 2015 at £0.178 million, largely as a result of there being a large accrued income balance at 31 July 2015 for a project that had finished in the year, and no similar balance at 31 July 2016.

Short and Long Term Creditors

38. At 31 July 2016, due to the application of FRS 102, deferred government capital grants have been reclassified from reserves into short and long term creditors. Comparative figures at 31 July 2015 have also been restated. This has significantly increased these balances.

39. There has been a decrease of £0.266 million in Accruals and deferred income within short term creditors to £0.259 million at 31 July 2016 due mainly to the utilisation in the year of a number of sources of income that had been deferred at 31 July 2015.

LGPS Pension

40. In 2015/16 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.

41. The College's LGPS pension liability increased in total by £1.593 million to £7.380 million at 31 July 2016 which was largely due to changes in key actuarial assumptions relating to discount rates, along with net interest on the increased pension liability.

42. The College has a provision in its balance sheet at 31 July 2016 of £0.748 million (31/07/15: £0.763 million relating to pension costs from early retirements awarded to former employees.

Financial Position (Continued)

Capital Income and Expenditure

43. During 2015/16 there were capital additions of £0.273 million. The main additions were windows at Ross House, IT equipment and equipment for research.

Valuation of Land and Buildings

44. 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, which requires a current valuation to be used.

45. 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 either annual indexation or regular desktop valuation update;
- a quinquennial valuation supplemented by an interim professional valuation in year 3;
- annual valuations; or
- a rolling programme of valuations of properties (whether specialised or non-specialised).

46. In 2014/15 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. For the purposes of the 2015/16 financial statements this was indexed forward to 31 July 2016 giving rise to a revaluation gain of £0.162 million.

47. 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.

48. 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 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

49. An arms-length foundation, The North Highland College Foundation, was set up during 2013/14 into which the College transferred £1.3 million by way of a donation in March 2014. No transfer has been made to the Foundation during 2015/16. A number of applications for funds were made to the Foundation during 2015/16 however none were approved during the year and no income was received from the Foundation prior to 31 July 2016. The College received its first income of £0.064 million from the Foundation in September 2016 in respect of one approved application. The Board is taking steps to meet with the Trustees to improve this position.

Financial Position (Continued)

50. 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.

51. 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 2015/16 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 financial statements in terms of the requirements of FRS 102.

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

52. 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.

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

54. 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. It has been determined that for the year ended 31 July 2016 consolidated financial statements for the region were not required.

SFC Financial Memorandum with Colleges

55. 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.

56. 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.

Corporate Governance

57. 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.

58. 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

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

60. The Post-16 Education (Scotland) Act 2013 includes provisions in relation to the identification of principles of good governance practice for the college sector. In December 2014 the 'Code of Good Governance for Scotland's Colleges' was published which is mandatory for colleges to comply with. An updated version of the Code was published in August 2016. The review of the Code took into account recommendations made by the Cabinet Secretary's Good Governance Task Group. 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.

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

62. Regional Strategic Body 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 Strategic Body approved the appointments.

63. 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 risk management arrangements. Governance arrangements were reviewed during the year and documents brought up to date. The Code of Good Governance for Scotland's Colleges issued in August 2016 has also been reviewed to ensure compliance. We previously reported on issues with members' availability to attend meetings resulting in meetings not being quorate or having to be rescheduled. This has been satisfactorily addressed by the Board through new appointments to committees and changing the regular time of meetings to suit members.

64. The College's internal auditors reviewed the College's compliance with the SPFM as part of their work for 2014/15, and followed-up their review in April 2016. This found that there was still 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. 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.

65. New guidance on severance payments was published by the SFC during 2016 and there is also guidance on severance relating to compliance with the SPFM. The SFC guidance requires consultation with SFC and the Regional Strategic Body for compulsory redundancies. During 2015/16 the College had several severance cases, primarily due to cessation of operations, with a total cost in the financial statements of £0.007 million. Savings in staff costs were discussed generally with UHI and the SFC as part of the financial recovery plan put in place in late 2015, and the action taken appears practical in each situation, however there is no formal record of SFC and UHI involvement in the process. We recommend, at R2 in Appendix III, that in future, discussions with SFC and UHI about severance payments are formally documented.

Systems of Internal Control

Control environment

66. No material weaknesses in the accounting and internal control systems were identified during the 2015/16 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.

67. Following our interim visit in July 2016, 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

68. 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 2015/16. 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.

69. The annual internal audit report issued in July 2016 stated 'We are satisfied that sufficient internal audit work has been undertaken to allow us to draw a conclusion as to the adequacy and effectiveness of the College's risk management, control and governance processes. In our opinion North Highland 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 our audit work. In our opinion, the College has proper arrangements to promote and secure value for money.'

Risk Management

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

71. 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.

72. 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 and consider the risk management arrangements to be good.

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

73. During 2015/16 we had regard to ISA 240: The Auditor's Responsibility to Consider Fraud in the Audit of Financial Statements.

74. 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, with the latest update made during 2016.

75. No frauds were identified during 2015/16 or in the period since 31 July 2016 to the date of this report.

76. 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.

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

Performance

Performance Audit

Introduction

78. 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.

79. One specific piece of audit follow-up work was identified by Audit Scotland for the College during 2015/16, to follow-up on the Accounts Commission and Auditor General report on Scotland's public sector workforce, and a questionnaire provided by Audit Scotland was completed and returned. This identified that the College undertook some workforce planning activities but not in a formal structured format. Audit Scotland also requested auditors to provide information in a data set to inform sector-wide reporting.

College performance arrangements

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

81. 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

82. 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.

83. Education Scotland undertook an external review of the College in February 2016 and a report on the findings from this was published in April 2016. The overarching judgement from the review was that the College has in place effective arrangements to maintain and enhance the quality of its provision and outcomes for learners and other stakeholders. This judgement means that, in relation to quality assurance and enhancement, the College is led well, has sufficiently robust arrangements to address any identified minor weaknesses, and is likely to continue to improve the quality of its services for learners and other stakeholders.

Outlook

2016/17 and beyond

Regional Outcome Agreement

84. A Regional Outcome Agreement with the SFC has been finalised and the regional allocation of funding agreed for 2016/17.

85. The further education allocations for academic year 2016/17 (North Highland College plus Argyll College) are teaching grant of £6.393 million (2015/16 – £6.368 million). The Credits target for 2016/17 (North Highland College plus Argyll College) is 18,507 (2015/16: 19,017).

86. The level of recurrent grant budgeted from UHI for the 2016/17 academic year is £1.484 million (2015/16 – £1.510 million).

87. In August 2016 the Director of Finance and Estates has updated the 2016/17 budget and prepared a draft budget for 2017/18 and 2018/19 and this has been discussed by the Finance & General Purposes Committee. This showed a deficit position of £0.259 million in 2016/17, but surpluses of £0.162 million and £0.307 million in 2017/18 and 2018/19. The projections take into account efficiency savings planned from a voluntary severance scheme, increased income from new areas of provision, and an assumption that the cost of national pay bargaining will be met by increased income allocation rather than further efficiency savings. Latest projections in October 2016 show an improved expected deficit position of £0.092 million for the year to 31 July 2017.

88. 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 2016/17, resulting in a further deficit in the financial statements if the money is spent. The College continues to work closely with the Regional Strategic Body to secure the College's future financial position.

ONS Reclassification

89. 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.

Consolidated regional financial statements

90. The College is assigned to UHI as part of the Highlands and Islands Region. Consolidated regional financial statements 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 May 2016 Audit Scotland Code of Audit Practice

17. The audited bodies have the primary responsibility for ensuring the proper financial stewardship of public funds, compliance with relevant legislation and establishing effective arrangements for governance, propriety and regularity that enable them to successfully deliver their objectives.

Corporate governance
18. Each body, through its chief executive or accountable officer, is responsible for establishing arrangements to ensure 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 should involve those charged with governance (including audit committees or equivalent) in monitoring these arrangements.

Financial statements and related reports
19. Audited bodies must prepare an annual report and accounts containing financial statements and other related reports. They have responsibility for:

- preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation
- maintaining accounting records and working papers that have been prepared to an acceptable professional standard and that support their financial statements and related reports disclosures
- 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 and publishing, along with their financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that are consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also clearly address the longer-term financial sustainability of the body.

20. Further, it is the responsibility of management of an audited body, with the oversight of those charged with governance, to communicate relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. The relevant information should be communicated clearly and concisely.

21. Audited bodies are responsible for developing and implementing effective systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of their objectives and safeguard and secure value for money from the public funds at their disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.

Standards of conduct for prevention and detection of fraud and error
22. Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and also to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.

Financial position

23. Audited bodies are responsible 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 their future use
- how they plan to deal with uncertainty in the medium and longer term
- the impact of planned future policies and foreseeable developments on their financial position.

Best Value

26. The Scottish Public Finance Manual sets out 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.

Appendix II – Follow-Up of Previous Year's Action Plan

Observation	Recommendation	Original Management Comment		Auditor Follow-up Comments
Fixed Asset Register –fully written off items 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 **To be completed by:** 31 July 2016		No progress has been made with this, other than the removal of photocopiers disposed during the year, and the original recommendation still applies. ***Further management comments at Dec. 2016:*** A fresh exercise will be undertaken in 2016/17 to review written down IT and plant and equipment. **Responsible officer:** Director of Finance and Estates **To be completed by:** 31 August 2017
		Grade	**C**	

Observation	Recommendation	Original Management Comment		Auditor Follow-up Comments
Capital Income and Expenditure 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 in previous years we noted the following: • ***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. • **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. 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 **To be completed by:** Next valuation by an independent valuer		Although some information was received during the year to progress this, this was not applied and the original recommendation still applies. ***Further management comments at Dec. 2016:*** There will be an effort to try and develop the componentisation information. External Valuers have done this exercise. **Responsible officer:** Director of Finance and Estates **To be completed by:** 31 August 2017
		Grade	**B**	

Appendix III – Action Plan

Observation	Recommendation	Management comment	
Paragraph 12. A set of draft **financial statements** was received in advance of the final audit visit on 26 September however these did not incorporate all of the financial statement figures or required disclosures. An updated draft of the financial statements incorporating FRS 102 adjustments and additional disclosures was received on 17 November 2016. Further work was required to help with FRS 102 transitional adjustments and fully comply with the SFC Accounts Direction, and several versions of the financial statements were received, with the final substantial changes received on 9 December 2016, and minor corrections on 12 and 13 December 2016.	**R1** We recommend that planning for 2016/17 is discussed early with the external auditor to ensure the timetable set is realistic and that full draft financial statements can be presented for audit. This will require to take into account any impact on the timetable if consolidated regional financial statements are to be produced.	There will be a more focused effort to ensure any further changes in financial reporting are picked up earlier. **Responsible officer:** Director of Finance and Estates **To be completed by:** 31 August 2017	
		Grade	**B**
Paragraph 65. New guidance on **severance payments** was published by the SFC during 2016 and there is also guidance on severance relating to compliance with the SPFM. The SFC guidance requires consultation with SFC and the Regional Strategic Body for compulsory redundancies. During 2015/16 the College had several severance cases, primarily due to cessation of operations, with a total cost in the financial statements of £0.007 million. Savings in staff costs were discussed generally with UHI and the SFC as part of the financial recovery plan put in place in late 2015, and the action taken appears practical in each situation, however there is no formal record of SFC and UHI involvement in the process.	**R2** We recommend that in future discussions with SFC and UHI about severance payments are formally documented.	Efforts have been made to discuss issues as appropriate regarding severance with SFC. More formal recording will be attempted if required. **Responsible officer:** Human Resources Manager **To be completed by:** On-going from 1 January 2017	
		Grade	**B**

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.