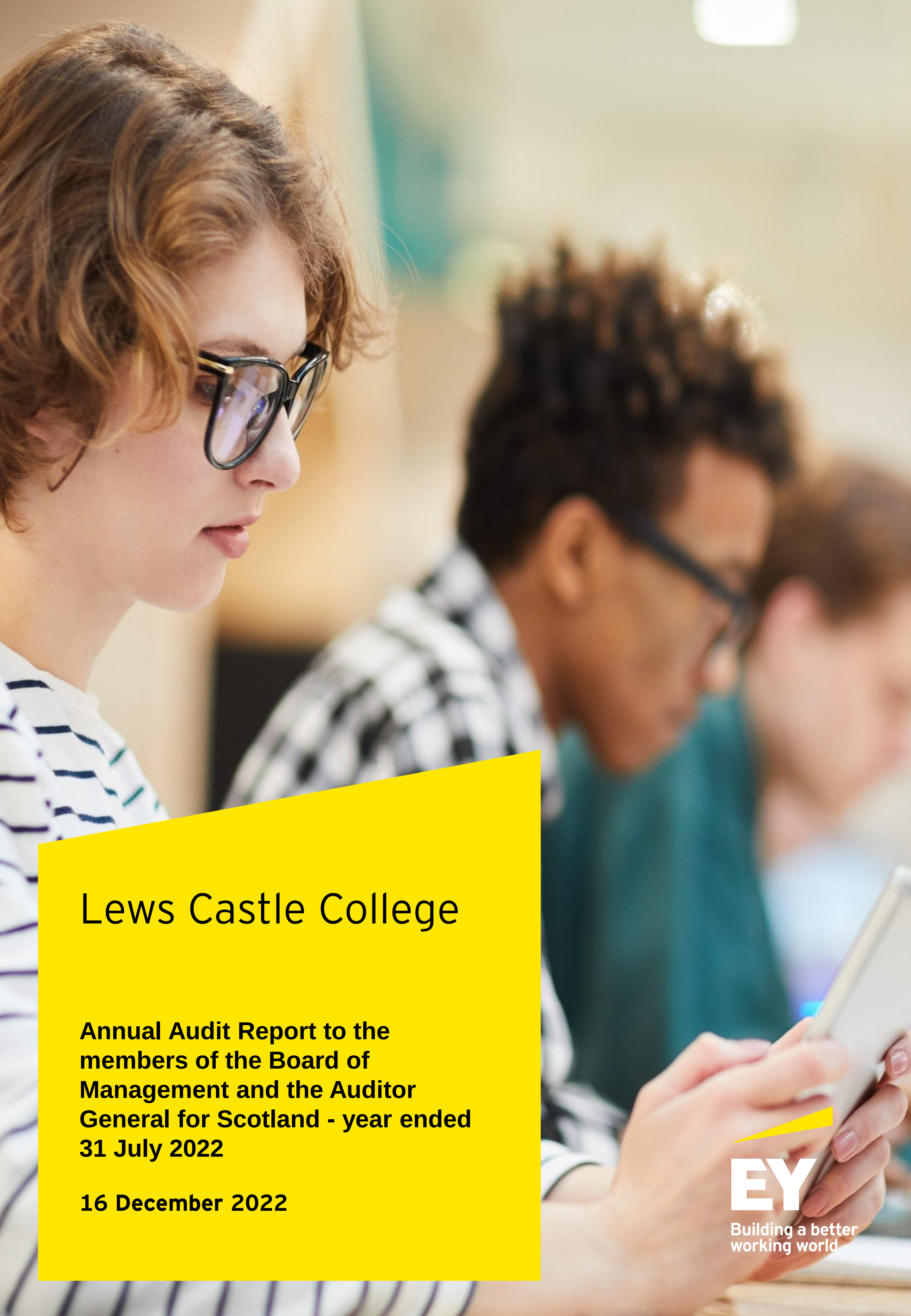


Lews Castle College

Annual Audit Report to the members of the Board of Management and the Auditor General for Scotland - year ended 31 July 2022

16 December 2022

Building a better working world

Contents

About this report

report has been prepared in accordance with Terms of Appointment Letter from Audit Scotland dated 31 May 2016 through which the Auditor General for Scotland has appointed us as external auditor of Lews Castle College (the College) for financial years 2016/17 to 2021/22. As a result of the impact of Covid-19 our appointment was extended by a further 12 months to include the financial year 2021/22. We undertake our audit in accordance with the Public Finance and Accountability (Scotland) Act 2000 and our responsibilities as set out within Audit Scotland's Code of Audit Practice. This report is for the benefit of the College and is made available to the Auditor General for Scotland and Audit Scotland. This report has not been designed to be of benefit to anyone except the recipients. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the recipients, even though we may have been aware that others might read this report.

Any party other than the Recipients that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Recipient's Publication Scheme or otherwise) and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, Ernst & Young LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the Recipients

Complaints

If at any time you would like to discuss with us how our service to you could be improved, or if you are dissatisfied with the service you are receiving, you may take the issue up with Stephen Reid who is our partner responsible for services under appointment by Audit Scotland, telephone 0131 777 2839, email sreid2@uk.ey.com. If you prefer an alternative route, please contact Hywel Ball, our Managing Partner, 1 More London Place, London SE1 2AF. We undertake to look into any complaint carefully and promptly and to do all we can to explain the position to you. Should you remain dissatisfied with any aspect of our service, or with how your complaint has been handled, you can refer the matter to Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN. Alternatively you may of course take matters up with our professional institute. We can provide further information on how you may contact our professional institute.

Executive Summary: Key Conclusions from our 2021/22 audit

We have issued an unqualified audit opinion on the College's 2021/22 financial statements.

We continued to review and update our risk assessment throughout the audit, including the materiality level applied. Our materiality levels were amended to reflect the increase in expenditure in 2021/22.

Financial Statements

We have concluded our audit of the College's financial statements for the year ended 31 July 2022. Three audit adjustments were required to be made and there were no unadjusted differences that we were required to communicate. The draft financial statements and supporting working papers were provided in line with the agreed audit timetable and were of a good standard. We worked with the finance team to update the financial statement disclosures, including in relation to areas where streamlining could occur to support the understandability of narrative sections and ensure focus on key areas.

We concluded that the other information subject to audit, including the applicable parts of the Remuneration Report and the Annual Governance Statement were appropriate. We were satisfied that the disclosures reflect the College's compliance with the *Code of Good Governance for Scotland's Colleges*.

Going Concern

In accordance with the Government Financial Reporting Manual ('the FReM'), the College prepares its financial statements on a going concern basis unless informed by the Scottish Government of the intention for dissolution without transfer of services or function to another entity.

Under a revised auditing standard, ISA 570, we are required to undertake greater challenge of management's assessment of going concern, including testing of the adequacy of the supporting evidence we obtained. The College has concluded that there are no material uncertainties around its going concern status, however it has continued to include enhanced disclosures around its future financial position in the financial statements to reflect the impact of Covid-19 and inflationary pressures as well as the impact of the potential merger with North Highland and West Highland colleges. We have no matters to report in respect of our work around going concern or the conclusions reached by the College.

Wider Scope

We summarise the conclusions we reached in response to our work on the wider scope dimensions below.

Financial Sustainability

The financial environment in which the College operates was already challenging, and the Covid-19 pandemic alongside the impact of the economic and geopolitical environments, including supply chain challenges, has resulted in further, significant financial pressures, and creates a risk that the College will not be able to develop viable and sustainable financial plans.

The College submitted a financial forecast return in October 2022 to the Scottish Funding Council (SFC) which outlines a cumulative underlying operating surplus position over the five years of £0.4 million, with a deficit forecast in 2022-23 only. The assumptions used were provided by the SFC in August 2022 and therefore, do not fully reflect the current economic environment.

Management continue to explore options to deliver savings and grow income, however the scale of the challenge is significant and will require collaboration both within the College and other stakeholders. The merger decision has been taken with a view to ensuring the future financial sustainability of the College, however the financial plans for the merged College show a challenging financial outlook with recurring deficits until 2027/28 and increasing liquidity shortfalls. Our assessment of red reflects the ongoing challenges facing colleges and the level of risk and uncertainty outside the College's control which could impact it's ability to deliver savings and grow commercial income

Financial Management

The College reported an adjusted operating deficit of £0.4 million, representing a decrease of £1 million compared to 2020/21. We were satisfied that the College's financial monitoring and reporting was clear and consistent throughout the year.

The College has an established budget setting and monitoring framework which includes presentation of financial updates to the Board and Finance and General Purposes Committee throughout the year. We are satisfied that the core financial management arrangements were not materially impacted as a result of Covid-19 or other external pressures with clear financial reporting continuing throughout the year.

The financial management resilience of the College has been an area of concern in recent years, but improved during 2021/22 with appointment of a Director of Finance in December 2021. While this has improved both skills and capacity within the team, the additional work in respect of merger has placed additional pressures on the team and will continue to do so moving forward. The College should ensure appropriate arrangements are implemented to safeguard continued capacity when the Director of Finance leaves the College in early 2023.

Governance & Transparency

The key features of good governance are in place at the College and have been operating effectively throughout the year. Significant progress continues to be made in addressing governance recommendations made in prior years and we are satisfied that the College is proactively managing governance actions through the rolling board development plan.

While the College experienced further turnover in Board members, a successful recruitment campaign has ensured an appropriate level of membership is now in place. Further changes have also occurred in respect of the senior management team and a further change will occur with the departure of the Director of Finance in early 2023. At a time of significant change for the College, it is essential that appropriate transition arrangements are implemented and a skills and capacity review undertaken to ensure the management team structure is appropriate.

Introduction

As a result of the impact of Covid-19, Audit Scotland agreed to extend our appointment as external auditor of the College to 2021/22.

Purpose of this report

In accordance with the Public Finance and Accountability (Scotland) Act 2000 ("the Act"), the Auditor General for Scotland appointed EY as the external auditor of Lews Castle College (the College) for the five year period 2016/17 to 2020/21. Our appointment term was extended by a further 12 months, to financial year 2021/22. We undertake our audit in accordance with the Code of Audit Practice (the Code), issued by Audit Scotland in May 2016; Auditing Standards and guidance issued by the Financial Reporting Council; relevant legislation; and other guidance issued by Audit Scotland.

This Annual Audit Report is designed to summarise our key findings and conclusions from our audit work. It is addressed to both members of the Board of Governors and the Auditor General for Scotland, and is presented to those charged with governance. This report is provided to Audit Scotland and will be published on their website.

We draw your attention to the fact that our audit was not designed to identify all matters that may be relevant to the College. Our views on internal control and governance arrangements have been based solely on the audit procedures performed in respect of the audit of the financial statements and the other procedures performed in fulfilling our Annual Audit Plan.

A key objective of our audit reporting is to add value by supporting the improvement of the use of public money. We aim to achieve this through sharing our insights from our audit work, our observations around where the College employs best practice and where practices can be improved. We use these insights to form our audit recommendations to support the College in improving its practices around financial management and control, as well as around key aspects of the wider scope dimensions of audit. Such areas we have identified are highlighted throughout this report together with our judgements and conclusions regarding arrangements, and where relevant recommendations and actions agreed with management. We also report on the progress made by management in implementing previously agreed recommendations.

Our independence

We confirm that we have undertaken client and engagement continuance procedures, which include our assessment of our continuing independence to act as external auditor. Further information is available in Appendix B.

Scope and Responsibilities

The Code sets out the responsibilities of both the College and the auditor (summarised in Appendix A). We outlined these in our Annual Audit Plan, which was presented to the College's Audit Committee in May 2022.

Our review and reassessment of materiality

We updated our assessment of materiality based on the 2021/22 financial performance. Planning materiality was increased from £0.14 million to £0.172 million.

Our Annual Audit Plan explained that our audit procedures would be performed using a materiality of £140,000. We considered whether any change to our materiality was required, including due to the College's 2021/22 financial performance. As a result of increased expenditure in year, our materiality was revised to £172,000.

Our evaluation requires professional judgement and so takes into account qualitative as well as quantitative considerations. Factors which we consider include the perspectives and expectations of users of the financial statements as well as our risk assessment as to the likelihood of material misstatements arising in the financial statements.

Overall Materiality	Tolerable Error	Nominal amount
£172,000	£86,000	£8,600
2% of the College's operating expenditure	Materiality at an individual account level	Level that we will report to committee

As outlined in our Annual Audit Plan, based on considerations around the expectations of financial statement users and qualitative factors, we apply lower materiality levels to the audit of the Remuneration Report and Related Party Transactions.

Financial statement audit

We are responsible for conducting an audit of the College's financial statements. We provide an opinion as to:

- whether they give a true and fair view of the state of affairs of the College as at 31 July 2022 and the deficit for the year then ended;
- whether they have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- whether they have been prepared in accordance with the requirements of the Further and Higher Education (Scotland) Act 1992 and directions made thereunder by the Scottish Funding Council, the Charities and Trustee Investment (Scotland) Act 2005, and regulation 14 of The Charities Accounts (Scotland) Regulations 2006 (as amended).

We also review and report on the consistency of the other information prepared and published along with the financial statements. Our findings are summarised in Section 2 of this report.

Wider Scope audit

Our responsibilities extend beyond the audit of the financial statements. The Code requires auditors to provide judgements and conclusions on the two dimensions of wider scope public audit set out in the Code which comprise the wider scope audit for small public sector bodies in Scotland. These are financial sustainability and governance and transparency. We outlined in our Annual Audit Plan that, given the associated risks around robust financial management identified in prior years, we would continue to consider this dimension as part of our work in 2021/22.

Our findings are summarised in Section 3 of this report.

Financial Statements audit

Introduction

The financial statements provide the College with an opportunity to demonstrate accountability for the resources that it controls, and report on its overall performance in the application of those resources during the year.

This section of our report summarises the audit work undertaken to support our audit opinion, including our conclusions in response to the significant and other risks identified in our Annual Audit Plan.

The plan highlighted two areas that we identified as a significant risk of material misstatement or fraud risk:

- the risk of fraud in revenue and expenditure recognition (significant risk); and
- misstatements due to fraud or error (fraud risk).

Compliance with Regulations

The draft financial statements and supporting working papers were submitted for audit in line with planned timescales.

As part of our oversight of the College's financial reporting process, we report on our consideration of the quality of working papers and supporting documentation prepared, predominantly by the finance team, to support the audit.

The financial statements were prepared in accordance with the Further and Higher Education (Scotland) Act 1992 and directions made thereunder issued by the Scottish Funding Council (SFC), the Charities and Trustees Investment (Scotland) Act and regulation 14 of The Charities Accounts (Scotland) Regulations 2006 (as amended).

Management provided draft financial statements at the start of the audit, in line with the agreed timetable. The financial statements had been updated for the new requirements as outlined in the SFC's 2021/22 Accounts Direction for colleges.

Audit Outcomes

We identified three adjusted audit differences arising from the audit which have been reflected within the financial statements. The differences related to the classification of income, the under accrual of the audit fee and a valuation adjustment in respect of the land and buildings. Our overall audit opinion is summarised on the following page.

Our audit opinion

Element of opinion	Basis of our opinion	Conclusions
Financial statements The financial statements provide a true and fair view of the state of affairs of the College at 31 July 2022 and of the deficit for the year then ended. The financial statements are prepared in accordance with the financial reporting framework	We report on the outcomes of our audit procedures to respond to our assessed risk of misstatements, including significant risks within this section of our report. We did not identify any areas of material misstatement. We are satisfied that accounting policies are appropriate and estimates are reasonable. We have considered the financial statements against the financial reporting requirements, and additional guidance issued by the SFC and Audit Scotland.	We issued an unqualified audit opinion on the 2021/22 financial statements for the College.
Going concern We are required to conclude and report on the appropriateness of the use of the going concern basis of accounting	We conduct core financial statements audit work, including management's assessment of the appropriateness of the going concern basis. Wider scope procedures, including financial forecasts are considered as part of our work on financial sustainability.	In accordance with the work reported in this report, our audit opinion is unqualified in this respect.
Other information We consider whether the other information in the financial statements is materially inconsistent with other knowledge obtained during the audit	We conduct a range of substantive procedures on the financial statements. Our conclusion draws upon: - Review of committee minutes and papers, regular discussions with management, our understanding of the College and the sector.	We are satisfied that the annual report materially meets the core requirements set out in the Accounts Direction.
Report on regularity of income and expenditure We are required to consider whether in all material respects the income and expenditure in the financial statements were incurred or applied in accordance with any applicable enactments and guidance issued by Scottish Ministers	Our procedures include: - Understanding the applicable enactments and guidance issued by the Scottish Ministers - Performed detailed testing of income and expenditure testing to ensure transactions are in line with enactments and guidance	We are satisfied that in all material respects income and expenditure are regular.
Matters prescribed by the Auditor General for Scotland Audited part of Remuneration Report has been properly prepared. The Performance Report and Annual Governance Statement are consistent with the financial statements and have been properly prepared.	We are required to report on whether the sections of the Remuneration and Staff Report, and Accountability Report have been properly prepared in accordance with the Further and Higher Education (Scotland) Act 1992 and directions made thereunder by the Scottish Funding Council.	We have no matters to report.
Matters on which we are required to report by exception	We are required to report on whether: - adequate accounting records have not been kept; or - the financial statements and the audited part of the Remuneration and Staff Report are not in agreement with the accounting records; or - we have not received all the information and explanations we require for our audit	We have no matters to report.

Significant and fraud audit risks

Risk of Fraud in expenditure recognition

As we outlined in our Annual Audit Plan, ISA (UK) 240 requires us to assume that fraud risk from income recognition is a significant risk. In the public sector, we extend our consideration to the risk of material misstatement by manipulation of expenditure.

As outlined in our audit planning report, we rebut the risk of improper recognition of SFC core grant funding because there is no judgement in respect of this income stream. With regards to expenditure, we rebut the risk of improper recognition of payroll expenditure.

Specific procedures relating to significant risks

We undertake specific, additional procedures over income and expenditure streams where we identified a significant risk, including:

- Review and test all relevant income and expenditure policies against the relevant accounting standards and SORP;
- Review, test and challenge management around any accounting estimates on income and expenditure recognition for evidence of bias;
- Develop a testing strategy to test all material income and expenditure streams;
- Test all material grant income with performance conditions to ensure income is recognised correctly in line with the outlined requirements;
- Review and perform focused testing on income and expenditure around the year end to ensure correct recognition around cut-off between financial periods;
- Perform testing for any evidence of clawback of income where conditions for entitlement have not been met;
- Review and develop a testing strategy for Covid-19 related income streams, including additional Covid-19 related grant income; and
- Assess and challenge manual adjustments or journal entries by management around the year end for evidence of management bias and evaluation of business rationale and evidence.

Our conclusions

- Our testing has not identified any material misstatements relating to revenue and expenditure recognition. We did not identify any areas of significant estimation or judgement as part of our audit work in these areas.
- We identified one income misclassification adjustment and one under-accrual of expenditure from our detailed testing of income and expenditure. Further details are set out in Appendix D.
- We have assessed the treatment of Covid-19 related income streams, including additional Covid-19 related grant income. We concur with management's accounting treatment for the revenue streams.

Risk of management override

Our Annual Audit Plan recognises that under ISA (UK) 240, management is considered to be in a unique position to perpetrate fraud in financial reporting because of its ability to manipulate accounting records directly or indirectly by overriding controls that otherwise appear to be operating effectively. We respond to this risk on every engagement.

Risk of Fraud

We considered the risk of fraud, enquired with management about their assessment of the risks of fraud and the controls to address those risks. We also updated and developed our understanding of the oversight of those charged with governance over management's processes over fraud.

Testing of Journal Entries

We tested the appropriateness of manual journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

We obtained a full list of journals posted to the general ledger during the year, and used our bespoke data analysers to identify potentially unusual journals based on posting patterns, amounts or areas of greater risk of judgement or incentive for management to adjust according to our identified risk areas for the audit. We evaluated the business rationale for any significant unusual transactions. In particular we considered:

- Journal entries made directly into the general ledger of a material nature to key accounts which are considered more likely to have an incentive to be manipulated;
- Journal entries made around year end; and
- Journals adjusting between income and expenditure accounts and capital accounts.

We identified no unusual journals which could not be explained by management or which indicated any additional risk of fraud.

Our conclusions

- We have not identified any material weaknesses in the design and implementation of controls around journal processing. We did not identify any instances of evidence of management override of controls.
- There was no disagreement during the course of the audit over any accounting treatment or disclosure and we encountered no significant difficulties in the audit.

Judgements and Estimates

ISA (UK) 540 on accounting estimates was issued in December 2019 and was applicable to the 2020/21 audit for the first time with a continuing focus in 2021/22. In particular, risk factors relevant to the public sector included the following examples for consideration by auditors:

- a very high degree of estimation uncertainty caused by the need to project forecasts far into the future, such as liabilities relating to defined benefit pension schemes; and
- areas where there may be a lack of available comparators for estimates that are unique to the public sector, such as the valuation of important public assets (such as property, plant and equipment).

Our procedures included:

- Testing management's process method, key assumptions, data;
- Testing management's process-estimation uncertainty;
- Considering evidence from events up to the report date; and
- Developing our own point estimate of the appropriate estimate.

We reviewed each significant accounting estimate for evidence of management bias as outlined above, including retrospective consideration of management's prior year estimates.

Management disclosed its assessment of the critical accounting judgements and key estimates in the financial statements.

Accounting Policies

We considered the consistency and application of accounting policies, and the overall presentation of financial information. We consider the accounting policies adopted by the College to be appropriate. There were no significant accounting practices which materially depart from what is acceptable under the Further and Higher Education SORP 2019.

Our conclusions

- We did not identify any areas of significant estimation or judgement as part of our audit work where we disagreed with management over the accounting treatment.
- There were no significant accounting practices which materially depart from what is acceptable under the College's financial reporting framework.

Other Inherent Risk Areas

Our Annual Audit Plan highlighted additional areas of inherent risk. We identified no further areas of risk as part of our audit procedures. The results of our procedures on our inherent risk areas is summarised below.

Valuation of pension assets and liabilities

The College participates in two pension schemes: the Local Government Pension Scheme (Highland Council Pension Fund) and the Scottish Teachers Superannuation Scheme (STSS). At 31 July 2022, the College's share of the local government pension scheme was originally a net asset totalling £0.859 million (2020/21: £3.48 million net liability). The actuary however had not allowed for the 2023 pension increase order which increases pensioner payments by CPI and a subsequent allowance of £0.59 million was made, reducing the net asset to £0.3 million. The pension asset has not been recognised within the College's financial statements in line with the College's accounting policy. This is on the basis that the asset is currently not anticipated to be recoverable, either through refunds or reduced contributions.

The present value of the unfunded obligation in relation to early retirements agreed in previous years was £0.673 million (2020/21: £0.684 million).

Accounting for both schemes involves significant estimation and judgement and therefore management engages an actuary to undertake the calculations on their behalf. The information disclosed is based on the FRS 102 report issued to the College by the actuary. ISAs (UK and Ireland) 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.

Our approach included:

- obtaining an actuarial report at the year end date for the scheme and considering the reasonableness and consistency of actuarial assumptions underpinning such reports in conjunction with our internal specialists;
- performing substantive testing on the verification of the pension assets. Specifically, we engage with the auditor of Highland Council Pension Fund in line with the assurance protocols laid out by Audit Scotland. We also analysed the fund's estimated asset position at 31 July 2022 from the prior year end against expectations based on equity and other market movements;
- developing our own point estimate for the College's liabilities in the Fund and comparing to the actuary's assessment;
- assessing the work of the actuaries in considering the impact of legal rulings impacting the liabilities in the fund; and
- reviewing the calculation of the College's valuation of future early retirement liabilities at 31 July 2022, including the integrity of the underlying pensioner data used by the actuary and College.

Our conclusions

- We assessed the reasonableness of the calculation of the College's share of the Fund's assets and liabilities and concluded these are consistent with our expectations. No issues were reported by the auditor of the Fund in respect of the Fund's controls or reported asset position.
- Assumptions used by the actuary and adopted by the College are considered to be generally acceptable. The sensitivities surrounding these assumptions have been correctly disclosed in the notes to the financial statements.

Valuation of Property, Plant and Equipment

The College's property, plant and equipment (PPE) portfolio totals over £17.1 million of assets (2021: £15.2 million). The valuation of these assets requires expertise and significant estimation. To meet the requirements of the accounting framework, the College values its property, plant and equipment on at least a 5 yearly cycle with regular desktop valuations in interim years.

For 2021/22, the College obtained a desktop valuation from their external valuer, recognising the impact that the high inflation environment would have on the campus valuation. The College's PPE totals £17.1 million, an increase of £1.9 million from 2020/21. This movement includes additions of £0.09 million, depreciation of £0.86 million, and a revaluation gain of £2.7 million.

Given the significance of the balance within the financial statements, the number of assumptions that are made in the valuation, we assigned an inherent risk to property, plant and equipment.

To address this risk, our work focused on the following key areas:

- Considered the work performed by the College's valuers, including the adequacy of the scope of the work performed, their professional capabilities and the results of their work.
- Sample tested key asset information used by the valuers in performing their valuation based on both size of asset value and our consideration of risk assigned to each valuation (e.g. floor plans to support valuations based on price per square metre).
- Ensured that the interim valuation has been appropriately reflected within the financial statements.
- Completed procedures designed to address the requirements of the revised ISA 540, as outlined earlier.

Our conclusions

- We did identified one adjustment related to the College's valuation of assets in 2021/22 which is set out in Appendix D.
- We concluded that management has undertaken sufficient procedures in respect of valuation of the College estate.

Going concern

Under the revised auditing standard, ISA 570, we are required to undertake greater challenge of management's assessment of going concern, including testing of the adequacy of the supporting evidence we obtained.

International Auditing Standard 570 Going Concern, as applied by Practice Note 10: *Audit of financial statements of public sector bodies in the United Kingdom*, requires auditors to undertake sufficient and appropriate audit procedures to consider whether there is a material uncertainty on going concern that requires reporting by management within the financial statements, and within the auditor's report. In accordance with the FReM, the College shall prepare its financial statements on a going concern basis unless informed by the relevant national body of the intention for dissolution without transfer of services or function to another entity.

However, under the revised auditing standard, ISA 570, we are required to undertake greater challenge of management's assessment of going concern, including testing of the adequacy of the supporting evidence we obtained. In light of the unprecedented nature of Covid-19, the ongoing cost of living crisis and inflationary pressures, we placed increased focus on management's assertion regarding the going concern basis of preparation in the financial statements, and particularly the need to report on the impact of financial pressures on the College and its financial sustainability. Management's going concern assessment and associated disclosures cover the 12 month period from the date of approval of the financial statements to December 2023.

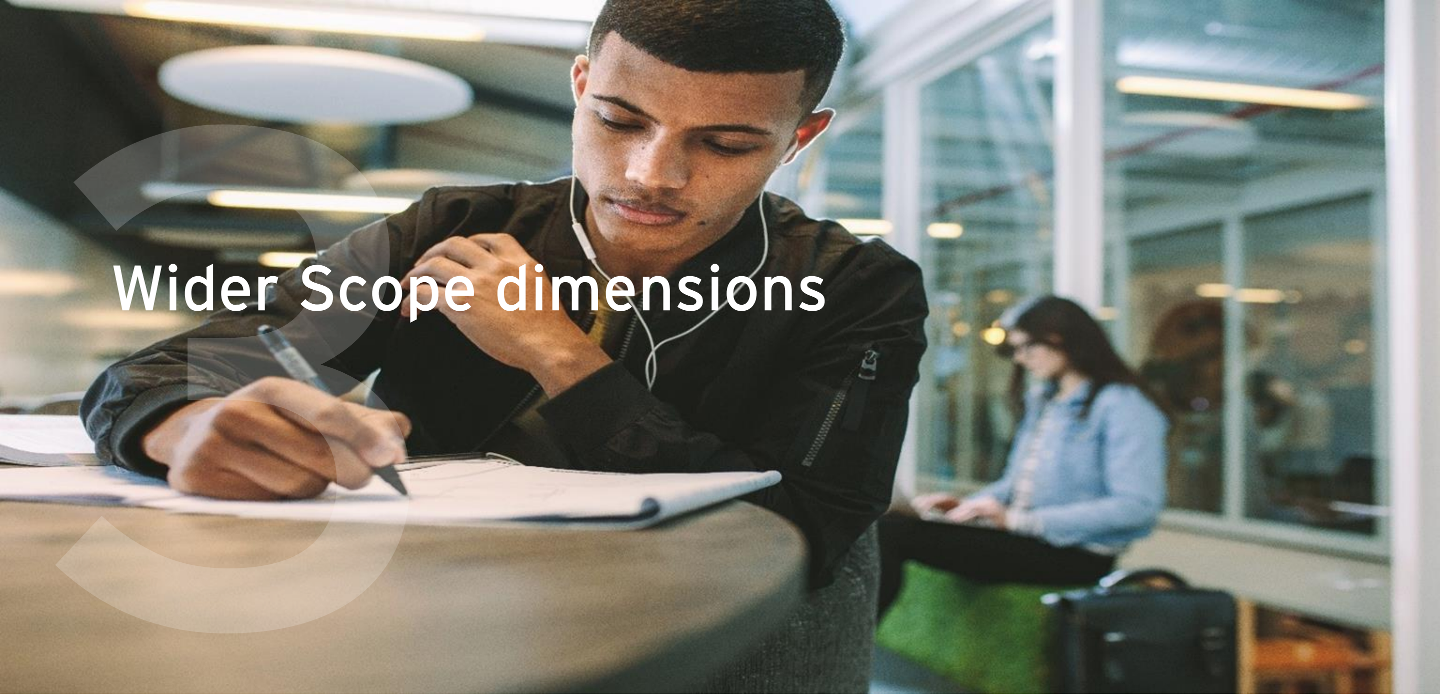
After completing its going concern assessment the College has concluded that while the scale of the financial challenge is significant, there are no material uncertainties around its going concern status. The proposed UHI merger of the North Highland, West Highland, and Lews Castle colleges has now been approved by the respective college boards and is pending final approval from the SFC and the Scottish Government. The College's long-term financial viability is now linked to the success of the merger project, which has a planned vesting date of 1 August 2023.

We have outlined our consideration of the College's financial position going forward in the Wider Scope - financial sustainability section of this report. We considered this together with management's assessment on going concern, focusing on:

- the completeness of factors in management's going concern assessment;
- the integrity and robustness of the underlying cash flow forecasts supporting future financial projections, in particular if the College projects to require financial support during the going concern assessment period;
- the completeness of disclosures in the financial statements in relation to going concern and future financial performance in line with the requirements of the SFC 2021/22 Accounts Direction; and
- an assessment of the financial model for the UHI merger project, including the reasonableness of financial assumptions included therein.

Our conclusions

- We are satisfied that it remains appropriate for the College's financial statements to be prepared on a going concern basis, in particular recognising the SFC and UHI's confirmation they would provide support in cash flow management should it be required through the going concern period. This relates to both the College and the merged College should this proceed.



Wider Scope dimensions

Introduction

We are required to reach conclusions in relation to the effectiveness and appropriateness of the College's arrangements for the wider scope audit dimensions.

We apply our professional judgement to risk assess and focus our work on each of the wider scope dimensions. For each of the dimensions, we have applied a RAG rating, which represents our assessment on the adequacy of the College's arrangements throughout the year, as well as the overall pace of improvement and future risk associated with each dimension.

- **Financial Sustainability:** Considers the medium and longer term outlook to determine if planning is effective to support service delivery.
- **Financial Management:** Considers the effectiveness of financial management arrangements, including whether there is sufficient financial capacity and resources, sound budgetary processes and whether the control environment and internal controls are operating effectively.
- **Governance and Transparency:** Considers the effectiveness of scrutiny and governance arrangements and the transparent reporting of financial and performance information.

Financial Sustainability

Our overall assessment: Red

The financial environment in which the College operates was already challenging, and the Covid-19 pandemic alongside the impact of the economic and geopolitical environments, including supply chain challenges, has resulted in further, significant financial pressures, and creates a risk that the College will not be able to develop viable and sustainable financial plans.

The College submitted a financial forecast return in October 2022 to the Scottish Funding Council (SFC) which outlines a cumulative underlying operating surplus position over the five years of £0.4 million, with a deficit forecast in 2022-23 only. The assumptions used were provided by the SFC in August 2022 and therefore, do not fully reflect the current economic environment.

Management continue to explore options to deliver savings and grow income, however the scale of the challenge is significant and will require collaboration both within the College and other stakeholders. The merger decision has been taken with a view to ensuring the future financial sustainability of the College, however the financial plans for the merged College show a challenging financial outlook with recurring deficits until 2027/28 and increasing liquidity shortfalls. Our assessment of red reflects the ongoing challenges facing colleges and the level of risk and uncertainty outside the College's control which could impact it’s ability to deliver savings and grow commercial income.

The **context for financial sustainability in the College sector**

The Scottish Government’s ‘Resource Spending Review’ was published on 31 May 2022 and sets out the high level parameters for resource spend within future Scottish budgets up to 2026-27. The plan is focused on how the Scottish Government will allocate funding to achieve their strategic outcomes and priorities:

- Tackling child poverty;
- Addressing the climate crisis;
- Securing a stronger, fairer, greener economy; and
- Delivering excellent public services.

The review sets out that there will be no increases to the Scottish Funding Council budget, who in turn provide funding to the College sector. While the spending review is not a finalised budget, it provides the sector with an indication of likely funding allocations. Colleges Scotland estimates that Colleges are facing a real terms budget cut of £51.9 million in 2022/23.

The Scottish Parliament’s Finance and Public Administration Committee, as part of its pre-budget setting scrutiny for 2023/24, launched a call for views on Scotland’s public finances and the impact of both the cost of living crisis and public service reform in August 2022. This consultation has included seeking views on the priorities within the Resource Spending Review and how the Scottish Government should respond to inflationary pressures and the cost of living crisis within its 2023/24 budget.

The Covid-19 pandemic led to increased reliance on SFC income across the College sector, which will create further challenges if flat cash settlements occur in future financial years.

The Scottish Funding Council published their report, 'Financial Sustainability of Colleges and Universities in Scotland' in March 2022. This paper set out that the sector had managed the impact of Covid-19 more positively than originally anticipated however the longer term financial sustainability remains challenging. The sector collectively was expected to deliver a combined surplus of £16.7 million for 2020/21 with two colleges expected to report adjusted operating deficits.

However, colleges remain heavily dependent on SFC grant funding with this income accounting for 79% of total income at a sector level in 2020/21. This illustrates the reliance that colleges have on funding which is expected to reduce in real terms moving forward. For colleges to remain financially sustainable, growth in other income as well as reductions in their cost base will be required. The continued impact of Covid-19 has resulted in challenges for colleges to achieve their student recruitment and retention targets as well as other income targets.

The Scottish Government and SFC are starting to take forward the recommendations within the SFC review on the provision and sustainability of further and higher education and research across Scotland, published in June 2021. The current financial outlook stresses the importance of the recommendations within this review being implemented as early as possible. A further update is expected in 2023 when the Scottish Government is due to set out the future role of the college and university sectors.

The turbulent financial environment creates significant challenges for college's to be able to prepare robust financial plans.

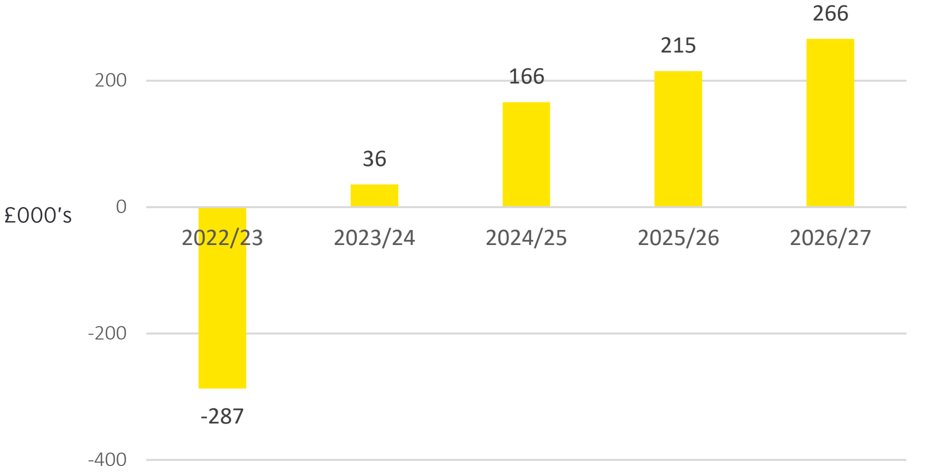
Medium term financial forecasting

The College prepared a five-year financial forecast for the period 2022 to 2027 and submitted this to the SFC in the form of the template Financial Forecast Return ('FFR'). The forecast is based on assumptions provided by the SFC in addition to College specific assumptions for areas such as other income and staff numbers. The assumptions were subject to scrutiny by, and approval from, the College's senior management team and Finance and General Purposes Committee.

The assumptions provided by the SFC were issued in August 2022 and therefore are not fully reflective of the current economic environment given the pace of change in areas such as inflation for both pay and non-pay costs. For example, the FFR assumes application of Scottish Government Public Sector Pay Policy with 2% pay awards assumed from 2023-24 onwards. The FFR also forecasts growing non-SFC income with the College currently undertaking an exercise to audit the estate and identify opportunities to generate rental income having identified a need for office space within the local area.

As set out in Exhibit 1, the College forecasts another significant adjusted operating deficit in 2022/23 before moving to a surplus position for future financial periods.

Exhibit 1: The College's FFR shows an improving financial position, however there are significant risks to the College's ability to deliver this position.



Source: Lews Castle College Financial Forecast Return, October 2022

The College's forecasts contains significant risks, particularly due to the challenging external environment with pressures on higher education student numbers, flat cash settlements for SFC funding and inflationary pressures in respect of pay and non-pay costs. Given this environment, delivery of savings and income growth will be particularly challenging and will require close monitoring and management.

The College has identified a number of key risks in respect of the FFR:

- Reductions in staff numbers will have a significant impact on the curriculum the College is able to offer and delivery across the Outer Hebrides;
- Reductions in funding for capital investment and maintenance could have a detrimental effect on the physical state of buildings and could impact the College's ability to manage energy costs and deliver the net zero agenda;
- Ability to invest in technology is likely to be reduced which may limit potential commercial income from the estate as well as impacting the student learning experience; and
- Ability to maintain student numbers without risk of clawback.

UHI merger

The College commenced exploration of a potential merger with West Highland (WHC) and North Highland (NHC) colleges in 2021. Following an extensive consultation with the college's stakeholders, internal and external, the proposed merger was approved by the respective college Boards in November 2022 and, subject to SFC and Scottish Government approval, will go forward with a planned vesting date of 1 August 2023. Endorsement of the merger has been given by UHI as Regional Strategic Body.

A Partnership Board was established in September 2021 to formally explore the option of merger. Under current proposals, in late 2022, the Partnership Board will become the Transition Board with new members appointed from December 2022 to March 2023. The Transition Board will become the new Board of Management on vesting date and has delegated authority to approve Year 1 budgets for the merged college.

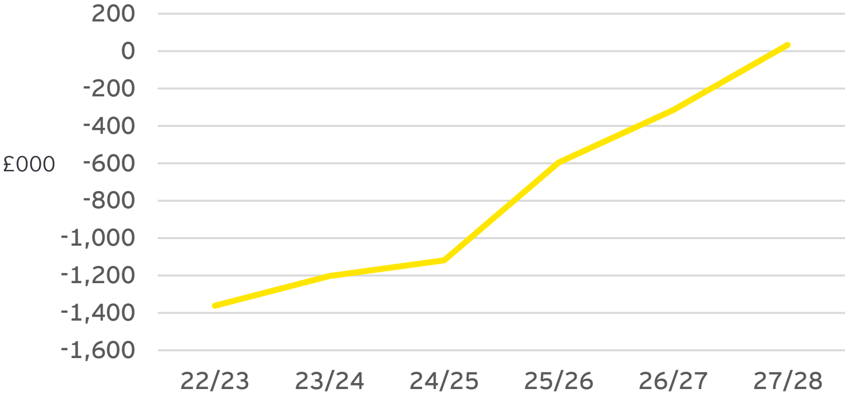
The business case sets out a robust governance framework for the merger process and newly formed entity, and the new framework will be formed in line with the Code of Good Governance. However, we note that a merged risk register has been developed which notes a high risk in relation to staff capacity in delivering the merger on time.

A full business case was presented to the college Boards alongside detailed financial projections for the merged entity. A due diligence exercise was undertaken by the Partnership Board's external advisers, Azets, which included consideration of the merged College's financial plan.

There are particular challenges in preparing a robust financial plan in the current economic environment and the plan acknowledges that future projections are likely to be less reliable. Further complexities arise from the different legal status of the different entities merging (WHC being assigned and the other colleges being incorporated). As illustrated by Exhibit 2, the merged College only forecasts achieving breakeven by 2027/28, within a period that the plan acknowledges projections are likely to be less reliable.

Significant work is required by the Partnership Board to ensure robust and realistic financial plans are in place for the merged College. The financial business case should be subject to regular review to ensure it accurately reflects the current economic environment and contains accurate assumptions.

Exhibit 2: The merged entity's financial model predicts a break-even position will not be achieved until 2027/28



Source: UHI merger proposal and business case

Some of the assumptions applied in the merger financial model may be too optimistic, particularly around expected costs.

Despite the robust governance arrangements in place, there are concerns over the capacity of staff to deliver the merger by the planned vesting date.

Review of the financial model identified a number of areas for improvement, largely relating to the reasonableness of financial assumptions. A number of the recommendations from the external advisers were incorporated into the final model presented to the Boards, but concerns remain over the accuracy of medium to long-term financial projections. These include:

- Fixed asset projections show a flat £0.7 million in additions which does not incorporate the planned new STEM facility or plans for campus redevelopment. Harmonisation of the accounting treatment for valuing fixed assets will be required.
- The pension liability is predicted to stay relatively static across the lifetime of the plan. However, WHC are in the process of gaining admission to the LGPS and the liability is expected to increase as a result and no increases to employer contribution rates have been assumed.
- The model assumes inflation on overheads at 4% per annum initially and then 2% from 2024/25. Forecast deficits are therefore likely to increase resulting in additional savings requirements.

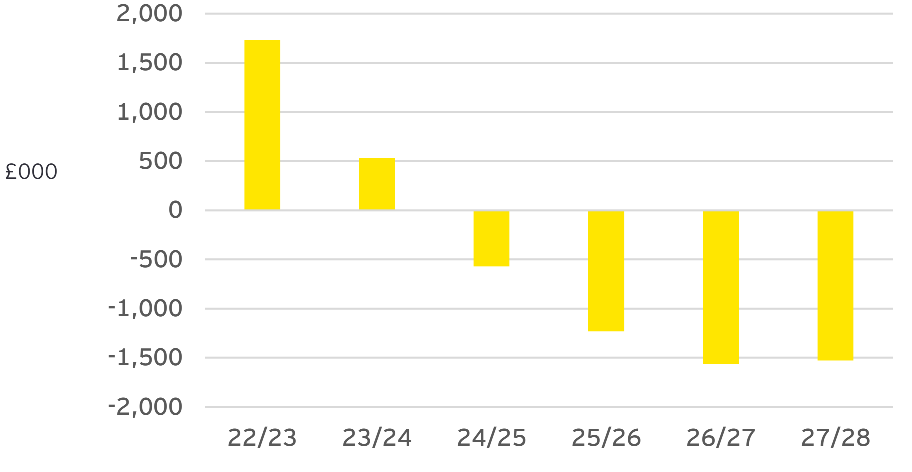
It is hoped that the merger will allow the colleges to able to combine their resources to attract talent and a wider pool of students, achieve savings and efficiencies, and reduce competition for students across the region. A key element of anticipated savings is an approximate £1 million per annum saved through voluntary severance. The colleges are aware that the merger will not change the challenging financial landscape facing the sector and therefore further fundamental changes are likely to be required in how services are delivered.

This is demonstrated within the financial model which predicts the first break-even year for the new entity to be 2027/28. In addition, the bank balance is predicted to deteriorate across the life of the projected cashflows, decreasing to minus £1.5 million by FY 2027/28. It is therefore vital that the merged entity is able to successfully diversify its revenue streams and reduce its cost base in order to achieve long-term financial viability.

Recommendation 1: The college Boards, including the Partnership Board's should review and update the merged entities financial plan on a regular basis to ensure appropriate mitigating actions can be taken to address any shortfalls in cash and reduce any increases to forecast deficits.

While the merged College forecasts an improving adjusted operation position, the cashflow forecasts show an increasing liquidity shortfall as illustrated within Exhibit 3. The business case recognises that cash support will likely be required from the Regional Strategic Body.

Exhibit 3: Challenges across the sector such as flat funding allocations are reflected by the £1.5 million cash deficit forecasted in the financial model by 2027/28



Source: UHI merger proposal and business case

Going concern cash flow forecasting

We outlined our work in respect of going concern earlier in this report. While the College has prepared its financial statements on a going concern basis as required by the FReM for a public body, it is required to consider its ability to meet liabilities as they fall due over the going concern assessment period to December 2023, being 12 months from the approval date for the financial statements.

As part of its financial forecasting arrangements the College has forecast its cash flow during this period, including testing a number of sensitivities which may be impacted by the current uncertainty around the 2022/23 and 2023/24 academic years as a result of pay and other inflationary pressures. As part of the FFR submission, the College has projected cashflows to 31 July 2023 and 31 July 2024 with a closing balance of £0.1 million. The College required an advance of funding from the Regional Strategic Body in July 2022, and it is currently expected that further advances in 2022/23 are likely to support the College's liquidity.

The College is continuing to engage with UHI and the SFC regarding their financial outlook and seek financial support as required. As previously noted, the College's decision to proceed with merger with North Highland and West Highland colleges has been taken with a view to securing a financially sustainable position moving forward, albeit that the outlook for the merged College will be challenging in the short-term.

Financial Management

Our overall assessment: Green

The College reported an adjusted operating deficit of £0.4 million, representing a decrease of £1 million compared to 2020/21. We were satisfied that the College's financial monitoring and reporting was clear and consistent throughout the year.

The College has an established budget setting and monitoring framework which includes presentation of financial updates to the Board and Finance and General Purposes Committee throughout the year. We are satisfied that the core financial management arrangements were not materially impacted as a result of Covid-19 or other external pressures with clear financial reporting continuing throughout the year.

The financial management resilience of the College has been an area of concern in recent years, but improved during 2021/22 with appointment of a Director of Finance in December 2021. While this has improved both skills and capacity within the team, the additional work in respect of merger has placed additional pressures on the team and will continue to do so moving forward. The College should ensure appropriate arrangements are implemented to safeguard continued capacity when the Director of Finance leaves the College in early 2023.

Financial performance and monitoring

The College reported a deficit of £1.6 million for the year (2020/21: £0.2 million). Following an actuarial gain of £4.9 million and a revaluation gain of £3.4 million, the College reported total comprehensive income of £8.3 million (2020/21: £1.4 million). The College had an operating deficit after removal of non-cash accounting adjustments (relating to pension and capital accounting) of £0.4 million (2020/21: £0.6 million surplus).

2021/22 was the second full financial year that the College had fully operated in the context of Covid-19 which continues to have an impact on student recruitment, retention and satisfaction. In addition, the ongoing economic and geopolitical uncertainty, including the cost of living crisis, has led to further financial challenges for the College. The College's approved financial sustainability plan set out that deficits would occur in both 2021/22 and 2022/23 before the College returned to surplus in 2023/24. The financial outturn in 2021/22 is therefore in line with plan.

In line with previous years, the College's financial performance was monitored throughout the year by management, the Finance and General Purposes Committee and the Board. There is evidence of financial monitoring, reporting and planning by the Board and Finance and General Purposes Committee through the financial year, up to the approval of the 2022/23 budget.

Throughout 2021/22 management reported budget pressures and variances through its management accounting. These were significant in the year, however we are satisfied these related to the impact of Covid-19 and other pay and non-pay inflation pressures on College operations and additional funding awarded late in the financial year.

Liquidity

Management's cash flow forecasts for 2021/22 set out a challenging outlook and required careful management throughout the year. As a result of the timing of both severance payments and the late pay award finalisation, the College required a cash advance of £0.65 million from the Regional Strategic Body in July 2022. We are satisfied that this advance was requested in a timely manner, subject to the appropriate approvals and has been accounted for appropriately.

Systems of internal control

Within the Annual Governance Statement, the College concluded that they have obtained assurance that the system of internal control was operating effectively during the year with no exceptions or issues identified. Through our audit of the financial statements, we consider the design and implementation of key controls related to areas of significant risk to the financial statements. This work has included documenting the key internal financial controls and performing walkthroughs to ensure controls are implemented as designed.

We undertook an initial assessment of the financial control environment as part of our planning work in May 2022, and updated our understanding as part of the yearend audit. Our work did not identify any significant weaknesses in the College's systems of internal control. In particular, we have not identified any significant changes to the design and implementation of controls as a result of the impact of hybrid working arrangements.

Finance working arrangements and management capacity

In the prior years, we encountered delays in receiving financial statements and underlying supporting schedules. We recognised that this was largely due to the additional pressures on the finance team and the impact of working from home on a small team with limited contingency and less sophisticated online systems compared to some institutions.

Significant improvements were noted during 2021/22. Throughout the year, we regularly engaged with management regarding the timetable for the financial statement preparation and audit. The implementation of a hybrid audit model resulted in efficiencies in provision of audit information requests.

In particular, the appointment of a new Director of Finance in December 2021 has provided additional management capacity and support to the finance team. The additional work in respect of merger has placed additional pressures on the team and will continue to do so moving forward. The Director of Finance leaves the College in early 2023, with the College progressing with plans to ensure appropriate transition arrangements are in place to ensure appropriate capacity remains within both the management and finance teams.

National Fraud Initiative (NFI)

NFI is a counter-fraud exercise co-ordinated by Audit Scotland and overseen by the Cabinet Office to identify fraud and error. The NFI exercise produces data matches by comparing a range of information held on public bodies' systems to identify potential fraud or error.

The College received matches for investigation in January 2021 and results of the investigation were recorded on the NFI system. We noted progress continued to be made by the College and that we had no matters to report.

Governance and Transparency

Our overall assessment: Green

The key features of good governance are in place at the College and have been operating effectively throughout the year. Significant progress continues to be made in addressing governance recommendations made in prior years and we are satisfied that the College is proactively managing governance actions through the rolling board development plan.

While the College experienced further turnover in Board members, a successful recruitment campaign has ensured an appropriate level of membership is now in place. Further changes have also occurred in respect of the senior management team and a further change will occur with the departure of the Director of Finance in early 2023. At a time of significant change for the College, it is essential that appropriate transition arrangements are implemented and a skills and capacity review undertaken to ensure the management team structure is appropriate.

Annual Governance Statement

The College has demonstrated through the year that it has the key requirements for good governance. The key aspects of governance arrangements require to be disclosed in the Annual Governance Statement within the financial statements. We reviewed the governance statement against the requirements outlined in the SFC's 2021/22 Accounts Direction and our understanding of the College up to 31 July 2022.

This includes the requirements to conclude on the College's compliance with the 2016 Code of Good Governance for Scotland's Colleges, or to explain any areas of non-compliance. Our consideration of the governance statement has included:

- Ensuring that the College has met all requirements of the SFC's 2021/22 Accounts Direction;
- Ensuring that the content of the statement is consistent with our understanding of the College's governance arrangements and any issues identified during the year; and
- Ensuring that the College has performed a self-assessment of compliance with the Code of Good Governance for Scotland's Colleges and that this assessment is reflected in the statement.

We reviewed the initial draft of the Annual Governance Statement by management and noted that management had taken account of prior year feedback, including in relation to ensuring disclosure around the status of planned actions from prior years. While we have provided comments in relation to the presentation of the governance statement, we have compared the statement against the required guidance and we were satisfied that it was consistent with both the governance framework, key findings from relevant audit activity and management's assessment of its own compliance with the Code of Good Governance for Scotland's colleges.

Governance Arrangements

Like all other public bodies in Scotland, the College moved to revised governance arrangements at the beginning of the UK lockdown period. Since March 2020, all Board and committee meetings continued as scheduled via remote working arrangements, and all relevant business continued to be considered as required.

Board Membership

Under legislation, college Board's of Management are required to have between 13 and 18 members. The Board had, in June 2021, just 11 members. This resulted in some committee meetings being either cancelled or rescheduled due to the lack of a quorum. The College temporarily dissolved the Quality, Learning and Teaching Committee to enable members to join the Audit Committee and Finance and General Purposes Committee. Matters reserved for this committee were submitted to the Board directly. It has since been determined that this arrangement is working well and there are currently no plans to re-introduce this committee.

A recruitment campaign undertaken in Spring 2022 which attracted the highest number of applicants experienced by the Board and resulted in five new non-executive appointments. Further changes in membership have occurred throughout 2022. The significant number of changes in membership creates a risk that there will be loss of knowledge on the Board which may impact the robustness of governance arrangements at a crucial time for the College. We are satisfied that management responded well to this risk and has ensured appropriate training and support is available to members to allow them to fulfil their roles effectively.

Enquiries of those charged with governance

In line with previous years, we formally wrote to the Chair of the Audit Committee to make inquiries around the College's governance arrangements, including consideration by those charged with governance in respect of compliance with laws and regulations; identification of fraud, error and breaches of internal control; and material litigation and claims. No matters were brought to our attention.

Internal audit's opinion for the year was based on its agreed audit plan for the year, as approved by the Audit Committee. For 2021/22, the internal auditor's opinion notes that, 'TIAA is satisfied that, for the areas reviewed during the year, Lews Castle College has reasonable and effective risk management, control and governance processes in place.'

Progress around governance improvements

In 2019/20, we noted concerns around the pace of improvement in addressing a number of outstanding actions in respect of governance. Significant progress has been made with all governance actions now included within the Board's rolling development plan which is regularly reported to the Board and supporting committees as appropriate. We are satisfied that improvements have continued to be made during 2021/22 and that the College has an appropriate mechanism for routine monitoring.

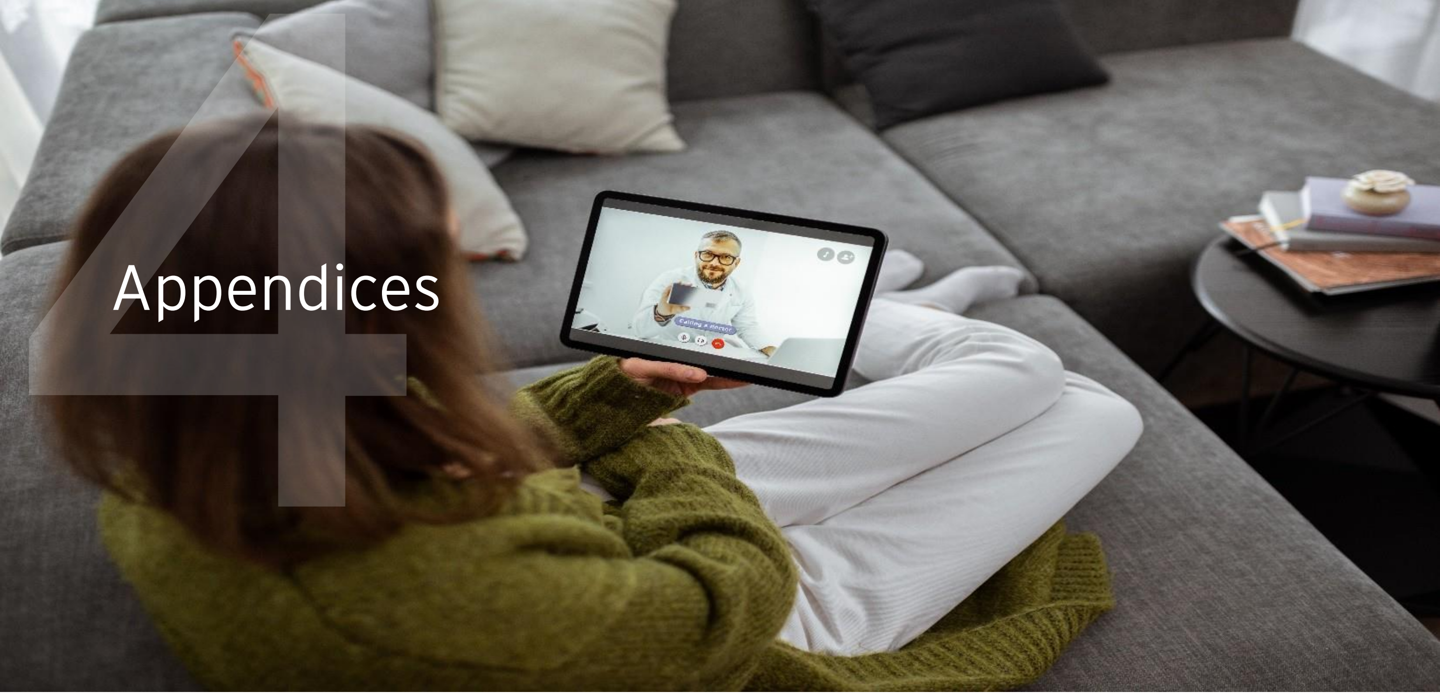
Voluntary Severance Scheme

During 2021/22, eight individuals left the College under voluntary severance agreements or redundancy. We confirmed that the College had followed the procedures outlined within SFC's guidance for seeking approval for severance schemes and settlement agreements.

Changes in the senior management team has resulted in reduced capacity at a time of significant change for both the College and Sector. The College should ensure that the management team continues to have sufficient capacity and skills and that appropriate transition arrangements are implemented.

Senior Management Team changes

In recent years, there has been a number of changes to the senior management team at the College. The College's interim principal left in September 2022 with the depute principal taking over as interim Principal. Further changes will occur in early 2023 with the departure of the Director of Finance. While we note that to date, appropriate transition arrangements have been implemented where changes have occurred, there is a risk that sufficient capacity, skills and experience will not be in place at a time of significant change for the College. Transition plans are being implemented and the College continues to engage with UHI partners for additional support as required.



4 Appendices

A – Code of Audit Practice: responsibilities

B – Independence and audit quality

C – Required communications with the Audit Committee

D – Adjusted errors identified during the audit

E – Current and Prior Year Action Plan

E – Timing and deliverables of the audit

Appendix A: Code of Audit Practice Responsibilities

Audited Body's Responsibilities

Corporate Governance	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, risk and governance committees or equivalent) in monitoring these arrangements.
Financial Statements and related reports	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 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. • Management, with the oversight of those charged with governance, should communicate clearly and concisely relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. 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 / prevention and detection of fraud and error	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.
Standards of conduct / prevention and detection of fraud and error	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	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 B: Independence and audit quality

Professional ethical standards, and the Terms of our Appointment, require us to communicate all significant facts and matters that have a bearing on EY's objectivity and independence as auditor of the College.

Matters that we are required to communicate

The FRC Ethical Standard requires that we provide details of all relationships between Ernst & Young (EY), its directors and senior management and affiliates, and you, including all services provided by us and our network to you, and other services provided to other known connected parties that we consider may reasonably be thought to bear on our integrity or objectivity, including those that could compromise independence and the related safeguards that are in place and why they address the threats.

There are no relationships from 1 August 2021 to the date of this report, which we consider may reasonably be thought to bear on our independence and objectivity.

Confirmations

We are not aware of any inconsistencies between the College's policy for the supply of non audit services and FRC Ethical Standard. We are not aware of any apparent breach of that policy.

We confirm that, in our professional judgment, Ernst & Young is independent, our integrity and objectivity is not compromised and we have complied with the FRC Ethical Standard.

We confirm that your engagement team (partners, senior managers and managers and all others involved with the audit) and others within the firm, the firm and network firms have complied with relevant ethical requirements regarding independence.

Audit Fees

	2021/22	2020/21
Component of fee:		
Total agreed auditor remuneration	£21,380	£20,930
Additional audit procedures (see below)	£10,300	£8,400
Audit Scotland fixed charges:		
Pooled costs	£1,190	£1,350
Audit support costs	£1,070	£880
Total fee	£33,940	£31,510

The expected fee for each body, set by Audit Scotland, assumes that it has sound governance arrangements in place and operating effectively throughout the year, prepares comprehensive and accurate draft financial statements and meets the agreed timetable for the audit. It also assumes there is no major change in respect of the scope of work in the year.

Through the 2021/22 audit cycle we have discussed with management areas of the audit which required additional work beyond that usually expected for the College. The fee variation in 2021/22 of £10,300 reflected additional work required in respect of our wider scope work, the follow up work required from a number of outstanding areas of focus in prior years, the requirement to reduce materiality on our audit testing and additional procedures in respect of the merger including consultation requirements. For these areas we have agreed the fee noted in the table above with management and Audit Scotland, based on the additional time required at the contracted Audit Scotland rates.

Matters that we are required to communicate	International Standard on Quality Control (UK and Ireland) 1 (ISQC1) requires that a system of quality control is established, as part of financial audit procedures, to provide reasonable assurance that professional standards and regulatory and legal requirements are being complied with and that the independent auditor's report or opinion is appropriate in the circumstances. The EY 2022 UK Transparency Report can be accessed on our website at EY UK 2022 Transparency Report | EY UK. This material is published to provide a timely and relevant source of information about EY in general, and our audit business in particular. This includes our Audit Quality Report. The disclosures are extensive. For example, they explain our outlook and how we are structured and governed, including the role of our Independent Non-Executives and how we apply the requirements of the UK's Audit Firm Governance Code. We refer to the quality of our audits and our commitment to recruiting, developing and diversifying our people and talent pool. We also explain how we manage our risks and remain innovative and technologically advanced in what we do and how we do it. Maintaining high audit quality across all of our engagements is of paramount importance to us. Our transformational Audit Quality Programme continues and is a part of the global EY Sustainable Audit Quality Programme (SAQ). Our Audit Quality Board (AQB) continues to oversee all matters relating to audit quality and sets the agenda for the Audit Quality programme. The AQB meets monthly and also holds an annual strategy session. The AQB reports to the EY UK Board. The AQB receives regular updates on regulatory matters, results of internal and external reviews, results of root cause analysis, resourcing, the SAQ programme and pursuit approvals, as well as a comprehensive dashboard on quality measures. Our Audit Quality Support Team (AQST), which started within the SAQ programme, reviews 40 to 50 audits each audit cycle providing challenge and guidance to the engagement teams. These are in-depth reviews carried out by experienced auditors independent of the audit team. AQST reviews enhance the quality of both the audit under review and other audits on which team members apply the lessons learned. The AQST has now become a business-as-usual function.

Audit Quality Framework / Annual Audit Quality Report	Audit Scotland's Appointments and Assurance Team are responsible for applying the new Audit Quality Framework across all financial audits and performance and Best Value audits. This covers the quality of audit work undertaken by Audit Scotland staff and appointed firms. The team are independent of audit delivery and provide assurance on audit quality to the Auditor General and the Accounts Commission. We support Audit Scotland in their commitment to reporting on audit quality through responding to requests for information and providing the results of internal quality reviews undertaken in respect of relevant public sector audits in Scotland. The most recent audit quality report which covers our work at the College since appointment can be found at: Quality of public audit in Scotland annual report 2021/22 (audit-scotland.gov.uk)

Appendix C: Required communications

Required communication	Our reporting to you
Terms of engagement / Our responsibilities Confirmation by the audit, risk and governance committee of acceptance of terms of engagement as written in the engagement letter signed by both parties. Our responsibilities are as set out in our engagement letter.	Audit Scotland Terms of Appointment letter – audit to be undertaken in accordance with the Code of Audit Practice
Planning and audit approach Communication of the planned scope and timing of the audit, any limitations and the significant risks identified. When communicating key audit matters this includes the most significant risks of material misstatement (whether or not due to fraud) including those that have the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team.	Annual Audit Plan
Significant findings from the audit ▸ Our view about the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures ▸ Significant difficulties, if any, encountered during the audit ▸ Significant matters, if any, arising from the audit that were discussed with management ▸ Written representations that we are seeking ▸ Expected modifications to the audit report ▸ Other matters if any, significant to the oversight of the financial reporting process	Annual Audit Plan Annual Audit Report
Going concern Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including: ▸ Whether the events or conditions constitute a material uncertainty ▸ Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements ▸ The adequacy of related disclosures in the financial statements	Annual Audit Report
Misstatements ▸ Uncorrected misstatements and their effect on our audit opinion, unless prohibited by law or regulation ▸ The effect of uncorrected misstatements related to prior periods ▸ A request that any uncorrected misstatement be corrected ▸ Corrected misstatements that are significant ▸ Material misstatements corrected by management	Annual Audit Report
Fraud ▸ Enquiries of the audit, risk and governance committee to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity ▸ Any fraud that we have identified or information we have obtained that indicates that a fraud may exist ▸ A discussion of any other matters related to fraud	Annual Audit Report

Required communication	Our reporting to you
Related parties Significant matters arising during the audit in connection with the entity's related parties including, when applicable: ▶ Non-disclosure by management ▶ Inappropriate authorisation and approval of transactions ▶ Disagreement over disclosures ▶ Non-compliance with laws and regulations ▶ Difficulty in identifying the party that ultimately controls the entity	No significant matters have been identified.
Independence Communication of all significant facts and matters that bear on EY's, and all individuals involved in the audit, objectivity and independence Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as: ▶ The principal threats ▶ Safeguards adopted and their effectiveness ▶ An overall assessment of threats and safeguards ▶ Information about the general policies and process within the firm to maintain objectivity and independence	Annual Audit Plan This Annual Audit Report – Appendix B
Internal controls Significant deficiencies in internal controls identified during the audit	This Annual Audit Report – no significant deficiencies reported
Subsequent events Where appropriate, asking the audit, risk and governance committee whether any subsequent events have occurred that might affect the financial statements.	We have asked management and those charged with governance. We have no matters to report.
Material inconsistencies Material inconsistencies or misstatements of fact identified in other information which management has refused to revise	This Annual Audit Report
Consideration of laws and regulations ▶ Audit findings regarding non-compliance where the non-compliance is material and believed to be intentional. This communication is subject to compliance with legislation on tipping off ▶ Enquiry of the audit, risk and governance committee into possible instances of non-compliance with laws and regulations that may have a material effect on the financial statements and that the Committee may be aware of	Annual Audit Report or as occurring if material.

Appendix D: Adjusted errors identified during the audit

This appendix sets out the significant adjustments processed as part of finalisation of the financial statements. There were no unadjusted audit differences identified above our reporting threshold.

[Adjusted] differences				
No.	**Description**	**Income and Expenditure Impact / £000's**	**Other Comprehensive Income/ £'000s**	**Balance Sheet Impact / £000's**
1	*SFC Income reclassification*	Dr Other Income £106 Cr SFC Income £106		
2	*Audit fee accrual adjustment*	Dr Expenditure £16		Cr Accruals £16
3	*Valuation adjustment*		Cr Revaluation Gain £732	Dr PPE £732

Appendix E: Action Plan, including an update on prior year recommendations

This action plan summarises specific recommendations included within the 2021 Lews Castle College Annual Audit Report and the latest status in respect of management's agreed actions.

Classification of recommendations		
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.	**Grade 2:** Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	**Grade 3:** Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.

No.	Findings and recommendation	Management response / Implementation timeframe
1	The College Boards, including the Partnership Board's should review and update the merged entities financial plan on a regular basis to ensure appropriate mitigating actions can be taken to address any shortfalls in cash and reduce any increases to forecast deficits. *Grade 1*	**Response:** For Financial Year 2022/23, each of the three merging entities will operate independently in terms of budgetary control, cashflow management, etc. Financial reporting (Year to date and forecast to year end) will continue through established reporting procedures to Boards and relevant sub committees (this will be the case for the other 2 entities also), in addition UHI Outer Hebrides senior management have monthly meetings with the Director of Finance at UHI Executive Office to ensure the RSB is up to date with our financial position and cashflow / liquidity issues are covered as part of these discussions. Out with the continued procedures around financial management and reporting for 2022/23, looking ahead for 2023/24 when the merger college shall vest, there is weekly finance workstream meetings with representatives from each of the three colleges in attendance. These meetings are focused now on preparatory work required for vesting, and a schedule of works and priorities is being developed. For example, procurement and planning for a single accounting system is being advanced at present, budget setting for the merged college will take place in Q3/4 of 2022/23 and other operational matters. The workstream is also responsible for overseeing the financial plan and amending according to any significant changes, these changes will be reported appropriately to Partnership Board. **Responsible officer**: Interim Principal/Senior Financial Controller **Implementation date:** Commenced/Ongoing through 2022/23

Prior year recommendations follow up			
	Findings and recommendation	**Original Management response**	**Update on status**
1	The FE/HE SORP 2019 edition became effective for the year ended 31 July 2020. We considered any required changes in conjunction with our review of the financial statements and concluded none were required. As part of our review of the accounts, we noted areas of disclosure which needed updated to reflect the requirements of the SFC accounts direction. Management should ensure a detailed review of future accounting standards and disclosure requirements is undertaken on a timely basis. *Grade 2*	Response: Management will review any planned changes to the financial reporting requirements in advance of preparing the annual financial statements. Responsible officer: Head of Finance Implementation date: Ongoing	Closed. The 2021/22 financial statements were of a higher quality with evidence of management's review of the SFC accounts direction and other supporting guidance.

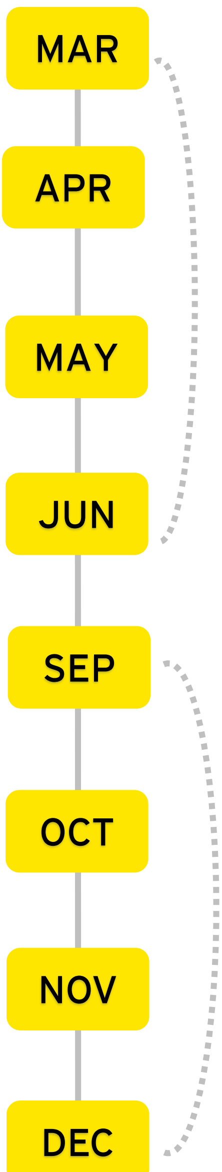
No.	Findings and recommendation	Original Management response	Update on status
2	While the College has prepared its financial statements on a going concern basis as required by the FReM for a public body, it is required to consider its ability to meet liabilities as they fall due over the going concern assessment period, being 12 months from the approval of the financial statements. We outlined in previous years that while the FFR submission process itself is robust, the College does not explicitly align its financial forecasts to its overall strategic or operational objectives. Financial forecasting, and the impact of required financial decisions, should be formally aligned to the College's strategic planning going forward. Management should ensure that its cash flow position and forecast for at least the next 12 months is subject to rigorous review on a routine basis. Any uncertainty around the College being able to support itself should be reported to the Regional Strategic Board and Scottish Funding Council to discuss support options. Grade 1	Response: Agreed. The College will align financial forecasts to the wider strategic planning in the future. A 12-month cashflow forecast was prepared with the financial statements and there was no indication that there would be a shortage of cash in the upcoming financial year. Responsible officer: College Board of Management, coordinated by the Principal Implementation date: Through to October 2021	Ongoing. Significant financial challenges lie ahead for the College (both in its current form or as part of the merged entity) and both the FFR and going concern cashflow outline that the College (in merged and single entity form) may run out or become close to running out of cash without further support. Further planning is required to ensure the College's sustainability in either merged or in its current form. In the ever-changing external environment, regular and proactive reviews of financial plans will be required.

No.	Findings and recommendation	Original Management response	Update on status
3	We have noted through this report that the timeframe for the preparation of the financial statements, and the underlying supporting schedules, has been significantly delayed this year compared to previous years. The additional time required this year clearly reflects the extent of additional pressures on the finance team, and the impact of working from home on a small team with limited contingency and less sophisticated online systems compared to some institutions. The longer working from home arrangements continue under Covid-19, the greater the risk that financial management arrangements, including key controls, start to be impacted. The head of finance, college management and the Finance Committee, should keep the financial management resilience of the College under close scrutiny through the remainder of working from home period. Grade 1	Response: Agreed. Management will keep the financial management arrangements and in particular progress against key deliverables under scrutiny through the rest of 2021. The College have seconded a Finance Director on a part time basis from another UHI partner and intend to appoint a permanent director in the 2021/22 academic year. Responsible officer: College Board of Management, coordinated by the Principal Implementation date: Throughout 2021 ongoing	Ongoing. While the recruitment of a Director of Finance in December 2021 eased some pressure within the finance team, the departure of the current Director of Finance in early 2023 will create further challenges. Recruitment and transition plans are underway to ensure appropriate skills and capacity remain within the finance and wider management team.
4	The College should ensure that Board member composition is subject to regular review and that recruitment exercises are undertaken in advance of need to ensure that there is minimal impact on governance activity from changes in members. *Grade 1*	Response: Regular and planned reviews of board membership size and composition will be carried out and recruitment plans implemented as required. Responsible officer: Board Secretary Implementation date: Ongoing	Closed. Recruitment was undertaken to ensure appropriate membership levels.

No.	Findings and recommendation	Original Management response	Update on status
5	Progress around improving governance arrangements has been limited in 2020, resulting from changes in key personnel and then the impact of the Covid-19 pandemic on the College Board's priorities. At the time of drafting this report a number of significant matters remain outstanding. The areas for improvement in governance arrangements should be addressed as a priority in 2021 as soon as capacity allows. Capacity going forward should be kept under ongoing review. Grade 1	Response: Agreed. The Board Secretary will establish a baseline setting out areas for improvement in consultation with the External Auditors. A Development Plan – Governance – 2021/22 with timelines, proposed actions and setting out ownership to address matters outstanding will be submitted to the Board in June 2021. Responsible Officer: Board Secretary Implementation timeframe: Report to Board – 22 June 2021. Capacity will be kept under review to enable the actions set out in the approved Development Plan - Governance to be implemented by 31 July 2022. **Updated Management response:** The Board Secretary will ensure that the RDP is submitted to the Audit Committee and the Board and that it is regularly up-dated. Where there is any slippage, this will be highlighted to Members so that a priority review may be undertaken and the need for further resourcing addressed to ensure continuous improvement. An annual review of compliance with the 82 principles of the 2016 Code of Governance will be undertaken in October of each year. Responsible Officer: Board and Board Secretary. Implementation timeframe: Ongoing. As this is a rolling Board Development Plan all actions cannot be addressed in any one year. Capacity will be kept under review.	Closed. Significant progress has been made in relation to outstanding actions with regular reporting to the Board on progress. Plans are in place to ensure actions are addressed.

Appendix E: Timing and deliverables of the audit

We deliver our audit in accordance with the timeline set by the College, in accordance with guidance from Audit Scotland. Below is a timetable showing the key stages of the audit and the deliverables through the 2021/22 audit cycle.



Audit Activity	Deliverable	Timing
Walkthrough Visit	Completion of internal documentation	April 2022
Audit planning and setting scope and strategy for the 2021/22 audit	Annual Audit Plan	April/May 2022
Year-end substantive audit fieldwork on unaudited financial statements	Audited Financial Statements	September/October 2022
Conclude on results of audit procedures	Issue Annual Audit Report	31 December 2022
Issue opinion on the College's financial statements	Submit Audit Scotland minimum dataset request	31 December 2022

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