Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - all modules

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Introduction to technical guidance note

The purpose of technical guidance note 2017/6(FE) is to provide auditors with guidance on planning and performing the audit of the 2016/17 annual report and accounts of colleges. It comprises the following modules

Module	Subject areas covered
Overview	Financial reporting framework, key auditing standards, and presentation of financial statements
1	Tangible fixed assets
2	Provisions, creditors and accruals
3	Retirement benefits
4	Other financial statement areas
5	Regularity of expenditure and income
6	Non-financial statements (i.e. performance report, governance statement, and remuneration and staff report)

The modules highlight the main risks of misstatement in each area, and set out actions for those risks that auditors should undertake to assess whether the college has followed the required accounting treatment. It is important that auditors follow the actions set out, subject to local judgements on materiality, to ensure that all auditors adopt a consistent approach to common risks.

For the convenience of auditors, all the above modules have been combined in this one document. The individual modules are also available from the relevant subject pages on the *Technical reference library*. There is also a checklist module containing a summary of the risks of misstatement available as a word document.

Paul O'Brien

Senior Manager (Technical)

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - overview module

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Foreword

Technical guidance notes are prepared by Audit Scotland's Audit Strategy business group to provide external auditors appointed by the Accounts Commission and Auditor General for Scotland with guidance to support them in meeting certain responsibilities under the *Code of audit practice*. They cover auditors' responsibilities to audit and report on the annual accounts, and review returns for whole of government accounts and local authority grant claims.

Technical guidance notes are available to external auditors from Audit Scotland's *Technical reference library,* and are also published on the Audit Scotland website so that audited bodies and other stakeholders can access them.

This particular type of technical guidance note is approved by the Assistant Auditor General and provides guidance on auditing the annual accounts.

While appointed auditors act independently, and are responsible for their own conclusions and opinions, Audit Strategy has a role in ensuring that those conclusions and opinions are reached on the basis of informed judgement. Consistency in similar circumstances is important and paragraph 108 of **the *Code of audit practice* requires auditors to consider Audit Strategy guidance.** This means that auditors are expected to follow the guidance or provide a reasonable explanation as to why not. Auditors should advise Audit Strategy promptly if they intend not to follow any guidance provided in this technical guidance note.

1 Introduction

Introduction

1. External auditors appointed by the Auditor General for Scotland are required under section 21(3) of the *Public Finance and Accountability (Scotland) Act 2000* (the 2000 Act) to audit the annual report and accounts prepared by colleges under schedule 2 of the *Further and Higher Education (Scotland) Act 1992* (the 1992 Act).

2. The annual report and accounts require to be prepared in accordance with an accounts direction issued by the Scottish Funding Council (SFC).

3. Section 22(1) of the 2000 Act requires auditors' reports to set out their findings from the audit as to
   - whether the annual report and accounts comply with the direction
   - the regularity of expenditure and income.

Purpose of technical guidance note

4. The purpose of this technical guidance note from Audit Strategy is to provide auditors with guidance on meeting their statutory responsibilities to audit the 2016/17 annual report and accounts.

5. In summary auditors' responsibilities in respect of a college's annual report and accounts are to
   - audit and express an opinion on whether the financial statements give a true and fair view and are properly prepared in accordance with the accounts direction
   - audit and express an opinion on the regularity of expenditure and income
   - audit and express an opinion on whether the audited part of the remuneration and staff report has been properly prepared
   - read the performance report and express an opinion as to whether it is consistent with the financial statements. As a new responsibility in 2016/17, an opinion is also required on whether the performance report has been prepared in accordance with the accounts direction
   - read the information in the governance statement and as a new responsibility in 2016/17, express opinions as to whether it is consistent with the financial statements and prepared in accordance with the accounts direction
   - read the information in the annual report and accounts other than the financial statements to identify any material inconsistencies with the financial statements or auditor's knowledge.

6. This technical guidance note comprises this overview module and the following other modules
   - 1 Tangible fixed assets.

- 2 Provisions, creditors and accruals.
- 3 Retirement benefits.
- 4 Other financial statement areas, including accounting policies, intangible assets, leases, investments, government grants, and various disclosures.
- 5 Regularity of expenditure and income.
- 6 Non-financial statements, which provides guidance on auditors' responsibilities in respect of the performance report, remuneration and staff report, governance statement, and parliamentary accountability report.
- A module which provides a list of the risks of misstatement that auditors may use as a checklist.

7. Auditors are required to obtain evidence about the amounts and disclosures in the annual report and accounts sufficient to give reasonable assurance that they are free from material misstatement.

8. The guidance in the modules highlights what Audit Strategy considers to be the main risks of misstatement in each area. It is for auditors to form a judgement regarding materiality at each college. The modules set out actions for each risk that auditors should undertake to assess whether the college has followed the required treatment. Although the modules provide a concise summary of the relevant financial reporting treatment, it may still be necessary for auditors to refer to the source material on which this note is based where issues of detail arise. The modules also
   - highlight changes from the previous year
   - provide a summary of the financial reporting requirements
   - list available further guidance.

9. Documents referred to in this note may be obtained by using the hyperlinks or are available from the further education site in the *Technical reference library*.

Purpose of overview module

10. The purpose of this overview module is to
    - provide information on the applicable financial reporting framework for 2016/17
    - highlight the application of key auditing standards that are particularly relevant to this technical guidance note
    - provide information on, and guidance on the risks of misstatement in, the presentation of financial statements.

Other guidance and assistance

11. The following other guidance and assistance from Audit Strategy in respect of 2016/17 will be provided in due course

- guidance on emerging risks and relevant technical developments in future technical bulletins
- technical training workshops
- technical guidance note 2017/7(FE) on the independent auditor's report.

12. Auditors are encouraged to contact the Audit Strategy 'helpdesk' with technical enquiries concerning colleges generally. Enquiries should be emailed to technicalqueries-furthereducation@audit-scotland.gov.uk.

Contact point

13. The contact points in Audit Strategy for this module of the technical guidance note are
    - Neil Cameron, Manager - Health and Central Government (Technical) - ncameron@audit-scotland.gov.uk
    - Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Financial reporting framework

Purpose of section

14. The purpose of this section is to provide information on the financial reporting framework that applies to colleges in 2016/17.

Changes in 2016/17

15. The 2016/17 accounts direction has been amended as follows
    - The requirements for the performance report have been amended to require
      - a short explanation of the purpose of the overview section
      - an analysis of how the cash budget allocation previously earmarked for depreciation was spent
      - details of the underlying operating position.
    - The requirement to disclose expenditure on consultancy and off payroll arrangements in the remuneration and staff report has been removed.
    - There are new requirements to include a statement at the foot of the statement of comprehensive income and a note explaining the impact of the non-cash budget provided for depreciation.

Accounts direction

16. The 2016/17 accounts direction from the SFC requires the annual report and accounts to be prepared in accordance with the 2015 Statement of recommended practice: Accounting for further and higher education (the 2015 SORP).

17. The direction also requires colleges to comply with the *Government financial reporting manual* (FReM) for 2016/17 for areas not addressed in the SORP. Appendix 2 of the direction sets out the additional disclosures required by the FReM that apply to colleges, and Appendix 3 sets out required corporate governance disclosures.

18. The accounts direction also contains additional requirements not required by either the SORP or the FReM.

2015 SORP

19. The 2015 SORP requires colleges that follow it to apply all requirements of FRS 102. In certain areas, the SORP provides an interpretation to aid the practical implementation of FRS 102 (e.g. government grants) it also requires a small number of additional disclosures.

20. Colleges are registered charities and are therefore subject to The Charities Accounts (Scotland) Regulations 2006 (as amended). However, regulation 14 requires compliance with the 2015 SORP rather than the charities SORP.

Applicable FReM requirements

21. Appendix 2 of the accounts direction sets out the disclosures which colleges are required to include in the annual report and accounts in order to comply with the FReM. These require a performance report and accountability report.

22. Paragraph 5.1.4 of the 2016/17 FReM has been amended to clarify that the FReM's disclosure requirements apply to Scottish bodies where they originate in accounting standards or Companies Act requirements, or where required by specific Scottish legislation or the *Scottish public finance manual* (SPFM). This means that some FReM requirements (e.g. disclosures on off-payroll arrangements and expenditure on consultancy) no longer apply to Scottish bodies.

3 Auditing standards

Purpose of section

23. The *Code of audit practice* requires appointed external auditors to perform the audit of the annual report and accounts in accordance with the Financial Reporting Council's international standards on auditing in the UK (ISA(UK)).

24. The purpose of this section is to highlight the application of key ISAs (UK) that are particularly relevant to this technical guidance note.

Changes in 2016/17

25. For 2016/17, auditors should follow the revised 2016 ISAs (UK).

Material misstatements

26. *ISA* (UK) *315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment* requires auditors to identify and assess the risks of material misstatement in the financial statements. This technical guidance note highlights potential risks of misstatement in the 2016/17 financial statements of colleges.

27. A misstatement is defined in *ISA* (UK) *450 Evaluation of misstatements identified during the audit* as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure required for the item to be in accordance with the applicable financial reporting framework.

28. *ISA (UK) 250 Section A Consideration of laws and regulations in an audit of financial statements* deals with material misstatements due to the college's non-compliance with laws and regulations. Auditors are required to
    - check compliance with the provisions of those laws and regulations which have a direct effect on the determination of material amounts and disclosures in the financial statements
    - perform specified procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements.

29. Auditors should request management and, if necessary those charged with governance, to correct all misstatements identified during the audit, other than those that are clearly trivial.

30. *ISA* (UK) *320 Materiality in planning and performing an audit* deals with the concept of materiality and requires judgments about materiality to be affected not only by the size of a misstatement, but also by its nature and the surrounding circumstances. It is for auditors to form a judgement regarding whether misstatements are material and nothing in this technical guidance note is intended to overrule that judgement.

Professional scepticism and audit evidence

31. This technical guidance note requires auditors to assess whether a college has followed the required financial reporting treatment. In making this assessment, auditors are required by *ISA* (UK) *200 Overall objectives of the independent auditor* to exercise professional scepticism throughout the audit. Professional scepticism is an attitude that includes
    - a questioning mind
    - being alert to conditions which may indicate possible misstatement
    - a critical assessment of audit evidence.

32. *ISA* (UK) *500 Audit evidence* explains what constitutes audit evidence, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence.

33. If information to be used as audit evidence has been prepared using the work of a management's expert (i.e. an individual with expertise in a field other than accounting or auditing, whose work is used by the board in preparing the financial statements), auditors should
    - evaluate the competence, capabilities and objectivity of that expert
    - obtain an understanding of the work of that expert
    - evaluate the appropriateness of that expert's work as audit evidence.

34. *ISA* (UK) *580 Written representations* deals with the auditor's responsibility to obtain written representations from management. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own.

35. ISA (UK) 200 also deals with professional judgment, which is the application of relevant training, knowledge and experience in making informed decisions about the appropriate courses of action. The fundamental purpose of this technical guidance is to ensure that auditors' opinions and judgement are reached on the basis of informed judgement.

Other information in the annual report and accounts

36. *ISA (UK) 720 The auditor's responsibilities relating to other information* deals with the auditor's responsibilities relating to information other than the financial statements that is included in the annual report and accounts.

37. This includes additional responsibilities for some of the other information (which the ISA describes as statutory other information). For colleges, statutory other information is the performance report and governance statement.

Independent auditor's report

38. *ISA (UK) 700 Forming an opinion and reporting on financial statements* establishes standards and provides guidance on the form and content of the independent auditor's report.

39. A separate technical guidance note from Audit Strategy containing model independent auditor's reports for 2016/17 will be published shortly. The models will follow the structure and wording of ISA (UK) 700 adapted for the further education sector.

4 Financial statements

Purpose of section

40. This section provides information on, and guidance on the risks of misstatement in, the presentation of a college's financial statements. Guidance on risks in respect of recognition and measurement of individual financial statement areas is provided in the relevant module.

Changes in 2016/17

41. The 2016/17 accounts direction requires colleges to include a disclosure at the foot of the statement of comprehensive income and a note to the accounts explaining the impact of the non-cash budget provided for depreciation.

Financial reporting requirements

42. The SORP at paragraph 3.1 specifies that colleges' financial statements should include
    - a statement of principal accounting policies and estimation techniques
    - a statement of comprehensive income presenting the financial performance during the accounting period
    - a statement of changes in reserves
    - a balance sheet
    - a statement of cash flows
    - notes to the accounts.
43. Consolidated statements are also required where a group exists. A format for each of the individual and consolidated financial statements is provided at Appendix 1 of the SORP.
44. The SFC requires a copy of the first page of the accounts direction to be reproduced as an appendix to the annual report and accounts.

Further guidance

45. Guidance notes from the SFC are intended to supplement the accounts direction.

Risks of misstatement

46. The following paragraphs highlight potential risks of misstatement in respect of the presentation of financial statements, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

A complete set of financial statements is not properly presented

47. Auditors should assess whether the college has

- presented a complete set of financial statements for 2016/17
- clearly identified the financial statements and distinguished them from the other information, statements and reports in the annual report and accounts
- clearly identified each primary financial statement and the notes
- offset assets and liabilities or income and expenses only where required or permitted by the SORP
- presented comparative information in respect of 2015/16 for all amounts reported, except when the SORP permits or requires otherwise

Balance sheet is not properly presented

48. Auditors should consider the presentation of the (consolidated) balance sheet and assess whether
    - the statement is presented in accordance with SORP appendix 1
    - the College Principal has signed the statement.

Presentation is not consistent with previous years

49. Colleges should retain the presentation and classification of items in the financial statements unless another presentation or classification is required by the SORP or is more appropriate.

50. Auditors should assess whether the college has
    - reclassified the 2015/16 comparative amounts for changes in the presentation, and any changes of classification, of items in 2016/17
    - disclosed the nature of, and reasons for, the reclassification, as well as the amount of each item reclassified.

51. Reclassification of comparative amounts is not required when it is impracticable. Auditors should assess whether the college has made every reasonable effort to reclassify the amounts. When auditors are satisfied that it is impracticable, they should assess whether the college has disclosed the
    - nature of the reclassification
    - reason for the reclassification
    - the amount of each item reclassified.

Statement of comprehensive income is not properly presented

52. Auditors should consider the presentation of the (consolidated) statement of comprehensive income and assess whether it is presented in accordance with the SORP Appendix 1.

53. Auditors should confirm that the college has complied with the accounts direction's new requirement to include a statement at the foot of the statement of comprehensive income that
    - explains that the SORP does not permit non-cash allocations for depreciation to be recognised as income in the statement of comprehensive income

- refers to a note which provides further explanation and sets out the operating position adjusted for the non-cash allocation for depreciation.

54. An illustrative form of words is provided at paragraph 1 of Appendix 6 to the accounts direction.

Note on non-cash allocations for depreciation is not properly disclosed

55. Auditors should confirm that the college has complied with the accounts direction's new requirement to disclose a note which sets out the college's operating position adjusted for the non-cash allocation for depreciation.

56. The note should also explain that (since reclassification) colleges received additional non-cash budgets to cover depreciation. However, the statement of comprehensive income shows a deficit equivalent to net depreciation because
    - this additional budget is not recognised as income under SORP accounting rules
    - colleges use the cash budget originally earmarked for depreciation on other revenue items in order to meet the requirement to spend the entire cash allocation.

57. An illustrative form of words is provided at paragraphs 2 and 3 in Appendix 6 of the accounts direction. The appendix also shows table for adjusting the deficit for the non-cash allocation.

Statement of changes in reserves is not properly presented

58. Auditors should consider the presentation of the (consolidated) statement of changes in reserves and assess whether it is presented in accordance with the SORP Appendix 1.

Donations to arms' length foundations not properly presented

59. Colleges generally donate their surpluses to arms' length charitable foundations to bring them outside Scottish Government budgeting limits. Paragraph 18 of the SFC guidance notes recommends that the donation should be included above the operating surplus line in the statement of comprehensive income and for this to be clearly disclosed.

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - module 1 tangible fixed assets

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Contents

Tangible fixed assets

Purpose of module

1. This module of technical guidance note 2017/6(FE) provides information on, and guidance on the risks of misstatements in, tangible fixed assets.

Changes in 2016/17

2. There are no changes in financial reporting requirements in 2016/17.

Definition

3. Tangible fixed assets are assets held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period.

Financial reporting requirements

4. Colleges are required to account for tangible fixed assets in accordance with section 17 of FRS 102. Specific requirements are set out at SORP section 11.

5. The cost of a tangible fixed asset should be recognised as an asset in the balance sheet (i.e. capitalised) if it is probable that future associated economic benefits or service potential will flow to the college and its cost can be measured reliably.

6. While the SORP requires tangible fixed assets to be carried at either historical cost or a current valuation, the FReM requires a current value. The SORP paragraph 11.10 requires assets to be revalued to fair value, usually determined by market based evidence. Where there is no market evidence colleges may need to estimate fair value by using an income or a depreciated replacement cost approach.

7. The SORP at paragraph 11.5 provides the following examples of classes of tangible fixed assets to be presented in the balance sheet
   - land and buildings
   - plant and machinery
   - fixtures, fittings, tools and equipment
   - assets under construction.

Risks of misstatement

8. The following paragraphs highlight potential risks of misstatement in respect of tangible fixed assets, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Acquisition costs are not properly recognised

9. A tangible fixed asset should be initially measured at its cost. Auditors should assess whether cost comprises
   - the purchase price
   - any costs directly attributable to bringing the asset into working condition for its intended use. FRS 102 gives examples of directly attributable costs, which include
     - the costs of site preparation, initial delivery and handling costs, installation and assembly costs, and the testing of functionality
     - the estimated costs of dismantling and removing the asset and restoring the site to the extent that it is recognised as a provision.

Construction costs are not properly recognised

10. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Auditors should assess whether
    - employee costs have been capitalised only where the employees' activities have contributed directly to bringing an asset to a location and a condition so that it is capable of operating as intended. However, it is acceptable to capitalise the entire price of the services rendered by the staff of external contractors, which can include items that are not capitalised for internal staff
    - recharges have been capitalised only if they can be traced back to activity on the asset (and so general overhead costs have not been capitalised). As an informal guideline, if there is not a more specific method of allocating costs than a blanket apportionment, they are not likely to be capital
    - recognition of costs in the carrying amount of an item of assets under construction ceased when the item was in the location and condition necessary for it to be capable of operating in the manner intended by management, even if it has not yet actually been brought into use
    - the cumulative balance for assets under construction were transferred to the appropriate class of tangible fixed asset when they began operating in the manner intended by management (and therefore assets under construction at 31 July 2016 represent projects not complete at that date)
    - abortive costs relating to projects that are discontinued and abnormal costs that arise from inefficiencies (e.g. design faults, theft of materials) have not been capitalised.

Subsequent costs are not properly recognised

11. The carrying amount of an asset is the amount at which it is recognised in the balance sheet after deducting any accumulated depreciation and impairment losses. Costs that can be included in the carrying amount of an asset (i.e. capitalised) include those incurred after the asset has been recognised to add to the asset or replace part of it. Auditors should assess whether

- any subsequent costs incurred on a recognised asset have been added to its carrying amount where the expenditure adds to its future economic benefits or service potential
- all other subsequent costs that maintain (rather than add to) the future economic benefits or service potential of an asset that it was expected to provide when it was originally acquired have been recognised as an expense in the statement of comprehensive income in the period in which they are incurred. This includes, for example, the costs of repairs and maintenance.

12. Capitalisation thresholds are not mentioned in either the SORP or the accounts direction, and auditors should assess whether the college has used appropriate thresholds. For example, the *Application note – Property* states that, for the Scottish Government, thresholds for subsequent expenditure which meet the recognition criteria are £10,000 for land, building structures and car parks, and £5,000 for plant and machinery.

The correct measurement basis for each asset is not used

13. The SORP allows the option of measuring tangible fixed assets at cost or revalued amount, but the FReM requires them to be measured on a revalued basis. Under the revaluation model, the SORP requires assets to be revalued to fair value.

Land and buildings are not properly valued

14. The SORP requires revaluations to be sufficiently regularly so that the carrying value of an asset at 31 July 2017 is not materially different from its fair value. The fair value of tangible fixed assets is usually determined from market based evidence by appraisal that is normally undertaken by a professionally qualified valuer.

15. Under ISA (UK) 500, auditors are required to
    - evaluate the competence, capabilities and objectivity of the valuer
    - obtain an understanding of their work
    - evaluate the appropriateness of the valuer's work as audit evidence.

Specialised properties are not identified

16. Auditors should assess whether colleges have identified their properties that are considered specialised. Specialised properties are those which, due to their specialised nature, are rarely sold on the open market for single occupation for a continuation of their existing use, except as part of a sale of the business in occupation.

17. Their specialised nature may arise from the construction, arrangement, size or location of the property, or a combination of these factors, or may be due to the nature of the plant and machinery and items of equipment which the buildings are designed to house, or the function, or the purpose for which the buildings are provided. Examples of specialised properties are
    - properties of such construction, arrangement, size or specification that there would be no market (for a sale to a single owner occupier for the continuation of existing use) for those buildings

- standard properties in particular geographical areas and remote from main business centres, located there for operational or business reasons, which are of such an abnormal size for that district, that there would be no market for such buildings there;
- college buildings where there is no competing market demand from other organisations using these types of property in the locality.

Specialised properties are not properly valued

18. If there is no market-based evidence because of the specialised nature of the asset and it is rarely sold, market value may be estimated using a depreciated replacement cost (DRC) approach. This is a method of valuation which provides the current cost of replacing an asset with its modern equivalent asset. It is the aggregate amount of the
    - value of the land for the existing use or a notional replacement site in the same locality
    - the gross replacement cost of the buildings and other site works, from which appropriate deductions may then be made to allow for the age, condition, economic or functional obsolescence, environmental and other relevant factors.
19. However, colleges should not automatically assume that market value evidence is not available simply because the property is specialised.

Equipment, vehicles, plant and equipment are not properly valued

20. Tangible fixed assets other than properties should be valued using market value where possible, or on the basis of DRC.

Assets are not revalued regularly

21. Each class of tangible fixed assets should be revalued simultaneously to avoid the selective revaluation of assets. However, FReM paragraph 7.1.2 allows a class to be revalued on a rolling basis. Where this option is taken, auditors should assess whether
    - it is completed within a short period
    - the carrying amount does not differ materially from that which would be determined using the current value at 31 July 2017.
22. Valuations are usually carried out as at 31 July. However, there is no requirement for this, and colleges may use 1 August provided the carrying amount at the end of the year does not differ materially from the current value at that date. Where a valuation has been carried out at 1 August 2016, auditors should
    - confirm the college has assessed whether there have been any movements in value during 2016/17
    - consider the adequacy of evidence that supports the assessment
    - confirm the college has made necessary adjustments to reflect any movements.

23. Where a valuation has been carried out at 1 August 2017, auditors should consider whether this should be treated as an adjusting event

Revaluation increases are not properly accounted for

24. Auditors should confirm that increases in value have been taken to the revaluation reserve, except to the extent that they reverse revaluation losses on the same asset that were previously recognised in the statement of comprehensive income.

Revaluation decreases are not properly accounted for

25. Auditors should confirm that decreases in valuation have first been set against any previous revaluation surplus for that asset, with only any remaining balance being recognised in the statement of comprehensive income.

Depreciation is not charged where it is required

26. Auditors should assess whether depreciation has begun to be charged at the point the asset is available for use, i.e. when it is in a location and condition for it to be capable of operating in the manner intended by management.

27. Auditors should establish the reasons if the college has failed to charge depreciation on any asset. Valid reasons for not charging depreciation are
    - land which has an unlimited useful life (excluding land subject to depletion)
    - assets in the course of construction
    - the residual value of an asset is equal to (or greater than) its carrying value
    - the asset has been reclassified as being held for sale
    - the asset has been derecognised.

28. Invalid reasons that do not negate the need to depreciate an asset that colleges may offer are
    - an increase in the asset's current value over the year
    - annual revaluations are undertaken
    - regular repair and maintenance of the asset is undertaken.

Depreciation is not properly calculated

29. Depreciation should be calculated by allocating the depreciable amount over the useful life of the asset using an appropriate depreciation method. The depreciable amount is the carrying value of the asset less any residual value.

30. Auditors should assess whether
    - the useful lives, residual values and depreciation methods have been reviewed at 31 July 2017
    - the useful lives reasonably reflect the period which the assets are expected to be available for use by the college (and therefore may be shorter than the economic life)

- the residual values are the estimated amounts that the college would currently obtain from disposal of each asset, after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life
- the depreciation methods reflect the pattern in which the asset's future economic benefits or service potential are expected to be consumed
- any change in useful lives, residual values or depreciation method has been accounted for prospectively as a change in accounting estimate
- land and buildings have been accounted for separately, even when acquired together. An increase in the value of land on which a building stands should not therefore affect the depreciable amount of the building.

Significant components are not identified

31. Depreciation should be provided for separately on each part (i.e. component) of an item of property, plant and equipment
    - with a cost that is significant in relation to the total cost of the item; and
    - has a different useful life or depreciation method.
32. Auditors should confirm that the college has
    - established a policy which specifies the basis for determining whether the cost of a component is significant. It is expected that the policy will refer to cost as a proportion of the overall cost of the asset (including the cost of the new component) rather than an absolute amount
    - determined significance by comparing a component's cost against the overall cost and assessing the result against the agreed criteria. The college should have documented its decision-making process
    - assessed the cost of the new component against the overall cost of an asset as at the same date. This means the college should have either
        - estimated the current build cost of the asset and compared it with the cost of the new component; or
        - discounted the cost of the new component back to the date when the asset was initially recognised and compared it with the original cost of the asset.
33. Colleges may choose to depreciate components separately even where the cost is not significant.

Depreciation is not properly accounted for

34. When considering whether depreciation on assets or asset components has been properly accounted for, auditors should assess whether
    - depreciation has been included in expenditure in the statement of comprehensive income.
    - any accumulated depreciation at the date of valuation has either been

  - eliminated against the gross carrying amount of the asset with the net amount restated to the revalued amount of the asset
  - restated proportionately with the change in the gross carrying amount of an asset.

Impairment reviews are not carried out

35. An impairment loss arises where the higher of the net recoverable amount or value in use of an asset is lower than its carrying amount in the balance sheet. Impairment reviews are therefore necessary if events or changes in circumstances indicate that the carrying amount may not be recoverable.

36. Auditors should confirm that colleges have
    - established appropriate indicators of impairment, e.g. operating losses; evidence of physical damage or obsolescence; a significant adverse change in the business, regulatory or statutory environment; a commitment to undertake a significant reorganisation; or withdrawal from the provision of a course
    - carried out an impairment review where such indications exist to determine whether there is an impairment and quantify the financial impact.

37. Assets should also be tested for impairment where
    - no depreciation has been charged on the grounds that it would be immaterial
    - assets are surplus to requirements in the long term.

Impairment losses are not properly calculated

38. When assessing whether an asset is impaired, auditors should check that the college has made a formal estimate of the recoverable amount of the asset. This should be the higher of its net selling price and its value in use (i.e. the present value of the asset's remaining service potential).

39. Revaluation principles generally take precedence over those for impairment. Before an impairment loss is calculated on an asset measured at current value, auditors should check whether the carrying amount of the asset has been brought up to date and any revaluation decrease accounted for.

Impairment losses are not properly accounted for

40. Auditors should assess whether impairment losses on revalued fixed assets have been recognised in the statement of changes in reserves and set against any revaluation surplus until the carrying amount of the fixed asset reaches depreciated historical cost and thereafter in the statement of comprehensive income.

Gains and losses on disposal are not properly accounted for

41. The gain or loss arising from the disposal of tangible fixed assets is the difference between the carrying amount of the fixed asset and the net sale proceeds. Gains or losses should be reported in the statement of comprehensive income.

42. Auditors should confirm that the net sale proceeds
    - exclude any proceeds required to be surrendered under the financial memorandum between the college and the SFC
    - have been included in the statement of comprehensive income and, if material, presented separately.

Subsequent expenditure is capitalised but written off

43. When expenditure has been added to an asset's carrying value, there is no requirement to revalue the asset unless the college has indications that it might be impaired. However, a valuation undertaken after a significant amount of expenditure has been incurred may be helpful.

44. Colleges sometimes reduce the carrying value of the asset by the amount of the subsequent expenditure and describe it as expenditure that does not add to the value of the asset. This is unlikely to be the correct treatment. Where a college reduces an asset's carrying value in this way, auditors should consider whether the subsequent expenditure was incurred
    - as repairs and maintenance which should not have been added to the asset's carrying value in the first instance
    - to replace a component of the asset but the old component was not first derecognised
    - because the asset was impaired but an impairment loss was not recognised before the remedial work was carried out.

45. Where any of the above scenarios apply, auditors should request the college to adopt the appropriate treatment.

Disposals are not properly derecognised

46. Auditors should assess whether the carrying amount of a tangible fixed asset has been derecognised (i.e. removed from the balance sheet)
    - on disposal, e.g. through its sale or the college entering into a finance lease as lessor. A disposal should be recognised on the date when the risks and rewards of ownership are transferred, rather than the point when the college becomes committed to the disposal. For a property transfer, this is likely to be the completion date rather than when contracts are exchanged; or
    - when no future economic benefits or service potential are expected from its use or disposal.

Gain or loss on disposal is not properly calculated

47. Auditors should check that
    - the gain or loss arising from derecognition of an asset is the difference between the net disposal proceeds and the carrying amount of the asset
    - if there are no proceeds, the loss equals the carrying amount.

48. If payment is deferred beyond normal credit terms, auditors should assess whether
    - the disposal has been discounted using a reasonable discount rate
    - the discounting has been unwound over the credit period by recognising the difference between the discounted amount and the total payments received as interest income in the surplus or deficit on the provision of services.

Gain or loss on disposal is not properly accounted for

49. Auditors should check that
    - the gain or loss has been recognised in statement of comprehensive income.
    - the credit balance on the revaluation reserve in respect of that asset has been eliminated.

A replaced component is not derecognised

50. Auditors should assess whether, when a component is replaced
    - the carrying amount of the replaced component has been derecognised
    - the new component has been reflected in the carrying amount.

51. Derecognition takes place regardless of whether the replaced component had been depreciated separately. If it is not practicable to determine the carrying amount of the replaced part, colleges may use the cost of the new component as an indication of the cost of the replaced part at the time it was acquired or constructed, which should be adjusted for depreciation and impairment, if required.

Donated assets are not properly accounted for

52. Donated assets are either assets donated by third parties or funds provided to acquire assets for which no consideration is given (excluding grant-in-aid and developer's contributions). Assets transferred from one public sector body to another for no consideration should also be treated as donated assets. Auditors should assess whether
    - donated assets have been measured at current value in existing use or fair value as at the date of acquisition
    - revalued, depreciated, and impaired in line with other assets
    - the funding element has been recognised as income
    - details of any restrictions or conditions imposed by the donor on the use of the asset has been disclosed in a note.

Disclosures are not properly made

53. Auditors should confirm that the college has complied with the disclosure requirements of FRS 102 and those for property, plant and equipment set out at FReM paragraph 7.1.12.

54. The requirements of FRS 102 include (at paragraph 17.31) a reconciliation of the carrying amount at 1 August 2016 and 31 July 2017. There is no requirement for a reconciliation in respect of prior periods to be disclosed.

Contact point

55. The contact point in Audit Strategy for this module of the technical guidance note is Helen Cobb, Technical Adviser (Central Government, Health and Further Education) - 0131 625 1901 or HCobb@audit-scotland.gov.uk.

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - module 2 provisions, creditors and accruals

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Contents

1 Introduction

Purpose of module

1. This module of technical guidance note 2017/6(FE) provides information on, and guidance on the risks of misstatements in, the following financial statement areas
   - Provisions and contingencies.
   - Creditors.
   - Accruals.

Contact point

2. The contact points in Audit Strategy for this module of the technical guidance note are
   - Neil Cameron, Manager - Health and Central Government(Technical) - ncameron@audit-scotland.gov.uk
   - Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Provisions and contingencies

Changes in 2016/17

3. There are no changes in financial reporting requirements in 2016/17.

Definition

4. Provisions are liabilities incurred of uncertain timing or amount.

Financial reporting requirements

5. Colleges are required to account for provisions in accordance with FRS 102 section 21. Specific requirements are set out at section 15 of the 2015 SORP.

6. FRS 102 requires provisions to be recognised as a liability in the balance sheet and an expense in the statement of comprehensive income when, and only when, the following three conditions are met
   - The college has an obligation at 31 July 2017 as a result of a past event.
   - It is probable that the college will be required to transfer economic benefits in settlement.
   - The amount of the obligation can be estimated reliably.

7. Specific types of provisions are covered by other sections of FRS 102 such as section 28 in respect of termination benefits.

8. The SPFM section on contingent liabilities addresses particular contingent liabilities (i.e. those that are legally enforceable undertakings in the form of a guarantee or indemnity, or even a letter of comfort that would impose a moral obligation).

Further guidance

9. Guidance on the early retirement provision is provided at paragraphs 19 to 20 of the SFC guidance notes. The SFC will also shortly provide guidance on the interest rate to be used and an accompanying spreadsheet.

Risks of misstatement

10. The following paragraphs highlight potential risks of misstatement in respect of provisions and contingencies, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Provisions are not recognised when the conditions are met

11. Auditors should assess whether the college has

- recognised a provision when the three conditions required by FRS 102 are met
- not recognised a provision where not all the three conditions are met. Where there is a present obligation but one or both of the other conditions are not met, a contingent liability should be disclosed.

12. Auditors should assess whether the college has identified its present obligations. A past event leads to a present obligation where the settlement of the obligation
    - can be enforced by law; or
    - where there is a constructive obligation, i.e. a college has indicated to other parties that it will accept certain responsibilities and has created valid expectations on the part of those other parties that it will discharge those responsibilities.

Provisions are not properly measured

13. When assessing the amount recognised for a provision, auditors should confirm that
    - the amount is the college's best estimate of the expenditure required to settle the obligation at 31 July 2017. This should be the case even where it is prohibitively expensive to settle the obligation at that date, and therefore auditors should particularly confirm that the amount recognised has not been restricted on the grounds of affordability
    - the estimates of outcome and financial effect have been determined by the judgement of the college's management, supplemented by experience of similar transactions and, in some cases, reports from independent experts
    - additional evidence provided by events after the reporting period has been considered
    - provisions recognised in previous years have been reviewed and adjusted, where appropriate, to reflect the current best estimate or to reflect material changes in the assumptions underlying the calculations of the cash flows
    - where the effect of the time value of money is material, the amount of the provision has been discounted to the present value of the expected payments. The FReM requires bodies to use the real discount rates set by Treasury in public expenditure system (PES) papers. PES (2016)10 sets out the rates for 2016/17.

Provisions are not properly accounted for

14. Auditors should assess whether
    - provisions are recognised by a charge to operating expenditure (or in limited cases as capital expenditure)
    - the unwinding of any discounting due to the passage of time has been recognised as an interest charge
    - the provision balance is debited when the liability is settled.

Provision is not recognised for restructuring costs

15. Auditors should assess whether the costs of restructuring the college's operations have been recognised as a provision when the recognition conditions are met. In this context, a constructive obligation to restructure arises when a college has by 31 July 2017
    - a detailed formal plan for the restructuring identifying the activities concerned, the principal locations, the number of employees who will be compensated for terminating their services, the cost and date
    - raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.
16. Auditors should assess whether the provision includes only the direct expenditure arising from the restructuring, which are those that are both
    - necessarily entailed by the restructuring
    - not associated with the ongoing activities of the college.

Provision is not recognised for termination benefits

17. The SORP requires bodies to account for termination benefits in accordance with section 28 of FRS 102. Termination benefits are often lump-sum payments, but may also include enhancement of retirement benefits and salary until the end of a specified notice period if the employee renders no further service to the college. They are payable as a result of either
    - a college's decision to terminate an employee's employment before the normal retirement date; or
    - an employee's decision to accept an offer of voluntary redundancy in exchange for those benefits.
18. The event which gives rise to the obligation for termination benefits is the termination of employment, rather than employee service. Auditors should assess whether the college has recognised a liability for the termination benefits no later than when it recognises a provision for the costs of a related restructuring.
19. The college is required to recognise the liability for termination benefits at an earlier date than the restructuring provision if events occur that means it can no longer withdraw the offer of those benefits.
20. For termination benefits payable as a result of an employee's decision to accept an offer of redundancy, the time when the college can no longer withdraw the offer is the earlier of when
    - the employee accepts the offer; and
    - a legal, regulatory or contractual restriction on the college's ability to withdraw the offer takes effect. This would be when the offer is made, if the restriction existed at the time of the offer.

21. When a college terminates an employee's employment, the college can no longer withdraw the offer when the college has communicated to the affected employees a plan of termination meeting all of the following criteria
    - Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
    - The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations and the expected completion date.
    - The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive.

22. Auditors should assess whether
    - termination benefits have been recognised as operating expenditure when the liability is recognised. Termination benefits are not provided in exchange for service, and do not provide a college with future economic benefits or service potential
    - where termination benefits fall due more than twelve months after 31 July 2016, they have been discounted using the discount rate determined by reference to market yields on high quality corporate bonds.

Provision is not recognised for outstanding legal claims

23. Colleges may have legal claims in progress that have not been settled by 31 July 2017. In some cases, it may not be clear whether a college has a present obligation. A past event is deemed to give rise to a present obligation if, taking account of all available evidence including the opinion of experts, it is more likely than not that a present obligation exists at the end of the reporting period. The evidence considered should include any additional information provided by events after the reporting period.

24. Auditors should assess whether
    - a provision has been recognised for outstanding legal claims if it is more likely than not that a present obligation exists at 31 July 2017 and the other recognition criteria are also met; or
    - a contingent liability has been disclosed if it not more likely than not that a present obligation exists.

25. A college should recognise a provision for the present obligation if the other recognition criteria are also met. If it is more likely than not that no present obligation exists, the college should disclose a contingent liability.

Provision recognised for future repairs

26. A provision for future repairs and maintenance is not normally recognised (unless, for example, a council issues a statutory order). This is because these costs relate to the future operation of a college, rather than to a past event, and should be recognised only when incurred.

Provision not recognised for early retirement costs

27. When calculating a provision for early retirement costs, in the absence of an actuarial valuation, colleges may use pension tables. The SFC is commissioning new pensions tables which will be available on the SFC website. The notes state that the tables may meet the 'best estimate' and 'present value' requirements of FRS 102. The SFC will advise of an appropriate discount factor (net interest rate) as at 31 July 2017 (2015/16 - 0.5%), and will also issue an accompanying spreadsheet for the calculation of the provision. Audit Strategy will advise auditors when they become available. Where a college uses a different net interest rate, auditors should confirm there is reasonable justification for doing so.

28. Where a college has recognised a pension liability under section 28 of FRS 102 (explained at module 3), the liability will include early retirement costs. Colleges should therefore reduce the early retirement provision for amounts recognised under section 28 to prevent double-counting.

Provision not recognised for back pay

29. The pay award for college lecturers for the 2017/18 financial year has not yet been agreed. Once agreed it will be backdated to 1 April 2017. Auditors should assess whether the college has recognised a provision at 31 July 2017 for any unpaid backdated element.

Provision not recognised for overtime holiday pay

30. A ruling from the Employment Appeal Tribunal states that holiday pay should include non-guaranteed overtime (i.e. overtime which is not guaranteed by the employer, but which the worker is obliged to work if it is offered).

31. The ruling may have implications for colleges where their employees are required to work overtime as a regular part of their job. The backdated claims have, however, been limited, with the tribunal ruling that workers can only make claims if it is less than three months since their last incorrect payment, although the claim can be backdated until such time as there is a three month break between underpayments.

32. Auditors should assess whether the college has considered the need to recognise a provision for any claims received, including obtaining legal advice, where the recognition conditions are met.

Provision not recognised for financial guarantees

33. The SORP requires bodies to comply with section 21 of FRS 102 in respect of financial guarantees. Financial guarantee contracts require colleges to make specified payments to reimburse the holder of a debt if the debtor fails to make a payment under a contract. Auditors should check that

- financial guarantee contracts have been recognised as a liability on the balance sheet
- the provision was initially recognised at fair value. This would normally be estimated by considering the probability of the guarantee being called and the likely amount payable

- the entries on initial recognition of any new provisions recognised in 2015/16 were a credit to the financial guarantee liability and a charge to operating expenditure
- the provisions have been amortised over their useful lives to match any reductions in the underlying risk exposure, e.g. a repayment of some of the principal by the debtor
- the carrying amount of the financial guarantee has remained at the initially recognised amount (less cumulative amortisation) unless payment under the guarantee has become probable in which case the amount of the provision should have been determined in accordance with FRS 102
- any movements in the carrying amount have been debited or credited to operating expenditure.

Expected reimbursements are not recognised

34. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, auditors should assess whether the reimbursement
    - has been recognised only when it is virtually certain that it will be received
    - has been treated as a separate asset (and not netted of the provision)
    - does not exceed the amount of the provision.

Information on provisions is not properly disclosed

35. Auditors should assess whether the college has complied with the disclosure requirements of FRS 102 section 21.

36. In extremely rare cases, where disclosure of some or all of the required information can be expected to prejudice seriously the position of the college in a dispute with other parties on the subject matter of a provision, the college need not disclose the information. Auditors should assess whether the college has instead disclosed the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Contingent liabilities are not disclosed

37. Auditors should assess whether a contingent liability has been disclosed where
    - there is a present obligation but it is not probable that an outflow of resources or service potential will be required or the amount cannot be reliably measured (and therefore a provision cannot be recognised)
    - there is a possible obligation arising from past events whose existence will be confirmed by uncertain future events not wholly within the college's control.

38. Auditors should assess whether the college has disclosed for each contingent liability
    - a brief description of its nature
    - an estimate of its financial effect
    - an indication of the uncertainties

- the possibility of any reimbursement.

39. The disclosure for a contingent liability in the notes is not required where

- the possibility of any outflow in settlement is remote. However, FReM paragraph 5.3.28 requires remote contingent liabilities to be included in the parliamentary and accountability report (as explained at module 6)
- it is not practicable to do so. Auditors should check that the fact it is not practicable has been disclosed
- disclosure of some or all of the required information can be expected to prejudice seriously the position of the college in a dispute with other parties on the subject matter of the contingent liability. Auditors should check that the college has instead disclosed the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

3 Creditors

Changes in 2016/17

40. There are no changes in financial reporting requirements in 2016/17.

Definition

41. Creditors are financial liabilities arising from the contractual obligation to pay cash in the future for goods or services or other benefits that have been received or supplied and have been invoiced or formally agreed with the supplier.

Financial reporting requirements

42. The SORP section 6 requires bodies to account for creditors in accordance with *FRS 102 Section 11.*

Risks of misstatement

43. The following paragraphs highlight potential risks of misstatement in respect of creditors, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Creditors are not recognised at the required point

44. Auditors should assess whether creditors have been recognised at the point when ordered goods have been delivered or services rendered.

Creditors are not recognised at the required amount

45. Auditors should assess whether creditors have been measured at the transaction price.

46. If payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate, the entity shall measure the financial liability at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

Revenue received in advance is not recognised as a creditor

47. In the event that revenue is received but the goods have not been delivered or services rendered, auditors should check whether the college has recognised a creditor (i.e. receipt in advance).

4 Accruals

Changes in 2016/17

48. There are no changes in financial reporting requirements in 2016/17.

Definition

49. Accruals are liabilities to pay for goods and services that have been received or supplied, including amounts due to employees, but technically differ from creditors in that they have not been invoiced or formally agreed with the supplier. Although it is usually necessary to estimate the amount of accruals, the uncertainty is generally much less than for provisions.

Financial reporting requirements

50. The SORP requires bodies to prepare their financial statements using the accrual basis of accounting.

51. Section 28 of FRS 102 requires colleges to recognise an accrual for the untaken element at the year end of short-term accumulating paid absences.

Risks of misstatement

52. The following paragraphs highlight the potential risks of misstatement in respect of accruals, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Accruals are not identified

53. Auditors should assess whether the college has satisfactory arrangements for identifying accruals to pay for goods and services that
    - have been received or supplied
    - have not been invoiced.

Untaken holiday accrual is not recognised

54. Paid absences are periods during which an employee does not provide services to the employer, but benefits continue to be paid. Accumulating absences are those that are carried forward and used in future periods if the current period entitlement is not used in full, e.g. annual leave and flexitime balances. It is therefore generally referred to as the untaken holiday accrual.

55. Accumulating paid absences should be recognised when employees render services that increase their entitlement to future compensated absences.

56. The accrual should be measured as the additional amount that the college expects to pay as a result of the unused entitlement that has accumulated at 31 July 2017. This should include salary as well as associated employer's national insurance and pension contributions. The reference to ‘expectation to pay’ does not relate to an additional payment over and above an employee’s normal salary. Instead it refers to the circumstance where an employee receives their salary for the current year but takes a day off that is part of their entitlement from an earlier year.

57. The accrual should be based on the proportion of the annual salary and associated costs which relates to the number of untaken days. Auditors should assess whether the college has gathered reliable information on the number of days of untaken leave as at 31 July 2017 to allow them to make the calculation.

58. It is likely that bodies will need to conduct a sample to establish the level of accrual required. Auditors should assess whether the sample reflects

- all groups of staff
- the amount of expenditure
- the expected level of leave.

59. Auditors should check whether

- the accrual at 31 July 2016has been reversed in 2016/17 and replaced with the accrual at 31 July 2017
- the net increase or decrease has been charged to operating expenditure.

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - module 3 retirement benefits

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Contents

Retirement benefits

Purpose of module

1. This module of technical guidance note 2017/6(FE) provides information on, and guidance on the risks of misstatements in, retirement benefits.

Changes in 2016/17

2. There are no changes in the financial reporting requirements in 2016/17.

Definition

3. Retirement benefits are all forms of consideration given by an employer in exchange for services rendered by employees that are payable after the completion of employment.

Financial reporting requirements

4. Colleges are required to account for retirement benefits in accordance with section 28 of FRS 102. Specific requirements are set out at paragraphs 21.6 to 21.26 of the 2015 SORP.

5. FRS 102 distinguishes between defined benefit schemes and defined contribution schemes, and prescribes different accounting and disclosure treatments for each scheme.

6. Colleges which have defined benefit schemes that are part of a multi-employer scheme, and which are unable to identify their share of the underlying assets and liabilities on a consistent and reasonable basis, should account for their participation on a defined contribution basis. FRS 102 states that an employer may be unable to identify its share of the underlying assets and liabilities on a consistent and reasonable basis if the scheme exposes the participating employers to actuarial risks associated with the current and former employees of other entities e.g. when the contributions from employers are set at a common level.

7. Colleges participate in two multi-employer defined benefit schemes, i.e. the *Scottish teachers superannuation scheme* (STSS) and the *Local government pension scheme* (LGPS).

Risks of misstatement

8. The following paragraphs highlight potential risks of misstatement in respect of retirement benefits, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Schemes are not properly classified

9. The SORP states that it is normally possible for individual employers in the LGPS to identify their share of assets and liabilities. Therefore it considers that these schemes should be accounted for as defined benefit schemes, provided that the assets and liabilities can be measured on a reliable and consistent basis.

10. However, it acknowledges some LGPS administrators have indicated that they can only provide colleges with a 'pooled valuation' (i.e. assets and liabilities are only identified on an aggregate basis for a group of bodies that then share a common contribution rate).

11. The SORP states that the STSS should be treated as a defined contribution scheme, and all colleges account in this way.

LGPS is not properly accounted for

12. FRS 102 requires assets in schemes accounted for on a defined benefit basis to be measured at their fair value at the balance sheet date, and liabilities to be measured on an actuarial basis. The objective of the valuation is to make the best estimate of the future cash outflows that will arise in respect of the benefits earned by employees at the valuation date.

13. Auditors should confirm that the estimated accrued liabilities have been discounted to their present value at the current rate of return on a high quality corporate bond of a currency and term that matches the scheme liabilities.

14. The net interest expense should be based on the net deficit.

15. The valuation normally requires the expertise of an actuary. Under ISA (UK) 500, auditors are required to
    - evaluate the competence, capabilities and objectivity of the actuary
    - obtain an understanding of their work
    - evaluate the appropriateness of the actuary's work as audit evidence.

16. The surplus/deficit in a defined benefit scheme is the excess/shortfall of the value of the assets in the scheme over/below the present value of the scheme liabilities.

STSS is not properly accounted for

17. The cost of a defined contribution scheme is equal to the contributions payable to the scheme for the accounting period.

Pension items are not properly presented on the balance sheet

18. Auditors should confirm that
    - an asset has been recognised to the extent that the college is able to recover a surplus either through reduced contributions in the future or through refunds from the scheme
    - liabilities have been recognised in the balance sheet to the extent that they reflect a legal or constructive obligation.

19. The 2015 SORP (in contrast with the 2007 SORP) does not provide for a separate pension reserve, and there is no concept of a pension reserve under FRS 102. Auditors should confirm that a pension reserve has not been presented in the balance sheet.

Pension items are not properly disclosed in the notes

20. Auditors should confirm that the disclosures for defined benefit schemes set out the nature of the scheme and follow the disclosure requirements set out in paragraphs 28.41and 28.41A of FRS 102.

21. Auditors of colleges which account for defined benefit schemes on a defined contribution basis should confirm that the college has disclosed
    - the cost for the period
    - any outstanding or prepaid contributions at 31 July 2017
    - the reason why sufficient information is not available to account for the scheme as a defined benefit scheme
    - the fact that the scheme is a defined benefit scheme but that the college is unable to identify its share of the underlying assets and liabilities
    - any available information about the existence of the surplus or deficit in the scheme and the implications of that surplus or deficit for the college.

Contact point

22. The contact point in Audit Strategy for this module of the technical guidance note is Helen Cobb, Technical Adviser (Central Government, Health and Further Education) - 0131 625 1901 or HCobb@audit-scotland.gov.uk.

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - module 4 other financial statement areas

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Audit Scotland is a statutory college set up in April 2000 under the College Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and college sector bodies in Scotland are held to account for the proper, efficient and effective use of college funds.

Contents

1 Introduction

Purpose of module

2. This module of technical guidance note 2017/6(FE) provides information on, and guidance on the risks of misstatements in, the following financial statement areas

- Accounting policies, estimates and errors
- Heritage assets
- Investment property
- Intangible assets
- Investments
- Leases
- Service concession arrangements
- Government grants
- Charitable funds
- Consolidated financial statements
- Events after the end of the reporting period
- Disclosures on key judgements, agency arrangements, and related parties.

Contact point

3. The main contact points in Audit Strategy for this module of the technical guidance note are

- Neil Cameron, Manager - Health and Central Government (Technical) - ncameron@audit-scotland.gov.uk
- Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Accounting policies, estimates and errors

Purpose of section

4. This section of module 4 provides information on, and guidance on the risks of misstatements in, accounting policies, estimates and errors.

Changes in 2016/17

5. There are no changes in financial reporting requirements in 2016/17.

Definitions

6. Accounting policies are the specific principles, bases, conventions, rules and practices applied in preparing and presenting financial statements.

7. Estimation involves judgements about the measurement of items based on the latest available, reliable information in cases where they cannot be measured with precision.

8. Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts.

Financial reporting requirements

9. Section 5 of the SORP requires colleges to comply with FRS 102 section 10.

10. The objective of section 10 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and the correction of errors.

Risks of misstatement

11. The following paragraphs highlight potential risks of misstatement in respect of accounting policies, estimates and errors, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Accounting policies are not appropriate

12. Where the SORP permits a choice of accounting policy, auditors should assess whether the college has used judgement in developing and applying an accounting policy that results in information that is relevant and reliable. A college cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by explanatory material.

13. Auditors should assess whether the accounting policies applied by the college
    - are appropriate to its circumstances

- have been consistently applied.

14. In accordance with ISA (UK) 240, auditors should evaluate whether the selection and application of accounting policies by the college, particularly those related to subjective measurements and complex transactions, is indicative of fraudulent financial reporting.

Accounting policies are not adequately disclosed

15. Auditors should check that significant accounting policies have been adequately disclosed in the notes.

Changes in accounting policies are not properly accounted for

16. Auditors should check that the college has changed an accounting policy only if
    - the change is required as part of the transition to FRS 102 or the 2015 SORP; or
    - it results in the financial statements providing reliable and more relevant information on an item.

17. Where a college changes an accounting policy, auditors should assess whether it has applied the changes retrospectively. Retrospective application involves adjusting the opening balance of each affected component of net worth for the earliest period presented and the other comparative amounts disclosed as if the new accounting policy had always been applied. Retrospective application is not required
    - where the SORP or FRS 102 specifies transitional provisions that should be followed
    - to the extent that it is impracticable. This means that the college cannot apply it retrospectively after making every reasonable effort to do so.

18. Auditors should check that
    - a restated balance sheet as at 1 April 2015 has been prepared if the restatement is material
    - the college's estimates originally made at that date have not been adjusted with the benefit of hindsight simply because more up to date information has become available. The receipt of new information should have been treated in the same way as non-adjusting events after the reporting date explained at section 12 of this module.

Accounting estimates are not reasonable

19. Many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information. An estimate cannot be determined to be accurate or inaccurate, but it can be considered free from error if
    - the amount is described clearly and accurately as being an estimate
    - the nature and limitations of the estimating process are explained
    - no errors have been made in selecting and applying an appropriate process for developing the estimate.

20. Auditors should judge whether the college's accounting estimates are reasonable and the related disclosures in the financial statements are adequate. As part of the judgement of reasonableness, auditors should assess whether
    - the method used in making the accounting estimate is appropriate
    - the underlying assumptions are reasonable
    - the college has considered and addressed the effect of estimation uncertainty
    - the estimate is free from error.

Changes in accounting estimates are not properly accounted for

21. Auditors should assess whether
    - accounting estimates have been revised
        - where there are changes in the circumstances on which the estimate was based; or
        - as a result of new information or experience.
    - the effect of a change in an accounting estimate has been recognised prospectively (i.e. from the date of change rather than retrospectively)
    - a change in the measurement basis applied to an accounting estimate has been treated as a change in an accounting policy rather than as a change in an accounting estimate.

Departures from FRS 102 requirements are not justified

22. In the extremely rare circumstances in which a college concludes that compliance with a requirement of FRS 102 would be so misleading that it would prevent the financial statements giving a true and fair view, the college may depart from that requirement.

23. Auditors should assess whether the departure is justified and, if so, check that the college has disclosed in accordance with FRS 102 paragraph 3.5
    - that management has concluded that the financial statements present fairly the college's financial position, financial performance and cash flows
    - that it has complied with FRS 102, except that it has departed from a particular requirement to achieve a fair presentation
    - the nature of the departure, including the treatment that FRS 102 would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements to provide useful information, and the treatment adopted.

Errors are not properly identified or corrected

24. Errors are omissions from, and misstatements in, a college's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that
    - was available when financial statements for those periods were authorised for issue; and

- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

25. Free from error means there are no errors in the information in the financial statements, and the process used to produce the reported information has been selected and applied with no errors. Auditors should encourage the college to correct all errors identified.

26. Changes in accounting estimates result from new information or new developments and are different from the correction of errors.

Prior period errors are not properly accounted for

27. In the case of errors relating to prior periods that are material, auditors should assess whether the college has corrected them retrospectively in 2016/17 by
    - restating the comparative amounts for the prior periods presented in which the error occurred; or
    - if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and net worth for the earliest prior period presented.

28. A retrospective restatement to correct an error is not required if it is impracticable. This is the case where the college cannot restate after making every reasonable effort to do so because
    - the effects of the retrospective restatement are not determinable
    - the retrospective restatement requires assumptions about what management's intent would have been in that period; or
    - the retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that
        - provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and
        - would have been available when the financial statements for that prior period were authorised for issue (explained in section 13).

29. When it is impracticable to determine the period specific effects of an error on comparative information, auditors should assess whether the college has restated the opening balances of assets, liabilities and net worth for the earliest period for which retrospective restatement is practicable (which may be the current period).

Prior period errors are not properly disclosed

30. Where a prior period error has been corrected in 2016/17, auditors should assess whether the college has disclosed
    - the nature of the prior period error
    - for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected
    - the amount of the correction at 1 April 2015.

3 Heritage assets

Purpose of section

31. This section of module 4 provides information on, and guidance on the risks of misstatements in, heritage assets.

Changes in 2016/17

32. There are no changes in financial reporting requirements in 2016/17.

Definition

33. Heritage assets are those that are held and maintained principally for their contribution to knowledge and culture.

Financial reporting requirements

34. The financial reporting requirements are set out in section 34 of FRS 102 and paragraphs 26.31 to 26.35 of the 2015 SORP.

Risks of misstatement

35. The following paragraphs highlight potential risks of misstatement in respect of heritage assets, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Heritage assets are not identified

36. Heritage assets are those that are intended to be preserved in trust for future generations and are held and maintained principally for their contribution to knowledge and culture. They include historical buildings, archaeological sites, scientific equipment of historical importance, and works of art. Auditors should confirm that colleges have reviewed their tangible fixed assets to identify those that meet the definition of a heritage asset.

37. However, assets that are also used by a college to provide services are tangible fixed assets (even if they otherwise meet the definition for heritage assets) and should be accounted for in accordance with FRS 102 section 17.

Heritage assets are not properly valued

38. Valuations of heritage assets may be made by any method that is appropriate and relevant. Where it is not practicable to obtain a valuation, heritage assets should be measured at historical cost. Auditors should confirm that, where a college has information on the cost or value of a heritage asset or can obtain it at a cost commensurate with the benefits, the assets has been recognised in the balance sheet.

39. Depreciation is not required on heritage assets which have indefinite lives, but the carrying amount should be reviewed where there is evidence of impairment.

Information on heritage assets is not properly disclosed

40. FRS 102 paragraphs 34.55 and 34.56 sets out disclosure requirements for the reporting of heritage assets, which apply whether or not they are reported in the balance sheet. Auditors should confirm that the following disclosures have been made for all heritage assets
    - an indication of their nature and scale
    - the policy for their acquisition, preservation, management and disposal
    - the accounting policies adopted
    - a summary of transactions disclosing the cost of acquisitions, the value acquired by donation, the carrying value of disposals and proceeds, and any impairment.
41. Auditors should confirm that the following have been disclosed for heritage assets recognised in the balance sheet
    - a reconciliation of the carrying amount at the beginning and end of the financial period showing additions and disposals, revaluation changes, any impairment losses, and any depreciation
    - the date of the valuation, valuation methods used to produce the valuation, and details of valuer etc.
42. For heritage assets that are not reported in the balance sheet, auditors should confirm that the reasons for non-recognition have been disclosed.

4 Investment property

Purpose of section

43. This section of module 4 provides information on, and guidance on the risks of misstatements in, investment property.

Changes in 2016/17

44. There are no changes in financial reporting requirements in 2016/17.

Definition

45. Investment property is property held to earn rentals or for capital appreciation or both, rather than for
    - use in the production or supply of goods or services or for administrative purposes
    - sale in the ordinary course of business.

Financial reporting requirements

46. Section 10 of the SORP requires colleges to account for investment properties in accordance with section 16 of FRS 102.

Risks of misstatement

47. The following paragraphs highlight potential risks of misstatement in respect of investment properties, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Investment properties are not identified

48. Auditors should confirm that colleges have identified any investment properties they hold. An investment property is an interest in land and/or buildings which is held for its investment potential, with any rental income being negotiated at arm's length.

49. This definition does not include a property
    - which is owned and occupied by a college for its own purposes
    - let to, and occupied by, a subsidiary.

50. Auditors should confirm that investment properties have been included in the balance sheet at their fair value without any depreciation.

5 Intangible assets

Purpose of section

51. This section of module 4 provides information on, and guidance on the risks of misstatements in, intangible assets.

Changes in 2016/17

52. There are no changes in financial reporting requirements in 2016/17.

Definition

53. An intangible asset is an identifiable non-monetary asset without physical substance.

Financial reporting requirements

54. Section 12 of the SORP requires colleges to account for intangible assets in accordance with section 18 of FRS 102.

55. While the SORP requires intangible assets to be carried at either historical cost or a current valuation, the FReM requires a current value.

56. FRS 102 requires a college to recognise an intangible asset if (it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and the cost or value of the asset can be measured reliably.

57. The SORP paragraph 12.8 states that all intangible assets are considered to have a finite life.

Risks of misstatement

58. The following paragraphs highlight potential risks of misstatement in respect of intangible assets, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Intangible assets are not identified

59. Auditors should assess whether

- the college has reviewed its expenditure to identify amounts that meet the FRS 102 definition of an intangible asset. For example, it is expected that in most cases purchased computer software will meet the definition and should therefore be recognised as an intangible asset
- expenditure to acquire or generate an item that does not meet the definition of an intangible asset has been recognised in operating expenditure when it is incurred
- subsequent expenditure incurred on an intangible asset has been recognised as an expense unless exceptionally it meets the recognition criteria.

Internally generated intangible assets are not recognised

60. Auditors should assess whether development expenditure has been recognised as an internally generated intangible asset when it meets the following criteria

- The technical feasibility of completing the intangible asset so that it will be available for use or sale must be demonstrated.
- There must be an intention to complete the intangible asset and use or sell it.
- The college must be able to use or sell the intangible asset.
- The college must be able to demonstrate how the intangible asset will generate future economic benefits or future service potential, e.g. existence of a market for the output of the intangible or, if it is to be used internally, the usefulness of the intangible asset.
- Adequate resources must be available to complete the development of the asset and to use or sell it.
- The college must be able to reliably measure the expenditure incurred during the development of the intangible asset.

61. The SORP paragraph 12.11 provides specific guidance on the types of expenditure to be considered for internally generated website projects. It states that expenditure incurred on developing a website for promoting and advertising a college's own products and services should be recognised as an expense. Costs in respect of new online course development are also likely to be expensed. Auditors should confirm that these costs have not been recognised as an intangible asset.

Intangible assets are not properly valued

62. Auditors should assess whether an intangible asset has been

- measured initially at cost
- measured at current value in existing use where an active market exists
- revalued using indices or some suitable model to depreciated replacement cost (or, if lower, value in use where the asset is income generating) where no active market exists.

Intangible assets are not properly accounted for

63. Auditors should assess whether amortisation has been included in operating expenditure.

6 Investments

Purpose of section

64. This section of the module provides information on, and guidance on the risks of misstatements in, investments.

Changes in 2016/17

65. There are no changes in financial reporting requirements in 2016/17.

Definition

66. Investments are equity instruments held in another entity.

Financial reporting requirements

67. SORP paragraph 6.2 allows a college to choose to apply either
    - the provisions of section 11 and section 12 of FRS 102; or
    - the recognition and measurement provisions of *IAS39 Financial instruments: recognition and measurement/IFRS 9 Financial instruments* and the disclosure requirements of sections 11 and 12.
68. Specific requirements are included at SORP section 6.

Risks of misstatement

69. The following paragraphs highlight potential risks of misstatement in respect of investments, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Investments are not properly measured

70. Auditors should confirm that any investments have been measured at fair value where publicly traded or their value can otherwise be reliably measured. Otherwise they should be measured at cost less impairment.
71. Paragraph 11.27 of FRS 102 sets out the following hierarchy to estimate the fair value of the shares
    - The best evidence is a quoted price for an identical asset in an active market.
    - When quoted prices are unavailable, the price of a recent transaction for an identical asset provides evidence of fair value as long as there has not been a significant change in economic circumstances or a significant lapse of time since the transaction took place.
    - In the absence of the above two options, a college should estimate the fair value by using a valuation technique.

Investments in subsidiaries are not properly measured

72. Auditors should confirm that investments in subsidiaries are recognised in accordance with paragraph 9.26 of FRS102.

7 Leases

Purpose of section

73. This section of module 4 provides information on, and guidance on the risks of misstatements in, leases.

Changes in 2016/17

74. There are no changes in financial reporting requirements in 2016/17.

Definition

75. A lease is an agreement whereby the lessor conveys to the lessee in return for payment the right to use an asset for an agreed period of time.

Financial reporting requirements

76. Section 14 of the SORP requires colleges to account for leases in accordance with section 20 of FRS 102. FRS102 requires a lease to be classified as either a finance lease or an operating lease.

Risks of misstatement

77. The following paragraphs highlight potential risks of misstatement in respect of leases, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Leases are not properly classified

78. Auditors should assess whether the college has identified all its lease agreements and has classified them properly between finance leases and operating leases. The difference between the two types of lease is that a finance lease transfers substantially all the risks and rewards incidental to ownership of an asset. Classification depends on the substance of the transaction, rather than the form of the contract, and the assessment should be made at the inception of the lease.

79. Auditors should assess whether the college has considered the following examples provided by FRS 102 of situations that individually or in combination would normally lead to a lease being classified as a finance lease

- The lease transfers ownership of the asset to the lessee by the end of the lease term. Generally land will always be an operating lease but in this situation it would be classified as a finance lease.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable.

- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset. This indicator does not apply to leases on non-commercial terms, i.e. nominal or at peppercorn rents.
- The leased property is of such a specialised nature that only the lessee can use it without major modification.

80. In addition, FRS 102 gives the following indicators of situations that could also lead to a lease being classified as a finance lease
    - If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
    - Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee.
    - The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

81. However, these examples may not be conclusive, and auditors should check that the lease has been classified as an operating lease if it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership.

82. Auditors should assess whether
    - lease classification has been made at the inception of the lease
    - where a lessee and lessor agree to change the lease (other than by renewing the lease), this has been regarded as a new agreement if the changed provisions result in a different classification of the lease
    - changes in estimates (e.g. in respect of the economic life or the residual value of the leased property) or changes in circumstances (e.g. default by the lessee) have not resulted in a new classification of the lease for accounting purposes
    - the land and buildings elements of a lease have been considered separately for the purposes of lease classification. The land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term. Separate consideration is not required
        - where the whole lease is quite clearly an operating lease
        - where the amount that would initially be recognised for the land element is immaterial
        - for investment properties where the college is the lessee.

Finance leases are not properly accounted for where the college is lessee

83. For finance leases where the college is the lessee, auditors should assess whether
    - assets and liabilities have been recognised at amounts equal to the fair value of the property or, if lower, the present value of the minimum lease payments

- the discount rate is the rate implicit in the lease. This is the rate that, at the inception of the lease, causes the present value of the minimum lease payments to be equal to the fair value of the leased asset
- any initial direct costs have been added to the value of the asset
- minimum lease payments have been apportioned between the finance charge (interest) and the reduction of the outstanding liability
- the finance charge has been calculated so as to produce a constant periodic rate of interest on the remaining balance of the liability
- contingent rents have been charged as operating expenditure
- leased assets have been depreciated in a manner consistent with owned assets. Where it is not certain that ownership of the asset will transfer at the end of the lease, the asset should be depreciated over the shorter of the lease term and its useful economic life
- leased assets are subject to revaluation in the same way as owned assets
- depreciation, impairment and gains or losses on revaluation have been charged in the normal way.

Operating leases are not properly accounted for where the college is lessee

84. For operating leases where the college is the lessee, auditors should assess whether

- lease payments have been recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the benefits received by the college
- lease incentives have been recognised in accordance with paragraph 20.15A of FRS 102 as a reduction in the lease expense over the lease term on a straight-line basis unless another systematic basis is more representative of the benefits received by the college
- any payment made on entering into a lease has been recognised as prepaid lease payments and amortised over the lease term in accordance with the pattern of benefits provided.

Finance leases are not properly accounted for where the college is lessor

85. For finance leases where the college is the lessor, auditors should assess whether

- the assets have been recognised as a long term debtor at an amount equal to the net investment in the lease (i.e. the minimum lease payments plus any unguaranteed residual value discounted at the interest rate implicit in the lease)
- the lease payment receivable has been treated as repayment of principal and finance income
- the finance income has been calculated so as to produce a constant periodic rate of return on the net investment.

Operating leases are not properly accounted for where college is lessor

86. For operating leases where the college is the lessor, auditors should assess whether

- the assets are properly presented in the balance sheet
- costs incurred in earning the lease income have been recognised in operating expenditure
- the depreciation policy for depreciable leased assets is consistent with the normal depreciation policy for similar assets, and depreciation has been charged to operating expenditure
- income has been recognised on a straight-line basis over the lease term, or another systematic basis that is more representative of the time pattern in which the benefit derived from the leased asset is diminished
- the cost of any lease incentives has been recognised as a reduction of rental income over the lease term, on a straight-line basis or another systematic basis that is more representative of the time pattern in which the benefit derived from the leased asset is diminished
- initial direct costs incurred in negotiating and arranging an operating lease have been added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

Sale and lease back transactions are not properly accounted for

87. A sale and leaseback transaction involves a college selling an asset and leasing back the same asset. The lease classification should be determined as soon as practicable as this determines the subsequent accounting treatment.

88. Where a sale and leaseback transaction results in a finance lease, auditors should assess whether any excess of sales proceeds over the carrying amount has been amortised over the lease term.

89. Where a sale and leaseback transaction results in an operating lease, auditors should assess whether

- any gain or loss on disposal has been recognised immediately when the sale and the lease are at fair value
- if the sale price is below fair value, and the loss is compensated for by future lease payments below market price, the loss has been amortised in proportion to the lease payments
- if the sale price is above fair value, the excess over fair value has been amortised over the period for which the asset is expected to be used.

Arrangements containing a lease are not identified

90. Paragraph 20.3 of FRS 102 specifies the accounting treatment for arrangements that do not take the legal form of a lease but which convey a right to use an asset in return for payment.

Examples of arrangements in which supplier may convey to a college the right to use an asset, often together with related services, may include outsourcing arrangements (e.g. catering contracts which may embed catering equipment assets). Where a college enters into such an arrangement, auditors should assess whether

- it has determined whether the arrangements contain a lease element at the inception of the arrangement and, if so, it has accounted for that element as a lease
- the determination has been made in accordance with paragraph 20.3A which requires the college to assess whether
  - fulfilment of the arrangement is dependent on the use of a specific asset or assets, e.g. it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets
  - the arrangement conveys a right for the purchaser (lessee) to control the use of the asset, e.g. where the purchaser can operate the underlying asset in a manner it determines, or controls physical access to the underlying asset.

Information on leases is not properly disclosed

91. Auditors should assess whether the college has met the disclosure requirements of section 20 of FRS 102.

8 Service concession arrangements

Purpose of section

92. This section of module 4 provides information on, and guidance on the risks of misstatements in, service concession arrangements.

Changes in 2016/17

93. .There are no changes to the financial reporting requirements in 2016/17.

Definition

94. A service concession arrangement is a contractual (or similar arrangement) between a college and a private sector operator in which
    - the operator uses an asset to provide a public service on behalf of the college for a specified period of time
    - the operator is compensated for its services over the period of the service concession arrangement.

Financial reporting requirements

95. Section 26 of the SORP requires colleges to account for service concession arrangements in accordance with paragraphs 34.12 to 34.16A of FRS 102.

96. Additional disclosure requirements are set out at paragraph 26.30 of the SORP.

Risks of misstatement

97. The following paragraphs highlight potential risks of misstatement in respect of service concession arrangements, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Service concession arrangements are not identified

98. Auditors should assess whether the college has carried out a review of its contractual (or similar arrangement) with a private sector operator in which
    - the operator uses an asset to provide a public service on behalf of the college for a specified period of time
    - the operator is compensated for its services over the period of the service concession arrangement.

99. Service concession arrangements typically involve the operator constructing or upgrading assets used in the provision of the service, and operating and maintaining those assets over the period. Other features of typical service concession arrangements are

- the operator is responsible for at least some of the management of the service concession assets and related services and does not merely act as an agent of the college
- the contract sets initial prices levied by the operator and regulates price revisions over the period of the service arrangement
- the operator is obliged to hand over the service concession asset to the college in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

100. Public private partnership (PPP) and private finance initiative (PFI) contracts, and non-profit distributed models, are generally service concession arrangements.

101. A college is required to account for service concession arrangements if it acts as principal in the arrangement. This would be the case where the college is responsible for an annual unitary payment. A college is a principal in respect of residence arrangements where the college

- takes the student debt and void risk on each student rental agreement
- has made a guarantee through a minimum occupancy guarantee
- has room nomination rights.

Service concession assets are not properly accounted for

102. An asset used in a service concession arrangement may be either

- provided by the operator which
  - the operator constructs, develops, or acquires from a third party, or
  - is an existing asset of the operator; or
- provided by the college and is an
  - existing asset of the college; or
  - upgrade to an existing asset of the college.

103. Auditors should check whether the college has recognised a service concession asset as a tangible fixed asset in the balance sheet if

- the college controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and where
- the college controls any significant residual interest in the asset at the end of the term of the arrangement.

104. The recognition criteria for the asset may be met during the construction or development period and, if so, auditors should check that the college has recognised the service concession asset during that period.

105. Auditors should assess whether the service concession asset has been initially recognised at fair value as follows

- Where the construction and service elements of the unitary payments to the operator can be separated (e.g. where the contract specifies the amount to be allocated to the asset), fair value should represent the element of the payments paid to the operator for the asset.
- Where the payments are not separable, fair value should be determined using estimation techniques.

106. Subsequently, auditors should assess whether

  - current value follows the appropriate class of asset
  - depreciation, impairment and gains or losses on revaluation have been charged in the normal way.

Service concession liabilities are not properly accounted for

107. Where a college recognises an asset provided by the operator or an upgrade to an existing asset as a service concession asset, auditors should assess whether

- a liability has also been recognised initially measured at the same amount as the service concession asset but adjusted by the amount of any other consideration, e.g. cash
- the service element has been charged to operating expenditure. Where it cannot be separated, the service element should be estimated
- the construction element has been accounted for as if it were a finance lease and allocated into a repayment of the liability and a finance charge.

Existing assets are not properly accounted for

108. A college may provide the operator with access to existing assets of the college (that are not to be used in the service concession arrangement) in exchange for reduced or eliminated payments.

109. Where the arrangement involves a permanent transfer of an asset to the operator or a finance lease, auditors should assess whether the college has

- derecognised the asset
- recognised the reduction in the liability in the balance sheet (and any other consideration received)
- recognised any difference between the carrying amount and the total consideration received in operating expenditure.

110. For other access arrangements, auditors should assess whether the college has accounted for the arrangement as an operating lease.

Prepayments are not properly accounted for

111. Service concession arrangements may be structured to require payments to be made before the related service concession asset is recognised on the balance sheet. Auditors should assess whether these payments have been

- recognised as prepayments
- applied to reduce the outstanding liability when it is recognised.

112. Any prepayments should be taken into account when estimating the fair value of the asset and liability and the separation of payments into the liability, interest and service charge elements.

Information on service concession arrangements is not properly disclosed

113. Auditors should assess whether the college has met the disclosure requirements of SORP paragraph 26.30 including

- movements in the value of assets and liabilities
- details of the future minimum payments to be made analysed by payment period
- a description of the arrangement, significant terms that may affect future cash flows, and the nature and extent of matters such as rights to use or obligations to acquire specified assets.

9 Government grants

Purpose of section

114. This section of the module provides information on, and guidance on the risks of misstatements in, government grants.

Changes in 2016/17

115. There are no changes to the financial reporting requirements in 2016/17.

Definition

116. Grants are assistance from the SFC and other sources in the form of cash in return for compliance with certain conditions relating to the operating activities of a college as set out in the outcome agreement.

117. Revenue-based grant to finance the general activities of a college is referred to as grant-in-aid. Other grants are for specific purposes under a particular agreement or contract.

Financial reporting requirements

118. Colleges are required to account for government grants in accordance with section 24 of FRS 102. Specific requirements are set out in the SORP at paragraphs 17.13 to 17.17.

119. The SORP allows revenue and capital (other than for land) government grants to be accounted for by applying the accrual model or performance model. The SFC considers this to be a 'conflict' with the FReM (which requires a methodology which equates to the performance model) and therefore considers that the SORP should take precedence. The SORP requires capital grants for land to follow the performance model.

120. Grants-in-aid and grants should be recognised in the statement of comprehensive income when the conditions for their receipt have been complied with and there is reasonable assurance that the grant will be received.

Further guidance

121. Guidance on SFC funding is provided at paragraphs 9 and 10 of the guidance notes. Annex A of the guidance notes provide a model disclosure note.

Risks of misstatement

122. The following paragraphs highlight potential risks of misstatement in respect of government grant, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Grants under the accrual model are not properly accounted for

123. The accrual model is the same treatment that was required under the 2007 SORP. For grants accounted for under this model, auditors should assess whether

- revenue government grants have been recognised in income on a systematic basis over the periods in which the college recognises the related costs for which the grant is intended to compensate
- capital government grants have been recognised in income on a systematic basis over the expected useful life of the asset to which the grant relates
- grant that has been deferred has been recognised as deferred income within creditors and not deducted from the carrying amount of the asset
- income has been recognised within the statement of comprehensive income under the relevant heading of funding body grants, research grants or other income as appropriate to the nature of the grant.

Grants under the performance model are not properly accounted for

124. The performance model requires grants to be recognised as income within the statement of comprehensive income when performance-related conditions are met. A performance-related condition is one which requires the performance of a particular level of service or units of output to be delivered, with entitlement to the grant conditional on that performance. There may be a restriction that limits or directs the purposes for which the grant may be used but that does not meet the definition of a performance-related condition.

125. For capital grants for land and other grants accounted for under this model, auditors should assess whether the college

- has recognised a grant as income when performance-related conditions are met
- is holding a grant with unfulfilled performance-related conditions as deferred income until such time that the conditions are met
- has recognised grant with a restriction (but no performance-related condition) as income as soon as the college is entitled to the income.

Grant is not recognised in case it is repaid

126. It is not necessary to postpone recognition of a grant solely because it might have to be repaid in the future. However, auditors should confirm that colleges

- regularly consider whether a breach of conditions is likely
- recognise a provision if repayment of the grant is considered probable.

Information on grants is not properly disclosed

127. Annex A of the guidance notes contains a model note which colleges are required to adopt as far as possible. Any significant one-off or ring-fenced grants should be identified on a separate line. Smaller grants may be grouped together under the ‘other’ heading, but this

should not represent a significant portion of the total grants received. Auditors should confirm that the college has made the required disclosures.

10 Charitable funds

Purpose of section

128. This section of the module provides information on, and guidance on the risks of misstatements in, charitable funds.

Changes in 2016/17

129. There are no changes to the financial reporting in 2016/17.

Definition

130. Charitable funds are endowment funds, specific charitable donations or the results of appeals where the governing body of a college has a fiduciary duty to protect the assets of the fund, spend funds appropriately (and in accordance with any restrictions) and ensure accountability.

131. Endowment funds are held on trust to be retained for the benefit of the college as a capital fund.

Financial reporting requirements

132. Colleges are required to account for charitable donations and endowments in accordance with SORP paragraphs 18.4 to 18.23.

133. The SORP uses the concepts of performance-related conditions and restrictions to distinguish how charitable donations should be accounted for.

134. Where a donor indicates an intention for the college to establish an endowment, the SORP requires the income to be accounted for as an endowment fund. Endowment funds require to be sub-divided into their capital element and an accumulated income fund.

Risks of misstatement

135. The following paragraphs highlight potential risks of misstatement in respect of charitable funds, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Unrestricted donations are not properly accounted for

136. Some donations are given to the college by way of cash or assets with no restrictions on how the donation should be used.

137. Auditors should assess whether charitable donations without any restrictions are recognised as income in the statement of comprehensive income when the donation has been received or there is evidence that the receipt is certain.

Restricted donations are not properly accounted for

138. If there is a restriction on the donation but no performance-related condition exists, the income should be recorded in the statement of comprehensive income as soon as the college is entitled to the income. The donation should be retained within a restricted reserve until the expenditure is incurred in line with the restriction.

139. Colleges may choose to designate elements of their reserves for specific purposes. Restrictions on the use of reserves only exist in financial reporting terms where they are imposed by a donor. Designations by the college should not be reflected in the balance sheet.

140. Auditors should assess whether any donations with a restriction, where the expenditure has not been incurred by 31 July 2017, have been retained within a restricted reserve.

Donations with performance-related conditions are properly accounted for

141. Colleges cannot recognise donations as income in the statement of comprehensive income until performance-related conditions are met. Donations with unfulfilled performance-related conditions should be held as deferred income until such time that the conditions are met.

142. Auditors should assess whether donations with performance-related conditions
    - were recognised as income when the conditions were met
    - are being held as deferred income where the conditions were not met by 31 July 2017.

New endowments are not properly recognised

143. The 2015 SORP requires new endowments to be recorded within the statement of comprehensive income, under donations and endowments, on entitlement to the income. This is a change from previous years where new endowments were credited to the balance sheet via the statement of total recognised gains and losses.

144. Auditors should confirm that any endowments received during 2016/17 have been recognised in the statement of comprehensive income when the college become entitled to the income.

Permanent endowment funds are not properly accounted for

145. A donation to establish an endowment fund which prohibits the conversion of the capital into income creates a permanent endowment fund.

146. The capital fund requires to be maintained in the balance sheet but auditors should confirm that the income on the endowment asset, which may or may not be restricted to a particular purpose, has been recognised in the statement of comprehensive income.

Expendable endowment funds are not properly accounted for

147. Where the college has the power to convert the endowed capital into income, it is an expendable endowment fund. Expendable endowment funds may also exist where a restricted donation is retained for more than two years.

148. Where capital is expended, auditors should confirm that this has been recognised by transferring the relevant amount from expendable endowment funds to general reserves.

Endowment funds are not properly presented in the balance sheet

149. Auditors should confirm that expendable endowment funds have been distinguished from permanent endowment funds on the face of the balance sheet.

Charitable funds are not properly disclosed in the notes

150. Auditors should confirm that the notes to the accounts disclose the information required at paragraphs 18.17 and 18.18 of the SORP.

11 Consolidated financial statements

Purpose of section

151. This section of the module provides information on, and guidance on the risks of misstatements in, consolidated financial statements.

Changes in 2016/17

152. There are no changes in financial reporting requirements in 2016/17.

Definition

153. Consolidated financial statements are the financial statements of a group prepared by the process of adjusting and combining financial information from the individual financial statements of a parent college and its subsidiaries to prepare statements that present financial information for the group as a single economic entity.

Financial reporting requirements

154. The SORP section 4 requires colleges with subsidiaries to prepare consolidated financial statements in accordance with section 9 of FRS 102.

155. The consolidated financial statements should follow the format set out in Appendix 1 to the SORP. These are
    - consolidated statement of comprehensive income
    - consolidated statement of changes in reserves
    - consolidated balance sheet
    - consolidated statement of cash flows.

156. To the extent that they are reflected in the book value of assets to be included in the consolidation, gains or losses on any intra-group transactions should be eliminated in full. Amounts in relation to debts and claims between subsidiaries included in the consolidation should also be eliminated.

Further guidance

157. There is no further guidance on group financial statements.

Risks of misstatement

158. The following paragraphs highlight potential risks of misstatement in respect of consolidated financial statements, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Subsidiaries are not identified

159. An entity is a subsidiary if a college is able to exercise control over its operating and financial policies. Auditors should confirm that colleges have identified the entities they control. A college is deemed to be able to exercise control if, for example, it has

- power over more than half of the voting rights by virtue of an agreement with other investors; or
- power to govern the financial and operating policies of the entity under a statute or an agreement; or
- power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- power to cast the majority of votes at meetings of the board of directors or

160. Auditors should confirm that a college's local charitable foundation does not require to be accounted for as a subsidiary. Paragraph 9.11 of FRS 102 states that consolidation may be required where the objects of another entity are substantially or exclusively confined to the benefit of the college. This may be the case, for example, where the objects of a charitable foundation are set so narrowly that the benefits cannot be applied to any party other than the college. Auditors should examine the documentation for their college's local charitable foundation and assess whether this is the case.

161. FRS 102 sets out specific circumstances where a subsidiary can be excluded, e.g. when there are severe restrictions over the management of the subsidiary, or the interest is held exclusively with the intention to resell.

Associates are not identified

162. An entity is an associate when a college is able to exercise significant influence over its operating and financial policies. This occurs when a college is actively involved and is influential in the direction of an entity through its participation in policy decisions.

163. A holding of at least 20% of voting rights is presumed to confer significant influence.

164. Auditors should assess whether the college has identified its associates.

College and subsidiary year ends are not aligned

165. Auditors should confirm that the financial statements of all subsidiaries have, wherever practicable, been prepared to the same financial year-end and for the same accounting period as the college.

166. Where the financial year of a subsidiary does not coincide, the consolidated financial statements should be prepared from

- the financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements. This is provided that the reporting date is no more than three months before that of the parent college; or
- interim financial statements prepared by the subsidiary as at the parent college's reporting date.

College and subsidiary accounting policies are not aligned

167. Auditors should confirm that uniform group accounting policies were used for determining the amounts to be included in the group financial statements. Where necessary, this may mean adjusting the amounts reported by subsidiaries for the purposes of the consolidation.

12 Events after the reporting period

Purpose of section

168. This section of module 4 provides information on, and guidance on the risks of misstatements in, events after the reporting period.

Changes in 2016/17

169. There are no changes in financial reporting requirements in 2016/17.

Definition

170. Events after the reporting period are those events that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Financial reporting requirements

171. Section 24 of the SORP requires colleges to account for events after the reporting period in accordance with section 32 of FRS 102.

172. FRS 102 paragraph 32.2 requires the annual accounts to reflect events after the end of the reporting period up to the date they were authorised for issue.

Risks of misstatement

173. The following paragraphs highlight potential risks of misstatement in respect of events after the reporting period, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Events after the reporting period are not identified

174. Auditors should assess whether that the college has identified all events occurring between 31 July 2016 and the date the annual accounts have been authorised for issue by the board of management. This involves auditors

- obtaining an understanding of any procedures the college has established to ensure that events after the reporting period are identified
- enquiring of the college whether any events have occurred which might affect the financial statements. This should focus on establishing the up-to-date status of items that were accounted for on the basis of preliminary or inconclusive data, e.g. developments regarding contingencies, or whether any events have occurred that are relevant to the measurement of estimates or provisions.

Relevant events after the reporting period are not properly adjusted for

175. The financial statements should reflect material events after the 31 July 2017 that provide evidence of conditions that existed at that date. Auditors should assess whether the college has adjusted the amounts recognised in the financial statements, including the notes, to reflect the new information.

Non-adjusting events are not properly disclosed

176. Colleges should not adjust the amounts recognised in the financial statements to reflect events that are indicative of conditions that arose after 31 July 2017 (i.e. non-adjusting events).

177. However, if the non-adjusting events are material, auditors should check whether the college has disclosed

- the nature of the event
- an estimate of its financial effect (or a statement that an estimate cannot be made).

Authorised for issue date is not properly disclosed

178. Auditors should check that the date the accounts were authorised for issue has been disclosed in accordance with FRS 102 paragraph 32.9 giving the date the financial statements were authorised for issue by the board of management, and who gave that authorisation.

179. The FReM states that

- the authorised for issue date is normally the same date as the certificate and report of the Controller and Auditor General. In Scotland, the equivalent is the independent auditor's report
- the disclosure of the authorised for issue date should not be on the title page.

Subsequent events are not identified

180. Auditors are required to comply with *ISA (UK) 560 Subsequent events*. Subsequent events are those occurring between 31 July 2016 and the date of the independent auditor’s report.

181. ISA (UK) 700 explains that the date of the auditor’s report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date. Auditors are required to consider events up to the date of their report, which may be later than the date the annual accounts are authorised for issue. Auditors should therefore seek, where possible, to sign their report on the same day the accounts are authorised for issue.

13 Miscellaneous disclosures

Purpose of section

182. This section of module 4 provides information on, and guidance on the risks of misstatements in, the disclosure of
    - key assumptions and judgements
    - related parties
    - agency arrangements.

Key assumptions and judgements

Changes in 2016/17

183. There are no new disclosure requirements in respect of information on judgements and key sources of estimation uncertainty in 2016/17.

Financial reporting requirements

184. Paragraphs 8.6 and 8.7 of FRS 102 require colleges to disclose
    - the judgements that management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements
    - information about the key assumptions, and other key sources of estimation uncertainty, at the end of the reporting period that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities within the next financial year.

Risks of misstatement

185. The following paragraphs highlight potential risks of misstatement in respect of disclosure of key assumptions and judgements, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Judgements are not identified

186. Auditors should assess whether the college has considered the judgements made in applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. Examples of judgements that should be considered are whether
    - a lease agreement is a finance or operating lease
    - land and buildings are investment properties
    - an item should be recognised as a provision or disclosed as a contingent liability.

Information on judgements is not properly disclosed

187. The aim of the disclosure is to highlight significant areas where others may have formed different judgements and provide justification for the view taken.

188. Auditors should check whether an explanation has been disclosed which refers to
    - the determining factors that were taken into account in making the judgements
    - judgements to exclude material items, e.g. a decision not to disclose a future transaction as a contingent liability.

Key assumptions are not identified

189. Auditors should assess whether the college has considered the key assumptions, and other key sources of estimation uncertainty, at 31 July 2017that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities by 31 July 2018.

190. The disclosure requirement focusses on assets and liabilities whose carrying amount relies on estimates which are dependent on complex judgements for which there is a risk that correction or re-estimation with material effect during 2017/18 may be required.

191. Estimation uncertainty disclosures deal with situations where a college has incomplete or imperfect information which will only be enhanced as a result of future events. Examples of estimates that the college should be considering for inclusion in the note include
    - assumptions used in the calculation of depreciation
    - assumptions about future events affecting provisions and retirement benefits
    - assessments of the recoverable amounts of arrears and other debtors
    - fair values that are not based on recently observed market prices.

Information on key assumptions is not properly disclosed

192. Auditors should check whether the college, after considering the key assumptions and other key sources of estimation uncertainty, has disclosed for the assets and liabilities affected
    - their nature
    - their carrying amount as at 31 July 2017.

Related parties

Changes in 2016/17

193. There are no changes in disclosure requirements in 2016/17.

Definition

194. Parties are considered to be related if one party has the ability to control, or exercise significant influence over, the other party, or if the college and another entity are subject to common control.

Financial reporting requirements

195. Colleges are required to disclose information to draw attention to the possibility their financial position has been affected by the existence of related parties, and the transactions and balances with such parties.

196. Specific requirements are set out at section 25 of the SORP.

Risks of misstatement

197. The following paragraphs highlight potential risks of misstatement in respect of related parties, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Related parties are not identified

198. Auditors should assess whether the college has identified their related parties in accordance with paragraph 33.2 of FRS 102. Related parties for colleges include

- those members of the governing body (and close members of their family) who hold influential posts in public bodies (e.g. local authorities, non-departmental public bodies, etc), private sector organisations with which the college has transactions, and arms-length foundations
- senior staff, including those who hold influential posts in other bodies with which the college has transactions, e.g. an NHS board
- associates, collaborations and joint venture entities not fully eliminated on consolidation
- pension schemes for the benefit of employees of either the college or an entity related to the college.

199. Colleges should also have given due consideration as to whether bodies such as students' unions and separate development trusts are related parties in the context of FRS 102.

200. Where a college shares key management personnel with another entity, or where a member of key management personnel of the college has significant influence over the other entity, this does not automatically mean that there is a related party relationship. Judgement is required as to whether it is likely that the person would be able to affect the policies of both the college and the other entity in their mutual dealings.

Information on related parties is not properly disclosed

201. Auditors should assess whether the college has disclosed

- the nature of the related party relationships
- the amount of transactions that have occurred, and their terms and conditions. A related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. This includes sales, transfers and exchanges of goods and services, leases and guarantees
- the amount of outstanding balances

- total employee benefits made to key management personnel.

202. Auditors should confirm that the required disclosures are made separately for each of the categories set out at paragraph 33.10 of FRS 102.

203. The disclosures do not apply to a government that has control, joint control or significant influence over the college.

Emoluments of higher paid staff are not disclosed

204. Paragraph 25.9 of the SORP requires colleges to disclose the remuneration of higher paid staff in bands of £10,000. The accounts direction sets the starting value which has increased from £50,000 to £60,000. Auditors should confirm that

- the number of higher paid staff above an emoluments threshold of £60,000 have been disclosed in bands of £10,000
- emoluments exclude pension contributions and employers national insurance,
- the number of senior post holders within each band has been separately disclosed.

Agency arrangements

Changes in 2016/17

205. There are no changes in financial reporting requirements in 2016/17.

Definition

206. A college is an agent when it is acting as an intermediary, and is a principal when it is acting on its own behalf.

Financial reporting requirements

207. The accounting treatment of transactions should reflect whether a college is acting as an agent or principal. Colleges are required to account for agency arrangements in accordance with SORP paragraphs 16.9 and 16.10.

Further guidance

208. Further guidance on student support funds is provided at paragraphs 12 to 19 of the guidance notes.

Risks of misstatement

209. The following paragraphs highlight potential risks of misstatement in respect of agency arrangements, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Colleges do not identify transactions when they act as agents

210. Colleges act as agents when they disburse funds on behalf of a funding body, and have no beneficial interest or risks related to the receipt and subsequent disbursement of the funds.

211. The guidance notes list the following as being agency arrangements

- national bursary funds
- educational maintenance allowances.

212. Agency arrangements do not include

- bursaries or scholarships made from a college's own funds
- childcare funds.

Agency arrangements are not properly accounted for

213. Auditors should confirm that any transactions where a college is acting as an agent are not recognised in the statement of comprehensive income.

214. Instead, auditors should confirm that the arrangement has been accounted for as follows

- In respect of cash collected or expenditure incurred on behalf of the principal, the balance sheet should reflect the debtor or creditor position, and the net cash position should be included in the financing activities in the cash flow statement.
- Where a college receives a commission for acting as an agent, it should recognise it as income.

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - module 5 regularity of expenditure and income

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Contents

Regularity of expenditure and income

Purpose of module

1. This module of technical guidance note 2017/6(FE) provides guidance on auditor's responsibilities for the regularity of income and expenditure.

Definition

2. The concept of regularity reflects Parliament's concern that public money raised through taxation on the public is used only for those purposes approved by Parliament. Regularity can be defined as the requirement that a financial transaction is in accordance with authorising legislation.

Auditor requirements

3. Auditors of further education colleges are required by section 22(1) of the *Public Finance and Accountability (Scotland) Act 2000* to set out their independent auditor's report their findings in on whether the expenditure and receipts shown in the account were incurred or applied in accordance with
   - any enactment by virtue of which the expenditure was incurred or the income received and the relevant Budget Act
   - any applicable guidance (whether as to propriety or otherwise) issued by the Scottish Ministers.
4. Although, the Act uses the term 'receipts' and 'income', normal practice is to refer to 'income'. Auditors are therefore required to report whether, in their opinion, in all material respects, expenditure and income were incurred or applied in accordance with applicable enactments and guidance issued by the Scottish Ministers.
5. This is generally referred to as the regularity opinion.

Guidance on auditing regularity

6. Practice note 10 Audit of financial statements of public sector bodies in the UK provides guidance the audit of regularity at pages 104 to 129.

Approach to auditing regularity

Overview

7. The responsibility to express an opinion on the regularity of income and expenditure is discharged through the audit of the financial statements and is reported in a separate section

of the independent auditor's report. Auditors should adopt an integrated approach to the audit of the financial statements and of regularity.

8. Auditors should be concerned with enactments and guidance which are specific to the college and provide direct authority for its financial transactions, rather than those laws and regulations which provide the general framework within which it conducts its activities.

9. ISA (UK) 250 provides the basis for the auditor's approach to the audit of regularity. It states that, where statutory requirements exist which requires the auditor to report whether a college complies with certain provisions of laws or regulations, the auditor should
   - obtain a general understanding of the legal and regulatory framework applicable to the college or sector, and how the college is complying with that framework
   - obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

10. In summary, the approach to regularity should involve auditors
    - obtaining a sufficient understanding of the framework of relevant enactments and guidance
    - testing the regularity of transactions
    - expressing an opinion on regularity in the report on the financial statements.

Understanding the regularity framework

11. In order to understand the regularity framework, auditors should
    - identify the enactments and guidance from the Scottish Ministers that apply to colleges (e.g. authorising legislation and regulations issued thereunder)
    - obtain a broad understanding that is sufficient to enable identification of transactions or events that may have a significant effect on the regularity of transactions in the financial statements
    - consider the systems and procedures in place at the college to ensure compliance with the applicable enactments and guidance
    - obtain an understanding of the internal control environment to enable a preliminary assessment of controls which mitigate against the risk of material irregularity.

Testing for regularity

12. Auditors are required to obtain sufficient appropriate evidence to substantiate assertions about regularity, and therefore will usually perform substantive procedures on transactions. The extent of these procedures will depend on the auditor's assessment of the effectiveness of the design of systems in translating enactments and guidance into controls and the extent to which the auditor derives controls assurance from tests of those controls.

13. Tests should be integrated with those relating to the audit of the financial statements.

14. Auditors should confirm that there is proper disclosure of any transactions which are not in compliance with applicable enactments and guidance.

Reporting on regularity

15. Cases of non-compliance with applicable enactments and guidance should be reported to the management of the college to allow corrective action to be taken.

16. Where it is not possible for the college to take corrective action, the auditor should encourage it to disclose the non-compliance in its financial statements by outlining the circumstances surrounding the breach and the possible extent of irregular transactions.

17. Even where the non-compliance is disclosed, auditors are still required to consider the implications for the audit opinion on regularity.

18. A model auditor's report, including the regularity opinion, is provided in technical guidance note 2017/7(FE).

Contact point

19. The contact point in Audit Strategy for this module of the technical guidance note is Helen Cobb, Technical Adviser (Central Government, Health and Further Education) - 0131 625 1901 or HCobb@audit-scotland.gov.uk.

Audit of 2016/17 annual report and accounts (further education)

Technical guidance note 2017/6(FE) - module 6 non-financial statements

AUDIT SCOTLAND

Prepared by Audit Strategy
3 August 2017

Contents

1 Introduction

Purpose of module

1. This module of technical guidance note 2017/6(FE) provides information and guidance on the following non-financial statements included in the annual report and accounts
   - Performance report.
   - Remuneration and staff report.
   - Governance statement.
   - Parliamentary accountability report.

Overview

2. The 2016/17 accounts direction sets out its requirements for the performance report at paragraphs 3 to 13 of Appendix 2. These are based on section 5.2 of the 2016/17 FReM.

3. The 2016/17 accounts direction sets out its requirements for the accountability report at paragraphs 14 to 31. These are based on section 5.3 of the FReM which requires the report to have sections for a
   - corporate governance report, which includes the
     - directors' report
     - statement of Accountable Officer's responsibilities
     - governance statement.
   - remuneration and staff report
   - parliamentary accountability and audit report.

4. The above requirements of the accounts direction replace the SORP's requirements for a strategic report, statement of corporate governance, and statement of responsibilities.

5. Paragraph 5.1.4 was amended in the 2016/17 FReM to clarify that the
   - FReM's disclosure requirements apply to Scottish bodies only where they originate in accounting standards or Companies Act requirements
   - accounts are also required to meet Scottish legislation and the SPFM requirements.

6. The auditor responsibilities for the performance report and the various parts of the accountability report are summarised in Appendix 1. The third part of the annual report and accounts (i.e. the financial statements) is also included in that appendix for completeness.

Contact point

7. The contact point in Audit Strategy for this module of the technical guidance note is Neil Cameron, Manager - Health and Central Government (Technical) - ncameron@audit-scotland.gov.uk.

2 Performance report

Purpose of section

8. This section of the module provides information and guidance on auditors' responsibilities in respect of the performance report.

Changes in 2016/17

9. The accounts direction's requirements for the performance report have been amended to require
   - a short explanation of the purpose of the overview section
   - an analysis of how the cash budget allocation previously earmarked for depreciation was spent
   - details of the underlying operating position.

10. As a new reporting requirement in 2016/17, auditors are required to provide an opinion on whether the performance report has been prepared in accordance with the accounts direction.

Definition

11. The performance report provides information on the college, its main objectives and strategies and the principal risks that it faces.

Financial reporting requirements

12. Section 5.2 of the FReM and paragraphs 3 to 13 of the accounts direction's Appendix 2 set out the requirements for the performance report. The requirements are based on the matters required by the *Companies Act 2006* to be included in a strategic report.

Auditor requirements

13. The Auditor General requires auditors to read the information in the performance report and, based on work undertaken in the course of the audit, express an opinion in the independent auditor's report on whether the
   - information given in the performance report is consistent with the financial statements
   - the performance report has been prepared in accordance with the accounts direction.

14. Auditors are also required to
   - state whether, in the light of the knowledge and understanding of the college and its environment obtained in the course of the audit, the auditor has identified material misstatements in the performance report
   - give an indication of the nature of each of the misstatements identified.

15. This reflects requirements in the *Companies Act 2006* which applies to the private sector and is applied to colleges under the audit appointment as a matter of good practice. Auditors may have to refer to ISA (UK) 720's requirements in respect of statutory other information when following the guidance in this module.

16. The model independent auditor's reports for 2016/17 are provided in technical guidance note 2017/7(FE) and include wording for the performance report opinions.

Risks of misstatement

17. The following paragraphs highlight potential risks of misstatement in the performance report, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Performance report is inconsistent with the financial statements

18. Auditors should perform procedures necessary to identify any material inconsistencies between information in the performance report and the financial statements.

19. The performance report may include amounts or other items that are intended to be the same as, to summarise, or to provide greater detail about, the amounts or other items in the financial statements. Examples of such amounts or other items may include
    - tables, charts or graphs containing extracts of the financial statements.
    - disclosure providing greater detail about a balance or account shown in the financial statements
    - descriptions of the financial results.

20. In order to evaluate their consistency, auditors should select amounts or other items in the performance report and compare them with the corresponding amounts or other items in the financial statements. Auditors are not required to compare all amounts or other items in the performance report that relate to the financial statements. When selecting the amounts or other items to compare, auditors should consider
    - the significance of the amount or other item in the context in which it is presented, which may affect the importance that users would attach to the amount or other item (e.g. a key ratio or amount)
    - the relative size of the amount compared with amounts or items in the financial statements or the performance report to which they relate
    - the sensitivity of the particular amount or other item in the performance report.

21. When checking the consistency of the selected items, auditors should
    - for information that is intended to be the same as information in the financial statements, compare the information to the financial statements
    - for information intended to convey the same meaning as disclosures in the financial statements, compare the words used and consider the significance of differences in wording used and whether such differences imply different meanings

- obtain a reconciliation between an amount within the performance report and the financial statements and
  - compare items in the reconciliation to the financial statements and the performance report; and
  - check whether the calculations within the reconciliation are arithmetically accurate.

22. If auditors identify a material inconsistency between information in the performance report and the financial statements, auditors should
    - conclude whether there is a material misstatement in the performance report
    - conclude whether there is a material misstatement in the financial statements
    - request that the college corrects any material misstatement identified.

23. Where a material misstatement in the performance report is not corrected, auditors should describe the misstatement in the independent auditors report and qualify that aspect of their opinion on the performance report.

Performance report is not in accordance with the accounts direction

24. Auditors should perform procedures necessary to conclude as to whether the performance report has been prepared in accordance with the accounts direction. The accounts direction requires compliance with the disclosure requirements of the FReM.

25. Auditors should assess whether information required to be included in the performance report has been omitted. This includes situations where required information has been presented separately without appropriate cross-reference.

26. FReM paragraph 5.2.3 requires the performance report to provide a fair, balanced and understandable analysis of the body's performance. Paragraph 5.2.6 requires the performance report to have an overview and an analysis section.

27. The overview section should give the user information to understand the college, its purpose, the key risks to the achievement of its objectives and how it has performed during the year. The minimum contents are set out at FReM paragraph 5.2.8. In accordance with FReM paragraph 5.1.4, the following table sets out the application of each requirement to colleges.

FReM requirement	Application to colleges
A short summary explaining the purpose of the overview section	No requirement in Companies Act, and no equivalent requirement in Scottish legislation or, the SPFM. However, the accounts direction requires colleges to include this disclosure.

FReM requirement	Application to colleges
A statement from the body's lead Minister or Chief Executive providing their perspective on performance	No requirement in Companies Act, and no equivalent requirement in Scottish legislation or the SPFM. However, the accounts direction requires such a statement from the Principal and therefore applies to colleges.
A statement of the purpose and activities of the body	Based on Section 414C(2) of the Companies Act and a requirement of the accounts direction, and therefore applies to colleges.
The key issues and risks that could affect the body in delivering its objectives	
(Primarily for arms-length bodies) an explanation of the adoption of the going concern basis where this might be called into doubt.	The accounts direction requires disclosure of material uncertainties regarding the adoption of the going concern basis and therefore applies to colleges.
A performance summary	Based on Section 414C(3) of the Companies Act and a requirement of the accounts direction, and therefore applies to colleges.

28. When concluding on compliance with the accounts direction, auditors should assess whether the overview section of the performance report includes
    - a short summary explaining the purpose of the overview section
    - a statement from the Principal providing their perspective on the performance of the college over the period
    - a statement of the purposes and activities of the college
    - the key issues and risks that could affect the college in delivering its objectives
    - an explanation of the adoption of the going concern basis where this might be called into doubt
    - a performance summary.

29. The performance analysis is where colleges report on their most important performance measures. The minimum requirements are set out at FReM paragraph 5.2.10, which includes an analysis using financial information from the financial statements. The following table sets out the application of each requirement to colleges.

FReM requirement	Application to health boards
Long term expenditure trend analysis	No requirement in Companies Act, and no equivalent requirement in Scottish legislation or the SPFM. The accounts direction states that long-term trend information may be provided, where appropriate.
Information on how the entity measures performance	Based on Section 414C(3) of the Companies Act and a requirement of the accounts direction, and therefore applies to colleges.
A more detailed analysis and explanation of the development and performance of the entity during the year	
Reporting entities are expected to comply with mandatory sustainability reporting requirements.	A sustainability report does not require to be published as part of the annual report and accounts. However, the accounts direction requires confirmation of compliance with the Scottish Government sustainability reporting requirements.
Performance on other matters as promulgated by HM Treasury in PES papers	PES papers do not apply in Scotland and there are no equivalent requirements in Scottish legislation or the SPFM.

30. In addition to FReM requirements, the accounts direction requires
    - details of colleges' financial year resource position for 2016/17. This should include a statement of the financial year end (i.e. to 31 March 2017) outturn against both resource and capital budgets, together with an explanation of any variances
    - a statement describing the payment practice code or policy adopted regarding the payment of suppliers and the performance achieved, together with disclosure of any interest paid under the Late Payment of Commercial Debts (Interest) Act 1998, or a statement that there were no matters to disclose
    - as a new requirement for 2016/17, an analysis of how the cash budget allocation previously earmarked for depreciation was spent. This is referred to as the 'cash budget for priorities' in the direction and the analysis should take the form of a table showing the expenditure under each heading and the impact on the operating position. An illustrative form of wording is provides at Appendix 5 of the accounts direction
    - as a new requirement for 2016/17, details of the underlying operating position. A template for calculating the underlying operating position is provided at Appendix 7 of the accounts direction.

31. When concluding on compliance with the accounts direction, auditors should assess whether the analysis section of the performance report includes in accordance with the accounts direction

- additional explanations of amounts included in the financial statements
- information on how the college measures performance
- an analysis and explanation of the development and performance of the college during the year
- confirmation of compliance with the Scottish Government sustainability reporting requirements
- details of the financial year resource position for the year to 31 March 2017
- required information regarding the payment of suppliers
- an analysis of how the cash budget allocation previously earmarked for depreciation was spent
- details of the underlying operating position.

32. If auditors identify a material misstatement in the performance report as a result of it not being in accordance with the accounts direction, auditors should request that the college makes the necessary correction.

33. Where the college does not make a correction, auditors should describe the misstatement in the independent auditors report and qualify that aspect of their opinion on the performance report.

Performance report is inconsistent with auditor's knowledge

34. The performance report may be consistent with the financial statements and be prepared in accordance with the accounts direction, but may still be inconsistent with the auditor's knowledge acquired in the course of performing the audit. The auditor's knowledge obtained in the audit includes the auditor's understanding of the college and its environment. Auditors should perform procedures necessary to identify any material inconsistencies between information in the performance report and the auditor's knowledge obtained in the audit.

35. In considering whether there is a material inconsistency between the performance report and the auditor's knowledge obtained in the audit, the auditor may focus on those matters that are of sufficient importance that a misstatement in relation to that matter could be material.

36. If auditors identify a material inconsistency between information in the performance report and their knowledge, auditors should
    - conclude whether there is a material misstatement in the performance report
    - consider whether their understanding of the college and its environment needs to be updated
    - request the college to correct any material misstatement identified.

37. Where the college does not make a correction, auditors should describe the misstatement in the independent auditors report.

Information in the performance report is misleading

38. A misstatement in the performance report can also exist when the information is misleading. This includes situations where it omits or obscures information necessary for a proper understanding of a matter disclosed in the performance report.

39. When reading the performance report, auditors should remain alert for instances where the information is misleading. Auditors should request the college to correct any material misstatement caused by misleading information.

40. Where a material misstatement in the performance report is not corrected, auditors should describe the misstatement in the independent auditors report.

Performance report is not properly signed

41. The accounts direction requires the performance report to be signed by the college's Principal. Auditors should check that the performance report has been signed as required.

3 Remuneration and staff report

Purpose of section

42. This section of the module provides information and guidance on auditors' responsibilities in respect of the remuneration and staff report component of the accountability report.

Changes in 2016/17

43. As a result of the amendment to FReM paragraph 5.1.4, the requirements for disclosures on expenditure on consultancy and off payroll arrangements no longer apply to colleges.

Definition

44. A remuneration and staff report provides information about the remuneration and pension entitlement of directors, as well as other staff-related matters.

Financial reporting requirements

45. FReM paragraphs 5.3.15 to 5.3.27 and paragraphs 24 to 28 of the accounts direction set out the requirements for the remuneration and staff report. The application of each requirement to colleges is set out throughout this section but in summary required disclosures include
    - remuneration policy
    - a single total figure for remuneration and pension entitlement for each senior official
    - compensation payments
    - fair pay disclosure
    - information in the staff report such as on exit packages.

Further guidance

46. Guidance on the remuneration and staff report is provided by the Cabinet Office in an employer pension notice (EPN) 492.

47. A template remuneration report is provided at Appendix 4 of the accounts direction.

48. Guidance on fair pay disclosure is provided in Hutton review of fair pay - implementation guidance.

Auditor requirements

49. Auditors are required by the Auditor General to audit part of the remuneration and staff report and express a separate opinion within their independent auditor's report on whether it has been properly prepared in accordance with the accounts direction. This reflects a requirement

in the *Companies Act 2006* which applies in the private sector and is applied to colleges under the audit appointment as a matter of good practice. The part of the report to be audited comprises

- the single total figure for remuneration for each senior official
- the pension entitlement of each senior official
- information disclosed on compensation payments, payments to past directors, and fair pay
- information in the staff report providing an analysis of staff numbers and costs and summary data on the use of exit packages.

50. The model independent auditor's report for 2016/17 will be provided in a separate technical guidance note and will include wording for the remuneration and staff report opinion.

51. Auditors are also required by ISA (UK) 720 to read the unaudited part of remuneration and staff report to identify any material inconsistencies with the financial statements or their knowledge.

Risks of misstatement

52. The following paragraphs highlight potential risks of misstatement in respect of the audited part of the remuneration and staff report, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Information is not disclosed on all relevant senior officials

53. Auditors should assess whether all relevant senior officials are included in the remuneration and staff report. FReM paragraph 5.3.9 describes senior officials as the management board (including advisory and non-executive members) having authority or responsibility for directing or controlling the major activities of the college during the year.

54. FReM paragraph 5.3.17 presumes that information on named individuals will be given in all circumstances. Non-disclosure is acceptable only for the reasons set out in that paragraph, e.g. where disclosure would cause substantial distress to the employee. In other cases, FReM paragraph 5.3.18 and the accounts direction require colleges to assess the official's reasons on a case-by-case basis and consider whether to accept them.

55. Where information is not disclosed for a senior official, auditors should assess whether
    - the college has properly assessed the case made by the official
    - the reasons given by the official are acceptable
    - the fact that required disclosures have been omitted has been disclosed.

Changes during the year are not properly reported

56. Where there are changes to the senior officials during the year, auditors should assess whether

- the actual remuneration has been reported for individuals who were appointed or left during 2016/17. The date of appointment or last day or service should be disclosed along with the full year equivalent salary
- there is only one disclosure for any director who changed posts during 2016/17 (rather than a disclosure for each post) and that the disclosure reflects the change of post
- where an employee has been promoted into a director post from a position that does not require disclosure, only the remuneration which relates to their new appointment has been disclosed. Prior year comparator information is not required.

Information on remuneration is not properly disclosed

57. FReM paragraph 5.3.21 requires colleges to disclose each component and the overall single total remuneration figure in the format set out in the EPN. This is based on requirements in regulations issued under the Companies Act and therefore, in accordance with FReM paragraph 5.1.4, applies to Scottish bodies. The components of the single total remuneration figure are as follows
    - Salary and allowances in bands of £5,000. Salary covers both pensionable and non-pensionable amounts and includes: gross salaries; overtime; recruitment and retention allowances; and other allowances to the extent that they are subject to UK taxation and any ex-gratia payments. It does not include amounts which are a reimbursement of expenses directly incurred in the performance of an individual's duties.
    - Performance pay or bonuses for officials in bands of £5,000, which should relate to the year in which they become payable. If the appraisal process does not allow sufficient time for the inclusion of any bonuses relating to 2016/17 performance, bonuses based on 2015/16 performance should be disclosed.
    - The estimated value of any non-cash benefits (e.g. cars) to the nearest £100.
    - The value of pension benefits, which should be calculated as the real increase in pension multiplied by 20, plus the real increase in any lump sum, less contributions made by the member. The real increases exclude increases due to inflation or any change due to a transfer of pension rights.
58. Auditors should assess whether
    - the single total figure of remuneration disclosures have been made in a tabular format
    - remuneration has been disclosed beside the post and name of each relevant individual in the required bands
    - the components of remuneration required by the FReM have been used
    - the remuneration disclosures are free from misstatement
    - total remuneration for 2016/17 and 2015/16 have been disclosed.

Pension entitlements are not disclosed

59. FReM paragraph 5.3.22 requires bodies to disclose pension entitlements for each senior official in the format set out in the EPN. This is based on requirements in regulations issued under the Companies Act and therefore applies to Scottish bodies. Auditors should assess whether the following information has been properly disclosed
    - The real increase during 2016/17 in the pension and any related lump sum at pension age in bands of £2,500.
    - The value at 31 July 2017 of the accrued pension and any related lump sum at pension age in bands of £5,000.
    - The value of the cash equivalent transfer value (CETV) at 1 August 2016 and 31 July 2017 (or at the starting or leaving dates during year), and the real increase in the CETV during 2016/17, both to the nearest £1,000.

60. CETV is the capital value of the pension and is worked out using guidance provided by the scheme actuary. It is an assessment of what it costs the scheme to provide these pension benefits. Auditors should check that the real increase in CETV
    - reflects the increase in accrued pension that is funded by the employer
    - excludes the increase due to inflation
    - excludes contributions paid by the employee (including the value of any benefits transferred from another pension scheme).

61. Auditors should assess whether
    - the accrued pension benefit includes any added years and transfers of benefits from another pension fund
    - where a senior official has opted out of the pension arrangements for the whole of 2016/17, no pension figures have been reported but instead a footnote explanation has been disclosed. If the official opts out or in during the year, they should have been treated as a leaver or joiner
    - where a senior official's pension has been subject to a pension sharing order on divorce, the gross pension before the pension debit is applied has been disclosed
    - where a member has taken partial retirement during 2016/17, benefits have been reported as a mix of active and pensioner benefits. Total pension should have been stated, with details of how much of this is in payment.

Information on compensation payments is not properly disclosed

62. FReM paragraph 5.3.23 requires disclosure where a payment for compensation on early retirement or for loss of office has been made to a senior official under the terms of an approved compensation scheme. This is based on requirements in regulations issued under the Companies Act and therefore applies to Scottish bodies.

63. Auditors should check whether the board has disclosed

- the fact that such a payment has been made
- a description of the compensation payment
- details of the total amounts paid. The cost to be used should include any top-up to compensation provided by the body to buy out the actuarial reduction on an individual's pension.

Information on payments to past senior officials is not properly disclosed

64. Auditors should assess whether the college has disclosed payments to past senior officials in accordance with FReM paragraph 5.3.24. The payments should exclude
    - regular pension benefits which commenced in previous years
    - payments in respect of employment other than as a senior official.

Information on fair pay is not properly disclosed

65. FReM paragraph 5.3.25 requires colleges to disclose information comparing the remuneration of the highest paid senior official with the median remuneration of the college's staff. Guidance from the Treasury on this requirement is provided in Hutton review of fair pay - implementation guidance.

66. Auditors should assess whether the college has properly disclosed together with prior year comparatives
    - the median remuneration of the college's staff. This should be based on annualised, full-time equivalent remuneration of all staff (including temporary and agency staff) as at 31 July 2017
    - the range of staff remuneration
    - the ratio between the median staff remuneration and the mid-point of the banded remuneration of the highest paid senior official
    - an explanation for any significant changes in the ratio between the current and prior year.

Information in the staff report is not properly disclosed

67. FReM paragraph 5.3.27 sets out the information that requires to be disclosed in the staff report. In accordance with FReM paragraph 5.1.4, the following table sets out the application of each requirement to colleges.

FReM requirement	Application to colleges
Number of senior civil service staff by band	No requirement in Companies Act, and no equivalent requirement in Scottish legislation or the SPFM. However, the accounts direction requires disclosure in £5,000 bands and therefore applies to colleges.

FReM requirement	Application to colleges
An analysis of staff costs and numbers	Based on Section 411 of the Companies Act and a requirement of the accounts direction, and therefore applies to colleges.
An analysis of the number of persons of each sex who were directors, senior civil servants and employees	Based on Section 414C(8) of the Companies Act and a requirement of the accounts direction, and therefore applies to Scottish bodies. This disclosure is not in the audited part of the report.
Sickness absence data	No requirement in Companies Act, and no equivalent requirement in Scottish legislation or the SPFM. However, the accounts direction requires this disclosure, although it is not in the audited part of the report.
Staff policies applied during the financial year for disabled persons	Based on regulations issued under the Companies Act and is a requirement of the accounts direction, and therefore applies to colleges. This disclosure is not in the audited part of the report.
Expenditure on consultancy	No requirement in Companies Act, and no equivalent requirement in Scottish legislation, the SPFM or the accounts direction.
Summary data on the use of off-payroll arrangements	No requirement in Companies Act, and no equivalent requirement in Scottish legislation, the SPFM or the accounts direction.
Summary data on the use of exit packages agreed in year	The SPFM requires bodies to report on compensation for severance, early retirement or redundancy to comply with the requirements for accounts disclosure. The accounts direction requires disclosure of information on exit packages.

68. Auditors should audit the following information and assess whether it has been properly disclosed
    - Number of senior staff by £5,000 pay band
    - An analysis of staff numbers and costs.
    - Summary data on the use of exit packages.

69. An exit package means any agreement by which a college and an employee agree that the employee will relinquish employment with the college in exchange for compensation. The

disclosure is required to be in the format required by the Cabinet Office which will be set out in the EPN. Auditors should check that the college has disclosed with comparatives

- the number of exit packages agreed in each cost band
- the total cost of packages agreed in each band
- an analysis between compulsory redundancies and other departures.

70. The disclosure requirement applies to those exit packages that have been agreed during 2016/17. A package is not 'agreed' until the offer has been accepted by the employee, and preferably 'signed off' or reasonably certain to be by 31 July 2017. Any offers rejected after 1 August 2017 indicates the package had not been agreed. This disclosure therefore has a more restricted scope than the termination benefits provision because (as explained at module 2) they are recognised when a college can no longer withdraw an offer (i.e. it is not necessary for a package to be agreed).

71. The requirement does not apply to any exit package that did not require the agreement of the college (e.g. where a person exercises their statutory right to leave employment on the grounds of ill health).

Remuneration and staff report is inconsistent with the financial statements

72. Auditors should read all of the remuneration and staff report to identify any material inconsistencies with the financial statements. If auditors identify a material inconsistency between the remuneration and staff report and the financial statements, auditors should conclude whether there is a material misstatement in either the remuneration and staff report or the financial statements.

73. If the inconsistency is caused by a misstatement in the financial statements, auditors should request that the college makes the necessary correction.

Audited part of remuneration and staff report contains material misstatements

74. If auditors identify a material misstatement in the part of the remuneration and staff report to be audited, auditors should request that the college makes the necessary correction. A misstatement includes an error in any information in the audited part of the report or the omission of any required information.

75. Where a material misstatement in the audited part of remuneration and staff report is not corrected, auditors should qualify their opinion on the remuneration and staff report.

Unaudited part of remuneration and staff report contains material misstatements

76. Auditors should read the unaudited part of the remuneration and staff report to identify any information that is apparently materially inconsistent with their knowledge acquired in performing the audit. The part of the remuneration and staff report that is not audited includes

- the remuneration policy

- an analysis of the number of persons of each sex who were directors, senior civil servants and employees of the board
- staff policies in respect of disabled persons
- sickness absence data.

77. If auditors identify a material inconsistency between information in the unaudited part of the remuneration and staff report and their knowledge, auditors should
    - conclude whether there is a material misstatement in the unaudited part of the remuneration and staff report
    - consider whether their understanding of the college and its environment needs to be updated
    - request that the college corrects any material misstatement identified.
78. Where a material misstatement in the unaudited part of the remuneration and staff report is not corrected, auditors should describe the misstatement in the independent auditors report.

4 Governance statement

Purpose of section

79. This section of the module provides information and guidance on auditors' responsibilities in respect of the governance statement.

Changes in 2016/17

80. The previous good governance code issued in 2014 has been replaced with the 2016 version of the Code of good governance for Scottish colleges. There are however no significant changes.

81. As a new requirement in 2016/17, auditors are required to express opinions on whether
    - information given in the governance statement is consistent with the financial statements. In previous years, auditors were required to consider this, but not provide an opinion on it; and
    - the governance statement has been prepared in accordance with the accounts direction. In previous years, auditors were required to report this as a matter reported by exception.

Definition

82. The governance statement provides users with a clear understanding of a college's internal control structure and its management of resources.

Financial reporting requirements

83. The accounts direction requires colleges to include with their financial statements a statement covering the responsibilities of their board of management in relation to corporate governance.

84. The SFC requires the governance statement to indicate how the college has complied with good practice in this area, including the Code of good governance for Scottish colleges, which colleges are required to comply with as a condition of grant. Colleges are required to include either a statement confirming compliance with the code or explanations for any non-compliance.

85. Colleges are required to take account of the requirements of the governance statement section of the SPFM which sets out the essential features of a governance statement.

Further guidance

86. Guidance on preparing the statement is contained in Appendices 2 and 3 of the accounts direction.

Auditor requirements

87. The Auditor General requires auditors to read the information in the governance statement and express an opinion in the independent auditor's report on whether the
    - information given in the governance statement is consistent with the financial statements
    - the governance statement has been prepared in accordance with the accounts direction.

88. Auditors are also required to
    - state whether, in the light of the knowledge and understanding of the college and its environment obtained in the course of the audit, the auditor has identified material misstatements in the governance statement
    - give an indication of the nature of each of the misstatements identified.

89. This reflects requirements in the *Companies Act 2006* which applies to the private sector and is applied to colleges as a matter of good practice. Auditors may have to refer to ISA (UK) 720's requirements in respect of statutory other information when following the guidance in this module.

90. The model independent auditor's report for 2016/17 will be provided in a separate technical guidance note and will include wording for the opinions on the governance statement.

91. Auditors' responsibilities are therefore not designed to provide positive assurance on internal control. In the context of the audit of the annual report and accounts, there is no requirement to form an opinion on the effectiveness of the college's corporate governance procedures, and auditors are not required to assess whether
    - all risks and controls have been addressed by the college
    - all risks are satisfactorily addressed by internal controls
    - the actions described in the statement will remedy any underlying weakness associated with an internal control issue.

Risks of misstatement

92. The following paragraphs highlight potential risks of misstatement in respect of the governance statement, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Governance statement is inconsistent with the financial statements

93. Auditors should perform procedures necessary to identify any material inconsistencies between information in the governance statement and the financial statements.

94. The governance statement may include amounts or other items that are intended to be the same as, to summarise, or to provide greater detail about, the amounts or other items in the financial statements. In order to evaluate their consistency, auditors should select amounts or other items in the governance statement and compare them with the corresponding amounts or other items in the financial statements.

95. When checking the consistency of the selected items, auditors should
    - for information that is intended to be the same as information in the financial statements, compare the information to the financial statements
    - for information intended to convey the same meaning as disclosures in the financial statements, compare the words used and consider the significance of differences in wording used and whether such differences imply different meanings
    - obtain a reconciliation between an amount within the governance statement and the financial statements and
        - compare items in the reconciliation to the financial statements and the governance statement; and
        - check whether the calculations within the reconciliation are arithmetically accurate.

96. If auditors identify a material inconsistency between information in the governance statement and the financial statements, auditors should
    - conclude whether there is a material misstatement in the governance statement
    - conclude whether there is a material misstatement in the financial statements
    - request the college to correct any material misstatement identified.

97. Where a material misstatement in the governance statement is not corrected, auditors should describe the misstatement in the independent auditors report and qualify that aspect of their opinion on the governance statement.

Governance statement is not in accordance with the accounts direction

98. Auditors should perform procedures necessary to conclude as to whether the governance statement has been prepared in accordance with the accounts direction. The accounts direction requires colleges to include with their financial statements a statement covering the responsibilities of their board of management in relation to corporate governance.

99. The SFC requires the governance statement to indicate how the college has complied with good practice in this area, including the Code of good governance for Scottish colleges, which colleges are required to comply with as a condition of grant. Explanations are required for any non-compliance.

100. Colleges are required to take account of the requirements of the governance statement section of the SPFM which sets out the essential features of a governance statement.

101. Auditors should assess whether the college has undertaken a review of its system of internal control during 2016/17 to establish the extent to which it complies with relevant requirements.

102. Where the college has failed to undertake a review, auditors should
    - confirm that the failure has been disclosed and explained in the statement
    - consider whether the explanation is consistent with auditors' understanding

- report the matter in the independent auditor's report as a qualification to the opinion on the governance statement where the failure has not been disclosed or the explanation provided is not consistent with auditors' understanding.

103. Auditors should assess whether required information has been omitted. This includes situations where required information has been presented separately without appropriate cross-reference. When assessing compliance with the accounts direction, auditors should assess whether the governance statement reflects the following essential features

- The governance framework, including information about the committee structure.
- The operation of the board of management during the period.
- An assessment of corporate governance with reference to compliance with generally accepted best practice principles and relevant guidance, and explanations where a different approach has been adopted.
- An assessment of the college's risk management arrangements and risk profile, including details of significant risk-related matters arising during the period.
- A record of any written authorities provided to the Accountable Officer.
- Details of any significant lapses of data security.

104. Auditors should assess whether the statement relates to the governance system as it applied during 2016/17, and whether any significant events between 31 March 2017 and the authorised for issue date have been included. Auditors should assess whether the descriptions are both supported by relevant documentation and appropriately reflect the process. Appropriate evidence will usually be obtained by

- considering whether the disclosures are consistent with the review of committee meeting minutes
- reviewing relevant supporting minutes
- reviewing the internal audit's report on the adequacy and effectiveness of internal control.

105. Colleges are required to consider whether a matter is significant. Auditors should assess whether the college has considered the following indicators in deciding whether a governance issue is significant

- The issue seriously prejudices or prevents achievement of a key objective.
- The issue has resulted in a need to seek additional funding to allow it to be resolved, or has resulted in significant diversion of resources from another aspect of the business.
- It has a material impact on the financial statements.
- The audit committee or internal audit advises it should be considered significant for this purpose.
- The issue, or its impact, has attracted significant public interest, or has seriously damaged the reputation of the college.

106. If auditors are of the opinion that the governance statement has not been prepared in accordance with the accounts direction, auditors should request that the college makes the necessary correction.

107. Where the governance statement is not corrected, auditors should describe the material misstatement in the independent auditors report and qualify that aspect of their opinion on the governance statement.

Governance statement is inconsistent with auditor's knowledge

108. The governance statement may be consistent with the financial statements and be prepared in accordance with the accounts direction, but may still be inconsistent with the auditor's knowledge acquired in the course of performing the audit. The auditor's knowledge obtained in the audit includes the auditor's understanding of the college and its environment. Auditors should perform procedures necessary to identify any material inconsistencies between information in the governance statement and the auditor's knowledge obtained in the audit.

109. In considering whether there is a material inconsistency between the governance statement and the auditor's knowledge obtained in the audit, auditors may focus on those matters that are of sufficient importance that a misstatement in relation to that matter could be material.

110. If auditors identify a material inconsistency between information in the governance statement and their knowledge, auditors should

- conclude whether there is a material misstatement in the governance statement
- consider whether their understanding of the college and its environment needs to be updated
- request the college to correct any material misstatement identified.

111. An inconsistency may arise because auditors are aware of a significant governance issue which has not been disclosed. If disclosure of information about a particular issue could prejudice the outcome of a specific investigation (e.g. prosecuting a fraud case, or disciplinary process), it is acceptable for the statement to explain that there are issues that cannot be disclosed.

112. Auditors should assess whether the disclosures of the action applied to address any significant governance issues appropriately reflect those actions. Where auditors consider that disclosures of the action applied to address any significant governance issue do not appropriately reflect those actions or they do not agree with the non-disclosure of an issue, they should attempt to resolve the matter with the college.

113. Where auditors are unable to resolve the matter, and a material misstatement in the governance statement is not corrected, auditors should describe the misstatement in the independent auditors report.

Information in the governance statement is misleading

114. A misstatement in the governance statement can also exist when the information is misleading. This includes situations where the statement omits or obscures information necessary for a proper understanding of a matter disclosed.

115. When reading the governance statement, auditors should remain alert for instances where the information is misleading. Auditors should request the college to correct any material misstatement caused by misleading information.

116. Where a material misstatement in the governance statement is not corrected, auditors should describe the misstatement in the independent auditors report.

5 Parliamentary accountability report

Purpose of section

117. This section of the module provides information and guidance on auditors' responsibilities in respect of the parliamentary accountability report.

Changes in 2016/17

118. There have been no changes to the 2016/17 FReM or the accounts direction that impact on the parliamentary accountability report as applied in Scotland.

Definition

119. The parliamentary accountability report brings together all the key documents related to parliamentary accountability.

Financial reporting requirements

120. The 2016/17 accounts direction requires a parliamentary accountability report to be included within the accountability report. FReM paragraph 5.3.28 sets out its requirements for the parliamentary accountability report. Further detail is provided at FReM paragraph 3.2.12 which clarifies that the specific disclosures apply to bodies covered my *Managing public money* (MPM). In accordance with FReM paragraph 5.1.4, the following table sets out the application of each requirement to Scottish bodies.

FReM requirement	Application to colleges
(Departments financed through the Westminster or Northern Ireland Assembly Estimates process) Statement of Parliamentary Supply and supporting notes	No requirement in Companies Act, and no equivalent requirement in Scottish legislation, the SPFM, or the accounts direction.
Regularity of expenditure (this refers to the requirement for departments that have incurred losses or made special payments or gifts to disclose details in a note)	The accounts direction requires the equivalent requirement for Scottish bodies in the losses and special payments section of the SPFM which requires total losses exceeding £250,000 and total special payments exceeding £250,000 to be disclosed in the annual accounts.

FReM requirement	Application to colleges
Parliamentary accountability disclosures as detailed in 3.2.12, i.e.	
(departments only) the names of any public sector bodies outside the boundary for which the department had lead policy responsibility	No requirement in Companies Act, and no equivalent requirement in Scottish legislation, the SPFM or the accounts direction.
a brief description of the nature of each of the entity's material remote contingent liabilities (that is, those that are disclosed under Parliamentary reporting requirements and not under IAS 37) and, where practical, an estimate of its financial effect	The equivalent requirement for Scottish bodies is in the contingent liabilities section of the SPFM which requires disclosure in accordance with the FReM of legally enforceable undertakings given in the form of a guarantee or indemnity which would bind the body into providing the resources in the event of the guarantee or indemnity maturing; or a letter or general statement of comfort which could be considered to impose a moral financial obligation.
(Public Sector Information Holders only) a statement is required if the entity has not complied with the cost allocation and charging requirements set out in HM Treasury guidance	No requirement in Companies Act, and no equivalent requirement in Scottish legislation, the SPFM or the accounts direction.
a statement of losses and special payments where the total amounts incurred are over the limits proscribed in *Managing public money*	The equivalent requirement is in the losses and special payments section as noted above.
notation of gifts made over the limits proscribed in *Managing public money*	The equivalent requirement is in the gifts section of the SPFM which requires gifts to be reported in notes to the annual accounts. Individual gifts of more than £250,000 should be noted separately.
entities should provide an analysis of fees and charges income where material	The equivalent requirement is in the fees and charges section of the SPFM which requires the following information to be provided for each service where the full annual cost is £1 million or more, or (if lower) where the amount of the income and full cost of the service are material to the financial statements • Financial objective performance against that objective. The standard approach to setting charges for public services is full cost

FReM requirement	Application to colleges
	recovery, i.e. recovering a 3.5% return on capital, but the SPFM lists some exceptions, e.g. subsidised services. • Full cost of the service. • Income from charging for the service. • Surplus or deficit. (It is not expected that this requirement will apply to most colleges in practice)

Auditor requirements

121. There are no additional auditor responsibilities in respect of the parliamentary accountability report, and no specific opinion is required. However, auditors are required to read the report under ISA (UK) 720.

Risks of misstatement

122. The following paragraphs highlight potential risks of misstatement in the parliamentary accountability report, and set out actions for auditors to undertake to assess whether the college has followed the required treatment.

Parliamentary accountability report is inconsistent with auditor's knowledge

123. Auditors should perform procedures necessary to identify any material inconsistencies between information in the parliamentary accountability report and the auditor's knowledge obtained in the audit. The auditor’s knowledge obtained in the audit includes the auditor’s understanding of the college and its environment.

124. In considering whether there is a material inconsistency between the parliamentary accountability report and the auditor’s knowledge obtained in the audit, auditors may focus on those matters that are of sufficient importance that a misstatement in relation to that matter could be material.

125. If auditors identify a material inconsistency between information in the parliamentary accountability report and their knowledge, auditors should

- conclude whether there is a material misstatement in the parliamentary accountability report
- consider whether their understanding of the college and its environment needs to be updated
- request the college to correct any material misstatement identified.

126. Where auditors are unable to resolve the matter, and a material misstatement in the parliamentary accountability report is not corrected, auditors should describe the misstatement in the independent auditors report.

Information in the parliamentary accountability report is misleading

127. A misstatement in the parliamentary accountability report can also exist when the information is misleading. This includes situations where the statement omits or obscures information necessary for a proper understanding of a matter disclosed.

128. When reading the parliamentary accountability report, auditors should remain alert for instances where the information is misleading. Auditors should request the college to correct any material misstatement caused by misleading information.

129. Where a material misstatement in the parliamentary accountability report is not corrected, auditors should describe the misstatement in the independent auditors report.

Appendix 1

Components of annual report and accounts

The purpose of this appendix is to summarise the components of the annual report and accounts, along with a summary of the auditor requirement and reporting for each.

Component	FReM paragraphs	Audit requirement	Audit reporting
PERFORMANCE REPORT	Section 5.2	Read for consistency with financial statements	Opinion on performance report
		Read to assess preparation in accordance with the accounts direction	Opinion on performance report
		Read for inconsistency with auditor's knowledge or otherwise misleading	Describe any material misstatement identified
ACCOUNTABILITY REPORT	Section 5.3		
1 Corporate governance report	5.3.7 to 5.3.29		
• Directors' report	5.3.9	Read for inconsistency with auditor's knowledge or otherwise misleading	Describe any material misstatement identified
• Statement of Accountable Officer's responsibilities	5.3.10 to 5.3.12		
• Governance statement	5.3.13 to 5.3.14	Read for consistency with financial statements	Opinion on the governance statement
		Read to assess preparation in accordance with the accounts direction	Opinion on the governance statement
		Read for inconsistency with auditor's knowledge or otherwise misleading	Describe any material misstatement identified

Component	FReM paragraphs	Audit requirement	Audit reporting
2 Remuneration and staff report	5.3.15 to 5.3.27	Audit for compliance with accounts direction	Opinion on remuneration and staff report
3 Parliamentary accountability report	5.3.28 to 5.3.29	Read for inconsistency with auditor's knowledge or otherwise misleading	Describe any material misstatement identified
FINANCIAL STATEMENTS	N/A (SORP applies)	Audit for misstatements	Opinion on financial statements and opinion on regularity