London South Bank
University

	PAPER NO: AC.54(12)	
Board/Committee:	Audit Committee	
Date:	30/10/2012	
Paper title:	Key Issues Memorandum	
Author:	Natalie Ferer, Financial Controller	
Executive sponsor:	Richard Flatman, Executive Director of Finance	
Recommendation by the Executive:	The Executive recommends that the Audit Committee note and consider the attached audit Key Issues Memorandum from Grant Thornton, which will be submitted to HEFCE.	
Aspect of the Corporate Plan to which this will help deliver?	Financial sustainability	
Matter previously considered by:	N/A	
Further approval required?	Board of Governors	On: 22/11/2012
Communications – who should be made aware of the decision?	HEFCE.	

Executive Summary

See attached Key issues memorandum, a copy of which will be submitted to HEFCE. No material weaknesses have been identified.

Attachments: Key Issues Memorandum

London South Bank
University

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Executive Summary

See attached Key issues memorandum, a copy of which will be submitted to HEFCE. No material weaknesses have been identified.

Attachments: Key Issues Memorandum

Key Issues Memorandum

London South Bank University

For the year ended 31 July 2012

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To the Audit Committee of London South Bank University

The purpose of this memorandum is to highlight the key issues affecting the results of the University and the preparation of the University's financial statements for the year ended 31 July 2012. It is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We take responsibility for this memorandum, which has been prepared on the basis of the limitations set out in 'The small print' (Section 7).

We would like to take this opportunity to record our appreciation for the kind assistance provided by the finance team and other staff during our audit.

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1 Key audit issues

In this section we present our findings in respect of matters and risks identified at the planning stage of the audit and we provide details of additional matters that arose during the course of our work.

1.1 Status of audit

Our audit is substantially complete although we are finalising our procedures in the following areas:

- Operating expenses review
- Governors and senior post holders emolument certificates
- Review of final accounts
- Review of HESES report
- HESA data collection report
- Bank letters
  - Barclays liquidity fund
  - Barclays loan
  - HSBC access account – 71375423
  - HSBC treasury – 01549642
  - HSBC Euro Liquidity fund
  - Natwest general 39218635
  - Natwest charitable funds
  - Natwest access
  - Natwest euro – 550042039487
  - Lloyds TSB bank 00849907
- Investment confirmation
  - BlackRock
- Review of impairment review paper
- Post balance sheet events review
- Representation letter

1.2 Matters identified at the planning stage

In the conduct of our audit, we have not had to alter or change our audit plan, which we communicated to you in our Audit Approach Memorandum presented to the Audit Committee in June 2012.

Our responses to the matters identified at the planning stage are detailed below in section 1.7.

1.3 Matters identified during the course of the audit in relation to fraud

There were no matters identified during the course of the audit in relation to fraud.

1.4 Matters identified during the course of the audit in relation to related parties

There were no matters that arose in the course of our audit in respect of related parties [subject to review of Governors and senior post holders emolument certificates.]

1.5 Matters identified during the course of the audit in relation to compliance with relevant laws and regulations

There were no matters identified during the course of the audit in relation to compliance with relevant laws and regulations.

1.6 Written management representations

Representations will be requested from management in respect of impairment of fixed assets.

1.7 Matters identified at the planning stage

	Issue	Auditor commentary
1	**Student numbers and existence of HEFCE income** The recognition of HEFCE funding has been a significant issue for the sector as a whole in recent years and continues to be a complex area. The increased focus on the accuracy of student data returns on which performance against the HEFCE contract is assessed continues. A number of institutions in the sector have suffered clawbacks of grant where data returns have been found to be inaccurate, or not fully in accordance with the HEFCE definition of student non-completions. We are aware that the University has historically had data quality issues and management implemented various controls in the prior year. A data quality review undertaken by internal audit in the current year did, however, identify significant weaknesses. Further evidence of poor data quality has resulted in an increased clawback provision for over-recruitment in 2010/11.	We have reviewed the amount of income recognised from HEFCE and agreed to supporting documentation and correspondence. No issues were noted from our work. A provision of £837k has been included in the accounts as a result of the penalty for over recruiting in 2010/11. We have reviewed the documentation relating to this provision and are satisfied that the amount represents an adequate estimation of the fine that is likely to be imposed, with £816k of this provision having been confirmed by HEFCE in a letter dated 26 September 2012, following their review of the HESES 2010 re-creation. We understand management are aware of the on-going data quality issues and are actively taking steps to ensure improved quality. Some of these remedial actions taken include regular reporting now made to the Board, and significant time being invested in staff training. We will need to review the HESA data collection systems report when this becomes available. [TO UPDATE WHEN RETURNS HAVE BEEN REVIEWED]
2	**Existence of tuition fee income and recoverability of debtors** Income from tuition fees continues to form an increasing part of the University's income each year. It should be noted that the University has an effective credit control function and consequently does not consider the recoverability of student debts to be a significant risk area.	We have carried out substantive testing and analytical reviews of tuition fee income and we are pleased to report that no issues were identified. Income recognised in the year is in line with our expectation, which was set, based on actual student numbers and standard fees set by the Board for 2011/12. The policy for providing against student debts has been applied consistently year on year and we consider this policy and level of provision to be appropriate.

	Issue	Auditor commentary
3	**Existence of income from Strategic Health Authority education contracts** These contracts constitute a significant proportion of the University's income and, given the current changes in the NHS, this income stream could potentially be at risk.	We have reviewed the amount of income recognised from the NHS and agreed to supporting documentation and correspondence. No issues were noted from our work. We do, however, highlight the significant increase in the claw-back provision in the year of £2.7m (2011: £1.4m) which is due to the under-recruitment of students. This was a consequence of the University piloting the new nursing BSc which is replacing the diploma. Students choosing to take the BSc rather than the diploma received a less favourable bursary from the NHS and so this impacted student applications at the University, with some students applying for the old diploma at other London HEIs in order to receive a better bursary. Going forward, all London HEIs will be offering the new BSc and so the difference in bursaries will no longer apply. The University has been assured by the NHS that it will not be penalised for the reduced student intake in 2010/11 as it was related to the pilot scheme. The main contract which is for Nursing and Midwifery has been renewed for 2012/13 following the tendering process. The contract was awarded for only 400 (2012: 886) students which is significantly less than in 2011/12 as there was a need to reduce the number of students in nursing training in London.
4	**Existence of payroll costs** Payroll expenditure constitutes a significant proportion of the University's costs.	We have carried out analytical reviews on payroll cost in the year. The results for the year were in line with our expectations. In light of the recent payroll issues identified in March 2012, we have reviewed the payroll investigation report prepared by the internal auditors. The investigation identified a number of control weaknesses present at the time of the salary payment in March 2012. In particular, it appears the requirement to check all entries/calculations on payroll hard copy documentation was not complied with. This lack of compliance was a contributory factor to the payment's occurrence. We note that following the appointment of an Interim Payroll Manager in March 2012 the control environment appears to have been strengthened with the implementation of a number of new controls. We have focussed our audit approach on these new controls to ensure they are being adhered to by staff

	Issue	Auditor commentary
		and that they are operating effectively. We were able to observe these controls through our walkthrough testing, and from this work are able to conclude that the controls appear appropriate for the detection and prevention of significant payroll fraud.

	Issue	Auditor commentary
5	**Existence of accommodation income and recoverability of debtors** Income from residences, catering and conferences continues to form a significant part of the University's income each year.	We carried out analytical review on these income stream and no issues were noted from our work. The income generated has remained fairly consistent year on year. Recoverability of debtors has been discussed in further detail in section 1.8.1 below.
6	**Completeness of creditors** Due to the nature of the University's activities creditors and accruals are significant and therefore there is a high risk that liabilities relating to the year could be missed in significant volumes, giving rise to a material impact on the reported results.	Our review of creditors and accruals at year end did not identify any significant issues. There has been a significant increase in account payable accruals in the year which is due to the on-going construction work at the Student Enterprise Centre.
7	**SBUEL negative reserves – presentation and measurement of proposed restructuring** For a number of years, SBUEL has been making gift aid payments of taxable surpluses to the University, despite having negative reserves. This is not in accordance with Company Law. Following legal advice received, the directors have converted the loan due to the University to equity, followed by a capital reduction.	We have reviewed the transactions for the capitalisation of the loan and the subsequent capital reduction, the associated documentation which has been submitted to companies house and the disclosure of the transactions in the financial statements of both the University and SBUEL. We are satisfied that the transactions have been accounted for correctly [subject to the adjustments required in the SBUEL accounts]. The resulting investment in SBUEL in the balance sheet of the University is subject to impairment as the value of SBUEL's net assets are significantly lower than the recorded cost of the University's investment. Any impairment charge could be subject to corporation tax, with the impairment amount being treated as taxable income in the University. This is because HMRC may view it as a non-qualifying investment or non-charitable expenditure and impute a tax charge on the amount not properly used for charitable purposes. Any resulting tax charge is unlikely to be material to the financial statements of the University. However, we recommend that management document clearly the reasoning behind the restructuring should there be any future challenge from HMRC. **Management comment:** Agreed. The reasoning behind the restructuring has been documented clearly and demonstrates the future benefits to LSBU of the transaction

	Issue	Auditor commentary
8	**Valuation of properties** The University has now finalised its plans for the Terraces which will be redeveloped at an estimated further cost of £13.5m. The resulting total spend will likely exceed the final carrying value and so an impairment charge of £3m (being the stabilisation costs incurred in previous years) will be incurred in the year. The University is also continuing its plans for the development of the Student Union building. It is likely that the final cost of the building will exceed the resulting 'market value', but the Board do not consider that the property will be impaired due to the wider benefits provided to the University from having a new Student Union building (for example improving student experience).	We have reviewed the documentation to support the carrying value of the Terraces and the Student Union building and have considered the arguments and assumptions therein. These have been discussed with senior members of the finance team. We have not identified any significant issues but we will monitor the progress of both the Terraces and the Student Union building going forward to ensure that the costs do not exceed the budget and that the completed buildings function and deliver according to the original plans.

	Issue	Auditor commentary
9	**Defined Benefit Pension Scheme** The University has received an actuarial report for the Local Government Pension Scheme (LGPS) valuation as at the year-end in accordance with FRS17. The Governors are responsible for ensuring that the assumptions used in these reports are appropriate to the members.	We have reviewed the assumptions used in the actuarial reports and our comments are detailed further in **Section 2**
10	**Loan covenants** The University has loans with financial institutions. The breaching of any of the covenants in these loans could lead to the University having to repay these amounts on demand and would need to be disclosed as such within the financial statements in accordance with Financial Reporting Standard 25.	We have reviewed the financial covenants' calculations and the group's compliance. No issues were noted from our work. Our review of non-financial covenants revealed that the bank requires management accounts on a quarterly basis within 45 days of quarter end, audited financial statements annually within 180 days and HEFCE forecasts at least annually in line with submission requirements to HEFCE. We understand from the relationship manager at the bank that there were some issues in the year with regards to receiving both management accounts and financial forecasts. Although the report from the bank stated that the issue has now been resolved, and all management information is up to date, this does highlight a control weakness as non-compliance with covenants (both financial and non-financial covenants) could result in the loan becoming payable on demand. We recommend that the covenant compliance process is formalised and documented within the monthly management information to ensure compliance is monitored appropriately. **Management comment:** A schedule of management information required by the banks will be compiled and the Treasury Manager will be tasked with ensuring that these are sent out as required.
11	**Going Concern** Each year the Governors consider the going concern status of the University and its subsidiaries for a minimum of 12 months from the signing of the statutory accounts. Part of this consideration is the availability of sufficient funding for that period, including availability of loan facilities that can be drawn immediately.	We are currently finalising our review of going concern. However from our discussions and understanding of the University, we do not anticipate any issues to be identified that would cause concern about the going concern status in the 12 months following the signing of the audit report. We will update this comment when our review is concluded, in advance of the finalisation of this document for the Board.

1.8 Matters identified during the course of the University audit

	Issue	Auditor commentary
1	**Halls debtors** The debtor balance at the yearend relating to halls of residence was £1,794k and a provision of £1,506k has been made against it. Historically, the provision has been in the region of 90%. We note that the large debtor balances arises as a result of students being invoiced for the year but only required to pay by instalments. To allow them access to the room they are required to pay in advance for the first term. Once the student has the key some students are less likely to paying the remaining instalments. The university is not permitted to withhold a student's degree due to non-payment of rent as the income is treated separately to student fees. This gives little or no leverage other than to issue outstanding notices during the student's remaining time in the accommodation. Once the student leaves the debt has historically been almost impossible to recover hence the large provision.	We recommend that management reviews its letting policies, procedures and agreements. For example, the accommodation could be let on a termly basis rather than an annual basis. Where students do not pay the rent in advance, they should not be granted access to the room. **Management comment:** Letting policies and procedures and credit control procedures will be reviewed and were necessary recommendations made for improvements.

	Issue	Auditor commentary
2	**Control accounts within bank reconciliations** A long standing problem with the financial transactional data transferred from the Kinetics Accommodation system (KX) to Agresso has resulted in a credit balance accruing on the Control accounts within bank and cash which management has been unable to reconcile. This issue has remained unresolved for a number of years. The total value of control accounts at the year-end was £837k (2011:305k). In previous years the adjustment has been to temporarily reclassify the balance to creditors for the purpose of preparing the financial accounts. A review of these control accounts carried out by management in the current year has identified that the amounts relate largely to halls debtors. However, this review has not yet been finalised and so the finance team will, again, reclassify the balance to creditors for the purpose of preparing the financial statements. The review will then continue and be concluded in 2012/13 so that the balances can be permanently adjusted and corrected.	We have reviewed management's reconciliation of the control accounts within bank and cash and we concur with the proposal to adjust the balances by £837k. We will review any adjustments made during 2012/13 which will likely reduce the halls debtor balances. We note that halls debtor balances are subject to a 90% bad debt provision and so any reduction in the halls debtor balance will require a matching release of the corresponding bad debt provision. **Management comment:** A great deal of work has been done during the year to resolve the system and process issues that are causing balances relating to Halls transactions to remain in control accounts. A solution has been proposed which includes changes to the journal that posts transactions from the Halls system to Agresso and reconciliation of data before and after posting. These changes will be implemented before the end of December 2012. Correcting accounting entries will be processed at this point and reflected in the 2013 financial statements.
3	**Demolition costs relating to the temporary student union building** The University applied for planning permission from Southwark Council to build a temporary student union accommodation in 2006 at Rotary Street. The planning permission has periodically been renewed and the most recent of which was in June 2012. The extended permit was received in June 12 for a period of 6 months expiring on 31 December 2012. The permit states that no further renewal would be granted and the building must be removed and the land returned to its original condition on or before 31 December 2012.	As the plan was that the building was only temporary and would be demolished at some stage, we would have expected that the cost of the building capitalised would include a dilapidation provision and the cost depreciated over the expected economic life of the asset. We understand from management that the estimated demolition cost will be approximately £244k based on a quote from a contractor. The accounting treatment under FRS 12 for provisions states that a provision should be recognised if there is a legal obligation, the liability can be reliably measured and it is probable that economic benefit will flow from the entity. We recommend that management recognises this provision in current year as it meets the requirement under FRS 12. An adjustment has been made to recognise a provision of £244k.

2 Financial reporting matters

2.1 Review of key accounting policies

We have reviewed the financial statements and present our view of the key accounting policies below, bringing to your attention in particular any significant judgements and estimates.

Accounting area	Summary of policy	Comment
Consolidated reporting	• The consolidated financial statements include the University and its subsidiary undertakings, London South Bank University Enterprise Limited and South Bank University Students Union. Intra-group sales and profits are eliminated fully on consolidation. As all subsidiary undertakings are wholly owned, the University has taken advantage of the exemption contained in FRS 8 and has therefore not disclosed transactions or balances with entities which form part of the group.	• The consolidation policy is in line with generally accepted accounting principles.

Accounting area	Summary of policy	Comment
Revenue	• Income from research grants, contracts and other services rendered is included to the extent of the completion of the contract or service concerned. This is generally equivalent to the sum of the relevant expenditure incurred during the year and any related contributions towards overhead costs. All income from short-term deposits is credited to the income and expenditure account in the period in which it is earned. • Fee income is stated gross and credited to the income and expenditure account over the period in which students are studying. Where the amount of the tuition fee is reduced, by a discount for prompt payment, income receivable is shown net of the discount. Bursaries and scholarships are treated as expenditure and not deducted from income. • Recurrent grants from the Funding Councils are recognised in the period in which they are receivable. Any payments received in advance are recognised in the balance sheet as a liability. • Non-recurrent grants from Funding Councils or other bodies receivable in respect of the acquisition or construction of fixed assets are treated as deferred capital grants and amortised in line with depreciation over the life of the assets.	• The revenue income is recognised in accordance with generally accepted accounting principles.
Depreciation	• Depreciation is provided to write off the cost or valuation less the estimated residual value of the tangible fixed assets by equal instalments over their useful economic life	• The accounting policy states that a rate 5 years is used for equipment, furniture and motor vehicles. From our review, furniture in depreciated over 15 years therefore we recommend that the disclosure of the depreciation policy is updated to show 7% - 20%.

Accounting area	Summary of policy	Comment
Bad debt provision	• A general provision of 80% is made against all tuition fee debtors, 90% against hall resident debtors and trade and other debtors are reviewed on a regular basis and specific provisions made as appropriate. The policy was set based on past experience.	• Accounting standards indicate that 'historic experience' should be used when trying to determine the appropriate provision at the year-end therefore it appears in accordance with generally accepted accounting principles. Additionally these policies has been applied consistently year on year.
Other judgements and estimates	• Pension assumptions • Impairment	• See 2.3 below • See 1.7.8 above

2.2 Disclosure omissions

Our review found no significant omissions in the financial statements.

2.3 FRS 17 Retirement benefits

The University is involved in three pension schemes; London Pension Fund Authority (LPFA); the Universities Superannuation Scheme (USS); and the Teachers' Pension Scheme.

The requirements of FRS 17 only impact on the LPFA. The other schemes are externally funded schemes where it is not possible to identify the University's share of the underlying assets and liabilities. As such, the University has taken advantage of the exemption under FRS 17 to account for its contributions to these schemes as if they were defined contribution schemes.

The movements in the FRS17 deficit for the year, as disclosed in the note 24 to the accounts, are set out below.

Movement	£'000	£'000
Brought forward pension deficit at 1 August 2011		**(55,340)**
Current service cost	(3,680)	
Employer's contributions paid	4,903	
Finance cost	(2,262)	
Settlements and curtailments	(139)	
Total charge reflected in income statement		**(1,178)**
Actuarial loss	18,146	
Total loss reflected in STRGL		**(18,146)**
Pension deficit at 31 July 2012		**(74,664)**

Assumptions:

The actuarial valuation on which the FRS 17 pension deficit is based has been provided by Barnett Waddingham. As part of our audit procedures we have reviewed their actuarial report, including the assumptions on which the calculations have been based.

The following table shows the key assumptions that have been used by the actuaries:

Actuarial assumptions	2012	2011	benchmark *
Pension increases	1.8%	2.7%	1.9% - 2.2%
Salary increases	3.5%	4.5%	1.9% - 4.0%
Discount rate	3.9%	5.3%	4.1% - 4.3%
RPI increases	2.6%	3.5%	2.5% - 2.8%
CPI increases	1.8%	2.6%	1.5% - 2.3%

* benchmark has been obtained from various other Educational institutions.

Pension increases

We have assumed that the assumptions for pension increases are based on CPI inflation but adjusted to allow for relevant CAP and floor (if applicable). Although this is lower than the benchmark, it is compensated by a lower discount rate.

Salary Increase

This is based on RPI +0.9%. We have seen a tendency to adopt a lower margin in the last couple of years usually 1% or sometimes lower, however, due to the changing economic conditions, the typical margin we have observed over recent periods has reduced to no margin.

Discount rate

This is in-line with the iBoxx AA-rated Corporate Bond index (for terms over 15yrs) which was around 3.89% as at 31 July 2012.

RPI increases

This is based on gilt yields less a usual adjustment for inflation risk premium. It is common for a deduction of up to 0.3% to be made to account for the inflation risk premium and excess demand in the market which pushes down the index-linked gilt yields. The expected return on gilts should be based on current market yields on appropriate Government Bonds. Based on the Market condition as at 31 July 2012, we would expect this to be around 2.8% and therefore the assumption is within an acceptable rage.

CPI increases

This is based on RPI less 0.8%. We have been observing downward adjustments of between 0.5% and 1%. We would therefore expect CPI to lie between 1.5% and 2.3%pa. The mean CPI assumption is therefore reasonable.

The mortality assumptions (based on average future life expectancies at 65) used at 31 July 2011are as follows:

Mortality	2012		benchmark *
	Males	Females	
Current pensioners	20.8	23.8	20.1 – 25.1
Future pensioners	22.8	25.7	22.5 – 26.1

** benchmark has been obtained from various other Educational institutions.*

It can be seen that the assumptions used for the University are in line with our expectations and with those used by other similar institutions.

We recommend that the Board keeps the assumptions for future periods under review in order to ensure that they remain appropriate for the University and its subsidiaries' circumstances.

3 Audit adjustments

3.1 Misstatements

We are required to communicate all uncorrected misstatements to you, other than those considered to be clearly trivial. We have requested that management correct these misstatements and have included (where applicable) the reasons given by them as to why the misstatements remain uncorrected.

3.2 Impact of misstatements

All adjusted misstatements are set out in detail in section 3.4 below. In summary, the impact of adjustments is:

Income and Expenditure account	**Increase/ (Decrease) in surplus**
	£'000
Surplus for the year per initial trial balance	6,079
Management adjustments posted	352
Auditor-proposed adjustments posted	84
Final surplus per financial statements	**6,515**

The aggregate impact of unadjusted misstatements on the income and expenditure account, were they to be processed, would increase the surplus for the year by £15,000.

There is no impact on the audit report as a result of these unadjusted misstatements.

3.3 Unadjusted misstatements

Journal reference	Detail	Balance sheet Dr £'000	Balance sheet Cr £'000	Income and Expenditure Dr £'000	Income and Expenditure Cr £'000	Surplus effect	Reason for not adjusting
Current period unadjusted misstatements							
University							
1	Accruals	83					
	Capital expenditure		83				
	Being overaccrual on a project on-going at the year-end					0	Not material
	Impact	**83**	**83**	**0**	**0**	**0**	
SBUEL							
1	Bad debt provision	17					
	Bad debt expense				17		
	Being overprovision against a debt recovered since the year-end					17	
2	Expenses			2			
	Prepayments		2				
	Being write-off of long-standing prepayment balance					(2)	
	Impact	**17**	**2**	**2**	**17**	**15**	
Group Impact		**100**	**85**	**2**	**17**	**15**	

3.4 Adjusted misstatements

Journal reference	Detail	Balance sheet Dr £'000	Balance sheet Cr £'000	Income and Expenditure Dr £'000	Income and Expenditure Cr £'000	Surplus effect
Draft surplus £'000						6,079
Management adjustments						
1	Interest accrual	129				
	Interest payable				129	
	Being overaccrued interest					129
2	Accruals	121				
	Other operating expenses				121	
	Being correction of accruals reversed					121
3	Other operating expenses			37		
	Prepayments		37			
	Being adjustment to prepayments					(37)
4	Accrued income	120				
	Other operating income				120	
	Being graduation income from Royal Albert Hall					120
5	Creditors	25				
	Other operating income				21	
	Other operating expenses			2		
	Intercompany balance		6			
	Being other trivial adjustments					19
Auditor adjustments						
1	Debtors	4,902				
	Creditors		4,902			
	Being reclassification of credit balances on debtors ledger					0
Adjusted surplus carried forward						6,431

Journal reference	Detail	Balance sheet Dr £'000	Balance sheet Cr £'000	Income and Expenditure Dr £'000	Income and Expenditure Cr £'000	Surplus effect
	Brought forward adjusted surplus					6,431
Auditor adjustments						
2	Trade debtors	270				
	Deferred income		270			
	Being payments received					0
3	Trade debtors	138				
	Creditors		139			
	Being reclassification of credit balances on debtors ledger					0
4	Cash at bank	837				
	Accruals		837			
	Being reclassification of balances due to KX adjustment					0
5	Provisions	80				
	Accruals		80			
	Being reclassification of balances					0
6	Debtors	158				
	Income				158	
	Being adjustment for additional NHS income in the year					158
7	Debtors	333				
	Creditors		333			
	Being reclassification of debit balances on creditors ledger (£142k) and Bursary income (£191k)					0
8	Accruals	170				
	Operating expenses				170	
	Being over-accrued expenses					170
9	Other course income			785		
	Other operating income				785	
	Being reallocation of income					0
10	Operating expenditure			244		
	Provisions		244			
	Being provision for demolition costs for temporary Students' Union building					(244)
Surplus per final accounts £'000						**6,515**

4 Design effectiveness of internal controls

4.1 Accounting system and internal control

We have applied our risk methodology to your audit. This approach allows us to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

The following observations have been noted in regards to your internal controls:

Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

See 'The small print' for further details of our approach.

Key to assessment of internal control deficiencies

- ● Material weakness - risk of material misstatement
- ● Significant deficiency - risk of significant misstatement
- ● Deficiency - risk of inconsequential misstatement

	Assessment	Issue and risk	Recommendation
1	●	**Authorisation of journals** There are currently two journal posting systems in operation: one system (J5) is primarily used by the financial accounting team while the other (G6) is primarily used by the business support management team. J5 journals are uploaded and require an electronic authorisation of each journal posted. The old G6 system is where journals are manually input in to Agresso. The G6 system does not require any electronic authorisation of any journals before they are posted and there is no manual authorisation process in place as the numbers of journals are significant and it is not considered practical to do so (these are usually journals posted by business support managers).	We note that the implementation of the new system in the prior year shows a positive move towards strengthening the internal controls process for the future. We understand that there are practical reasons why two systems are currently in operation: the J5 system being used for large multi-line journals and the G6 system for short corrections and adjustments. However we recommend that all journals are posted from one system which includes an appropriate authorisation process. Until this is considered practical, we recommend a journal report of journals posted outside the J5 system is obtained on a regular basis (weekly or monthly) and reviewed to identify any unusual entries. It should be noted that this will only act as an a method of identifying any potential fraud rather than as a control to

	Assessment	Issue and risk	Recommendation
			prevent it occurring. We also note that manual G6 journals posted by the Financial accountant are not reviewed or approved by the Financial controller. We do, however, appreciate the fact that risk of misstatements through journals is mitigated through the preparation and review of month end management accounts. **Management response:** G6 journals which are ad hoc journals and adjustments do not require approval. Other controls are in place, ie all BSMs meet with their Budget Managers each month to review spend, and the Financial Accounting team perform reconciliations of balance sheet accounts after the month has been closed We agree that journals posted by the financial accountant will be reviewed monthly by the Financial Controller.
2		**Credit control - SBUEL** Letting income in the year is approximately £1 million including a £244k provision. The provision has arisen as a result of some letting income being in arrears from as far back as June 2011. The largest debtor is LKIC to whom £192k of the provision is attributed to.	There appears to be some credit control issues where old debts are not being chased up effectively. LKIC currently has cash flow issues and has not paid the outstanding rents. The management of SBUEL are working with LKIC to recover the outstanding debts and to modify future letting arrangements to avoid such difficulties arising going forward. **Management response:** There are plans to restructure the lettings arrangements in Technopark with invoices being issued direct from SBUEL and normal University credit control procedures being used to recover unpaid invoices.

	Assessment	Issue and risk	Recommendation
3	●	**Oracle database management** The Agresso and QL applications are built on Oracle databases which can be accessed directly by the IT staff and the third party software vendor Unit 4. We noted that all access to the underlying database is being undertaken through a generic system admin account. We also noted that audit logging at the database level does not record changes to key data and that other logs in place to record access to the databases are not being monitored. There is a risk that the generic account is accessed and inappropriately used to alter key financial data. In such an instance, there would be no trail of who has performed such an action. Without an appropriate review of audit logs changes could be made without the knowledge of the business. By members of staff accessing the underlying database, it undermines the access controls exercised within the application unless such compensating controls are also introduced.	We recommend that IT establishes named user accounts at the Oracle database level. IT should also review the audit logging capability of the Oracle database to ensure that data and system changes are logged. Such audit logs should be monitored periodically, preferably by an individual independent of IT within the business who does not have direct access to the database. This will provide a degree of segregation. As a minimum, critical tables within the system such as bank details and supplier and customer master files should be restricted and any alterations made to fields within these logged and reviewed periodically. **Management response:** ICT will investigate setting up named user accounts for accessing the Oracle database. An audit logging facility is available but has not been switched on. ICT will investigate using this facility to produce reports on activities undertaken through the database.
4	●	**IT - Business continuity** LSBU has established a disaster recovery server room; this however, is on the same site as the main server room. There is a risk that a disaster affecting the entire LSBU site could result in the total loss of key operational data. This could have a detrimental impact on business relationships and cause reputational damage. We also noted that LSBU has an approach to disaster recovery for its IT infrastructure based on two data centres, but this is not formally documented. Disaster recovery and business continuity plans are necessary to ensure the restoration of critical information processing and business activities within a pre-defined period of time following an	We recommend that LSBU document and formally communicate the Disaster Recovery plan/ arrangements over the organisation's IT infrastructure. The plan should ensure that offsite back-up arrangements are established. Once the plan is in place we also recommend that the plan is periodically tested at least once a year. **Management response:** LSBU is reviewing its ICT Strategy in detail and will ensure that the requirements for disaster recovery and security of data backups are fully considered. Changing the current arrangements with respect to the provision of off-site facilities will require investment and this needs to be weighed against the potential risk of systems and data unavailability. A

<table>
<tr><th></th><th>Assessment</th><th>Issue and risk</th><th>Recommendation</th></tr>
<tr><td></td><td></td><td>unplanned interruption.

The lack of comprehensive, documented and tested plans for critical business systems and processes can severely inhibit the ability to recover such systems or processes in the event of an interruption / disaster occurring. The non-availability of these systems and processes may significantly impact the day-to-day operations of the business and limit the University's ability to respond to student requirements, which may result in financial and reputational loss. Independent studies indicate that many organisations fail to survive major incidents in the absence of effective business continuity planning.</td><td>business case will be presented to the Executive for decision. Any agreed corrective actions will be taken following this business decision point</td></tr>
<tr><td>5</td><td>●</td><td>Logical access parameters
There are different password parameters for Agresso core users and those who use Agresso Web. The parameters for those using the Web version are the same as for the University network and include the following:

• password complexity - disabled
• enforce password history – not defined
• maximum password age – 180days
• minimum password age – 0days
• maximum password length – 6 characters
• store passwords using reversible encryption- not defined
• account lockout duration – not defined

By not implementing suitable logical access controls such as these there is the increased risk of the applications and the operating system being accessed by unauthorised individuals and placing the residing financial information at risk.</td><td>We recommend that the following best practice password parameters be enforced on the network, Agresso Web and the core Agresso system:

• minimum password length of 6-8 characters
• minimum password age of at least 1 day
• maximum password age of 30-60 days
• alphanumeric passwords (complexity) enabled
• account lockout set to 3-5 invalid lockout attempts
• inactivity lockout set to 10-20 minutes
• lockout period should be set to indefinite, with access only reinstated by an administrator

Management response:
Passwords for those using the core back office system, including Agresso, are as recommended above, with the exception that the maximum password age is 90 days, not 30-60 as recommended.

Password parameters for Agresso Web users do not meet all the critieria recommended and there is a project in place to strengthen the current system and improve user</td></tr>
</table>

	Assessment	Issue and risk	Recommendation
			identification. Once in place, this will comply with most of the recommendations above. In the meantime the risk of information being accessed by unauthorised users is low as web users access the system infrequently and the financial information available to view is limited to the cost centre that individual manages

5 Sector specific issues

5.1 VAT

As part of our audit work, we carried out a review of the VAT status of the University and we would like to draw management's attention to a number of arrears:

Treatment of grant income

There is a great deal of litigation being heard in the Courts at the moment surrounding the VAT treatment of grant income. Where a grant is freely given with nothing provided in return it falls outside the scope of VAT. However, where the person providing the grant is receiving something in return for the money it is consideration to be a supply and VAT is due at the applicable rate (this would not include a report outlining how the funds have been spent).

We recommend that management ensures adequate controls are in place to identify any grant funding where VAT is likely to be due.

Overseas Recruitment Agent Fees

Where Universities use overseas recruitment agents to attract students, any commissions payable to these recruitment agents are deemed by HMRC to be supplied and subject to VAT in the UK. Therefore, where LSBU is receiving invoices from overseas recruitment agents it should be applying the reverse charge mechanism to these fees and self-assessing a 20% VAT charge. This charge should be declared in box 1 of the VAT return and can be recovered, to the extent that it relates to taxable supplies, in box 4. As the majority of the supplies to which the recruitment agents' fees relate are likely to be exempt from VAT the figure in box 4 is likely to be significantly lower than the entry in box 1, resulting in a net payment being due to HMRC as a result of the overseas recruitment agents' fees.

Reverse charge on overseas recruitment agent fees

The rules which require Universities to account for the reverse charge on overseas recruitment agents fees were introduced on 1 January 2010 and we understand that the University has been applying the reverse charge since that date. However, we have noted in recent year, instances where some universities have received assessments for the VAT due on overseas recruitment agents fees prior to 1 January 2010. This may be a potential exposure for the university where we believe its overseas recruitment agent costs are approximately £500k per annum.

HMRC are able to assess going back up to four years, therefore based on the above figure there is the potential for a VAT assessment of over £100k, if HMRC were to take the point. HMRC may however not take the point on this, particularly given that it does not appear to have been picked up in the visit earlier this year. We would however, like to make management aware of the potential risk.

5.2 Phase out of funding for old regime students

HEFCE will be phasing out the mainstream funding for old regime students over the next three years The process for allocating (and retrospectively adjusting) the grant in each year will be different from that used in previous years and will result in more frequent, and potentially more substantial, adjustments to the funding levels.

This is due to the fact that when the final grant allocation is determined based on actual student numbers there will be no tolerance band and therefore the grant will be subsequently adjusted for each difference.

This final reconciliation will not be carried out for the 2012/13 year until 2014 (and similarly for future years). Management will need to consider the potential impact on cash flows as there is a higher likelihood that future funding will be adjusted retrospectively and will need to budget accordingly.

5.3 Proposed changes to UK GAAP

What is proposed?

The Accounting Council is planning to replace all current UK financial reporting standards with a new framework, incorporating two new standards. The standards are "The FRS", a 300 page standard which will be applied by the majority of UK companies, and the Reduced Disclosure Framework, an option of IFRS with reduced disclosures available for subsidiaries and parent company individual accounts.

For more information on the proposals and their implications, visit our website, http://www.grant-thornton.co.uk/services/audit_and_assurance/the_future_of_uk_gaap.aspx.

What would this mean for LSBU?

Under the proposals, the University would be considered to be a public benefit entity, as its main purpose is not the generation of profit. The FRS includes supplementary paragraphs which address issues specific to public benefit entities, for example non-reciprocal transactions such as donations.

When undergoing transition to The FRS, there are likely to be recognition and measurement differences on transition, for example regarding the classification of leases, the treatment of lease incentives and accounting for short-term employee benefits. These differences are likely to impact on the reported surplus and also on the balance sheet, and could, therefore, have an impact on the ratios used in loan covenants calculations.

What other issues should be considered?

There are also operational issues which may need to be addressed in preparing for transition, such as:

- training requirements
- possible systems changes to ensure all information is captured
- education of stakeholders
- potential need for additional resources.

What about the not-for-profit SORPs?

The Accounting Council intends to retain the three not-for-profit SORPs, for Charities, Registered Social Landlords and Higher and Further Education Establishments. However as stated above these SORPs will need to be updated to reflect the requirements of The FRS.

Planning for the transition

Although the final standard will not be published until the end of 2012, and will not be effective until accounting periods beginning on or after 1 January 2015 at the earliest, it is not too soon to start considering how you will address the transition process.

For the University this will mean the first reporting period is likely to be the year ended 31 July 2016, which will mean comparative balance sheets will be required for 31 July 2015 and 31 July 2014. It is expected that once the final standard is issued, early adoption will be permitted. This may be beneficial in some circumstances and therefore worth considering.

From our extensive experience in assisting clients with transition to EU-adopted IFRS, good planning is key to success. Timely actions and the right support will ensure that the process goes as smoothly as possible. We will continue to discuss the requirements with management and share experiences we have had across the sector and with other commercial organisations.

6 Independence

Ethical standards require us to give you full and fair disclosure of matters relating to our independence. In this context, we disclose the following to you:

We confirm that there are no significant facts or matters that impact on our independence as auditors that we are required or wish to draw to your attention. We have complied with the Auditing Practices Board's Ethical Standards and therefore we confirm that we are independent and are able to express an objective opinion on the financial statements.

In accordance with best practice, we analyse our fees below:

	£
Audit of company and subsidiaries	38,625
Tax compliance services (i.e. related to assistance with corporate tax returns)	2,500

7 The small print

Purpose of memorandum

This Key Issues Memorandum has been prepared for the benefit of discussions between Grant Thornton, the **Audit Committee** of **London South Bank University** and the Board of Directors.

The purpose of this memorandum is to highlight the key issues affecting the results of the Group and the preparation of the **University**'s financial statements for the **year ended 31 July 2012**.

This document is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We would point out that the matters dealt with in this report came to our attention during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements of the **University**.

This memorandum is strictly confidential and although it has been made available to management to facilitate discussions, it may not be taken as altering our responsibilities to the **University** arising under our audit engagement letter.

The contents of this memorandum should not be disclosed to third parties without our prior written consent.

Responsibilities of the directors and auditors

The directors are responsible for the preparation of the financial statements and for making available to us all of the information and explanations we consider necessary. Therefore, it is essential that the directors confirm that our understanding of all the matters in this memorandum is appropriate, having regard to their knowledge of the particular circumstances.

Clarification of roles and responsibilities with respect to internal controls

The **University**'s management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the **Audit Committee** that it has done so.

We have applied our audit approach to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

In consequence, our work cannot be relied upon to disclose defalcations or other irregularities, or to include all possible improvements in internal control that a more extensive special examination might identify.

We would be pleased to discuss any further work in this regard with the **Audit Committee**.

ISAUK 260 requires communication of:

- relationships that have a bearing on the independence of the audit firm and the integrity and objectivity of the engagement team
- nature and scope of the audit work
- significant findings from the audit