Reclassification of Incorporated Colleges

Issue date: 12 July 2013

Number: Communication number 2, background briefing and questions and answers

Purpose: This document comprises a background briefing on the reclassification of incorporated colleges and a series of questions and answers addressing topics that have come to SFC from colleges or arisen in discussions within the ONS Project Team.

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ONS Reclassification of colleges: Background briefing and Questions and Answers

Purpose

This document pulls together background briefing (Section 1) and a series of questions and answers (Section 2). As we receive more questions from colleges and/or identify relevant issues, we will update the Q and A.

Should you have any queries in relation to this document, please contact Andrew Millar (email: amillar@sfc.ac.uk) or Peter Ward (email: pward@sfc.ac.uk).

Section 1: Background briefing

1.1 What is the issue?

The UK Office of National Statistics has reclassified all incorporated colleges as central government entities, to be referred to as Arms-Length Bodies for the purposes of accounting and budgeting.

1.2 How has the ONS reclassification arisen?

Following the creation of Sixth Form College Corporations on 1 April 2010 (which are classified as Local Government entities) ONS decide to review the classification of all FE colleges in the UK. The key factors examined by ONS are the 'public sector powers' held by government Ministers, and their public agencies (e.g. SFC) over FE colleges. Against this criteria the ONS assessed that all FE colleges should be classed as public sector bodies. The decision was made on the basis of current legislation (i.e. before the current post-16 Reform Bill).

UK Ministers accepted the basis of the ONS decision.

1.3 What does that mean for colleges?

This has wide implications for colleges who will need to change their budgeting, reporting and accounting practices to align with those that apply for central government organisations.

Colleges currently budget and account on an academic year basis – in line with their business – but will need to switch to the same financial year basis used across the public sector (April to March).

1.4 When will the change occur?

UK Government Ministers have insisted that reclassification must be implemented with effect from financial year 2014-15 – from 1 April 2014.

It is hoped that colleges can defer the full implementation of International Financial Reporting Standards (IFRS) for producing annual accounts until 2015-16. This is currently the proposed implementation date for the IFRS compliant FE/HE SORP. The 2015-16 implementation date would have been the expected date for first set of financial statements to be prepared under the new SORP irrespective of the reclassification of colleges.

1.5 What will the incorporation status of colleges be from 1 April 2014?

For the purposes of budgeting and reporting, colleges are classified as public bodies.

For all other purposes, colleges, regional boards and regional strategic bodies are incorporated under the relevant Education Acts.

1.6 What will be the impact of ONS reclassification on the charitable status of colleges?

We understand from discussions with OSCR that the charitable status of colleges will be unaffected by the ONS reclassification.

1.7 What support will the SFC/Scottish Government offer to colleges to implement Government Accounting and Budgeting changes that occur as a result of the reclassification?

With input from the sector and the Scottish Government, SFC is currently assessing support needs. Training and training materials are also being developed.

1.8 What mitigation of the reclassification is being offered to the sector?

Scottish Ministers have committed to trying to mitigate the impact of the reclassification on colleges to enable colleges to continue to operate, as far as is possible, as they do now.

SFC and Scottish Government will work with colleges to find ways of managing the deployment of existing reserves within government accounting and budgeting rules.

SFC is currently exploring using its own year-end flexibility and the use of arm's length charitable trusts. The options for mitigation are discussed in the briefing attached below.

1.9 How incorporated colleges' income and expenditure is treated within UK-wide government budgeting arrangements?

For the purposes of HM Treasury budgeting, incorporated colleges will be classified as 'Arms-Length Bodies' (ALBs). The budgeting requirements this places on them is analogous to that for NDPBs. The detailed arrangements are set out in chapter 9 of HM Treasury's *Consolidated budgeting guidance 2013-14*.

The key points to note from that document are as follows:

- Incorporated colleges' own 'resource consumption' (i.e. their recurrent expenditure) and their own capital expenditure will be counted as part of the Scottish Government's spending. Therefore, since there is an annual ceiling placed on each area of government expenditure (referred to as 'Departmental Expenditure Limits' or 'DEL'), incorporated colleges will also have to control their expenditure so that it does not exceed pre-set limits
- Even if expenditure is financed from incorporated colleges' own reserves or borrowing, it is still included as part of overall government expenditure and therefore has to be allocated an equivalent amount from the Scottish Government's overall budget (even though the Scottish Government would not actually have to pay for or fund the expenditure). This is referred to as 'budget cover'
- However, if the expenditure is financed from colleges' other /commercial income, budget cover is not required

With regard to the year-to-year position, the Scottish Government's expenditure is controlled on an annual basis with only very limited scope to manage any under or over spent budget beyond the financial year end. From 1 April 2014 the incorporated college sector will be subject to the same annuality, including limitations on end year flexibility. The Budget Exchange Mechanism (BEM) offers the Scottish Government some ability to manage funds over the year end. The limits of this are 0.6% of the total Scottish Government resource budget and 1.5% of the total capital budget. This equates to around £150m of resource and £50m of capital for the whole of the Scottish Government. Any future college budget management across the year end will have to be managed, along with all other Scottish public bodies, within these narrow limits.

Essentially what all this means is that:

- All income and expenditure by incorporated colleges, including that funded from either reserves or borrowing, counts as part of the Scottish Government's own income and expenditure for budgeting purposes (there is no intention to consolidate colleges from an accounting perspective)
- All expenditure by incorporated colleges (net of income) requires budget cover from within the Scottish Government's own budget limits
- From 1 April 2014 onwards, any expenditure funded from incorporated colleges' own reserves would be considered as additional within the context of the Scottish Government's budget, and require corresponding budget cover. From 1 April 2014 there will only be limited scope for incorporated colleges to carry forward surpluses to future years

1.10 Will Colleges be able to generate and retain non-SFC sources of income?

Incorporated colleges will still be able to engage in activities to generate other income – indeed Ministers expect this drive to continue to support direct public investment. Projected additional external income will effectively be matched against the additional expenditure which it supports, leaving the net amount of expenditure that is supported by SFC grant and similar income. There is no intention to revisit previously indicated levels of college funding in light of reclassification. There are already Central Government bodies that successfully generate large proportions of their funding through commercial activity (such as Historic Scotland, the Scottish Qualifications Authority and the National Collections). We are speaking to these bodies, to understand how they manage commercial income.

1.11 What will the impact of reclassification be on colleges' ability to generate and retain surpluses?

Any surplus is treated as an underspend against the budget limit and any underspend rolled forward requires additional budget cover to allow it to be spent (deficits are effectively overspends). The Scottish Government has very limited flexibility (under the BEM) to roll forward underspends across year ends.

1.12 Can colleges spend existing reserves from 1 April 2014?

As already noted, from 1 April 2014, spending of accumulated reserves will also require budget cover from within the Scottish Government's overall budget limit.

1.13 What will the impact on access to capital and commercial borrowing be?

As now, the college sector has access to Scottish Government capital funding along with all other public sector bodies. However, from 1 April 2014 onwards they will not be able to augment that capital funding by using reserves or commercial borrowing without the requisite budget cover from the Scottish Government.

1.14 What will the impact on non-profit distributing projects be?

Careful consideration will be required on the use of college reserves and other sources of income in terms of the affordability of the projects and their unitary charges. However, Ministers remain fully committed to all three college projects, and will work to mitigate any risks to affordability. In particular Ministers are committed to securing the continued use of accumulated reserves for the purpose defined within the college business cases

1.15 What will the reporting cycle for government look like?

Prior to the start of each financial year (some of which will also be required in the run up to 1 April 2014)

- Individual incorporated colleges prepare draft full budgets by July for the following April to March year
- Scottish Funding Council prepares a collated position and ensures it is consistent with current information about the budget position for the relevant year, before submitting to the Scottish Government
- Scottish Parliament considers draft Scottish Government budget between September and February for the following April to March year

Monthly throughout the year

- Incorporated colleges will prepare a projection of their likely income, expenditure and cash requirements
- The projections will be collated by the Scottish Funding Council for reporting to the Scottish Government
- The Scottish Funding Council will pay individual incorporated colleges their cash requirement for the month ahead

Mid-year Scottish Government budget updates

- Enhanced returns will be required in July and November to feed into the Scottish Government's budget revision processes. The November return is particularly important since it represents the Scottish Government's last opportunity to adjust all budgets across its portfolio and ensure there is adequate 'budget cover' in place for all planned expenditure

Prior to the year-end

- Incorporated colleges will prepare an updated projection of any under or over-shoot of their previously agreed net expenditure limits by the end of February.
- These projections will also be collated by the Scottish Funding Council and will be used to determine whether the total position will be within acceptable limits.
- As long as the total position is within acceptable limits, the Scottish Funding Council may also use that information to manage underspends and overspends at individual college level.

1.16 What are the financial reporting requirements?

Change to the financial year end

Strictly speaking, incorporated colleges could continue to prepare annual accounts on an August to July basis. However, they would also need to prepare separate accounts for Scottish Government and HM Treasury purposes on an April to March basis. In practice, therefore, incorporated colleges will need to move towards an April to March financial year. It is recognised that this will impose a transitional burden on colleges and introduce an imbalance between financial and academic year. The reclassification implementation project will seek to find ways of minimising the negative impact of that mismatch.

Financial reporting framework

Central Government bodies are required to follow the Government Financial Reporting Manual (FReM) available at: http://www.hm-treasury.gov.uk/frem_index.htm

This is essentially a version of International Financial Reporting Standards (IFRS), adapted for the government sector. It is anticipated that this will operate in conjunction with the HE/FE Statement of Recognised Practice (HE/FE SORP). The expectation is that accounting would follow the FReM unless contradicted by the HE/FE SORP, in which case **the SORP would take precedence**.

The current financial reporting framework for incorporated colleges, the HE/FE SORP, is based on UK Generally Accepted Accounting Principles (UK GAAP). Government accounts (and the FReM) are prepared under International Financial Reporting Standards (IFRS) and incorporated colleges' accounts will ultimately have to be consistent with IFRS.

The HE/FE SORP is intended to be revised in line with IFRS for 2015-16, one year after the impacts arising from the ONS reclassification of incorporated colleges is meant to take effect. However, it is currently anticipated that financial reporting for the sector will **continue to follow the HE/FE SORP throughout** and therefore:

- IFRS compliance is likely to be for 2015-16 financial year onwards
- The changes to incorporated colleges' financial reporting framework will essentially only be those which were going to happen anyway

However, it should be noted that this position still needs to be confirmed by HM Treasury. Also, it may be that the budgetary impact of IFRS compliance will need to be assessed for 2014-15 as part of the ONS reclassification implementation exercise dependent on the outcome of on-going HM Treasury negotiations.

Summary of financial reporting changes

Bringing together the change in year end and the move to the new HE/FE SORP, the annual accounts which will be prepared throughout this period, for colleges not involved in mergers, are expected to be as follows.

- **1 August 2012 to 31 July 2013** (twelve months), using the **<u>current</u>** HE/FE SORP
- **1 August 2013 to 31 March 2014** (eight months), using the **<u>current</u>** HE/FE SORP
- **1 April 2014 to 31 March 2015** (twelve months), using the **<u>current</u>** HE/FE SORP (and also taking account of the FReM, where necessary).
- **1 April 2015 to 31 March 2016** (twelve months), using the **<u>new</u>** HE/FE SORP. This will also require revised comparative figures to be prepared for:
- 1 April 2014 to 31 March 2015
- Opening balance as at 1 April 2014 (which might also require some associated reworking of prior year income and expenditure)
- **1 April to 31 March** for each subsequent year, using the new HE/FE SORP.

With the exception of the move to a 1 April to 31 March reporting period and the additional FReM disclosure, **<u>all the above would have taken place anyway</u>**, as a result of the implementation of the new HE/FE SORP.

1.17 What would the impact be on financial reporting for Colleges involved in mergers?

Financial reporting changes for colleges involved in mergers

Again, with the exception of the move to a 1 April to 31 March reporting period from 1 April 2014 onwards and the additional FReM disclosure, all the financial reporting changes that might impact on the accounts preparation processes of colleges involved in mergers were already going to happen. The following table uses an example of a merger with a 1 November 2013 vesting date.

Current arrangements		Revised arrangements	
College which will be the host	**The other colleges in the merger**	**College which will be the host**	**The other colleges in the merger**
1 August 2012 to 31 July 2013 (twelve months), using the current HE/FE SORP		1 August 2012 to 31 July 2013 (twelve months), using the current HE/FE SORP	
1 August 2013 to 31 July 2014 (twelve months), using the current HE/FE SORP and incorporating the 1/8/13-31/10/13 results of the other colleges in the merger	No accounts prepared	1 August 2013 to 31 March 2014 (eight months), using the current HE/FE SORP and incorporating the 1/8/13-31/10/13 results of the other colleges in the merger	No accounts prepared
1 August 2014 to 31 July 2015 (twelve months), using the current HE/FE SORP		1 April 2014 to 31 March 2015 (twelve months), using the current HE/FE SORP	
1 August 2015 to 31 July 2016 (twelve months), using the new HE/FE SORP		1 April 2015 to 31 March 2016 (twelve months), using the new HE/FE SORP	

However, it needs to be emphasised that the accounting for 1/8/2013 to 31/10/2013 or similar periods for non-host colleges will be subject to agreement between the relevant colleges and their auditors.

1.18 What are the potential mitigating actions under consideration?

Reclassification of Incorporated Colleges – Communication 1 issued on 3 July 2013 (a copy of Communication 1 accompanies this document as an email attachment) set out approaches currently being considered and we will issue an update on progress as soon as greater clarity is achieved. However, we would continue to welcome any suggestions that might suit the specific circumstances of your college or more generally.

Section 2: Questions and Answers

The following questions have arisen either from colleagues in colleges or from discussions in the ONS project team. We have tried to answer questions as fully as we can at this stage, but in some areas there are still some unknowns. In such areas we will update the answers and also add to the Q and A as more questions and issues are identified.

Basis for accounting

2.1 What is the basis for accounting?

Colleges will account as before on an accruals basis and not cash accounting. Resource accounts and the associated returns are prepared on an accruals basis.

2.2 What are Resource and Capital Department Expenditure Limits (DEL) and Annually Managed Expenditure (AME)?

Resource and Capital Department Expenditure Limit

Colleges will be set an overall resource budget (resource (i.e. revenue) and capital DEL) this resource limit is set currently at the £522m funding floor for colleges. All college resource scores against this figure (with the exception of movements on some provisions e.g. pensions) and colleges will be expected to work towards a balanced budget at the year end.

Total Department Expenditure Limit (Total DEL) is arrived at through the following calculation: Total DEL = Resource DEL+Capital DEL-Depreciation/Impairment DEL.

Annual Managed Expenditure

The movement on items such as pension provisions is covered by Annual Managed Expenditure (AME). AME covers the non-cash fluctuations in these items. Use of AME is to cover such items is dependent on its availability and compliance with the Consolidated Budgeting Guidance.

The sum of the resource and capital DEL and AME is Total Managed Expenditure (TME) this is total public expenditure.

2.3 Could Colleges be treated, for accounting purposes, in the same way as local authorities?

Colleges could only be treated in the same way as local authorities if they were transferred to local authority control.

Reserves

2.4 What is meant by reserves?

In practical terms, cash reserves refer to the cash and near cash (e.g. term deposit accounts) which colleges hold and spend.

Revaluation reserves and pension reserves (non-distributable) will remain the same after the ONS reclassification.

2.5 What will happen to existing college reserves?

Any accumulated reserves that have not been utilised at the point the reclassification comes into effect would require additional budget cover to allow them to be spent. In other words, colleges would have these funds but be unable to spend them without additional budget cover being made available from the Scottish Government. Spending reserves without budget cover would be an overspend; which could have implications for the wider Scottish budget.

2.5.1 How would merging colleges apply reserves earmarked to support merger costs from 2014-15 onwards?

We are currently looking, on a case by case basis, at options around the use of reserves to meet some merger costs.

2.6 What reserves will be moved to arms-length trusts?

Only cash reserves can be moved to arms-length trusts. The likely impact of the transfer of surplus cash would be the generation of a deficit and a consequent reduction in the College's income and expenditure reserves as a result of the transfer via gift aid.

Working capital

2.6.1 What level of working capital is allowed?

Any movement in working capital will impact on the resource outturn position for colleges. In establishing a working capital position colleges will be expected to broadly maintain that position at subsequent year ends, although the position can fluctuate over the course of the year.

Working capital should therefore be the minimum necessary to manage cash flow over the course of the year, bearing in mind that, as part of the central government cash management arrangements, the Scottish Government can tailor the cash payments for colleges to help manage any peaks and troughs in that cash requirement over the course of the year. Cash balances within central government bodies tend to be low.

2.7 Are there any specific sector issues, for example how are SAAS fees to be accounted?

Income such as SAAS, other commercial and fee income that spans beyond the new March year-end will be accounted for in line with accruals accounting. The working capital movement to match them would occur in the period to which the income or expenditure relate.

2.8 How will multi-year projects funded in advance be accounted for after reclassification?

Activities that span more than one academic/financial year will be accounted with as now, through accruals accounting covered by associated working capital movements. However, plans to apply reserves to such projects will be affected.

Capital investment and borrowing

2.9 How would a college fund capital investment after reclassification?

Colleges would need to compete with other public sector organisations for capital funds. The college sector would need to make a continued and robust case for investment in the College estate. This process for capital investment does not differ from the process currently used in relation to large capital projects in the sector.

As a general rule, Colleges would require budget cover to invest in capital projects, unless these projects were funded in their entirety by external income.

2.10 Do depreciation and amortisation impact on a college's resource budget?

Depreciation and amortisation score against the College resource budget and requires resource budget cover annually. The cover comes from Resource DEL. HM Treasury has committed to release additional non-cash budget cover to match depreciation. This means that current levels of depreciation will have the non-cash resource budget cover required to ensure the funding floor of £522m.

Items such as provisions and FRS 17 pension provisions are generally processed through an adjustment using Annual Managed Expenditure (AME). This does not impact on colleges' resource budgets.

2.11 What is the impact on existing college borrowing?

Current borrowing can be carried forward post-April 2014. New borrowing cannot be added to after 1 April 2014.

Discussions are ongoing with HM Treasury as to how existing borrowing will be accounted for. The current working assumption, subject to confirmation, is that interest payments would score and that capital repayments would be outwith the scope of budgeting.

2.12 How would revaluations of College fixed assets be treated?

In respect of an upwards revaluation, the impact is on the balance sheet only and as a result there is no budgetary impact. If a college recognises an impairment then the Scottish Government would look to secure AME cover for the movement through the year.

2.13 What will happen to College's Lennartz liabilities after reclassification? How will repayment be treated?

Discussions are ongoing with HM Treasury as to how this will be treated.

The current working assumption, subject to confirmation by HM Treasury, is that capital repayments would be outwith the scope of budgeting.

2.14 What happens to existing SFC debt?

The debt (as a form of borrowing) will continue. Current arrangements for repayment of the SFC borrowing will also remain in place.

2.15 Should College use reserves prior to 1 April 2014 to repay existing debt?

Colleges could opt to repay borrowing early; however, most banks would charge College's an early repayment penalty that could make this option less attractive. As stated above, College debt at 31 March 2014 will be covered as part of the baseline and be serviced from 1 April 2014 to the loans maturation.

Furthermore, repayment of debt as a means of reducing/using cash reserves would need to consider the mitigations, such as arms-length trusts, which are being explored.

2.16 How will capital projects that span the period after 31 March 2014 be funded?

The SFC and Scottish Government will make every effort to ensure that such projects as committed to that span 2013-14 and 2014-15 are able to be completed.

The Scottish Government and SFC has already contacted those Colleges that are have NPD projects on the issue of the impact of the ONS and will also take steps to mitigate the impact in respect of these projects.

VAT

2.17 How will the Classification impact on the VAT status of colleges?

The VAT status of colleges will not change or be impacted as a result of the reclassification. This means that colleges will still apply the partial exemption regulations after the 1 April 2014.

SFC Funding

2.18 Can SFC continue to manage its main grants on an academic year basis?

We believe that there may be advantages in continuing to manage our main grants on an academic year basis, not least because colleges' own planning cycles will almost certainly continue to be based on academic years. However, we recognise that other aspects of the new arrangements will have to be fully examined before we decide the best approach.

2.19 Are student support funds to be treated as part of income and expenditure?

Student support income and expenditure funded by the SFC should not be included in income and expenditure. This is because allocations are made to Colleges on the assumption that such funds are spent, reallocated or returned if unspent. The colleges own expenditure and overspend would be that which normally appears in FFRs and College financial statements.

Colleges are to treat childcare funding as they have done before.

2.20 Does the ONS reclassification impact on SFC interventions with colleges in financial difficulty?

SFC will continue to monitor colleges' financial sustainability and seek to provide cash support where this is deemed appropriate and necessary.

The key issue here is the impact of annuality for both the colleges and the SFC's budgets.

Budgeting and reporting

2.21 What balance sheet impacts will there be as a result of moving towards a 31 March year end?

Leaving aside the impacts that will flow from changes that are already planned (such as implementation of the expected new FE/HE SORP), no specific impacts have been identified from using a 31 March year end rather than a 31 July year end. However, both we and individual colleges will want to keep this under review.

2.22 What would the comparator period be for Colleges 2013-14 financial statements?

The comparator period for 2013-14 will be as follows: Balance sheet at 31 July 2013; income and expenditure account for the period 1 August 2012 to 31 July 2013 (twelve months).

2.23 Would the sector position be aggregated for reporting and budgeting purposes? Would surplus and deficits be transferred between Colleges?

The net whole-sector surplus/deficit may be manageable within the overall Scottish Government budget control limits, although the net annual amount will have to be small (say, £1M to £3M) because the Scottish Government's overall flexibility is very limited. Aggregating individual results to report a net position would not involve cash or budget transfers between colleges. It would simply involve the Scottish Funding Council aggregating individual college results into one return for the purposes of Scottish Government budgeting and reporting.

2.24 Will Colleges need to adopt a uniform capitalisation threshold going forward or any other standardised accounting treatment?

The standardisation of any accounting policy/treatment would need to be considered in the context of College's requirement to comply with the SORP and the

FReM. As a general rule, the SORP takes precedence over the FReM where they conflict, but the FReM introduces additional disclosure requirements for colleges.

A paper on the impact and interaction of the FReM and the SORP is being prepared part of the ONS project and will be circulated to colleges. We will also reflect these changes in our Accounts Direction for 2014-15 and future accounts directions.

Trading subsidiaries

2.25 What impact will the ONS classification have on colleges trading subsidiaries?

Colleges could continue to operate trading subsidiaries after reclassification as before. Trading subsidiaries will be consolidated and therefore become a part of the same annuality and resource limits as the college.

Subsidiaries will fall within the accounting boundary of the College and as such their surplus/deficits will score for budgeting purposes. Any expenditure of reserves held in subsidiaries would also score against college resource limits.

Procurement

2.26 What is the impact of the classification on EU procurement thresholds?

We understand, that for the foreseeable future at least, there will be no impact on the procurement status of Scotland's colleges.

2.27 APUC as Procurement centre of expertise for incorporated colleges?

The Scottish Government's Procurement Directorate has indicated that it expects colleges to continue to use the services of APUC.