

Rùnaire a' Chaibineit airson Foghlaim agus Ionnsachadh Fad-bheatha  
Cabinet Secretary for Education and Lifelong Learning  
Michael Russell MSP/BPA

F/T: 0845 774 1741  
E: scottish.ministers@scotland.gsi.gov.uk



Ann Jones AM  
Chair of Children and Young People Committee  
National Assembly for Wales  
Cardiff Bay  
Cardiff  
CF99 1NA



 26<sup>th</sup> June 2013

Thank you for your letter of 20 June. I very much appreciate the opportunity to engage on the issue of college reclassification, and contribute to your consideration of the Further and Higher Education (Governance and Information) (Wales) Bill.

Your letter confirms that this legislation seeks to remove various statutory controls Welsh Ministers exercise over Further Education Institutions (FEIs), given those controls have led to the Office of National Statistics (ONS) reclassifying FEIs as part of central government. In Scotland, those colleges incorporated under the Further and Higher Education (Scotland) Act 1992 are also subject to reclassification.

ONS' decision to reclassify colleges is both unhelpful and unwelcome in Scotland, coming at a time of substantial change as we implement a programme of reform to Post 16 education.

Our reforms are informed by the independent Griggs Review of Further Education Governance in Scotland, published in January 2012. That review highlighted the need for greater democratic accountability for the significant funding we allocate to colleges. In response, Scottish Ministers have developed policy which is both appropriate and builds on existing arrangements. We are clear that Ministerial controls, enhanced as proposed in our Post 16 Education (Scotland) Bill, are the right solution for Scotland.

We cannot support any suggestion that accounting rules, such as those proposed through ONS' decision, should determine our policy, or that democratic accountability should be sacrificed as a result of that decision.

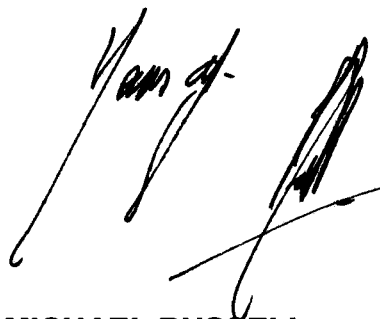
Since 2010, the Scottish Government has been engaged in an extensive period of negotiation with HM Treasury on the basis for ONS' decision, the timing of implementation and the scope for mitigating the implications. While we continue to believe it is within power of HM Treasury to mitigate this decision, it has regrettably

chosen not to do so. We continue to disagree with the HMT position. Indeed, we now believe there could be an inconsistency in the treatment of Scottish colleges and continue to press this point with HMT.

In taking its position, HM Treasury has sought to use the distinctive nature of our response as a means to avoid fully reflecting the budgetary impact of ONS' decision in Scotland. I would therefore welcome the development of a joint approach with other devolved administrations to HM Treasury in pursuit of fairness, parity and increased flexibility.

I believe there is much to be gained and learned from a shared approach on this issue. My officials will continue to engage with their counterparts in Wales and are happy to provide further advice, while also exploring the options contained within the legislation you are considering.

I attach a full briefing note on the ONS decision and its ramifications in Scotland, which has been shared with key stakeholders including affected colleges. It includes details of our proposed mitigations. We are working collaboratively with our colleges to develop these into practical solutions which will maintain the effectiveness and valuable contribution of the college sector, from within central government.

A handwritten signature in black ink, appearing to read 'Michael Russell', written in a cursive style.

**MICHAEL RUSSELL**

# **Office of National Statistics reclassification of incorporated further education colleges**

## **Introduction**

- 1 This paper provides an initial overview of the background to the UK's Office of National Statistics' reclassification of incorporated colleges, the consequential impacts and the steps that are being taken to manage the transition and ensure the successful delivery of the post-16 reform programme.
- 2 This paper has been prepared for the use of the college chairs and principals and therefore, as far as possible, has been written in non-technical language. Consequently, it does not describe the precise technical arrangements for government budgeting and reporting. Such detail can be found in the documents to which links have been provided.
- 3 The paper has eight sections:
  - Executive Summary
  - Background
  - Overview of government financial budgeting and financial reporting arrangements
  - How incorporated colleges' income and expenditure is treated within UK-wide government budgeting arrangements
  - Potential Mitigating Actions
  - The UK-wide arrangements for the setting, monitoring and control of government budgets
  - Financial reporting requirements
  - Project board

## **Executive summary**

- 4 In October 2010 the UK Office of National Statistics (ONS) decided to reclassify incorporated further education colleges throughout the UK so that they would be treated as part of central government for financial budgeting and reporting purposes. The UK ONS's reclassification decision is the consequence of the current level of Ministerial control

and does not relate to the plans for improved governance that feature in the Post-16 Bill. Scottish Ministers have argued the case against these changes but the UK Treasury have refused to change their approach.

- 5 Scottish Ministers want to work closely with incorporated colleges to implement the changes in a way that is least unsettling for the colleges. To that end, a Project Team is being established with representation from college experts, and the college representative body, to help manage the changes. The Scottish Government and the Project Team are therefore exploring a range of mitigating actions in relation to:
  - Generation and retention of income
  - Generation and retention of surpluses (reserves)
  - Use of existing reserves
  - Access to capital funding and commercial borrowing
- 6 None of this affects the Scottish Government's commitment to provide a floor in college funding of £522m in 2013-14 and 2014-15.
- 7 The first stage of implementation takes effect on 1 April 2014 when incorporated colleges will need to:
  - Move to an April to March financial year
  - Manage their expenditure within the wider Scottish Government financial budgeting and reporting arrangements.

## **Background**

- 8 In October 2010 ONS decided to reclassify incorporated further education colleges throughout the UK so that they would be treated as part of central government for the purposes of reporting government income, expenditure, finances and associated matters. Previously incorporated colleges were treated as being outwith central government for these purposes. The UK Government has taken a direction of travel on colleges that has allowed them to avoid reclassification so far but recent announcements regarding the FE Commissioner south of the border has created a perception of inconsistency of treatment of the sector by the UK Treasury.
- 9 The UK ONS's reclassification decision is the consequence of the current level of Ministerial control and does not relate to the plans for improved

governance that feature in the Post-16 Bill. Scottish Ministers are clear that those controls, as enhanced by the Bill, are the right solution for Scotland and are appropriate given the very significant public investment in colleges.

- 10 As described in the rest of this paper, the impact of the UK ONS's reclassification goes well beyond statistical reporting of government income, expenditure and finances. Following clarity from HM Treasury on the position of the Scottish Government's budget following reclassification, Ministers have been conducting detailed negotiations since Autumn 2012 exploring possible flexibilities in implementation. Unfortunately, HM Treasury has only offered some limited additional resource budget support and it is insisting that the changes to incorporated colleges' financial budgeting and reporting are implemented from 1 April 2014.

### **Overview of government financial budgeting and financial reporting arrangements**

- 11 Up until now what has counted as government expenditure relating to incorporated colleges has essentially been the money allocated by government to colleges (most of which flows through the Scottish Funding Council). From now on it will be what colleges actually spend that is included in the Scottish Government's total expenditure figures. If colleges' only expenditure was that funded by their income from government and their expenditure was consequently very predictable, this change would make little difference. However, a significant amount of college activity is funded from other sources and therefore colleges' income and expenditure levels do fluctuate because of changes in business activity.
- 12 Given the close interest that is taken in measures such as total public expenditure and the public sector borrowing requirement, all the main aspects of government finance have to be monitored closely. Further, because the control of government finance is focussed on the balance of income and expenditure within an individual year, there is only very limited scope to manage financial resources across different years.
- 13 In the following sections these features are described in more detail, as follows:
  - How incorporated colleges' income and expenditure is treated within UK-wide government budgeting arrangements

- The UK-wide arrangements for the setting, monitoring and control of government budgets
- Financial reporting requirements

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

14 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*:

- [http://www.hm-treasury.gov.uk/d/consolidated\\_budgeting\\_guidance\\_201213.pdf](http://www.hm-treasury.gov.uk/d/consolidated_budgeting_guidance_201213.pdf)

15 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'.

16 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 annularity, 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 within these narrow limits.

17 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
- 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.

18 The following sections describe how the foregoing will impact on:

- Generation and retention of income
- Generation and retention of surpluses (reserves)
- Use of existing reserves
- Access to capital funding and commercial borrowing.

19 The paper then describes how some of these impacts might be mitigated.

#### *Generating and retaining income*

20 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).

*Ability to generate and retain surpluses*

- 21 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.

*Ability to spend existing surpluses*

- 22 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.

*Access to capital and commercial borrowing*

- 23 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.

*Non-profit distributing projects*

- 24 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

**Potential Mitigating Actions**

- 25 There are a number of ways in which the impact of having to follow Consolidated Budget Guidance on reserves may potentially be managed.

*Protection of reserves*

- 26 It may be possible to protect reserves as at 31 March 2014. This could be achieved by paying over the relevant reserves to the Scottish Government before 1 April 2014, on the understanding that these would



then be made available as and when required. The Scottish Government BEM could potentially then be used to shelter these reserves until required. However, it is again worth noting that the BEM limits are small relative to the size of the total Scottish Government budget. Ministers have to date needed to allocate all their BEM flexibility to managing existing spending priorities and it may not be possible to accommodate all college reserves within the limits available. Ministers have indicated that they would be unlikely to commit to allocating a proportion of the BEM to the incorporated college sector as a whole, but could allow the use of the BEM to support specific investment plans for reserves where other mechanisms are not available. Year end flexibility and the BEM are discussed further below.

*Aggregating incorporated colleges' surpluses and deficits for Scottish Government financial reporting purposes*

- 27 As already noted, Scottish Government budgets will be impacted by the net movement in reserves across the sector from year to year. However, there will be off-setting movements between individual colleges and the net year-on-year movement will usually be small at whole-sector level. These net whole-sector movements may therefore be manageable within the overall Scottish Government budget control limits, although the net amount would have to be very small (say, £1M to £3M) because, as explained above, the Scottish Government's overall flexibility is very limited. To be clear, this would not involve cash or budget transfers between colleges. (It should also be noted that individual incorporated colleges will be able to retain a certain level of working capital, therefore maintaining a certain level of reserves.)

*Separate charitable trusts*

- 28 Some other bodies have utilised separate charitable trusts to accumulate funds (reserves/donations) outside of the limits described above, where they can then be deployed as and when required on individual projects. In order to be successful this mechanism would require such a trust to be established as a separate independent organisation, which brings its own risks and considerations. Significant further work is required to establish the extent to which this may (or may not) be a possible mechanism for sheltering reserves and future surpluses for incorporated colleges. This would include consideration of whether one trust for the sector/per region/per individual college would be best.

## **The UK-wide arrangements for the setting, monitoring and control of government budgets**

29 The UK-wide arrangements for government 'budgeting' include processes for monitoring and control, as well as budget setting. These monitoring and control aspects are in addition to the financial reporting requirements (e.g. annual accounts) described in paragraphs 30 to 40 below. Special arrangements will be developed to reflect the unique characteristics of the college sector and the role of the Scottish Funding Council. The following is therefore only an indication of how these processes will operate.

*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.

**Financial reporting requirements**

- 30 As well as bringing colleges within the Scottish Government budgeting boundary, the reclassification will also have an impact on existing accounting practice. Whilst these changes will not have the same potential financial impact on the sector, there will be considerable administrative and technical issues to be managed, which are briefly set out below. The intention is that colleges will be supported through the implementation of changes.

*Change to the financial year end*

- 31 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*

- 32 Central Government bodies are required to follow the Government Financial Reporting Manual (FRoM) available at:
- [http://www.hm-treasury.gov.uk/frem\\_index.htm](http://www.hm-treasury.gov.uk/frem_index.htm)

- 33 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**.
- 34 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.
- 35 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.
- 36 However, it should be noted that this position still needs to be accepted 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*

- 37 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 **current** HE/FE SORP
  - **1 August 2013 to 31 March 2014** (eight months), using the **current** HE/FE SORP

- **1 April 2014 to 31 March 2015** (twelve months), using the **current** HE/FE SORP (and also taking account of the FReM, where necessary).
- **1 April 2015 to 31 March 2016** (twelve months), using the **new** 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.

38 With the exception of the move to a 1 April to 31 March reporting period, **all the above would have taken place anyway**, as a result of the implementation of the new HE/FE SORP.

*Financial reporting changes for colleges involved in mergers*

39 Again, with the exception of the move to a 1 April to 31 March reporting period from 1 April 2014 onwards, 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 <u>current</u> HE/FE SORP		1 August 2012 to 31 July 2013 (twelve months), using the <u>current</u> HE/FE SORP	
1 August 2013 to 31 July 2014 (twelve months), using the <u>current</u> HE/FE SORP <u>and</u> 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 <u>current</u> HE/FE SORP <u>and</u> incorporating the 1/8/13-31/10/13 results of the other colleges in the merger	No accounts prepared

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 2014 to 31 July 2015 (twelve 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	
1 August 2015 to 31 July 2016 (twelve months), using the <u>new</u> HE/FE SORP		1 April 2015 to 31 March 2016 (twelve months), using the <u>new</u> HE/FE SORP	

40 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.

### **Project board**

41 A project team and Project Board is currently being established.

42 The Project Board's proposed membership is:

- The project's 'Senior Responsible Officer'
- A Regional Lead
- College sector – college principal
- College sector – college finance director
- Scottish Government post-16 programme team representative
- Scottish Government Finance
- Audit Scotland
- Scottish Funding Council - Finance
- Scottish Funding Council - Learning, Governance & Sustainability

43 The Project Board has effectively already met twice in workshop mode and the product of its initial thinking is reflected in this document.