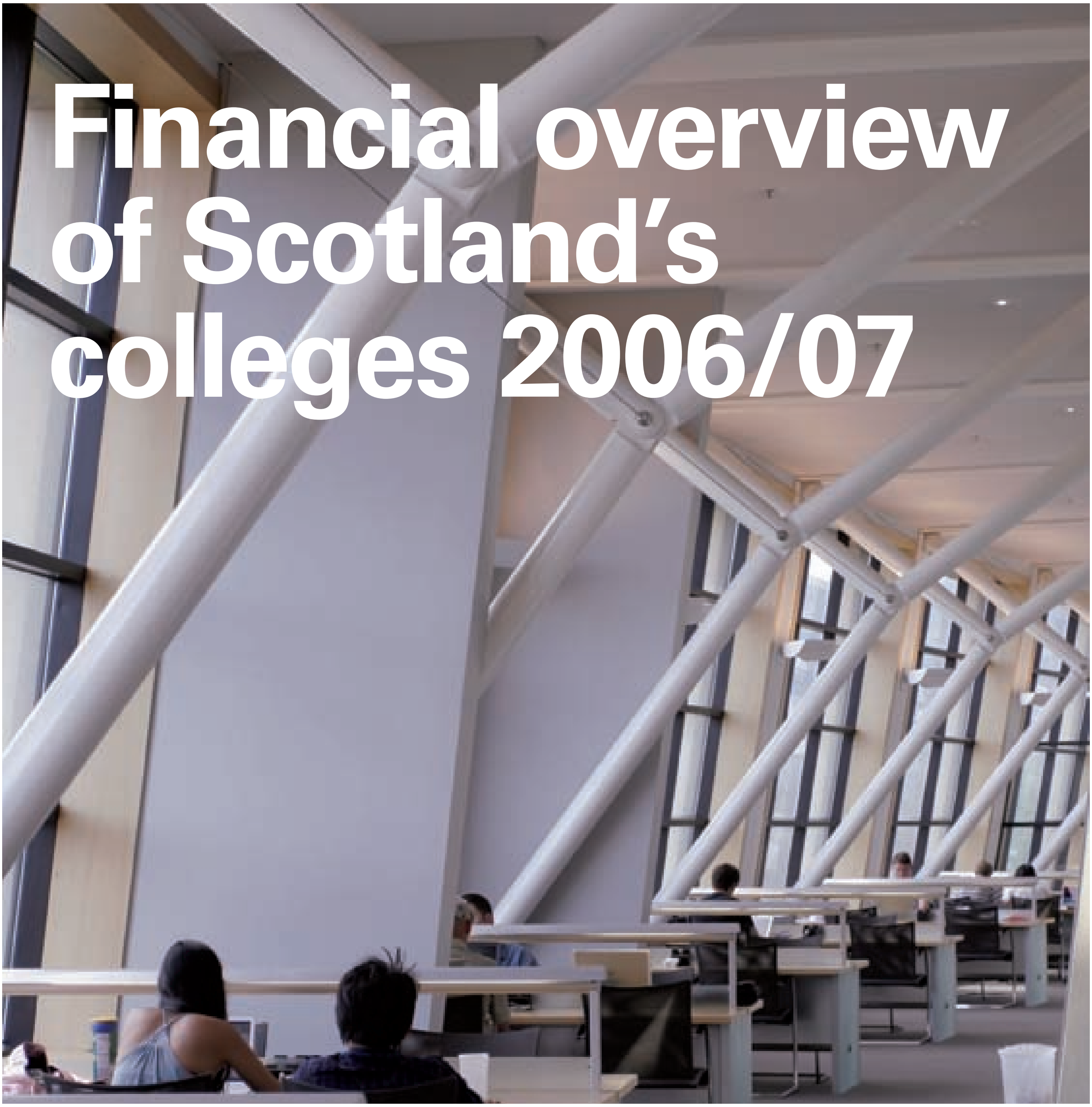
Financial overview of Scotland's colleges 2006/07



AUDIT SCOTLAND

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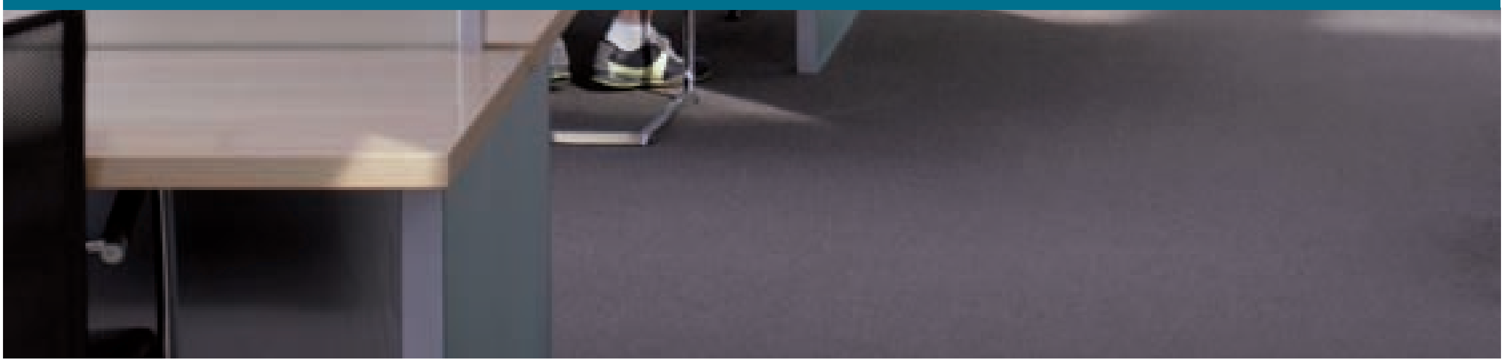

Auditor General for Scotland

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

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Summary

The financial position of Scotland's colleges has improved significantly in the last five years.

Introduction

1. This report provides an overview of the financial performance and governance arrangements of Scotland's colleges in 2006/07.

2. The college sector is an important vehicle for the delivery of education in Scotland, and plays an important role in the government's lifelong learning and social inclusion agenda. Scotland's colleges are the primary providers of further education and offer a diverse curriculum – including vocational, further and higher education – to a wide range of people and communities.

3. There are currently 39 incorporated colleges in Scotland which operate as independent corporate bodies.[1] A number of incorporated colleges have merged in the last five years reducing the total number from 42 to 39. Glasgow College of Food Technology and Glasgow College of Building and Printing became Glasgow Metropolitan College in 2004; Fife College and Glenrothes College became Adam Smith College in 2005; and Clackmannan College and Falkirk College became Forth Valley College in 2005. A further four education colleges operate under the control of local authorities or were established under different legal arrangements.[2] This report covers the 39 incorporated colleges only.

4. Colleges spent around £626 million in 2006/07 providing education to around 363,000 students.[3] The Scottish Further and Higher Education Funding Council (SFC) provided colleges with £438 million of revenue grants to fund the provision of this education. A further £67 million was provided by SFC for direct support to students, in the form of bursaries, Education Maintenance Allowances and child care. The remainder of colleges' income comes from other sources.

5. The last financial overview report on colleges' 2001/02 annual accounts highlighted concerns about the sector and within individual colleges.[4] Since then the Auditor General has prepared 14 Section 22 reports on the annual accounts of seven colleges bringing deficits to the attention of the Scottish Parliament.[5, 6] The Parliament's Audit Committee held evidence sessions on the Section 22 reports on West Lothian, Lews Castle and Inverness Colleges.[7]

6. Over the last few years various key stakeholders have expressed concerns about the financial performance of the sector including the Scottish Parliament's Audit Committee, Scottish ministers and the SFC. There has, however, been a significant increase in public sector funding provided to colleges since 2001/02 – an increase of around £31 million (real terms) in revenue funding and an increase of £64 million (real terms) of capital funding.

7. There has also been a combined effort to improve financial sustainability and governance arrangements across the sector and within colleges.

8. This overview report provides an updated position on the overall financial performance and governance of the sector and individual colleges. It includes explanations of how overall performance has improved and what progress has been made against recommendations made in previous Auditor General reports. It also identifies challenges to the financial sustainability of colleges. The report is in four parts:

- Part 1 comments on colleges' financial performance in 2006/07.
- Part 2 discusses the factors that have contributed to improved financial performance.
- Part 3 outlines challenges to colleges' financial performance and sustainability.
- Part 4 comments on financial accountability and governance arrangements across the sector.

Information sources

9. The commentary on financial performance and governance arrangements is based largely on our analysis of colleges' annual accounts and auditors' reports for 2006/07. The Public Finance and Accountability (Scotland) Act 2000 provides for the Auditor General to decide who is appointed as external auditor for individual colleges. The Auditor General has appointed five firms to conduct the audits for colleges. The appointed auditors act in their own capacity, make their own judgements and form their own opinions.

10. To avoid duplication and minimise disruption for colleges, we have also, wherever possible, drawn on further information held by the SFC. In addition, we visited six colleges to provide us with further contextual information.[8] Details of the colleges and our reasons for selecting them are set out in Appendix 1.

11. We have tried to minimise the use of jargon and technical terms, but in some places this is unavoidable and we have therefore included a glossary of terms at Appendix 2.

1 The 39 colleges are incorporated under the Further and Higher Education (Scotland) Act 1992.
2 The four colleges not incorporated under the Act are: Orkney College, Shetland College of Further Education, Newbattle Abbey College and Sabhal Mór Ostaig.
3 SFC Council Paper 08/20.
4 *Financial performance of the further education sector in Scotland*, Audit Scotland, December 2003.
5 The Auditor General may prepare a report on the accounts of a college under Section 22 of the Public Finance and Accountability (Scotland) Act 2000. The reports are laid in the Scottish Parliament along with the accounts. Section 22 reports are normally considered by the Parliament's Audit Committee.
6 Inverness, Kilmarnock, James Watt, West Lothian, Lews Castle, Glasgow College of Food Technology, Moray and North Glasgow.
7 Audit Committee 7th report, 2005 (session 2), Further Education Colleges and 4th report, 2006 (Session 2) the 2004/05 audit of Inverness College.
8 Lews Castle College, Inverness College, Edinburgh's Telford College, Adam Smith College, John Wheatley College, Glasgow College of Nautical Studies.

Summary of key messages

- The overall financial performance of Scotland's colleges has improved over the last five years moving from an overall operating deficit of £6 million in 2002/03 to an overall surplus of £16.9 million in 2006/07. The number of colleges recording operating surpluses has increased and the overall accumulated surplus has grown to £98.9 million.

- This improving position has been achieved by increases in funding; a sustained concentration on financial security by the SFC and colleges; and a renewed focus on networks and peer support within the sector. There has also been significant capital investment since 2000 with a number of major campus and estates developments.

- Against this picture, however, the sector continues to face a number of challenges over the next few years including a tighter financial settlement and the risk of reductions in other sources of funding. Seven colleges forecast deficits in at least one of the next three years.

- Auditors report that governance arrangements appear to be generally sound although there remains some room for improvement. In general there is evidence to show that lessons are being learned from those colleges where weak governance arrangements have led to financial difficulties.

Key recommendations

The Scottish Funding Council should:

- consider whether to prescribe a specific approach in accounting treatment, where UK accounting standards allow more than one approach to be taken, to ensure consistency. This will aid in the comparability of accounting information across the sector.

The Scottish Funding Council and colleges should:

- continue to work together to achieve financial sustainability within the sector

- agree a revised core set of financial performance measures, benchmarking data and wider performance measurement arrangements

- continue to support networking and benchmarking arrangements.

Colleges should:

- ensure they have robust financial plans in place to reduce deficits, where relevant

- provide good quality draft accounts to auditors in sufficient time to meet statutory deadlines

- improve their financial forecasting.

Part 1. Financial performance 2006/07

The overall financial performance of Scotland's colleges has improved.

Key messages

- The financial performance of Scotland's college sector has improved over the past five years, moving from an overall operating deficit of £6 million in 2002/03 to an overall surplus of £16.9 million in 2006/07.
- Four colleges recorded operating deficits in 2006/07 totalling £1.9 million although all but one can cover the deficit from reserves.
- Seven colleges reported operating surpluses in 2006/07 but continue to have accumulated deficits.
- The number of colleges recording operating surpluses has increased and the overall surplus on income and expenditure reserves has grown to £98.9 million. However, £42 million of these reserves relate to two colleges only.
- In April 2007, West Lothian College bought out its PFI contract at a cost of £27.7 million.

Colleges achieved an overall surplus in 2006/07 but four colleges reported deficits

12. Overall, colleges achieved an operating surplus of £16.9 million at 31 July 2007, with 35 colleges reporting surpluses and four reporting deficits. A summary of all colleges' year-end financial position is included at Appendix 3.

Four colleges reported operating deficits in 2006/07

13. Four of the 39 colleges – Edinburgh's Telford, Elmwood, James Watt and North Glasgow – reported operating deficits in 2006/07, totalling £1.9 million and ranging from 0.22 per cent to 5.61 per cent of their annual income (Exhibit 1). The annual accounts of three of the colleges received unqualified audit opinions. The remaining college's annual accounts were qualified but this related to a separate matter, described at paragraphs 23 to 27.

Exhibit 1
Four colleges recorded operating deficits in 2006/07

College	Operating deficit 2006/07	I&E reserve 2006/07
	£m	£m
Edinburgh's Telford	-0.067	32.705
Elmwood	-0.221	3.036
James Watt	-0.919	-5.690
North Glasgow	-0.741	2.605

Source: Colleges' annual accounts 2006/07

Case study 1
James Watt College has been experiencing financial difficulties since 2002/03

James Watt College has reported operating deficits in each year since 2002/03 with deficits increasing each year, rising from £9,000 in 2002/03 to almost £2.4 million in 2005/06. The college has again reported an operating deficit in 2006/07 but this represents a significant improvement on 2005/06, reducing from almost £2.4 million to £0.92 million. As a result the deficit on the college's reserves continues to rise. The Auditor General has prepared Section 22 reports in both 2005/06 and 2006/07 to highlight the college's financial position to the Scottish Parliament.

	2002/03	2003/04	2004/05	2005/06	2006/07
	£m	£m	£m	£m	£m
Operating deficit	-£0.009	-£0.315	-£2.029	-£2.398	-£0.919
Accumulated I&E reserve	-£0.743	-£0.722	-£1.241	-£5.336	-£5.690

In 2005/06, the college ended the year with an operating deficit of £2.4 million and an accumulated deficit on its reserves of £5.3 million. The auditor expressed uncertainty about the college's ability to continue as a going concern. As a result the college's bank would not renew its overdraft without a guarantee from the SFC, which the SFC could not legally give. But the SFC provided advance grants of £3 million to support the college between July and September 2006.

The college has been working with the SFC's Further Education Development Directorate (FEDD)[1] to address its problems. The college developed a financial recovery plan in February 2007 to eliminate the deficit and has started to put this in place. It is now forecasting surpluses in each of the next three years which will reduce its accumulated deficit in the I&E reserve to £2.7 million by 2009/10. The college has also completed its planned restructuring which included a mixture of voluntary redundancies and redeployment of staff. A new principal was appointed to the college in January 2008.

Note: 1 – See paragraph 59.

14. Edinburgh's Telford College forecast a surplus of £0.871 million for 2006/07. However, for several reasons, including an additional depreciation charge and an additional interest charge, the college ended the year with a deficit of £0.067 million (0.22 per cent of income). This is a movement of over £0.9 million between forecast and actual position at the year end. The college has an accumulated income and expenditure (I&E) reserve of £32.7 million which is more than sufficient to cover the operating deficit. The college's reserves included a £26 million gain on land sold during its recent estate redevelopment, which was fully re-invested in its new campus development.

15. Elmwood College was originally forecasting an operating surplus of £0.006 million but a delay in the confirmation and receipt of European Structural Funds (ESF) resulted in the college ending the year with a deficit of £0.221 million (2.08 per cent of income). The main reason for this movement in the financial position was the college's forecast of ESF income being around £0.14 million more than actually received. Despite reporting an operating deficit in 2006/07, the college ended the year with an accumulated surplus of around £3 million on its I&E reserve.

16. James Watt College reported an operating deficit of £0.919 million in 2006/07 (2.47 per cent of income). The Auditor General has, for a second year running, prepared a Section 22 report on the annual accounts of the college as a result of its continued financial problems. Case study 1 provides further information on the ongoing financial difficulties at the college.

17. North Glasgow College ended 2006/07 with an operating deficit of £0.741 million (5.61 per cent of income). The year-end position was £0.277 million worse than expected due to accelerated depreciation being higher than budgeted. The college ended the year with an accumulated I&E reserve of £2.6 million.

Seven colleges have accumulated deficits on reserves despite reporting operating surpluses in 2006/07

18. Seven colleges reporting operating surpluses in 2006/07 have accumulated deficits in their reserves – Clydebank, Forth Valley, Inverness, Lews Castle, Moray, Reid Kerr and West Lothian. The combined deficit on the income and expenditure reserves of these colleges is £16.9 million.

19. Inverness College has reported an operating surplus in 2006/07 but continues to have an accumulated deficit on its reserves. The college's auditor has included an explanatory paragraph in the audit opinion for 2006/07 due to its reliance on cash advances from the SFC, its overdraft facility and because of the college's balance sheet position (current liabilities are greater than current assets by £0.5 million). In addition, the auditor's report highlights a lack of an audit trail to evidence whether a severance payment made to two senior staff had been made in accordance with SFC guidance. Further details of Inverness College's financial performance over the last few years are included at Case study 2.

Case study 2

Inverness College has experienced financial problems in the last few years but its financial position is now starting to improve

Inverness College reported an operating surplus of £0.43 million in 2006/07 and ended the year with an accumulated deficit of £2.9 million. The college reported operating deficits and accumulated deficits in every financial year from 2002/03 to 2005/06 and the college's auditors highlighted going concern issues in the opinion on the annual accounts. As a result the Auditor General prepared Section 22 reports in each of these years to bring the college's financial position to the attention of the Scottish Parliament.

	2002/03	2003/04	2004/05	2005/06	2006/07
	£m	£m	£m	£m	£m
Operating deficit	-£0.218	-£0.525	-£1.015	-£0.667	£0.43
Accumulated I&E reserve	-£3.355	-£3.317	-£3.248	-£3.482	-£2.888

The financial situation led to the involvement of the SFC's Further Education Development Directorate (FEDD) and increased financial monitoring by the SFC's Governance Management Appraisal and Policy (GMAP) section. The Scottish Parliament Audit Committee held an inquiry on the Section 22 report on Inverness College's 2004/05 annual accounts. In March 2006, FEDD produced a highly critical report on the management and governance arrangements within the college.

In September 2006, the principal resigned and in February 2007 the chair of the board resigned. A caretaker principal was appointed in the interim period before the new principal was appointed in summer 2007. A new board chair has been appointed along with other new board members.

The FEDD acted in an advisory capacity in helping the new management to implement changes at the college. This has led to the introduction of new governance processes at the college. Early indications are that the new processes are beginning to work and that the college appears to be on the road to financial recovery. The college has recorded an operating surplus of £0.43 million in 2006/07, reducing its accumulated deficit on its reserves to £2.9 million. It is forecasting surpluses in each of the next three years, which will reduce the accumulated deficit on the I&E reserve to £1.36 million by 2009/10.

20. The Auditor General previously prepared Section 22 reports on the annual accounts of Moray and Lews Castle colleges in 2002/03. Moray College reported an operating deficit of £0.3 million and an accumulated deficit in its income and expenditure reserve of £1.6 million in 2002/03. Since then, the college recorded deficits in each of the next two years but has recorded operating surpluses since 2005/06. It is forecasting surpluses in each of the next three years. Case study 3 provides an outline of the improved financial performance of Lews Castle College.

21. Accumulated deficits at the other four colleges – Clydebank, Forth Valley, Reid Kerr, West Lothian – relate to historical financial problems and these are reducing year-on-year.

Case study 3

Lews Castle College's financial performance has improved since 2003/04

Lews Castle College reported an operating surplus of £0.1 million in 2006/07 which reduced the accumulated deficit on its reserve to £0.9 million. Lews Castle College experienced significant problems in 2002/03 and 2003/04 which resulted in operating deficits. The college's auditors raised going concern issues in the audit opinion on the annual accounts. As a result the Auditor General prepared Section 22 reports in both of these years.

The SFC provided the college with a specific grant as part of its financial security campaign and increased funding to compensate for the remoteness of the college. Since 2003/04 the college's financial performance has improved because it received additional funding from SFC. It has reported operating surpluses in the three subsequent years.

The college has now adopted a more robust approach to financial decision-making and has introduced better management and governance systems. It has also reduced its staff numbers to control rising staff costs.

Five colleges' 2006/07 accounts were qualified by the auditors

22. Five colleges' 2006/07 annual accounts received qualified audit opinions by the auditors. Four of these qualifications relate to the accounting treatment of pension liabilities and the other relates to limitation of scope by the auditors due to a lack of audit evidence.

Four colleges' accounts were qualified due to accounting treatment for pensions liabilities

23. Four colleges – Glasgow Metropolitan, John Wheatley, Langside, North Glasgow – received qualified audit opinions as a result of their accounting treatment of pension liabilities. These colleges are members of the Strathclyde Pension Fund (SPF). The SPF administers pensions for a number of public bodies including 18 colleges in the west of Scotland.

24. From our review of the annual accounts and audit reports of the 18 college members we have identified variation in both the accounting treatment adopted by the colleges and in the audit opinions expressed by auditors. Three colleges have accounted for pension liabilities as a defined benefit scheme, while the other 15 have adopted a defined contribution scheme.

25. The accounting standard FRS 17 requires that multi-employer defined benefit pension schemes are accounted for as defined benefit schemes unless it is not possible for the pension scheme's actuary to reliably disaggregate the share of pension scheme assets and liabilities that an individual employer owns. This can occur when various employers pool their pension funds into a multi-employer pension scheme.

26. The current financial reporting standard allows flexibility in treatment but certain conditions must be met. In the case of the four colleges, the auditors did not consider that the colleges met those conditions and, as a result, the auditors' opinions were that the colleges' treatment was incorrect and did not, therefore, provide a true and fair view of the financial position.

27. Recent correspondence between the Auditor General, Audit Scotland, SFC and a number of individual colleges has highlighted the differences in treatment. All relevant parties have been invited to participate in round-table discussions over the next few months to discuss the accounting treatment of the SPF from 2007/08 onwards. The Scottish Colleges Finance Network commissioned consultants in 2006 to consider whether valuations within actuarial reports were based on a reliable methodology.

Kilmarnock College's accounts were qualified as a result of insufficient evidence

28. Kilmarnock College's 2006/07 annual accounts were received in February 2008, two months later than the agreed deadline for submission. The college has received qualified audit opinions on both the true and fair view and regularity of its annual accounts. The auditors have issued a disclaimer of opinion as a result of them being unable to form an opinion on the accounts because of limited evidence being available. The qualified opinion relates to two specific issues – an ongoing investigation by the college's internal auditors into the relationship between the college and associated bodies and a qualified opinion by the college's internal auditors on its SUMs audit.[9]

9 Colleges are required to secure an independent audit of their student activity data (measured in terms of SUMs – student unit of measurement) submitted to SFC. The SUMs data is the basis for grant funding from SFC.

29. The ongoing investigation is focused upon a review of governance arrangements, transactions between related parties and any evidence of impropriety. The results of this investigation have not yet been published.

30. The college's internal auditors were unable to reach a satisfactory conclusion that the college's processes are sufficient to properly identify programmes or students that should be excluded from annual funding claims. As a result the external auditor was unable to determine whether the college had achieved its student activity target and therefore if it is at risk of being subject to a clawback of funding from SFC.

31. Both of these issues have limited the evidence available to the auditors. As a result the auditors have concluded that they do not have enough evidence to determine whether the college's accounts represent a true and fair view of its activities.

Overall, colleges' financial performance has improved over the last five years

The overall operating surplus has increased in the last five years

32. Over the last five years there has been a gradual improvement in the financial performance of colleges, both in the number of colleges reporting operating surpluses and the overall financial outturn.

33. The number of colleges reporting operating surpluses has increased from 21 in 2002/03 to 35 in 2006/07. This has improved the overall position from an overall deficit of £6 million in 2002/03 to an overall surplus of £16.9 million in 2006/07 (Exhibit 2).

Exhibit 2

From a deficit in 2002/03 the sector has recorded an overall operating surplus in each of the subsequent years

Note: The figures for 2005/06 and 2006/07 are drawn from colleges' 2006/07 annual accounts. The figures for previous years were drawn from SFC data.
Source: SFC data/colleges' annual accounts

The number of colleges with accumulated surpluses has increased over the past five years

34. Colleges' net assets and liabilities are financed by reserves. Colleges may have a number of reserves but the main ones are the I&E reserve and pensions reserve.[10]

Colleges have overall net surpluses of almost £100 million

35. Colleges' surpluses and deficits are transferred to I&E reserves. The overall net surplus on colleges' I&E reserves was £98.9 million in 2006/07. However, two colleges account for £42.2 million of the overall surplus – Edinburgh's Telford (£32.7 million) and Aberdeen College (£9.5 million).[11]

36. The overall surplus is made up of 31 colleges with surplus reserves of £121.5 million and eight colleges with deficits amounting to £22.6 million. This has improved since 2001/02 when only 22 colleges had surplus I&E reserves amounting to £18 million.

Colleges' pension reserves have improved over the last three years

37. From 2004/05, colleges have been required to comply with the accounting standard for pensions (FRS 17). This had a negative effect on colleges' pension reserves when it was first implemented – resulting in an overall deficit in the pension reserve of £43.5 million in 2004/05. However, this position has improved with the overall pension reserve deficit reducing to £8.4 million in 2006/07, primarily due to increased contributions to the schemes and improved financial markets.[12]

Seven colleges faced financial difficulties in the last four years but for most the financial performance is improving

38. Since the last overview report, the Auditor General has prepared 14 reports under Section 22 of the Public Finance and Accountability (Scotland) Act 2000, in relation to eight different colleges. Reports on seven of these colleges were as a result of deficits (Exhibit 3, overleaf).

10 Definitions of these reserves are provided in the glossary of terms at Appendix 2.
11 See paragraph 14.
12 The value of pension assets and liabilities are heavily dependent on the prevailing position of the financial markets in which funds have invested. This means that the overall value of pension reserves are largely outside the direct control of individual colleges.

Exhibit 3

Section 22 reports have been prepared on the annual accounts of eight colleges in the last five years

College	2002/03	2003/04	2004/05	2005/06	2006/07
Glasgow College of Food Technology	✓				
Inverness	✓	✓	✓	✓	
James Watt				✓	✓
Kilmarnock					✓
Lews Castle	✓	✓			
Moray	✓				
North Glasgow	✓				
West Lothian	✓	✓			
	6	3	1	2	2

Source: Audit Scotland

39. Two of these colleges – James Watt and North Glasgow – have reported operating deficits in 2006/07. Five of the colleges – Inverness, Lews Castle, James Watt, Moray and West Lothian – continue to have accumulated deficits on their reserves. Further details of the financial position at James Watt, Inverness and Lews Castle colleges have previously been outlined at Case studies 1, 2 and 3.

40. North Glasgow College received a Section 22 report in 2002/03 as a result of an operating deficit of £1.9 million and the auditor expressing concern about the college's ability to operate as a going concern. Since then the college achieved operating surpluses in each of the subsequent three years. As noted at paragraph 17, it has again reported an operating deficit in 2006/07. The auditor has not expressed a specific concern about the deficit.

41. Kilmarnock College's Section 22 report related to insufficient evidence, as described at paragraphs 28 to 31.

West Lothian College's campus has been brought into public ownership after buyout of the PFI contract

42. In 2001, West Lothian College moved to a new purpose-built campus in Livingston. The move was financed through a Private Finance Initiative (PFI) agreement lasting 25 years. The agreement specified that:

- the college would pay a unitary charge to the PFI provider in return for continued use of the campus and its facilities
- ownership of the facility would be retained by the PFI provider at the end of the contract but the college would have options to extend the agreement, move to alternative location or buy back the campus at market value.

43. However, the PFI contract was signed on the understanding that the college would receive a period of funding for growth in student numbers. After signing the agreement, funding mechanisms have changed resulting in the college forecasting a substantial funding gap (£11 million) over the 25 years.

44. In December 2006, Scottish ministers authorised the SFC to review the PFI contract to ensure the most efficient and effective use of public money. Several options were explored including part buyout, prepayment, renegotiation and termination.

45. The SFC led the process for producing the final business case. It set up a working group involving the (then) Scottish Executive, SFC, the college and Partnerships UK to take this forward and appointed Grant Thornton as financial advisers. SFC, through the working group, commissioned and directed all of the financial analysis to support the option appraisal and held all supporting documentation.

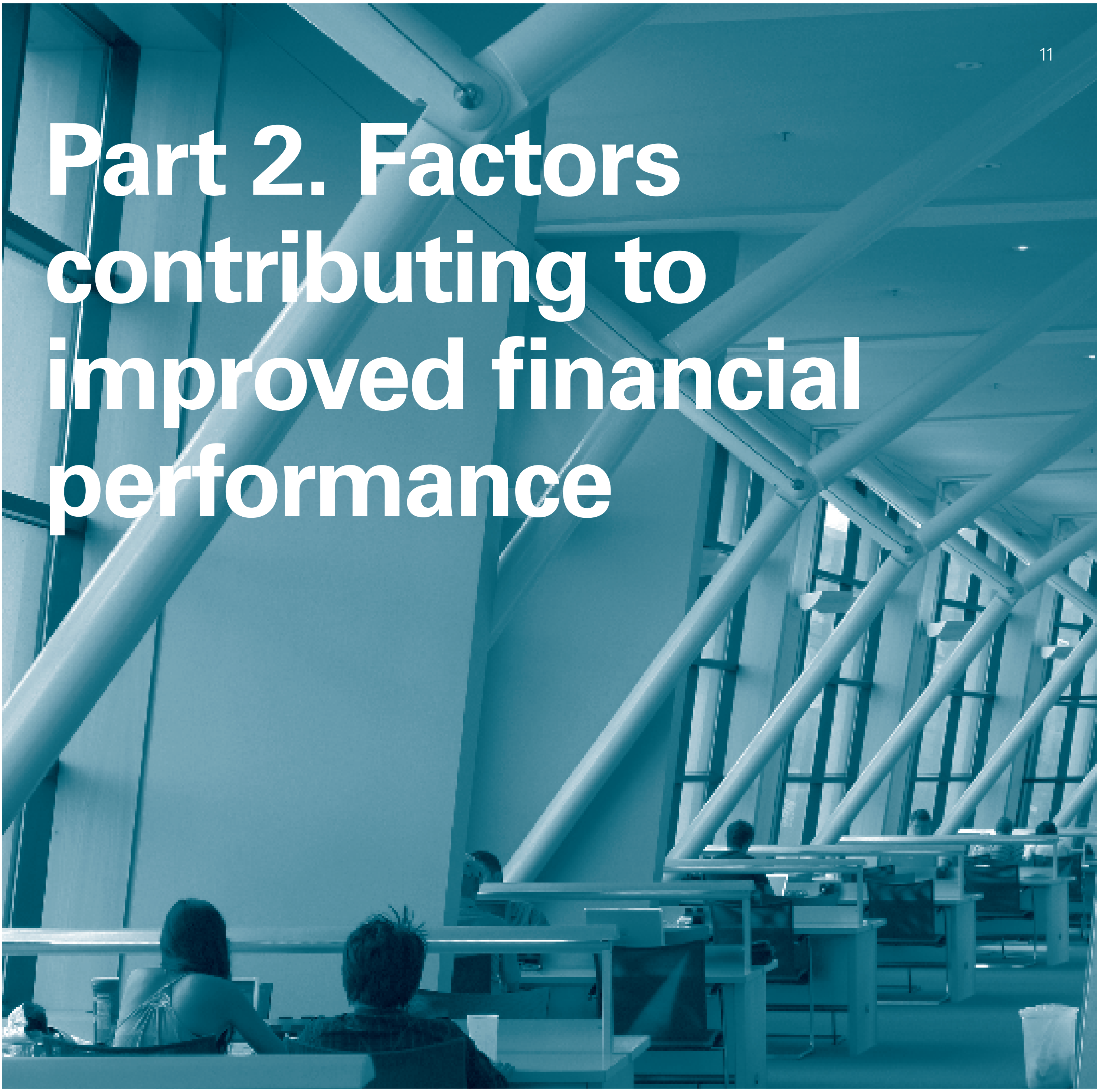
46. In March 2007, ministers approved the funding package to terminate the contract and provided the college with full funding to do this in the form of a £22.16 million capital grant and £5.54 million repayable advance.

47. On 2 April 2007, the campus was brought into public ownership. The college paid £27.7 million to the contractor to terminate the contract and buy the land and buildings valued at £18.158 million.

48. The difference between the amount paid and the value of the assets of £9.542 million has been treated as a revenue cost in the college's 2006/07 annual accounts. The 2006/07 accounts show the repayable advance as an exceptional item on the income and expenditure account which has resulted in a bottom-line deficit of £5.2 million.

49. The college's auditor has reviewed the processes for terminating the PFI contract. The auditor concluded that processes were appropriate and adequate to permit the college and SFC to demonstrate that the buyout of the PFI contract delivered best value for public money.

Part 2. Factors contributing to improved financial performance



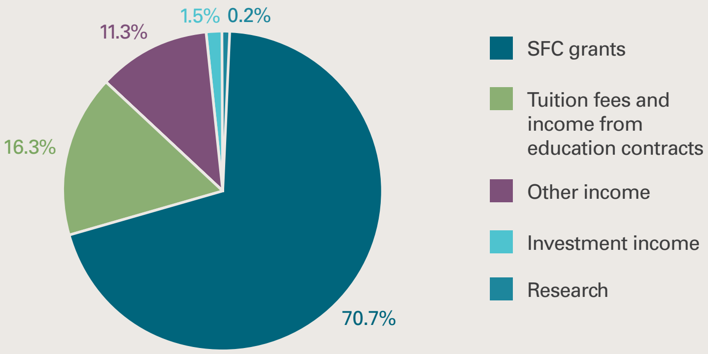
A number of factors have contributed to colleges' improved financial performance.

Key messages

- Colleges have received a significant increase in public sector funding since 2001/02. This funding, along with the SFC's financial security campaign, has contributed to improved financial performance.
- The SFC and colleges have worked together to deliver improved financial performance through strengthening peer support mechanisms and networking arrangements.
- The college and university sectors have reported significant efficiency savings in the last two years.

Exhibit 4

SFC provided approximately 70 per cent of colleges' income in 2006/07



Source: Audit Scotland (from colleges' annual accounts)

Colleges have received a significant increase in public sector funding since 2001/02

SFC's financial security campaign has focused colleges on improving their financial performance

50. In December 2002, SFC directed all colleges to ensure that by 2005/06 their underlying operating positions were sufficient to ensure that they were financially secure. A financially secure college is one that, on a continuing basis, is able to generate modest operating surpluses reliably and as planned and, through that, accumulate a reasonable level of financial reserve. The college must also generate sufficient cash to finance its operations and meet its liabilities.[13]

51. Audit Scotland's previous overview report also recommended that the SFC should:

- ensure that colleges use additional funds to improve their financial position in the longer term (rather than using them for short-term fixes)
- continue to monitor the position of each college to ensure that as far as possible the target for all colleges' financial security is met by July 2006.

52. Since then both SFC and colleges have focused attention on improving and delivering effective governance and financial management across the sector. The rest of this chapter discusses some of the factors that have contributed to improved financial performance.

SFC provides around 70 per cent of college funding

53. The SFC provides around 70 per cent of colleges' total income (Exhibit 4). However, the level of SFC funding varies among colleges ranging from 85 per cent in John Wheatley College to 47 per cent in Glasgow College of Nautical Studies.

Capital funding has increased significantly

54. Capital funding has increased significantly in the last five years, from £21 million to £88 million.[14] This represents an increase of £67 million in cash terms. Further information about capital funding and expenditure is included in Part 3.

Core grant funding has increased to £355 million

55. The level of core grant funding provided by SFC has increased in the last five years, to £355m – an increase in cash terms of around £79 million (Exhibit 5).[15] This included additional funding to support a five per cent growth in student activity (measured in WSUMs).[16] The increase in student activity focused upon two main areas: supporting enrolments by school pupils through the school/college partnership initiative; and increasing student activity in three specific areas of the country (Lanarkshire, Dunbartonshire and the Highlands) to bring them up to the Scottish average. SFC also provides revenue funding to colleges for other, specific purposes. Exhibit 5 shows that funding for ICT, strategic development and one-off grants was around £18 million in 2006/07. Funding for other purposes, allocated to colleges for their direct use, was around £64 million in 2006/07.

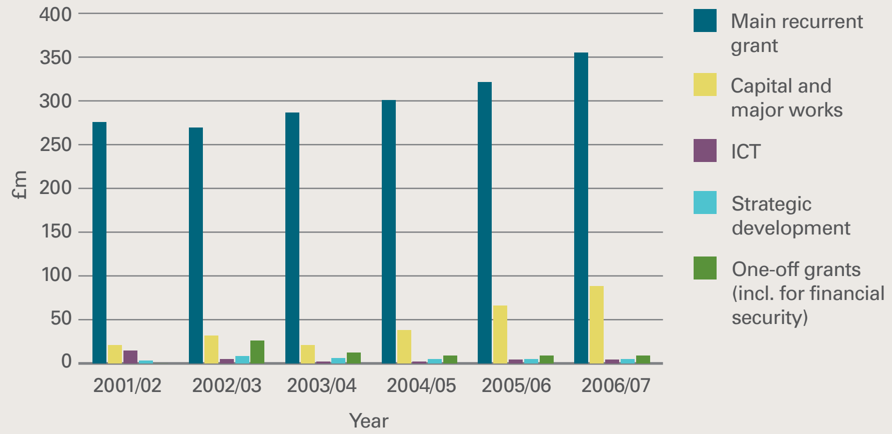
56. SFC allocates recurrent grant funding on the basis that each college will deliver an agreed target of weighted student units of measurement (WSUMs) each academic year. Exhibit 6 shows that

13 *Financial security, disability legislation and other priorities*, Scottish Funding Council, Circular FE/54/02, December 2002.
14 From SFC main grant circulars.
15 From SFC main grant circulars.
16 College activity is measured in weighted student units of measurement (WSUMs). This provides a method of aggregating student activity on different types of course and different modes of attendance in such a way that the duration of each programme and its resource demands are approximately reflected in the aggregate totals.

Exhibit 5

Revenue and capital funding 2001/02 to 2006/07

Both revenue and capital grants increased in the last five years.



Note: Funding in cash terms.
Source: Audit Scotland (SFC data)

Exhibit 6

WSUMs payments 1999/2000 to 2006/07

Student activity remained relatively constant between 2001/02 and 2005/06 but has increased in 2006/07.

Source: Audit Scotland (SFC data)

although there has been an increase in funded student activity in 2006/07, there was relatively no increase in funded student activity between 2001/02 and 2005/06. Although the level of funded WSUMs remained relatively constant, the funding received for these has increased in recent years and, since 2003/04, at a rate above inflation (Exhibit 7, overleaf). This means that the price paid per WSUM to colleges has increased from £156.19 in 2001/02 to £189.63 in 2006/07.[17] The limited growth in student numbers between 2001/02 and 2005/06 has therefore allowed colleges to concentrate on improving their financial position.

57. SFC is currently reviewing its teaching funding methodology, which it uses to calculate its main grant funding stream. The Council will consider a draft of the consultation in May 2008 and then publish it. This will outline the work undertaken to date and the various options considered.

SFC has provided £38 million to achieve financial security

58. In 2002, SFC launched a specific campaign to achieve financial security in all colleges by 2006. To support this campaign the SFC has provided £38 million of ring-fenced funding to colleges. The majority of this funding was provided between 2002/03 and 2004/05 and was targeted at three main areas:

- Financial security (49 per cent of the funding).
- Compliance with disability legislation (16 per cent).
- Other priorities requiring the investment of one-off funds (35 per cent).

SFC and colleges have worked together to improve financial performance

Peer support mechanisms and networking arrangements among colleges have been strengthened

59. In direct response to financial difficulties in the sector, the SFC introduced the Further Education Development Directorate (FEDD) in 2002. FEDD is a peer support mechanism whereby colleges experiencing difficult or challenging financial issues can access confidential support and advice from senior managers with relevant expertise from within the sector. On

17 The 2001/02 figure has been recalculated to take account of rebasing that took place in 2005/06. The rebasing reflected a change in the activity measurement methodology in relation to full-time further and higher education provision. The details of the effect of this methodology change can be found in SFEFC Circular FE/14/04 – Measurement of Full Time Courses.

Exhibit 7

Funding per WSUM has increased at a higher rate than inflation in each of the last four years

Source: Audit Scotland (SFC data)

average about 12 colleges per year access the support provided by FEDD. In the last three years there have been two high-profile cases – Inverness, James Watt – where the FEDD has worked with the colleges to identify problems and help them to improve.

60. The Scottish Colleges Finance Network was relaunched in 2002. SFC provided funding to relaunch the Network and encouraged colleges to participate. The Network comprises the directors of finance from all of Scotland's colleges and provides a forum to share knowledge and experience. It organises finance conferences and working groups to discuss specific technical issues such as pensions. The Network also shares information on best practice through its website. The full Network meets on a quarterly basis to consider key issues, while the Executive Group, consisting of five members, meets at least eight times each year.

61. The Association of Scotland's Colleges (ASC), the representative body for Scotland's colleges, provides support and networking opportunities. The ASC facilitates both the Principals' Forum and the Chairs' Forum. Both forums were established in their present form in 1996 and meet regularly to discuss key issues affecting the sector. ASC also supports the Scottish Further Education Unit (SFEU) in delivering the Principals' Continuous Professional Development programme.

62. The SFEU is the primary development agency for staff in Scotland's colleges. SFEU facilitates and delivers a range of training and other development opportunities for all staff, including sharing of experiences and good practice. In particular, SFEU is responsible for delivering the Principals' Continuous Professional Development programme which involves a wide range of activities, including workshops on aspects of college management.

63. SFC also provides guidance and support to the sector with its primary guidance being provided through the Financial Memorandum with colleges. The latest version of the Financial Memorandum became effective in January 2006 and set out a number of expectations:

- SFC and colleges will have regular and open dialogue.
- Colleges plan and manage resources in a sustainable way.
- Colleges are expected to have good governance and management systems in place. SFC needs to be satisfied that these systems are working effectively to ensure that the grant funding is being used for its intended purpose.
- College principals are directly accountable to colleges' governing bodies but they are also responsible to the SFC's chief executive for ensuring the proper use of the grant funding.

64. SFC publishes regular circulars concerning all aspects of sector activity, including financial issues and more general, sector-wide developments and issues.

SFC has introduced financial performance indicators and cost benchmarking data

65. SFC first published financial performance indicators for the sector in July 2003, and cost benchmarking data in July 2004. Both sets of data were developed by involving sector representatives and following consultation with the sector. These data allow colleges to compare their performance in particular areas, or across particular groupings of colleges.

Financial performance indicators provide trend and in-year comparisons

66. The SFC prepares a set of 16 financial performance indicators covering three main areas: financial performance; balance sheet strength; and cost and income analysis. The indicators are calculated by SFC from colleges' annual accounts and associated returns. The indicators provide comparison of the sector position over time and for individual colleges. Exhibit 8 outlines some of the financial performance indicators.

Exhibit 8
The latest financial performance indicators show mixed performance

Performance indicator	2005/06	2006/07
Financial performance		
Operating surplus/(deficit) as % of total income	0.6%	1.6%
Balance sheet strength		
Current assets: current liabilities	1.3:1	1.43:1
Long-term liabilities: total reserves	0.08:1	0.11:1
Cost and income analysis		
Premises costs as % of total expenditure	9.8%	9.6%
Recurrent grant as % of total income	52.6%	54.1%

Source: SFC

Exhibit 9
The college and university sectors have reported nearly £68 million efficiency gains so far

Efficiency gains	2005/06			2006/07			2007/08
	Target	Actual	Variance	Target	Actual	Variance	Target
	£m	£m	£m	£m	£m	£m	£m
Cash-releasing	1.0	1.0	0	5.0	0	-5.0	95.0
Time-releasing	5.0	11.0	6.0	45.0	55.7	10.7	
Total	**6.0**	**12.0**	**6.0**	**50.0**	**55.7**	**5.7**	**95.0**

Source: Scottish Government efficiency outturn reports 2005/06 and 2006/07

Cost benchmarking data are key elements of SFC's financial security campaign

67. The SFC introduced cost benchmarking data to contribute to its financial security campaign. The benchmarking model was developed by KPMG under the joint direction of the SFC, ASC and the Benchmarking Steering Group. Colleges were expected to embed the cost benchmarking data within their management processes. The model includes 105 principal performance indicators and 25 supplementary indictors – the indicators are listed in Appendix 4.

68. The SFC has encouraged colleges to form benchmarking clubs so that these data will be used to share best practice. So far 12 clubs have been formed which cover almost all of the sector. Some of the clubs are at an early stage and are developing methodologies and work streams rather than identifying actual cost savings or areas for improvement.

Colleges are not routinely using the financial performance indicators and cost benchmarking data

69. From our review we have identified that colleges believe that the financial performance indicators and the cost benchmarking data could be improved. The main development areas identified relate to the number of indicators (105 principal and 25 supplementary indicators); the resources required in preparing the data returns; and the time delay between providing the information and SFC publishing the collated information.

70. We understand that SFC is reviewing the process for collecting and publishing these data. The SFC wrote to colleges in January 2008 to inform them about this and its intention to consult colleges in this process.

71. In reviewing this process it may be worth noting that Audit Scotland, together with the other UK audit agencies, published a report in 2007 outlining corporate performance indicators covering finance, human resources, information and communications technology, estates management and procurement that public bodies may wish to adopt.[18]

The sector has reported significant efficiency gains in the last two years

72. The Scottish Executive launched its Efficient Government Initiative in 2004. At that time the SFC estimated that efficiency gains of up to £50 million could be achieved across the college and university sectors by the end of 2007/08. In the Scottish Government's 2006/07 efficiency outturn report this estimate was revised to £95 million by SFC.

73. Three main strands of work have been developed to deliver the estimated savings: business process improvements (including changes to examination systems, management and maintenance of IT, and marketing), procurement and estates.

74. The college and university sectors have reported efficiency gains of £68 million in the last two years against a target of £56 million (Exhibit 9). Of these amounts colleges were expected to contribute £4 million and £5.6 million respectively. Colleges are expected to contribute £8.6 million in 2007/08.

18 *Value for money in public sector corporate services – A joint project by the UK public sector audit agencies*, May 2007.

Part 3. Financial challenges faced by colleges

The sector continues to face a number of challenges.

Key messages

- Seven colleges forecast operating deficits in at least one of the next three years although they all have sufficient reserves to cover these. In most cases these deficits relate to the additional costs associated with redeveloping their estates.
- Colleges face a number of financial challenges over the next few years due to a tighter financial settlement and potentially less income being available from other sources.
- The accuracy of financial forecasting makes it difficult for governing bodies and other stakeholders to predict financial performance.
- Colleges have spent around £400 million investing in the estate since 2000 and further investment is planned.

Seven colleges forecast deficits in at least one of the next three years

75. Each college is required in June of each year to submit to SFC a financial forecast return (FFR) covering the current year and the following three years. In June 2007, seven colleges were forecasting an operating deficit in at least one of the next three years, with four forecasting deficits in more than one year (Exhibit 10). None of these colleges have experienced financial difficulties in the last five years. However, the main reason for these deficits is additional charges related to new campus developments, for example, fully depreciating existing buildings over a shorter period of time in preparation for their disposal.

76. It is worth noting that four of the seven colleges have indicated to us that, since the forecasts were submitted in June 2007, their financial forecasts have changed. Unlike the formal forecasts submitted in June to SFC, these have not been subject to the same board approval and SFC review. Further explanation of the forecast deficits and the changes in each of the colleges is outlined below. It should be noted that the analysis in this section relates only to those colleges forecasting deficits at June 2007.

77. In June 2007, Anniesland College was forecasting a deficit of around £0.5 million in each of the next three years as a result of three years accelerated depreciation on the buildings on its main campus (valued at £3.8 million). By March 2008, the college was forecasting a deficit of around £1.2 million in each of the next three years. The reason for this is a change in presumptions about the charging of depreciation, resulting in a higher write-off rate. The college does not anticipate the deficits having any impact on its accumulated surplus (forecast at around £2 million by 2009/10), since the costs will be met by transfers from its revaluation reserve.

Exhibit 10

Colleges' forecast surplus/(deficit) 2007/08 to 2009/10 at June 2007

Seven colleges forecast operating deficits over the next three years.

College	Actual 2006/07	Forecast 2007/08	Forecast 2008/09	Forecast 2009/10	Forecast accumulated I&E reserve 2009/10
	£m	£m	£m	£m	£m
Anniesland	0.075	-0.506	-0.527	-0.501	2.005
Borders	0.252	0.034	-0.100	0.122	2.522
Dundee	1.282	-0.054	-0.155	-0.199	7.909
Elmwood	-0.221	0.010	-0.152	-0.099	4.088
Jewel & Esk	0.256	0.220	0.430	-0.075	4.796
Langside	0.868	0.050	0.050	-4.030	2.093
Oatridge Agricultural	0.133	-0.087	-0.175	-0.152	2.502
Total number of colleges	1	3	5	6	

Source: SFC data/colleges' annual accounts

78. Borders College is redeveloping its estate to a 'hub and spoke' model to meet the needs of its population, including a project to develop a Scottish Borders Campus shared with Heriot-Watt University in Galashiels and the provision of services from five other sites across the Borders. In June 2007, the college was forecasting to reduce its operating surplus in 2007/08 to around £34,000 and record an operating deficit of £100,000 by 2008/09. The forecasts related to high depreciation charges and interest payments to finance its new campus. By March 2008, the college was forecasting a surplus of around £200,000 in 2007/08, and surpluses of around £100,000 in each of the subsequent years. The main reasons given by the college for the improved positions are improved estimates of sale proceeds (which reduce borrowings) and the zero VAT rate now being applied to its Hawick construction project. The college currently has an accumulated surplus of £0.643 million in its I&E reserve.

79. Dundee College is forecasting deficits in each of the next three years due to parallel running costs for its old and new sites while it rationalises its estate. The college currently has an accumulated surplus of £7.6 million on the I&E reserve which is sufficient to cover the planned deficits.

80. Elmwood College reported an operating deficit in 2006/07 and was originally forecasting a small surplus (£10,000) in 2007/08 before reverting back to operating deficits in each of the following two years. The forecast deficits relate to the loss of both EU income and additional depreciation following the refurbishment of the student residence. The college was forecasting an accumulated surplus of around £4.1 million by 2009/10. We understand that the SFC asked the college to provide a new financial strategy and updated financial forecast to address those deficits going forward. The college's mid-year forecasts projected an operating deficit of £0.306 million in 2007/08, partly as a result of additional depreciation resulting from a revaluation of buildings at July 2007 and a provisional reduction in EU income. However, subsequent to the mid-year forecast, the college has been successful in securing a share of redistributed student funds. The college's forecast at March 2008 is for a deficit of £0.206 million. The college received assistance from FEDD with a high-level review of the finance function and FEDD also provided some personal support to the new director of finance on sector-wide issues.

81. In June 2007, Jewel & Esk College was forecasting a deficit of around £75,000 in 2009/10 due to development costs for its new campus. By March 2008 the college was predicting a deficit of around £460,000 in 2008/09, due to known development costs and debt interest for the new campus. The college's accumulated surplus should be sufficient to cover the forecast deficit and the college believes that once the new campus opens it will again be able to produce operating surpluses. The campus should be ready for occupation by the end of 2008 and the college is predicting a surplus of £35,000 in 2009/10.

82. Langside College is forecasting reduced surpluses (of around £50,000) over the next two years and a deficit of over £4 million in 2009/10. These forecasts take account of the college's plans to redevelop its campus. The large deficit in 2009/10 relates to accelerated depreciation needed to write off the value of existing buildings in the final year of the development. This will be offset by a release from the college's revaluation reserve.

83. Oatridge College is forecasting deficits for each of the next three years with deficits increasing from £87,000 in 2007/08 to £152,000 in 2009/10. The forecast income assumptions in the FFR are very cautious. In particular, the college included a very cautious assumption about the increase in SFC recurrent grant in 2008/09. The college has also been cautious on its forecasted income levels in relation to training programmes and residential income. There was also a significant forecast reduction in income from European Funds in 2008/09 and 2009/10. The college will have to increase income streams to compensate, but did not include all of its plans in the FFR. The college has now advised SFC of its updated position for 2007/08, which shows a small surplus (£0.014 million). The college has an accumulated surplus of almost £2.7 million.

84. The SFC engages with all colleges in respect of their future financial security and sustainability, including those mentioned above.

Colleges are facing a number of challenges to their financial positions

85. Because there is wide variation in location, funding, age of estate and curriculum, each of Scotland's colleges faces different challenges. For example, declining populations; social inclusion; enhancing links with higher education institutions; developing employer engagement; knowledge exchange; and school/college partnerships.

86. The demographics in Scotland are changing, which may affect the number of potential students in future. Latest data show that the majority of full-time students in colleges are aged under 20. Latest population data show that the number of people in Scotland in this age group will decline over the next 30 years. However, the SFC and colleges are aware of this issue and are aiming to widen the student age group. Colleges have large amounts of part-time students covering all age groups – the largest proportion of part-time students are aged 41 and over.

Average surpluses could be improved

The average operating surplus has improved over the last four years but this may not provide sufficient year-end flexibility

87. Colleges generally forecast to break even or make small surpluses in any year. The level of surplus forecast may allow colleges flexibility to cope with any unforeseen problems and still break even at the year end.

88. For those colleges that recorded an operating surplus in 2006/07, the average operating surplus, as a percentage of income, was around three per cent. This has shown a year-on-year increase from 0.93 per cent in 2003/04. But in 2006/07 there was wide variation between the highest and lowest surpluses from 0.02 per cent at Banff and Buchan College (£2,000) to 8.84 per cent at Coatbridge College (£941,000).

Exhibit 11

Colleges' actual positions vary from forecasts

	2002/03	2003/04	2004/05	2005/06	2006/07
Total number of colleges	42	42	41	39	39
Colleges where the variation between forecast and actual position was greater than 3% of income	13	2	7	7	9
Colleges forecasting surpluses at year end	22	29	34	33	34
Colleges forecasting surpluses that actually reported deficits	7	5	2	1	2
Colleges forecasting deficits at year end	20	13	7	6	5
Colleges forecasting deficits that actually reported surpluses	9	6	3	3	3

Source: Audit Scotland (SFC data)

89. The potential consequence of forecasting for small surpluses is that relatively small changes in income or expenditure may significantly affect the financial position at the year end – moving colleges from forecast surplus into deficit or vice versa. Of the 35 colleges with surpluses, 23 reported a year-end surplus that was less than three per cent of income.

Financial forecasting could be improved

Colleges' financial forecasting makes it difficult to predict accurately future financial performance

90. While submitted in June, colleges' forecasts are typically prepared in April and May so that they can be reviewed and approved by colleges' finance committees and boards of management. We found there were variances when forecasts were compared with the actual outturn figures (Exhibit 11). Our analysis shows that, in each of the last five years, a small number of colleges moved from forecast operating surplus to operating deficit, while others moved from forecast deficit to operating surplus. This has improved over the last five years but in 2006/07 five colleges' actual positions moved from the surplus or deficit position they had forecast in June 2007. We also found that around a quarter of all colleges reported an outturn that varied from the forecast by more than three per cent of their income level.

91. SFC also analyses these data to assess whether there are any colleges that are particularly weak in terms of their forecasting but it has found no discernible pattern. Both colleges and SFC have suggested a number of factors that may result in inaccurate forecasts such as year-end adjustments, availability of finance staff, allocation of funds during or after the forecasts being prepared, and time required to secure board approval prior to submission.

92. Colleges' financial forecasts are used for budgeting and planning purposes. Colleges' senior management teams and boards therefore need to be able to place reliance on this financial information. Inaccurate budgets and forecasts may result in inappropriate action by colleges and result in SFC providing support and guidance to the wrong colleges.

93. Case study 4 (overleaf) provides an outline of how changes at the year end resulted in Edinburgh's Telford College's financial position changing from forecast surplus to deficit.

Less funding will be available to colleges in the future

94. As previously outlined, colleges receive around 70 per cent of their funding from SFC but colleges receive income from a range of other sources, including:

- other grant income – this is generally from the European Union. It can be used to support specific additional courses or capital projects

- education contracts – colleges will have contracts with local firms, Scottish Enterprise and Highlands & Islands Enterprise, local authorities and other bodies to provide specific training

- tuition fees and charges – many domestic students pay a proportion of their fees and overseas students generally pay the full amount of the course
- research income – this is much smaller for colleges than it is for universities. Some colleges conduct specific pieces of research for local companies
- investment income – colleges may invest surplus cash. This is generally quite a small proportion of colleges' income
- other income – for example, Carnegie College has a business and conference centre and Elmwood College has a golf course. Both colleges raise income from these facilities.

Case study 4

Edinburgh's Telford College's 2006/07 financial position moved from forecast surplus to reported deficit at the year end

Edinburgh's Telford College submitted its financial forecast for 2006/07 to SFC at 30 June 2007, as required. At that time the college was forecasting an operating surplus of £0.9 million. However, the audited annual accounts report an operating deficit of £0.07 million – a difference of around £1 million. There were several reasons for the deterioration in operating position between the production of the forecast and the final accounts, including:

- a higher than anticipated depreciation charge on the new campus, and a change in accounting treatment for VAT on the new building
- a provision being raised for the payback of recurrent grant to SFC as a result of student activity targets not being met
- repayment of some of its fee waiver grant to SFC for 2005/06
- an additional interest charge due to several increases in interest rates at a time when the college's core debt was £13 million. The core debt was reduced to £8 million in March 2007 once the final instalment of land sales proceeds was applied
- revaluation of the unfunded pension liability, in accordance with the requirements of the SFC accounts direction.

The college acknowledges that it faced a number of challenges during 2006/07, primarily related to its move to a new campus. The college was also aware of shortcomings in its student information systems but considered it risky to implement the new systems while also going through a major move. The new systems are now being implemented.

Source: Audit Scotland

The Scottish Government's budget proposals mean that increases in funding will reduce significantly

95. The funding increases experienced in recent years will not continue. The Scottish Government's budget is equivalent to an average increase of 0.9 per cent per year in real terms over the next three years, compared with around 2.5 per cent in each of the last five years.[19]

96. Colleges' financial forecasts for the next three years were submitted to SFC prior to the announcement of the Government's budget proposals. On this basis a number of colleges' forecasts of future SFC funding may be too high. SFC has still to finalise funding arrangements for future years.

European funding income is forecast to decrease by around 50 per cent in the next three years.

97. Scotland's colleges received a total of £22.3 million in EU grants in 2006/07 and European funding has equated to around three per cent of colleges' income over the last five years. However, there is wide variation in the amounts of European funding received by individual colleges. For example, while European funding accounted for over five per cent of income for 13 colleges in 2006/07, it accounted for less than one per cent of income for another 12 colleges.

98. The sector is forecasting that European funding will halve over the next three years (Exhibit 12). The primary reason for this relates to the increase in the number of EU members. A significant proportion of European funding is awarded on the basis of social deprivation and, in relative terms, Scotland is better off than many of the new member states. Scotland has been allocated approximately £540 million of funding for 2007-13, compared with £1.1 billion for 2000-06.[20, 21]

99. SFC has alerted colleges to these changes and encouraged them to consider the impact of this reduction in future funding. It has also sought information on colleges' plans and expectations for European funding and is challenging those colleges that do not appear to have taken into account the overall reduction in funding available.

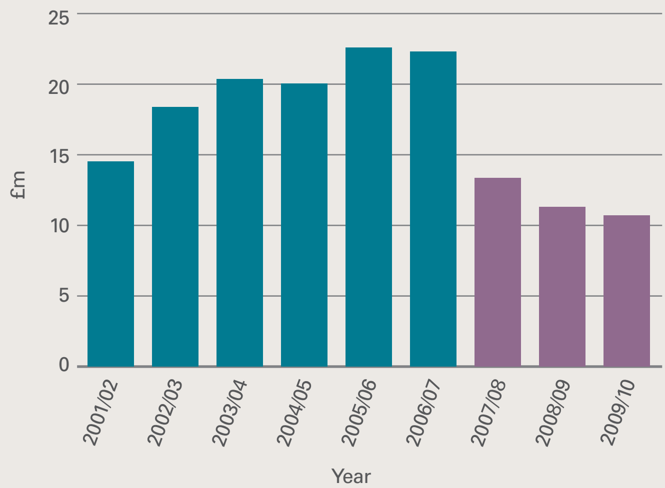
19 SFC Council Paper 07/173.
20 Future Programmes Q&A, Scottish Government, August 2007. Note that because European funding is expressed in euros, this figure can vary with exchange rates.
21 It should be noted that colleges complete forecasts for three years while European funding is allocated on a seven-year basis. It could reasonably be assumed that the expected decreases will continue for the duration of the seven-year period.

100. The potential impact of this reduction is that colleges may be unable to undertake some of their current activities. EU funding has traditionally been used to support social inclusion, widening access and targeted skills training for small businesses. The reduction in funding could lead to a change in focus or activity by individual colleges.

101. In our previous overview report we commented on delays in receiving EU grants, with five colleges reporting delays in the receipt of EU grants during 2001/02. In 2006/07, the auditors of two colleges have commented on delays in receipt of EU grants.

Exhibit 12

Colleges are forecasting a 50 per cent reduction in European funding income by 2009/10



Source: Audit Scotland (SFC data)

Colleges are forecasting increases in income but these may be over-optimistic

102. Colleges can charge tuition fees to overseas students or to students who are ineligible to have their fees paid from government funds. Colleges are free to set their own fees for these students and the level of fees charged therefore varies.

103. Colleges can also enter into education contracts to deliver education or training on behalf of external organisations. For example, colleges provide training contracts for Scottish Enterprise or private companies.

104. Colleges' financial forecasts suggest that they expect to increase the level of income they generate from tuition fees and education contracts to £115 million by 2009/10. This represents an increase of around £9 million (8.4 per cent in cash terms) on 2006/07 income levels.

105. However, the financial forecasts were prepared before the announcements relating to the restructuring of Scottish Enterprise and Highlands and Islands Enterprise. Where forecasts were based on increased funding from contracts with Scottish Enterprise or Highlands and Islands Enterprise, there is a risk that the increase in funding will not materialise due to potential changes in the future awarding of contracts. The SFC is currently discussing with colleges these assumptions in forecasts.

Colleges' spending may increase at a higher rate than funding

Staff costs account for a significant proportion of colleges' expenditure

106. Providing education is labour intensive and staff costs are therefore the most significant item of expenditure for most colleges, accounting for around 65 per cent of total expenditure. In each of the last four years staff costs have increased above inflation (Exhibit 13, overleaf). Colleges have identified increases in staff costs as a potential cost pressure for the next few years. Each college undertakes its own pay negotiation.

There are a number of other issues which may affect future financial performance

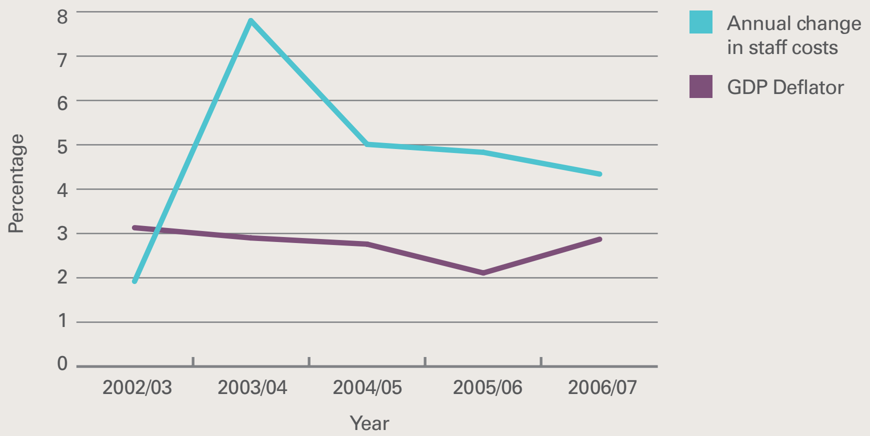
The potential loss of charitable status for colleges is under consideration

107. Charitable status entitles an organisation carrying the status to be exempt from, or be given relief on, certain tax liabilities. Colleges have traditionally been afforded charitable status but this was brought into question following a pilot exercise undertaken by the Office of the Scottish Charity Regulator (OSCR).

108. The pilot exercise applied OSCR's charity test to a number of organisations registered as charities. The exercise included eight case studies, one of which was John Wheatley College in Glasgow. OSCR published its report in July 2007 and found that, while the purposes of the college were considered to be charitable and provided public benefit, the college did not pass the charity test due to it being considered not to be independent from the control of Scottish ministers. These conditions apply to all colleges and

Exhibit 13

Colleges' staff costs have increased at a rate above inflation in each of the last four years



Note: The chart is based on total staff costs. Data are drawn from the annual accounts for 2005/06 and 2006/07; and from existing SFC data for previous years. The changes include both changes in rates of pay and in the number and mix of staff employed.
Source: Audit Scotland (SFC data)

therefore the potential impact is sector-wide. The impact of colleges losing charitable status is estimated at around £25 million.[22]

109. The Scottish Government has made a public commitment to 'introduce any legislation which is necessary to support a decision that the charitable status of colleges should be retained'.[23] The government announced its intention to exempt colleges from the independence aspect of the charity test and has invited comments from the Scottish Parliament's Education and Lifelong Learning and Justice Committees.

The future procurement of goods and services provides opportunities to deliver efficiencies but progress is slower than planned

110. The McClelland Review examined procurement arrangements across the whole of the public sector in Scotland and recommended the creation of Procurement 'Centres of Expertise' to improve procurement across the public sector.[24]

111. As a result, in 2007, APUC Limited (Advanced Procurement for Universities and Colleges) – the centre of expertise for the university and college sectors – was established. APUC is owned and governed by Scotland's universities and colleges and has a board of directors consisting of ten members: three drawn from each of the college and university sectors, three independent non-executive members and APUC's chief executive. While the members are drawn from within the sector, as members of the board of a limited company, their responsibilities under the Companies Act require that, when acting as such, they must act in the interests of the company rather than those of their main employer.[25]

APUC is expected to deliver savings of up to £285 million

112. The business case, submitted to the Scottish Government's Efficient Reform Fund (ERF) in August 2006, estimated savings of £105 million would be delivered over the first five years of the reform programme, increasing to £285 million over eight years. It estimated that the associated costs of achieving these savings would be £38 million for the first five years and around £2 million per year thereafter. Funding of £15 million was secured to kick-start the procurement reform, including the establishment and initial running of APUC, with £11.4 million from the Government's ERF; £1.5 million from SFC; and £2.2 million from institutions. The business case anticipated that efficiency savings, along with levies from suppliers and nominal subscription fees, would cover the remaining £23 million programme costs for the first five years. APUC meets quarterly with the Scottish Government and SFC jointly to discuss progress.

There have been a number of developments since the business case was submitted

113. Since the original business case, there have been a number of developments meaning that the initial delivery of the benefits has been slower than estimated. This is partly related to a change in anticipated funding sources and partly related to over-optimistic timescales for delivery. APUC has now established that the lead-time to negotiate and implement a large-scale collaborative contract can be between nine and 16 months.

114. The primary change in terms of APUC's ongoing funding is that centres of expertise in other sectors have elected not to pursue levies from suppliers. In light of this, APUC believes that applying such levies could discourage suppliers from working with the sector and, as a result, it has reviewed its funding sources. APUC now expects that the level of subscription fees will need to increase to cover all of its ongoing operational costs, estimated at around £2 million. APUC has

22 Charitable status of colleges, Scottish Government News Release, 26 January 2008.
23 *Principles and priorities: The Government's programme for Scotland*, Scottish Government, September 2007 (http://www.scotland.gov.uk/Resource/Doc/197113/0052743.pdf).
24 *Review of Public Procurement in Scotland*, March 2006.
25 Companies Act 2006, section 170 et seq.

indicated that fees will be calculated on a proportionate basis, although the precise basis for calculating these has yet to be decided.

Only 13 colleges have signed their Partnership Agreement with APUC

115. APUC has already developed collaborative contracts for a number of goods and services, such as dairy produce, catering and bottled water, and has supported Procurement Scotland (the national Centre of Expertise) with a contract covering IT hardware. It expects to finalise contracts for other commodities and services, including gas and electricity, within the next few months. However, some colleges have indicated that their existing procurement arrangements allow them to take advantage of contracts with other consortia, which they consider to be effective. Some colleges have also expressed concerns about the impact new procurement methods may have on their renewable energy policies or their economic contribution to their local communities.

116. For APUC to successfully deliver the estimated savings it expects that colleges will use the contracts as they are expected to deliver best value. APUC acknowledges that colleges may opt out where they have a strong business case for doing so.

117. At the time of the ERF business case, all colleges signed a Statement of Project Support, to confirm their support for the high-level vision for advanced procurement and their commitment to the achievement of the business case objectives. The SFC also encouraged colleges to participate in APUC in its 2007/08 grant letter by stating 'we therefore expect all institutions to participate fully in the establishment of APUC, its ongoing activities and to support the widespread adoption of eProcurement Scotl@nd.'[26] However, to date, only 13 colleges have signed their Partnership Agreement with APUC. The main reasons for the slow progress with colleges signing their Partnership Agreements seem to be the uncertainties over subscriptions and lead time required to demonstrate the benefits from collaborative contracts.

118. The lack of certainty around subscription fees appears to be a significant factor in restricting progress towards the sector's procurement aims. Some colleges have expressed doubts about the balance between subscription fees and the actual savings that can be delivered. It is clear that the sector needs to resolve the current concerns, particularly concerns around the subscription fee, if the opportunities and efficiencies envisaged by the McClelland Review are to be achieved.

Variations in approaches to accounts preparation make it difficult to make like-for-like comparisons

119. SFC provides guidance on certain aspects of accounts preparation and presentation of financial information by issuing an annual accounts direction. However, colleges may choose to record certain items or transactions in different ways. This is partly because of their autonomous nature and partly because of flexibility within accounting and financial standards. For example, in the case of both FRS 17 on accounting for pensions and FRS 15 on accounting for fixed assets, colleges can and do adopt different accounting treatments.

120. The accounting treatment adopted will affect the figures recorded in annual accounts and may affect the overall financial position. This means that it is difficult to make like-for-like comparisons among colleges.

Colleges' accounting treatment of fixed assets affects the amount of depreciation charged

121. FRS 15 is the accounting standard with regards to the treatment of fixed assets. In general, it gives reporting entities (eg, colleges) two options on how to disclose the value of the assets on the balance sheet. They can either show it at the historic value at which they bought the asset or they can show the asset at its revalued amount.

122. In general, colleges revalue their assets on a five-year basis. However, three colleges show their fixed assets at historic cost. This makes comparison of the operating position among colleges more difficult as those colleges that revalue assets are likely to have a higher depreciation charge than colleges that do not revalue assets.

Different accounting treatment of pensions can affect disclosed pension liabilities

123. FRS 17 was designed to show the reader of the accounts a better reflection of the actual costs and liabilities associated with the running of pension schemes. The different approaches adopted on the treatment of the local government pension schemes by the colleges impacts upon their financial statements in two main ways:

- It affects the amount of expenditure reported in the I&E account. For example, in 2006/07 Adam Smith College recorded a pension charge of £0.669 million. However, if the college had not applied FRS 17 the expenditure for pensions would have been £0.818 million.

- It affects the level of reserves. For Adam Smith College the impact of applying FRS 17 means that it has a liability of £1.3 million in its pension reserve – effectively a deficit reserve.

124. As outlined in paragraph 37, overall colleges have a negative pension reserve of £8.4 million in 2006/07. This may indicate that local

26 SFC Circular SFC/19/2007.

government pension schemes have been underfunded in recent years. The gradual reduction in the pension liability over the last three years suggests that the increased funding provided by SFC is being successfully used to make increased payments into the pension schemes. However, as noted previously, the effect of changes in financial markets will also have contributed to the overall position.

125. We also identified variation in the accounting treatment of early retirement provisions. This is because those colleges which account for the pension schemes as defined benefit schemes under FRS 17 tend to use the same valuation method to measure their early retirement provision.

SFC uses the 'underlying position' to assess financial performance

126. SFC uses the 'underlying position' to assess the financial performance of the sector. The underlying position is derived from the operating position after a number of adjustments are made. For example, removing 'exceptional, one-off' items from the overall financial position. SFC asks colleges to identify any such exceptional items and it may also suggest adjustments to colleges after reviewing the annual financial returns.

127. The SFC considers the underlying position to be a more accurate representation of the financial position of the sector and uses it to make comparisons among colleges and identify individual colleges that appear to be facing financial difficulties.

128. Our work had identified that although colleges prepare underlying position for SFC they may not use it when reporting financial information to their college boards, although the returns are formally approved on behalf of boards of management. The main reasons provided for this is that colleges are doubtful that the underlying position is being calculated on a consistent basis across the sector, which leads to uncertainty over comparisons being made on a like-for-like basis.

129. While we appreciate that the use of the underlying position is purely an internal measure used by the SFC, we recommend caution in its use as it is does not appear on the colleges' audited financial statements nor does it comply with commonly accepted accounting practice (UK GAAP).

There has been significant investment in the estate and more is planned

The 2000 estates review identified that significant capital investment was needed

130. The last survey of the sector estate was undertaken in 2000.[27] The results of the survey provided an indication of the minimum level of capital investment needed to bring the existing college estate up to an operational standard. It also prioritised the work needed by degree of urgency. It did not allow for improvements or reconfiguration of the estate. The review identified that around:

- £12.2 million of investment was needed immediately or within a year for urgent work to prevent immediate closure or address high-risk health and safety issues
- £37.4 million of investment was needed within three years on essential work to prevent serious deterioration and medium-risk health and safety issues
- £63.8 million of investment was needed within five years on desirable work to prevent deterioration and address low-risk health and safety issues
- a further £2.7 million investment was needed within ten years.

131. The majority of this capital investment was needed in colleges in Fife, Edinburgh and the Lothians, Lanarkshire, Glasgow and the West.

132. The SFC is currently commissioning a new estates survey with a view to this being completed in summer 2008.

There has been a significant increase in capital investment since 2000 and more is planned

133. SFC has provided significant amounts of capital funding in the last few years reaching around £88 million in 2006/07. In addition, it has also provided almost £28 million funding to West Lothian College to buy out its PFI contract (Part 1). This funding has been supplemented by colleges resulting in a significant increase in colleges' capital expenditure since 2000/01. Much of the increase in capital expenditure has occurred in the last three years, increasing from around £30 million in 2003/04 to £126 million in 2006/07 (Exhibit 14). The increase in expenditure includes European funding and borrowing by colleges.

134. In October 2007, the Scottish Government announced an additional £100 million of capital funding for the college and university sectors. Each sector will receive £50 million. It is expected that some projects currently in progress or under consideration may be progressed faster than would otherwise have been the case.

Around £225 million has been invested in major capital projects since 2000 and a further nine projects are in progress

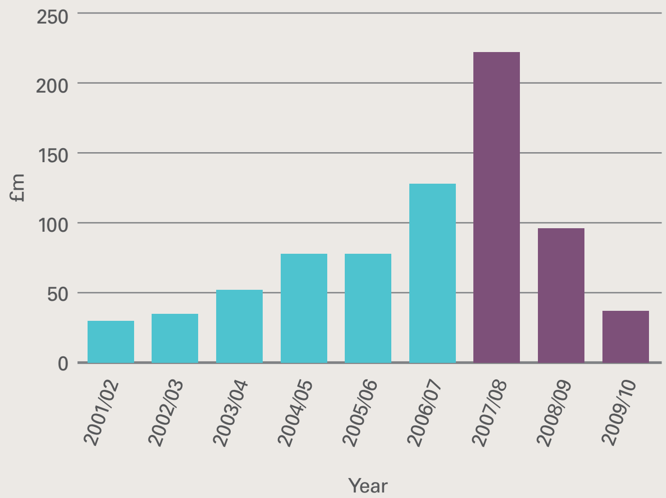
135. Since 2000, twelve colleges have completed major capital projects costing around £200 million to redevelop their estates and campus. West Lothian College has also bought out its PFI contract at a cost of £27.7 million. A further nine colleges currently have capital projects in progress which are estimated to cost around £380 million (Exhibit 15).

27 The 2000 FE estates condition survey was undertaken by Currie Brown on behalf of SFC.

Exhibit 14

Capital investment 2001/02 to 2009/10

Colleges have invested significant funds to upgrade their estates and more spending is planned.



Source: SFC

Exhibit 15

Thirteen major capital projects costing approximately £225 million have been completed since 2000

Capital projects completed	Cost[1]
	£m
Adam Smith	16.3
Angus	7.0
Ayr	0.9
Carnegie	4.9
Clydebank	34.7
Cumbernauld	11.2
Edinburgh's Telford	75.7
Glenrothes	3.9
John Wheatley	14.9
Oatridge	5.9
Reid Kerr	12.0
Stevenson	10.1
West Lothian	27.7[3]
Total	**225.2**

Capital projects currently in progress	Indicative cost[2]
	£m
Anniesland	
Borders	
Cardonald	
Dumfries and Galloway	
Jewel & Esk	
Langside	
Motherwell	
North Glasgow	
South Lanarkshire	
Total	**378.1**

Notes:
1 – The individual costs are estimates provided by SFC as the total costs have still to be finalised. The dates of the estimates range between March 2005 and March 2008.
2 – For reasons of commercial confidentiality, colleges are unable to publish the detailed figures for these projects.
3 – The West Lothian figure relates to the PFI buyout.
Source: SFC

136. As outlined at paragraph 132, the majority of capital investment was needed in the estates of colleges in five areas. Exhibit 15 shows that there has been major capital investment in colleges' estates in each of these areas.

137. The SFC's capital programme for the sector includes five projects which have not yet been fully approved, one of which is the significant development of four Glasgow colleges' proposal for a shared campus which is currently estimated to cost around £300 million.[28]

138. Any major estate development presents significant challenges, for example, ensuring the necessary project management experience and capability is in place to support successful delivery of the project. SFC provides expertise in this area through its property support team. Colleges share experiences of large capital projects with each other informally and at network events. The sharing of these experiences should help the sector to deliver the projects more effectively and to build the capacity of college staff for future projects.

139. In developing their estates colleges also need to consider the long-term implications of new buildings such as whole-life costs and maintenance costs, and budget for these accordingly.

28 The colleges involved are Central College of Commerce, Glasgow Metropolitan College, Glasgow College of Nautical Studies and Stow College.

Part 4. Governance arrangements

Governance arrangements are generally sound.

Key messages

- Governance arrangements are generally sound but there is room for improvement in some colleges.
- Key stakeholders in the sector are working together to take forward the recommendations from the Review of Scotland's Colleges.
- Lessons are being learned from those colleges where weak governance arrangements led to financial difficulties.

The SFC's governance and management arrangements are generally effective

140. SFC's auditor reviews and comments on corporate governance arrangements as part of their annual audit. The 2006/07 auditor's report has concluded that systems and procedures in place are operating satisfactorily. The auditor completed a separate review of corporate governance in 2006/07 and found that SFC has satisfactory corporate governance arrangements in place although the report identified some areas for further development.

141. SFC has in place a number of arrangements for monitoring the financial performance of the sector:

- Annual financial returns – these are prepared by colleges and contain financial information from the annual accounts and other additional information. These returns include the 'underlying position'.
- Annual financial forecasting returns – as outlined in Part 2, colleges submit financial forecasts for the current and following three years in June each year, one month before the financial year end.
- Regular visits to all colleges – SFC visits each college two to three times a year. As a result of SFC's analysis of financial forecasts and underlying position it identifies potentially high-risk colleges. SFC visits these colleges more frequently to discuss particular issues and problems.
- Financial performance indicators – as outlined in Part 2, the SFC publishes annual financial performance indicators.
- Cost benchmarking data – as outlined in Part 2, the SFC publishes annual cost benchmarking data.

142. We found that these procedures appear to operate effectively and SFC is generally aware of issues that might affect the financial position of individual colleges or the sector as a whole. However, we have identified a few areas where improvements could be made:

- The financial forecasting process could be improved. For example, the accuracy of financial forecasts, despite being submitted to SFC one month before the financial year end, is uncertain.
- SFC could consider whether the financial performance indicators and cost benchmarking data could be improved by: reducing the number of indicators; reducing the resources needed to prepare data returns; and producing comparative information on a more timely basis. As noted previously, SFC is currently reviewing this area.

Colleges' governance arrangements appear generally sound but there is room for improvement

Corporate governance arrangements are generally sound but there are some weaknesses

143. As part of our review we analysed: 2006/07 annual accounts, including corporate governance statements; auditors' annual audit reports; and supplementary information requested from auditors on specific issues relating to financial management and governance arrangements.[29] Our analysis of this information indicates that colleges' governance arrangements are generally sound but has identified a number of areas where improvements could be made:

- Most, but not all, colleges have a board that includes members with recent, relevant financial experience (as set out in the Smith report).[30]
- Not all colleges comply fully with the Combined Code of Corporate Governance, in so far as it applies to colleges.[31]
- Risk management systems, including risk registers and reporting, are not fully developed and embedded in all colleges.
- Not all colleges have up-to-date registers of board members' and staff interests.
- Some colleges do not have up-to-date fixed asset registers.

29 This was the first year in which Audit Scotland sought supplementary information from colleges' auditors. The responses did indicate some variation in interpretation by auditors and there is scope to develop greater consistency. However, the data have been used where the interpretation is clear.
30 *Audit Committees combined code guidance*, Financial Reporting Council, December 2002.
31 *The combined code on corporate governance*, Financial Reporting Council, June 2006.

Some colleges' financial management and governance arrangements could be improved

144. In 2006/07, auditors reported that the draft annual accounts of 12 colleges were either not provided to the auditor or were incomplete by the agreed date. In most instances these problems were relatively minor in nature and were resolved in sufficient time to allow the deadlines to be met. In some cases the problems resulted in additional audit fees being incurred by the colleges.

145. However, two colleges – Cumbernauld and Kilmarnock – were unable to resolve the problems easily, resulting in significant delays to the audit process. Explanations provided for these delays are:

- Cumbernauld College – audited annual accounts were submitted in March 2008. The auditor indicated that a number of issues contributed to this delay, the primary issue being staff shortages and unforseeable absences.

- Kilmarnock College – audited annual accounts were submitted in March 2008. As previously outlined the auditor has qualified the audit opinion on the basis of limitation of scope.

146. Delays in the preparation of good quality draft accounts may lead to pressure on the audit timetable, providing less time for college boards and committees to adequately consider and comment on the accounts and associated audit report. It may also have an impact on the audit fees paid to appointed auditors.

Key stakeholders in the sector are working together to improve governance arrangements

The recommendations from the Review of Scotland's Colleges are being taken forward

147. In 2005, the (then) Scottish Executive established a national review of Scotland's colleges. The remit of the review was to provide Scottish ministers with a robust evidence base and, where appropriate, informed recommendations for change to allow sound decisions on how to fund and equip colleges to meet future challenges and demands.

148. The findings of the Review of Scotland's Colleges, and the associated recommendations, were published in June 2007 with a separate report on governance and accountability arrangements.[32] The review identified future drivers that will place increased pressure on the governance of boards including:

- high-level skills
- training and development
- time commitment
- remuneration
- board powers.

149. In October 2007, the Scottish Government published its response to the review.[33] The SFC is currently in discussion with the Scottish Government, ASC and colleges on the most efficient and effective way to address the Scottish Government's response.

Lessons are being learned from colleges where poor governance arrangements affected the financial performance

150. Inverness and James Watt Colleges have experienced poor financial performance over the last few years. FEDD investigations into the reasons for poor financial performance have identified weak governance arrangements as a major contributory factor.

151. Although these are isolated cases they provide an opportunity for other colleges to learn from the weaknesses identified. SFC highlighted the key issues to the sector and encouraged colleges to consider the lessons.

152. We did not undertake a systematic assessment of how colleges responded to this but we did find evidence that some colleges had reviewed their own arrangements following the emergence of the issues at these colleges. During 2007, the board at John Wheatley College requested its internal auditor to carry out an assessment of the college's governance arrangements against the findings of the FEDD reports on Inverness College and James Watt College. The assessment was completed by the auditor and reported back to both the audit committee and full board. The auditor concluded that the college has satisfactory governance arrangements in place.

32 *Review of Scotland's Colleges: Report of the Accountability and Governance Working Group*, Scottish Executive, June 2007.
33 *Promoting Excellence: The Scottish Government's Response to the Review of Scotland's Colleges*, Scottish Government, October 2007.

Appendix 1.

Colleges visited as part of this study

College	Reason for selection
Lews Castle College, Isle of Lewis	A small, remote college, likely to face particular demographic challenges. Section 22 reports were prepared by the Auditor General on the 2002/03 and 2003/04 annual accounts.
Inverness College	The college serves a large geographical area. It was the subject of Section 22 reports in each of the last four years, from 2002/03 to 2005/06. The college indicates that it is now making significant progress towards improving its financial position.
Edinburgh's Telford College	A large, city centre college, delivering a wide curriculum to a large number of students. The college has recently opened its new campus.
Adam Smith College, Fife	The college serves a wide geographical area and was formed as a result of a merger of two previous colleges – Glenrothes and Fife – in 2005. The college has experienced the particular challenges and opportunities of merging two separate colleges.
John Wheatley College, Glasgow	A large community college providing learning in an area of social deprivation. The college has recently opened a new campus building.
Glasgow College of Nautical Studies	A specialist college. The college is one of four colleges working together on proposals for a shared campus in Glasgow city centre.

Appendix 2.

Glossary of terms

Accelerated depreciation	Where a college's board has approved a decision to close, demolish or sell a property, the asset must be written down to its net realisable value over the estimated remaining life of the asset. The resulting increase in the annual depreciation charge is known as accelerated depreciation.
Accounts direction	Annual guidance issued by the SFC to the sector on the formal disclosures required by the colleges when compiling their financial statements and associated notes.
Accounting standards	These are issued by the Accounting Standards Board (ASB) and apply to most organisations that produce financial statements, including colleges. An example is FRS 17 which gives guidance on the accounting treatments of pensions in the financial statements.
Accounting year	In the college sector this runs from 1 August to 31 July. This is also the same period as the college's academic year. This is different from the financial year used by the SFC (1 April to 31 March).
Accumulated surplus/(deficit)	Generally, this refers to the surplus/(deficit) shown in the college's income and expenditure reserve.
Annual accounts	The annual accounts of a college provide the financial position for a financial year. The format of the annual accounts is set out in the SORP and the SFC's accounts direction. The annual accounts include the financial statements, notes to the accounts and corporate governance statement.
Audit report	A final report by a college's auditor on the findings from the audit process.
Bottom line surplus/deficit	The difference between income and expenditure after the inclusion of gain/loss on the sale of fixed assets and exceptional items.
Break-even	Where the college's income equals expenditure.
Capital grants	Payments by the SFC to colleges for securing or improving assets (eg, buildings or IT equipment).
Capital receipts	Funding received from the sale of capital items including land, buildings and equipment.
Cash-releasing savings	Where a saving is realised because the organisation or function delivers the same service with less money. For example, by delivering support services differently.
Corporate governance	Arrangements put in place by the college to ensure proper use of management and resources.
Defined benefit pension scheme	A type of pension scheme where the amount of benefit employees receive is dependent upon factors such as their final salary and length of service. This means that the employer's obligation cannot be readily determined.
Defined contribution pension scheme	A type of pension scheme in which the contributions made by both the employers and employees are invested by the scheme administrators. This means that the employer's obligation is restricted to amounts of contributions payable.
Depreciation	The accounting term used to record the wearing out of a fixed asset. Depreciation is calculated as the estimate of this measure of wearing out and is a charge in the income and expenditure statement.

Efficient Government Initiative	A Scottish Government initiative to increase efficiency across the whole of the public sector in Scotland by delivering the same services with less money or delivering more services with the same money.
Financial forecasting return	This is an annual return that must be completed by every college and returned to the SFC by 30 June. It duplicates the format of the annual accounts and includes the forecast year-end position for the current year and the next three years.
Financial performance	Result of income compared with expenditure, ignoring any impact of the previous years' financial results.
Financial security	SFC defined a financially secure college as one that, on a continuing basis, is able to generate modest operating surpluses reliably and as planned and, through that, accumulate a reasonable level of financial reserve. The college must also generate sufficient cash to finance its operations and meet its liabilities.
Financial security campaign	The campaign initiated by the SFC in December 2002. Its aim was to ensure lasting improvement in the financial health of the sector. Its success would be measured by the number of colleges which still had underlying deficits by 31 July 2006.
Financial statements	The main statements in the annual accounts of a college. These include: income and expenditure statement, statement of surplus on a historic costs basis, statement of recognised gains and losses, balance sheet and cash flow statement. The format of these statements is specified in the SORP and by the SFC's accounts direction.
Financial stewardship	Financial stewardship ensures that expenditure is properly incurred and authorised. Proper accounting records are maintained and financial statements are prepared in line with standard accounting practice and relevant guidance.
General reserves	These are reserves on which there are no legal or operational restrictions as to the purpose for which they may be used.
Governance	The framework of accountability to users, stakeholders and the wider community, within which the organisations take decisions, and lead and control their functions, to achieve their objectives.
Income	For colleges this is generally of two types: grants from the SFC or funds that the college has earned from its own activities.
Income and expenditure reserve	The surplus (or deficit) produced by a college at the year end is transferred to the income and expenditure reserve. In effect this represents the accumulated position for the colleges from all of its years in existence. A positive amount indicates that the college is able to finance any operating deficit and still remain a going concern. A negative amount could be indicative of financial problems.
Income and expenditure statement	One of the primary financial statements produced by every incorporated college. It lists the main income and expenditure items.
Non-recurring funds	An allocation of funding for projects with a specific lifespan, or one-off receipts. This includes ring-fenced funding, capital receipts and capital to revenue transfers.
One-off funding	Funding which is provided for a limited period (quite often one financial year). Grants received during the financial security campaign are an example of one-off funds.

Operating deficit	Where the college's expenditure is greater than its income in a financial year.
Operating position	The difference between income and expenditure before the inclusion of gain/loss on the sale of fixed assets or exceptional items.
Operating surplus	When a college's income is greater than its expenditure.
Outturn	The final financial position, which could be the actual or forecast position.
Private Finance Initiative (PFI)	The UK government's initiative to encourage the development of private finance in the public sector. A generic term for projects involving both the public and private sectors. The involvement can be to varying degrees and the partnership can take different forms.
Qualified audit opinion	When an auditor is of the opinion that there is a problem with the annual accounts of a college, they can issue a qualified report on the accounts. The qualification may be on the truth and fairness of the accounts, the regularity of transactions or both.
Regularity opinion	Auditors provide an opinion as to whether a college's transactions throughout the year are regular, ie they are in accordance with relevant legislation and guidance issued by Scottish ministers.
Restructuring costs	Costs incurred by a college when undergoing a fundamental change in the way it conducts its business.
Revenue grant	Grants given by the SFC to colleges to pay for recurring costs such as staff pay.
Section 22 report	Reports produced by the Auditor General for Scotland to draw attention to significant issues concerning public sector bodies. Section 22 reports are only produced for bodies where the Auditor General for Scotland is responsible for securing the audit.
Statement of Recommended Practice (SORP)	This is the primary guidance document for the colleges when producing their financial statements. It incorporates the accounting standards and represents best accounting practice.
Spending review	UK Government reviews which set firm and fixed three-year budgets upon the Scottish Government. The most recent one took place in 2007. The Scottish Government (through the parliamentary budget approval process) decides upon the precise areas in which this funding will be used.
Time-releasing savings	Efficiencies which do not release cash but allow frontline services to deliver more or better services with the same money. For example, through reducing sickness absence.
True and fair opinion	Auditors provide an opinion as to whether a college's accounts have been prepared in accordance with all relevant accounting standards, legislation and guidance.
Underlying position	This is a measure used by the SFC to monitor college financial performance. It differs from operating position as it removes one-off costs such as restructuring costs. Unlike operating position, it does not appear in the financial statements.
Unqualified audit opinion	When auditors of a college are satisfied with the annual accounts they will issue an unqualified audit opinion.

Appendix 3.

Financial performance of colleges 2006/07

College	Operating surplus/ (deficit) before exceptional items and tax	Operating surplus/ (deficit) after exceptional items and tax	I&E reserve	Pension reserve	Total reserves[34]
	£m	£m	£m	£m	£m
Aberdeen College	3.122	3.051	9.498	n/a	36.956
Adam Smith	0.808	0.808	4.924	-1.298	17.434
Angus College	0.123	0.123	3.077	n/a	7.864
Anniesland College	0.075	-0.284	1.579	n/a	22.211
Ayr College	0.656	0.656	2.362	n/a	7.857
Banff and Buchan College	0.002	0.002	0.573	n/a	6.561
Barony College	0.049	0.045	1.196	-0.008	2.874
Borders College	0.252	0.252	0.643	-2.368	-0.148
Cardonald College	0.939	0.939	2.680	0.533	6.822
Carnegie College (formerly Lauder)	0.657	0.657	1.462	-0.498	4.605
Central College of Commerce	0.075	0.075	1.063	n/a	9.783
Clydebank College	0.339	0.339	-1.874	n/a	-1.874
Coatbridge College	0.941	0.941	0.316	n/a	5.736
Cumbernauld College	0.054	0.054	1.736	n/a	2.476
Dumfries and Galloway	0.218	0.218	5.506	-0.370	7.353
Dundee College	1.282	-4.996	7.611	n/a	18.982
Edinburgh's Telford College	-0.067	-0.032	32.705	-0.603	32.811
Elmwood College	-0.221	0.176	3.036	-0.148	13.210
Forth Valley	0.674	0.674	-0.292	-2.292	5.658
Glasgow College of Nautical Studies	0.811	0.811	4.744	n/a	13.108
Glasgow Metropolitan College	0.829	0.829	7.174	n/a	20.268

College	Operating surplus/ (deficit) before exceptional items and tax	Operating surplus/ (deficit) after exceptional items and tax	I&E reserve	Pension reserve	Total reserves[34]
	£m	£m	£m	£m	£m
Inverness College	0.430	1.491	-2.888	-0.290	21.323
James Watt College	-0.919	-0.919	-5.690	n/a	9.909
Jewel & Esk College	0.256	0.063	1.428	-0.687	6.668
John Wheatley College	0.035	0.035	0.789	n/a	3.377
Kilmarnock College	0.322	0.322	0.267	n/a	16.090
Langside College	0.868	0.868	1.573	n/a	8.597
Lews Castle College	0.107	0.107	-0.909	0.133	-0.751
Moray College	0.304	0.304	-0.786	n/a	5.561
Motherwell College	2.090	2.090	6.516	n/a	13.599
North Glasgow College	-0.741	-0.741	2.605	n/a	6.382
Oatridge Agricultural College	0.133	0.145	2.656	-0.075	7.456
Perth College	0.364	0.344	2.123	n/a	12.231
Reid Kerr College	0.343	0.343	-0.125	0.206	11.771
South Lanarkshire College	0.91	0.91	1.043	0.337	8.266
Stevenson College	0.779	0.779	7.670	0.038	21.084
Stow College	0.064	0.064	1.464	n/a	5.410
The North Highland College	0.442	0.442	1.474	-0.359	3.893
West Lothian College	0.340	-5.200	-10.005	-0.687	-10.662
Totals	**16.926**	**5.966**	**98.924**	**-8.436**	**386.876**

34 Colleges have a number of reserves which make up total reserves – the two main reserves are I&E and pensions.

Appendix 4.

SFC cost benchmarking indicators

Diagnostic Model Indicators (DMIs)		
High level	DMI001	Surplus (deficit) per EWSUM
	DMI002	Income per EWSUM
	DMI003	Gross cost per EWSUM
	DMI004	Surplus (deficit) on commercial non-teaching activities per EWSUM
	DMI005	Teaching costs per EWSUM
	DMI006	Non-teaching costs per EWSUM
Income	DMI007	Funding Council grants per EWSUM
	DMI008	Education contracts per EWSUM
	DMI009	Academic fees per EWSUM
	DMI010	Other income per EWSUM
Direct teaching	DMI011	Teaching staff costs per EWSUM
	DMI012	Teaching non-staff costs per EWSUM
	DMI013	Staff cost per teaching FTE
	DMI014	EWSUMs per teaching FTE
	DMI015	EWSUMs per contact hour
	DMI016	Average contact hours per teaching FTE
	DMI017	Average contact hours per permanent FTE
	DMI018	Proportion of permanent teaching FTEs
	DMI019	Average contact hours per non-permanent FTE
	DMI020	Contracted contact hours per teaching FTE
	DMI021	Utilisation (contact hours/contract hours)
Indirect teaching and other	DMI022	Admin & academic services cost per EWSUM
	DMI023	Premises cost per EWSUM (after income)
	DMI024	Residences and catering surplus (deficit) per EWSUM
	DMI025	Other costs per EWSUM
	DMI026	A&A block 1 costs per EWSUM
	DMI027	A&A block 2 costs per EWSUM
	DMI028	A&A block 3 costs per EWSUM

Admin and academic block 1	DMI029	College management cost per EWSUM
	DMI030	Libraries & Learning Resource Centres per EWSUM
	DMI031	Academic support cost per EWSUM
	DMI032	College management staff cost per EWSUM
	DMI033	College management non-staff cost per EWSUM
	DMI034	Libraries & Learning Resource Centres staff cost per EWSUM
	DMI035	Libraries & Learning Resource Centres non-staff cost per EWSUM
	DMI036	Academic support staff cost per EWSUM
	DMI037	Academic support non-staff cost per EWSUM
	DMI038	EWSUMs per college management FTE
	DMI039	Cost per college management FTE
	DMI040	EWSUMs per Libraries & Learning Resource Centres FTE
	DMI041	Cost per Libraries & Learning Resource Centres FTE
	DMI042	EWSUMs per academic support FTE
	DMI043	Cost per academic support FTE

Admin and academic block 2	DMI044	Finance cost per EWSUM
	DMI045	HR cost per EWSUM
	DMI046	Marketing cost per EWSUM
	DMI047	MIS cost per EWSUM
	DMI048	ICT cost per EWSUM
	DMI049	Finance staff cost per EWSUM
	DMI050	Finance non-staff cost per EWSUM
	DMI051	HR staff cost per EWSUM
	DMI052	HR non-staff cost per EWSUM
	DMI053	Marketing staff cost per EWSUM
	DMI054	Marketing non-staff cost per EWSUM
	DMI055	MIS staff cost per EWSUM
	DMI056	MIS non-staff cost per EWSUM
	DMI057	ICT staff cost per EWSUM
	DMI058	ICT non-staff cost per EWSUM
	DMI059	EWSUMs per finance FTE
	DMI060	Cost per finance FTE
	DMI061	EWSUMs per HR FTE
	DMI062	Cost per HR FTE
	DMI063	EWSUMs per marketing FTE
	DMI064	Cost per marketing FTE
	DMI065	EWSUMs per MIS FTE
	DMI066	Cost per MIS FTE
	DMI067	EWSUMs per ICT FTE
	DMI068	Cost per ICT FTE

Admin and academic block 3	DMI069	Admin support cost per EWSUM
	DMI070	Student support cost per EWSUM
	DMI071	Other admin & academic cost per EWSUM
	DMI072	Admin support staff cost per EWSUM
	DMI073	Admin support non-staff cost per EWSUM
	DMI074	Student support staff cost per EWSUM
	DMI075	Student support non-staff cost per EWSUM
	DMI076	Other admin & academic staff cost per EWSUM
	DMI077	Other admin & academic non-staff cost per EWSUM
	DMI078	EWSUMs per admin support FTE
	DMI079	Cost per admin support FTE
	DMI080	EWSUMs per student support FTE
	DMI081	Cost per student support FTE
	DMI082	EWSUMs per other admin & academic FTE
	DMI083	Cost per other admin & academic FTE
Premises	DMI084	Premises cost per m^2 NIA
	DMI085	EWSUMs per m^2 NIA
	DMI086	Cleaning/security/janitorial cost per m^2 NIA
	DMI087	Ground maintenance cost per m^2 NIA
	DMI088	Building maintenance cost per m^2 NIA
	DMI089	Estate management cost per m^2 NIA
	DMI090	Other premises cost per m^2 NIA
	DMI091	Premises income per m^2 NIA
	DMI092	Leasehold rent paid per m^2 NIA
	DMI093	Rates per m^2 NIA
	DMI094	Total insurance premium per m^2 NIA
	DMI095	Energy costs per m^2 NIA
	DMI096	Water and sewerage per m^2 NIA
	DMI097	Other premises related costs per m^2 NIA
Residences and catering	DMI098	Residences surplus (deficit) per EWSUM
	DMI099	Catering surplus (deficit) per EWSUM
	DMI100	Residences surplus (deficit) per bedspace
	DMI101	Bedspaces per 1,000 EWSUMs
	DMI102	Catering gross cost per EWSUM
	DMI103	Catering gross income per EWSUM
	DMI104	Residences gross cost per bedspace
	DMI105	Residences gross income per bedspace

Supplementary Indicators (SIs)	
SI001	Total income/total expenditure
SI002	Teaching costs as a percentage of total gross costs
SI003	Teaching staff (inc non-payroll) as a percentage of total staff
SI004	Avg days sickness and absence per employed teaching FTE
SI005	Avg days sickness and absence per non-teaching FTE
SI006	Avg days training and development per teaching FTE
SI007	Avg days training and development per non-teaching FTE
SI008	Promoted FTEs as a percentage of total teaching FTEs
SI009	Average contracted contact hours per promoted FTE
SI010	Average contracted contact hours per non-promoted FTE
SI011	Utilisation of promoted staff
SI012	Utilisation of non-promoted staff
SI013	Teaching staff costs as a percentage of total teaching costs
SI014	Part-time as a percentage of total teaching FTEs
SI015	College management cost as a percentage of total expenditure
SI016	Finance cost as a percentage of total expenditure
SI017	HR cost per employee (teaching and non-teaching)
SI018	Marketing cost as a percentage of total expenditure
SI019	ICT cost per student (headcount)
SI020	Student support cost per student (headcount)
SI021	Teaching space as a percentage of total NIA
SI022	Learning resource space as a percentage of total NIA
SI023	Residences cost recovery
SI024	Catering cost recovery
SI025	Catering net cost per student (headcount)

Source: SFC

Appendix 5.

Study advisory group members

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