THE
FURTHER
EDUCATION
FUNDING
COUNCIL

For information

Circular 00/10

Information

College Accounts

Summary

This circular provides summary information on the financial performance of sector colleges for the financial year ended 31 July 1998. Comparative information is also provided on key financial indicators for the sector for each financial year-end since incorporation. This circular is of interest to college principals and chairs of college corporations.

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Further information

Enquiries:
College accounts support desk
Tel 024 7686 3065

or write to:

The Further Education
Funding Council
Cheylesmore House
Quinton Road
Coventry CV1 2WT.

Website www.fefc.ac.uk

College Accounts

Introduction

1 This circular contains summary information extracted from college accounts for the year ended 31 July 1998. Similar information for the financial periods ended 31 July 1994 to 31 July 1997 was included in Circulars 95/30, 96/29, 97/35 and 98/43.

Financial Health of the Sector

2 An analysis of the data published in respect of previous years' financial statements has indicated that the financial health of colleges in the sector has deteriorated each year since incorporation. This year, for the first time, the audited financial statements indicate an improvement in the overall financial health of the sector compared to the previous year. The sector has generated an operating surplus of £38 million (1% of turnover) whereas in previous years the sector has generated operating deficits.

3 The improvement in the financial health of the sector has resulted in a reduction in the number of colleges assessed as financially weak and which are, or may become, dependent on the goodwill of others. However, there is a considerable number of colleges that are still considered financially weak, and which give cause for concern. The number of colleges in this position has reduced from 96 at 31 July 1997 to 80 at 31 July 1998. The improvement in the financial health of the sector has continued and, at the date of publication of this circular, the number of colleges assessed as financially weak has fallen to less than 60.

4 The improvement in the financial health of colleges in the sector is also evidenced by an improvement in solvency, reductions in the number of colleges with operating deficits and an increase in the level of general reserves held.

5 A number of reasons can be identified for the overall improvement in the financial health of colleges in the sector which include the additional resources made available, the rationalisation of the sector resulting in improved efficiencies, and the action taken by colleges in weak financial positions to develop and implement recovery plans.

Financial Details

6 A summary of the information extracted from college accounts is attached at the annex to this circular. The data have been aggregated to give an overall indication of the sector's financial position and, where appropriate, compared with the performance of the sector in previous years.

7 Summary information for college accounts is available on the Council's website, www.fefc.ac.uk. The information can be used to assist colleges in making benchmarking comparisons.

David Melville

College Accounts 1997-98

Background

1 Under the terms of the financial memorandum between colleges and the Council, colleges are required to produce audited accounts within five months of the financial year end, that is, by 31 December 1998 for the 1997-98 financial year. By the due date the Council had received 66% of audited returns. In the 1996-97 financial year only 43% of colleges produced audited accounts by the due date (30 November 1997), that is within four months of the financial year end.

2 The Council has now received audited accounts from 428 colleges from the 435 returns expected, equivalent to a 98% return rate. Seven colleges are currently in breach of the financial memorandum with the Council. The Council will consider, on an individual basis, whether to confirm provisional allocations for such institutions and may choose to limit funding to them.

3 Colleges are required to provide a copy of their audited accounts in electronic format to enable the Council to consolidate financial data for the sector. The summary information in this circular has been based on the electronic returns made by 417 colleges. The summary information for college accounts made available on the Council's website, www.fefc.ac.uk, will be updated as outstanding returns are received.

4 Colleges are required to make their audited accounts available to members of the public. This circular and the associated financial information on the Council's website are part of the effort to encourage openness and accountability.

Summary

5 Whilst the financial health of the sector continues to show weakness in some areas, the overall position shows an improvement (albeit small) on the previous year. This is the first time since incorporation that there has been an improvement, year on year.

6 The improvement in the financial health of the sector can be seen from the overall improvement in solvency ratios, generation of an overall operating surplus for the first time, increase in the level of general reserves and less reliance on the Council to assist with cashflow support. However, there remains a significant number of financially weak colleges as evidenced by 18% of colleges having net current liabilities, 43% of colleges that incurred operating deficits and 11% of colleges that have accumulated deficits.

7 Colleges are asked to carry out a self-assessment of their financial health and to state in which of three financial health groups they believe they fall. The Council's regional finance directors carry out an independent assessment of each college's financial health to verify the college's self-assessment. The key characteristics of the three groups are set out in appendix 1 to this annex. The number of colleges assessed as falling into financial health group C, that is a college that is considered financially weak, has fallen. However, on the basis of 1997-98 audited accounts, 18% of colleges are in financial health group C. An analysis of the financial health assessment of colleges is shown in table 1.

Table 1. Sector of financial health groups

	Year Ended 31 July				
	1994	***1995***	***1996***	***1997***	***1998***
Group A (reasonably robust)	309 (70%)	257 (57%)	206 (46%)	197 (44%)	213 (49%)
Group B (financially vulnerable)	106 (24%)	135 (30%)	148 (33%)	151 (34%)	142 (33%)
Group C (financially weak)	25 (6%)	60 (13%)	93 (21%)	96 (22%)	80 (18%)

8 Key accounting ratios for the sector have been calculated from the aggregated data provided by colleges. These accounting ratios may be used by colleges to compare their performance against the sector and against similar colleges. Comparative data for previous years have been updated to reflect returns made by colleges since Circular 98/43 was published. Details of the basis used for calculating key ratios are set out in appendix 2 to this annex.

9 A small number of colleges are unable to demonstrate long-term viability and the Council has developed procedures to ensure that adequate and sufficient further education provision continues to be secured in those areas where these colleges are located. (Circular 98/12, *The Council's Approach to Identifying Colleges Requiring Additional Support*).

Income

10 The total income for the sector for the year ended 31 July 1998 was £3.8 billion. This represents a small reduction of some £70 million on the 1996-97 financial year.

Grant income

11 Colleges generate the majority of their income from public funds, including those from the Council. The Council remains the major source of income for the sector, providing approximately 70% of total income. Other public sources of income include training and enterprise councils, European funding and local education authorities.

Diversification of income

12 Colleges are encouraged to increase their income from other sources so that they become less reliant on the Council, the major source for the vast majority of colleges.

13 The diversity of income is measured by the income derived from sources other than the Council. The trend since incorporation is shown in table 2.

Table 2. Diversity of income

	1994 *%*	***1995*** *%*	***1996*** *%*	***1997*** *%*	***1998*** *%*
Percentage of income from non-Council sources	32.6	30.1	26.7	26.4	28.4

Source: College finance records for each financial period

14 Table 2 shows that the percentage of non-Council income received by colleges in 1998 increased after successive declines since incorporation. The major reason for the decrease in diversity in the early years following incorporation was as a result of the switch of work-related further education funding from training and enterprise councils to the Council. The increase in diversity in 1997-98 is as a result of increases in income generated from tuition fees and other income-generating activities.

15 The diversity of income varies according to the type of institution. Further details on sector diversity are set out in paragraphs 32 to 47 of this annex.

Expenditure

16 Colleges should aim at least to break even at the operating level so that resources can be generated for reinvestment within the college. A college may sustain an operating deficit for one or two years but a prolonged period of operating deficits may lead to a decline in its financial health. Colleges therefore need to control expenditure closely so that, as a minimum, it is balanced by income.

Pay

17 For the sector as a whole, the majority of colleges' income is expended on staff resources. Details on the trend of pay costs as a percentage of income since incorporation are shown in table 3.

18 Table 3 shows that the percentage expenditure on pay fell in 1997-98. This reduction appears to be the result of staff restructuring undertaken by colleges, the use of external providers for lecturing services and as a result of increases in income without comparable increases in expenditure.

Non-pay

19 The adoption by colleges of public-private partnerships for aspects of facilities management and purchasing lecturing services from agencies will have the effect of transferring expenditure from the pay to the non-pay classification. Expenditure identified as pay expenditure in one year may be classed as non-pay expenditure in another year if a college uses a contractor to provide the service.

Table 3. Pay expenditure as a percentage of income

	1994 %	*1995* %	*1996* %	*1997* %	*1998* %
Including restructuring costs	68	71	71	67	64
Excluding restructuring costs	66	69	68	65	63

Source: College finance records for each financial period

Operating position

20 As indicated in paragraph 16 to this annex, colleges are expected to break even on an operating basis from year to year. Details of the operating position for the sector are shown in table 4.

Table 4. Comparison of the operating position for the sector

	Year Ended 31 July				
	1994	***1995***	***1996***	***1997***	***1998***
Total operating surplus/(deficit) £m	(6)	(122)	(123)	(29)	38
Surplus/(deficit) as a percentage of income	(0.2)	(3.5)	(3.4)	(0.8)	1.1
Number of colleges with an operating deficit	204	266	266	207	179

Source: College finance records for each financial period

21 Table 4 shows that the sector generated an operating surplus for the first time since incorporation and the number of colleges that have generated an operating deficit has also fallen to its lowest level since incorporation. However, 43% of colleges have generated an operating deficit in 1997-98 and this is of continuing concern.

Reserves

22 Whilst the value of general reserves shown in a college's balance sheet is indicative of a college's financial performance over time, it is less meaningful as a measure of a college's financial health. The major factor to consider in assessing a college's financial strength is its solvency, that is, its ability to meet its liabilities as they fall due. A number of colleges have relatively strong reserves but poor levels of solvency, the principal cause of which is the purchase of fixed assets from working capital.

23 Colleges are encouraged to consider a mix of financing in capital developments to ensure that a sufficient level of working capital is maintained to support ongoing operations and future investments. Over a period of time a college would be expected to generate reserves to fund future investment within the college.

24 The trend for the balance on accumulated general reserves for the sector is set out in table 5.

Table 5. Accumulated general reserves for the sector

	1994	*1995*	*1996*	*1997*	*1998*
Accumulated balances	£250m	£276m	£309m	£402m	£556m
Accumulated balance as a percentage of income	7.6	7.9	8.6	10.8	15.3
Number of colleges with negative reserves	55	73	81	67	44

Source: College finance records for each financial period

25 Table 5 shows that the accumulated surpluses within the sector have increased and the number of colleges with an accumulated deficit has fallen to its lowest level since incorporation.

Solvency

26 Two main ratios are used by the Council to indicate a measure of the solvency of the sector and individual colleges. These are the current ratio and the number of cash days in hand. The definition of these ratios is set out in appendix 2 to this annex.

27 The Council has advised colleges that they should aim for a current ratio in the range of 1.5:1 to 2.5:1. A ratio of 1.5:1 will provide a margin of security to a college in meeting its liabilities as they fall due. A ratio higher than 2.5:1 may indicate that funds are being set aside unnecessarily rather than being used to further the mission of the college and to enhance the students' learning experience. Colleges may be able to operate safely on current ratios below 1.5:1 in some circumstances.

28 The trend for the sector for the current ratio is set out in table 6.

Table 6. Comparison of the current ratio for the sector

	Year Ended 31 July				
	1994	*1995*	*1996*	*1997*	*1998*
Current ratio for the sector	1.8	1.7	1.5	1.7	1.8
Number of colleges with ratio below 1:1	53	69	89	86	75

Source: College finance records for each financial period

29 The current ratio for the sector indicates that the sector's overall solvency remains at the lower end of the Council's recommended range. However, the table shows that the solvency of the sector has shown an improvement over the previous year for the first time.

30 The number of cash days in hand is a measure of the cash that a college has available to meet its liabilities. A college in financial health group A would normally have at least 25 cash days in hand. The funding profile for colleges is such that July (the month at which the ratio is struck) is likely to be the month with the lowest cash balance for most colleges. The trend for the sector for this ratio, since incorporation, is set out in table 7.

Table 7. Comparison of cash days in hand for the sector

	Year Ended 31 July				
	1994	*1995*	*1996*	*1997*	*1998*
Cash days in hand for the sector	38	46	42	46	56
Number of colleges with less than 25 cash days in hand	98	121	149	129	105

Source: College finance records for each financial period

31 Whilst this ratio shows some improvement in the solvency of the sector, the number of colleges with fewer than 25 cash days in hand still represents approximately one quarter of the sector.

Comparison of sector types

32 Tables 1 to 7 indicate the financial performance for the sector as a whole. However, an analysis of the data for the various college types within the sector shows that the financial performance across the sector is not consistent. Accounting ratios for the four main college types are shown in table 8.

Table 8. College ratios by type for year ended 31 July 1998

	Agriculture & horticulture colleges	***Art, design & performing arts colleges***	***General FE and tertiary colleges***	***Sixth form colleges***
Current ratio	1.7	1.8	1.7	3.0
Cash days in hand	40	70	54	80
Operating surplus/ (deficit) income %	(2)	0	1	1
General reserve/ income %	25	18	14	25
Pay expenditure/ income %	54	63	63	70
Income from non-Council sources %	53	45	29	10

Source: College finance records for each financial period

33 The table shows that the solvency of sixth form colleges, which are more dependent on the Council for income than the rest of the sector, is the highest whilst agriculture and horticulture colleges have the weakest solvency. One major factor for the lower cash days in hand of agriculture and horticulture colleges is that these colleges maintain considerably higher levels of stock than other types of colleges.

34 Pay expenditure is proportionately lower in agriculture and horticulture colleges as they incur expenditure and generate significant levels of income from the operation of farming activities.

35 Details of the trend in accounting ratios for the individual college types, since incorporation, are set out in the following paragraphs.

Agriculture and horticulture colleges

36 Table 9 shows the accounting ratios for agriculture and horticulture colleges since incorporation.

Table 9. College ratios for agriculture and horticulture colleges for year ended 31 July

	1994	*1995*	*1996*	*1997*	*1998*
Current ratio	2.4	2.0	1.9	1.9	1.7
Cash days in hand	N/A	43	34	41	40
Operating surplus/ (deficit) income %	1	(2)	(2)	(2)	(2)
General reserve/income %	17	20	21	22	25
Pay expenditure/income %	51	54	55	55	54
Income from non-Council sources %	45	53	52	53	53

Source: College finance records for each financial period

37 Table 9 shows that the financial health, as measured by the solvency ratios, of agriculture and horticulture colleges has weakened since incorporation and that the colleges have become less reliant on the Council for income.

38 One factor that has influenced the financial health of agriculture and horticulture colleges is that they were generally funded at higher than average levels of funding (ALF) compared to the sector as a whole and, therefore, faced reductions in ALF as a result of convergence.

Art, design and performing arts colleges

39 Table 10 shows the accounting ratios for art, design and performing arts colleges since incorporation.

40 The table shows that the financial health of the colleges improved in 1997-98. The diversity of income has remained relatively constant over the period under review.

41 Art, design and performing arts colleges have faced similar pressures in the reduction in ALF, although not to the same extent as agriculture and horticulture colleges.

General further education and tertiary colleges

42 Table 11 shows the accounting ratios for general further education and tertiary colleges since incorporation.

43 Table 11 shows that the solvency ratios of the colleges has improved in 1997-98 and that for the first time colleges have generated an operating surplus. However, the colleges are now more reliant on the Council for income than at incorporation.

44 The improvement in the financial health of general further education and tertiary colleges since 1995-96 reflects the trend for the sector. Factors for this improvement include the impact of developing and implementing recovery plans by those colleges in a weak financial position and the merger of a number of institutions with financially healthier colleges.

Table 10. College ratios for art, design and performing arts colleges for year ended 31 July

	1994	*1995*	*1996*	*1997*	*1998*
Current ratio	2.0	2.1	2.7	1.7	1.8
Cash days in hand	N/A	71	79	54	70
Operating surplus/ (deficit) income %	1	1	(2)	(4)	0
General reserve/income %	11	16	11	13	18
Pay expenditure/income %	63	64	69	68	63
Income from non-Council sources	44	47	45	42	45

Source: College finance records for each financial period

Table 11. College ratios for general further education and tertiary colleges for year ended 31 July

	1994	*1995*	*1996*	*1997*	*1998*
Current ratio	1.7	1.6	1.4	1.6	1.7
Cash days in hand	N/A	44	39	44	54
Operating surplus/ (deficit) income %	(1)	(4)	(4)	(1)	1
General reserve/income %	6	7	7	9	14
Pay expenditure/income %	68	72	71	67	63
Income from non-Council sources %	34	31	27	27	29

Source: College finance records for each financial period

Sixth form colleges

45 Table 12 shows the accounting ratios for sixth form colleges since incorporation.

Table 12. College ratios for sixth form colleges for year ended 31 July

	1994	*1995*	*1996*	*1997*	*1998*
Current ratio	2.4	2.3	2.5	2.8	3.0
Cash days in hand	N/A	67	64	68	80
Operating surplus/ (deficit) income %	2	0	0	0	1
General reserve/income %	12	15	17	21	25
Pay expenditure/income %	69	74	74	72	70
Income from non-Council sources %	6	7	8	8	10

Source: College finance records for each financial period

46 Table 12 shows that the financial health of sixth form colleges has improved each year and that the reliance on Council income has fallen each year since incorporation.

47 A factor in the improvement in the financial health of sixth form colleges has been as a result of the levels of funded growth which has been consolidated into funding allocations in 1997-98.

Principals' emoluments

48 Council guidance on the form of accounts requires colleges to publish details of the emoluments of senior postholders, banded by value. The emoluments of the principal are required to be shown as a separate item in the accounts. The publication of this information is required, in line with best practice, to ensure transparency of information. Details of pay awards for senior postholders are included in a note to each college's published accounts.

49 Table 13 shows information on principals' emoluments. Principals' emoluments include salaries, bonuses, employers' pension contributions and benefits in kind.

Table 13. Principals' emoluments for year ended 31 July 1998

	Agriculture & horticulture colleges	*Art, design and performing arts colleges*	*General FE colleges: turnover*			*Sixth form colleges*
			Up to £10 million	*£10 million to £20 million*	*Over £20 million*	
	£000	*£000*	*£000*	*£000*	*£000*	*£000*
10th percentile	42	45	52	63	74	47
Median	55	58	61	74	82	55
90th percentile	68	67	72	91	102	64

Source: College finance records for each financial period

Definitions of Financial Health Groups

Group A

1 Colleges that appear to have sufficiently robust finances to implement their strategic plan and to deal with the circumstances which are most likely to occur during the planning period.

2 These colleges will normally have:

- a positive cashflow from operations each year
- more than 25 days cash in hand
- a positive balance on their general reserve (income and expenditure account).

3 These colleges will have carried out a rigorous sensitivity analysis and modelled the issues which are most critical to their success. They will also have identified contingency plans to deal with the most likely adverse variance.

Group B

4 Colleges that show signs of financial weakness which might limit their ability to implement their strategic plan if they encounter adverse circumstances during the planning period.

5 Colleges in this group are likely to have weaker solvency than those in group A but should still have:

- more than 15 cash days in hand
- a positive balance on their general reserve (income and expenditure account).

6 In addition, this group also covers those colleges which may appear to have features similar to those for group A but whose assumptions appear either unrealistically ambitious or optimistic.

Group C

7 Colleges that are financially weak and which are, or may become, dependent on the goodwill of others. This might involve, for example, a loan from their bank for revenue purposes. Colleges in this position are likely to have an accumulated deficit on their general reserve account and/or negative net working capital.

Calculation of Ratios

1 There are a number of ratios that are particularly useful in determining a college's financial health.

Cash days in hand

2 The key concern of a college should be solvency rather than profitability. The level of cash days in hand gives a measure of solvency of the college. This is calculated as:

$$\frac{\text{cash and cash equivalents}}{\text{annual income}} \times 365$$

Annual income = (Total income less deferred capital grants, Section 6(5) income and restructuring grants).

Cash and cash equivalents = short-term investments plus cash less overdrafts less loans repayable within one year.

Current ratio

3 This compares the amount of cash and other current assets with the level of current liabilities, such as creditors.

Surplus and reserves

4 The Council generally considers the surplus or deficit as percentage of income rather than in absolute terms at two levels: operating and historic cost. The operating surplus is after charging depreciation on inherited assets. The historic cost surplus is after a transfer from the revaluation reserve of an amount equivalent to the depreciation charge on inherited assets. Colleges should now be aiming to at least break even at the operating surplus level as this would show that the college is able to cover all the costs of providing education with its income.

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Further copies can be obtained by contacting the communications team at:

The Further Education
Funding Council
Cheylesmore House
Quinton Road
Coventry CV1 2WT.

Tel 024 7686 3265
Fax 024 7686 3025
E-mail fefcpubs@fefc.ac.uk

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