## Reclassification of Incorporated Colleges

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Summary: This communication comprises a briefing note on the management of working capital and a series of further questions and answers addressing topics that have come to the Funding Council from colleges.

FAO: Principals, Chairs and Finance Directors of Scotland's colleges; College regional leads

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## Reclassification of incorporated colleges:

### Purpose

1. To provide a briefing note on the management of working capital and a series of further questions and answers addressing topics that have come to the Funding Council from colleges.

### Management of working capital

2. The ONS reclassification of colleges will require the reporting and management of the full income and expenditure of colleges (on an accruals basis) against Scottish Government budget control limits, in accordance with consolidated budgeting guidance. This is in contrast to the current position where all that scores against HM Treasury budget controls are the grants made to the sector through the Funding Council.

3. In assessing the net expenditure/impact (or the outturn position) against Scottish Government budgets, movements in working capital (defined as net current assets) will have the potential to affect the net expenditure (outturn) position. At a simplistic level, if a college spends all the grant received in one year and any additional cash held in reserves, then the total that would score against Scottish Government budget for that year would be the sum of all the grant received in one year and the cash reserves expended. As no additional budget cover is likely to be available as a result of the reclassification, such action would potentially breach the overall budget limit for the sector as the cumulative impact of the grant and reserve spend would score against Scottish Government budgets.

4. Colleges will be expected to have to maintain broadly the same level of working capital year on year. In setting the level of working capital at 1 April 2014, a college may therefore want to adopt a position where it holds a minimum level of working capital necessary to meet its' needs over the year. If a college holds a higher level of working capital at year end, this is in effect tied unless additional budget cover is available to support the expenditure. Should a colleges working capital reduce significantly this is indicative of an overspend.

5. In considering the working capital position, it is important to note that the budgeting and accounting treatment in some areas differ. It is the budgeting treatment that impacts on the Scottish Government budget. While working capital movements from a budgeting perspective are broadly equivalent to the movement in net current assets, they are not

the same. In practice, a large part of a college's net current asset position is attributable to the cash or near cash that it holds. In order to monitor this position, the Scottish Government will be looking at colleges' net current assets on a Financial Reporting Manual (FReM) compliant basis.

6. To assist colleges in establishing and managing working capital under public sector budgeting rules, this paper discusses some of the items that colleges have asked about and those that have added complexity due to straddling financial years.

***Income received in advance***

7. Colleges receive funds in advance for overseas fees, commercial contracts, SAAS and other fees and grant income from other sources. The accounting treatment for these is detailed below:

   Initial recognition:

   ***Dr Cash***
   ***Cr Deferred/accrued income creditor***

   When criteria for release are met:

   ***Dr Deferred/accrued income creditor***
   ***Cr Income***

8. Income and expenditure on an accruals basis scores against Scottish Government budget limits. In this case, the accounting treatment supports that. At initial recognition, the working capital impact is neutral. At release, the creditor relating to the income reduces, this would reduce creditors and, all other things being equal, increases the college's available working capital while the associated expenditure would reduce working capital.

9. In most cases, income will match expenditure and there will be no budgetary impact as a result but where expenditure recognised exceeds income, or income exceeds expenditure, there are budgetary implications e.g. the requirement for resource cover in respect of the surplus or deficit generated (unless the surplus is transferred to a trust).

***Asset held for sale***

10. If a college held an asset within its fixed assets that was intended for disposal within a year of the balance sheet date, under FRS 15, this asset would need to be recognised as an asset held for sale within current assets.

    ***Dr Asset held for sale***
    ***Cr Tangible fixed assets***

11. While this will impact on working capital on an accounting basis, increasing net current assets by the amount of the asset held for sale, there is no budgetary impact. The impact on budget only crystallises when the sale is actually made.

12. The cash to settle the disposal would arrive in the following financial year, this is how the capital receipt would be recorded:

    ***Dr Cash***
    ***Cr Asset held for sale***

13. It is this transaction that causes the budgetary impact and needs to flow through the budget monitoring and management process.

***Restructuring provision (and provisions more generally)***

14. This is an area where the budgeting and accounting treatment is complex and is clearly of relevance given the fact that some colleges are currently undertaking restructuring through voluntary severance. Accounting practice requires that the full cost of severance is recognised as a provision in respect of an individual when a formal agreement has been reached for their departure. In some cases a general provision for restructuring is also recognised on the balance sheet. The entries would be as described below:

    ***Dr Exceptional Staff costs (Income and expenditure/outturn statement)***
    ***Cr Restructuring provision (balance sheet)***

15. The settlement of the provision gives rise to the following entries:

    ***Dr Restructuring Provision (balance sheet)***
    ***Cr Cash (balance sheet)***

16. If the budgeting treatment is followed, the full costs would impact on Scottish Government departmental expenditure limits (DEL) and would have a resource DEL budgetary impact when the provision is created.

However, the consolidated budgeting guidance is clear that the DEL budget impact is scored when ***the cash payment to settle the liability is made***. Budget management and monitoring systems therefore need to reflect the ***cash payment***. The initial creation of the provision does require to be recorded but the initial budgetary impact scores against an Annual Managed Expenditure (AME) budget. There will be an exercise in year to pick up any planned provisions on an annual basis.

17. The reversal of the provision has no impact on working capital (provisions are classified as current liabilities in so far as they require settlement within 12 months) but does impact on the budget as it reflects the use of cash to pay the actual severance awards. The transfer of cash (e.g. payment) to settle the liability in relation to the provision scores against ***resource DEL***. The initial recognition of the provision and the release **(*non-cash*)** score against ***resource AME***. Budget management and monitoring post ONS reclassification will need to be set up to accurately record the budget impact.

18. There is a further issue to consider in respect of provisions that are accrued before 31 March 2014. There is the potential that these could score twice against the budget. For example, if the Funding Council was to provide grant to support early severance/restructuring costs in 2013-14, these grants would impact Scottish Government budgets and colleges would incur the full costs of creating the provision. Any scoring of the cash payment from the college in subsequent years would be double counting and unfair (as the budget impact has already been recognised). In order to prevent that double counting, any release of provisions created prior to the reclassification date would be excluded from scoring against budgets - the release will not therefore require either AME or DEL resource cover. This is consistent with the treatment agreed as part of the Police reform programme. We will communicate with the sector more fully on this issue when the impact for Colleges is clearer.

19. It is proposed that, given the complexity of this area, training should be provided on the budgeting and accounting treatment of provisions.

**Questions and answers**

20. This section of the communication provides a series of further questions and answers addressing topics that have come to the Funding Council from colleges. These questions and answers will be added to those already on the Funding Council's website with further updates on a periodic basis.

| Issue | Response |
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| Should future forecasts be prepared on a cash or accruals basis? | Colleges should continue to prepare forecasts on an accruals basis. |
| How should deferred capital grants be treated? | Colleges should continue to treat deferred capital grants per the current FE/HE SORP. |
| Should capital grants be treated per draft FE/HE SORP? | Colleges should continue to treat capital grants per current FE/HE SORP. |
| Should a holiday pay accrual be included in the forecasts per draft FE/HE SORP? | No, though it is recognised that the impact of holiday pay accrual is likely to be significant, there are ongoing discussions between the Funding Council and Scottish Government Finance in this area. |
| Should cash reserves or net current assets be transferred to arms-length charitable foundations? | Only cash reserves can be moved to arms-length charitable foundations. In making this transfer, colleges should ensure that they have sufficient working capital available to meet their liabilities and have regard to their solvency. It is important that cash balances are minimised as far as possible and a positive working capital balance maintained. |
| How will under/overspends will be calculated? | A college overspends when it exceeds its resource budget (limit) for the year. An overspend would be classified as an excess of expenditure over income. A college with a deficit on all activities will have exceeded its resource limit and overspent. It is the responsibility of the college to monitor carefully its year-end position to ensure that either a breakeven or surplus position is |

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| | achieved. An underspend equates to an excess of income over expenditure on all of colleges activity. This surplus can be transferred to the arms-length foundation prior to the 31 March year-end. |
| What is the accounting treatment for surpluses generated and subsequently transferred into and out of arms-length charitable foundations? | It is anticipated that such transfers will require adjustments to colleges' income and expenditure which in turn should be factored into colleges' cash flow projections. |
| What is the accounting treatment for cash reserves transferred into arms-length charitable foundations before 31 March 2014? | The gift aid to the trust will appear below the operating surplus line in the income and expenditure account as it is a distribution of profit. The transfer needs to be carried out prior to the 31 March 2014 year-end. |
| Treatment of surpluses generated from grant-funded activity, how will these be treated in practice? | Our current understanding is that all surpluses, regardless of the source of the surplus, will be able to be transferred to the arms-length foundation with the proviso that the funds held within the foundation will eventually be used in line with the college's strategic plan. This should not require the disaggregation of surpluses between commercially generated and publically generated surpluses. |
| What is the budgeting and accounting treatment for severances? | See working capital guidance. |
| Is it acceptable to transfer title of surplus property to an arms-length charitable foundation? | Transfer of the title of surplus property to an arms-length foundation would require Ministerial consent. Transfer of proceeds to an arms-length foundation for reinvestment in future years is a more complicated issue in respect of the accounting treatment, we are currently looking into this in conjunction with Scottish Government colleagues. However, it is more straightforward if colleges can reinvest disposal proceeds in-year. |

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| Is there a formal process for application for capital funds? | Colleges will need to compete with other public sector organisations for capital funds. The college sector would need to make a continued and robust case for investment in the College estate. There is no separate process and the process for capital investment does not differ from the process currently used in relation to large capital projects in the sector. It is likely that further information on colleges' 2014-15 capital plans will be requested in due course. |
| Are UHI colleges affected by the reclassification? | The five incorporated UHI colleges (Inverness, Lews Castle, Moray, North Highland and Perth) are affected by the reclassification. All incorporated colleges are required to adopt the 1 April to 31 March financial year as a result of the reclassification. Colleges are required to adopt this year end as a result of HM Treasury's reporting requirements which include audited information at 31 March each year. UHI partner colleges' individual financial statements may require consolidation by UHI, this is currently under review. |
| Will colleges be allowed to operate an overdraft facility? | It is possible for colleges to operate an overdraft facility but our current understanding is that it is unlikely that colleges will require an overdraft facility as the Funding Council should be able to meet the cash funding requirements of colleges subject to this not exceeding the overall cash and resource limits for the college. Colleges will need to remain within their resource budget and avoid overspends on both a resource and cash basis. |
| Will colleges be allowed to generate loans from corporate banks? | Colleges are technically still able to borrow with the consent of Ministers. It is felt that such consent is unlikely |

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| | to be forthcoming and the capital funding process highlighted above will be followed. Given the resource limits that colleges are required to operate within, even if they did borrow they would not be able to use these funds without additional resource cover as spending the funds raised would breach the resource limit. So, in short, colleges will not be able to generate new loans from commercial providers. |
| How should colleges deal with potential challenges in relation to their existing bank covenants? | The Council is currently collecting information through the FFR returns on current lending and banking covenants. The Council will engage with colleges that have existing borrowing and covenants to work with them to reach a resolution on these issues. Any colleges that anticipate challenges in relation to their existing covenants from 1 April 2014 should contact us at an early stage. |
| How will the Lennartz liability be treated after 1 April 2014? | Discussions are ongoing with HM Treasury in relation to the treatment of the Lennartz liability. The current working assumption, subject to confirmation by HM Treasury, is that capital repayments will be outwith the scope of budgeting. |
| Is there any guidance on costing/pricing commercial activity that colleges need to comply with? | Colleges should refer to the Scottish Public Finance Manual which states that the full cost of services must be recovered. |
| Will SDS funding be classified as commercial activity? | We understand that SDS should be classified as commercial activity. |
| What consideration has been given to ensuring that there is no double counting of college expenditure by other public bodies? | Any double counting will be eliminated as part of the consolidation process for Whole of Government Accounts. |
| How can colleges be incentivised to spend funding as efficiently as possible? | Colleges will be expected to comply with the duty of Best Value in their use of public funds. |

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| Confirm that colleges will not be subject to deficit funding | The Funding Council will agree a volume of activity and pay a price for that activity in line with current arrangements. It is anticipated that colleges will transfer overall surpluses to arms-length foundations. |
| Is there further clarity on overall reporting requirements? | The overall reporting requirements will be clarified soon and training/workshops will be provided on the information requirements. Communication No. 4 highlighted that Aberdeen College has agreed to pilot the work on the '14-15 FReM disclosures, this work is underway and we expect to be in a position to circulate the outcome of this exercise to the sector next month. |
| Clarify support to be provided by SFC to colleges | See Communication No. 5, further guidance in this area will be made available in the near future. |

**Further information**

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