Financial performance of the further education sector in Scotland

An update report

Prepared for the Auditor General for Scotland

December 2003

AUDIT SCOTLAND

Auditor General for Scotland

The Auditor General for Scotland is the Parliament's watchdog for ensuring propriety and value for money in the spending of public funds.

He is responsible for investigating whether public spending bodies achieve the best possible value for money and adhere to the highest standards of financial management.

He is independent and not subject to the control of any member of the Scottish Executive or the Parliament.

The Auditor General is responsible for securing the audit of the Scottish Executive and most other public sector bodies except local authorities and fire and police boards.

The following bodies fall within the remit of the Auditor General:

- departments of the Scottish Executive eg the Health Department
- executive agencies eg the Prison Service, Historic Scotland
- NHS boards and trusts
- further education colleges
- water authorities
- NDPBs and others eg Scottish Enterprise.

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 Executive and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Summary

1. This report covers the quality of financial stewardship in Further Education (FE) colleges, the forecast financial health of colleges, and the progress made by the Scottish Further Education Funding Council (SFEFC) in addressing recommendations made by the Scottish Parliament's Audit Committee on previous overview reports of the FE sector. I have also published a separate report on the arrangements SFEFC has in place for measuring and managing the performance achieved from the public funds granted to the further education sector[1].

Financial stewardship

2. The colleges' accounts and audit reports for 2001-2002 indicate that overall financial stewardship in the FE sector is of a good standard. College boards of management produce statements on internal financial control and on corporate governance arrangements within the college. Auditors examine these statements and comment where the content of the statement is not consistent with audit findings. None of the auditors commented that the statements were inconsistent with audit findings.

3. None of the auditors' opinions on the accounts of individual college's account were qualified. I have, however, included reports, under section 22 of the Public Finance and Accountability Act, with the accounts laid in Parliament in respect of ten colleges.

- One of these reports deals with the late delivery of accounts and fundamental uncertainty over the continued operation of Lews Castle College.
- Another report deals with fundamental uncertainty over Borders College's plans for recovering its financial deficit.
- The remaining reports relate to cases where the auditor has drawn attention to technical aspects of the college's accounting practices in the light of the college's continuing dependence on recurrent funding from SFEFC and/or bank overdraft facilities.

4. The 2000/01 FE overview report highlighted significant debtor balances recorded by some colleges resulting from delays in the payment of EU claims. Auditors of five colleges reported delays in the receipt of EU grant payments during 2001/02. The Scottish Executive acknowledged that there had been a consistent problem over the last two years in the administration of EU grants and have taken steps to improve this. These steps have had a significant impact on the settlement of claims; at August 2002 some 450 claims had not been processed within 30 days. This had been reduced to 80 claims by April 2003.

Financial health

5. My previous FE overview reports have highlighted the relatively poor financial position of some colleges and the steps SFEFC have been taking to improve the situation. Following evidence from SFEFC and others on the overview report for 2000/01, the Parliament's Audit Committee found that improvements in financial health depended on colleges taking appropriate steps to achieve their financial forecasts. The Committee signalled its intention to monitor progress through future overview reports.

6. In 2001/02 the sector recorded an operating surplus of £2.3 million. This represents a significant improvement over the £14.1 million deficit recorded in 2000/01 and the colleges' own forecast of a deficit of £1.9 million for 2001/02. The accumulated historic cost deficit for the sector also improved, falling from £17.5 million in 2001/02 to £4.9 million in 2002/03. The improvement can be attributed to a number factors including:

- an increase in SFEFC grant funding
- an increase in education contracts and tuition fees
- the effects of staff restructuring at a number of colleges
- a one-off sum of £7 million made available to accelerate the pace of recovery for those colleges in most financial difficulty.

SFEFC forecasts suggest that the overall surplus for 2002/03 will be £1.3 million and that the sector will achieve an overall accumulated surplus of £7.3 million.

Operating Surpluses

7. Twenty-four colleges achieved operating surpluses in 2001/02, of which 19 have turned their position around from a deficit in 2000/01. The number of colleges incurring operating deficits in 2001/02 was 18 compared to 34 in 2000/01, a significant improvement. Most colleges have met, or exceeded, forecast financial targets for 2001/02 but three colleges incurred higher than forecast operating deficits.

Accumulated deficits

8. Early retirement provides a means by which college managers can restructure staffing profiles to match future costs with income projections. It is evident from auditors' reports and college recovery plans that a number of colleges are dependent on restructuring as a means of achieving financial equilibrium. Standard accounting practice requires colleges to establish provisions in their balance sheets to meet the cost of enhanced pensions to former

1 *Scottish Further Education Funding Council: Performance management of the further education sector in Scotland,* Audit Scotland, 2003

employees who retired early. Auditors have reported that the total provision across the sector in 2001/02 was £37 million and exceeds the total accumulated deficit of £4.9 million recorded by the sector at July 2002.

9. In my overview report on the 2000/01 accounts I reported on financial recovery plans for the 19 colleges whose financial health had been assessed by SFEFC as being of most concern at that time. Since then three of the colleges have eliminated their accumulated deficits and a fourth no longer operates as a FE college. The recovery plans in place for the remaining 15 colleges forecast that individual colleges would take between three and ten years to eliminate their deficits. Auditors' reports show that at 31 July 2002 all the colleges were on target to achieve, or better, target dates for eliminating accumulated deficits.

10. The Scottish Parliament's Audit Committee[2] recommended that SFEFC should accelerate improvements in the sector's financial health. In December 2002 SFEFC launched a joint campaign for financial security. This included an allocation of £26 million additional funding to colleges to achieve lasting improvement in the financial health of the sector and to support colleges in complying with disability legislation and in achieving local priorities in their strategic plans (Appendix 1). The first priority for the additional funding is to improve the financial health of the sector through a new strategy for financial security. Colleges are expected to use their allocations to fund one-off investments that will improve their financial position.

11. Financial forecast information submitted by colleges at the end of June 2003 indicates that 38 out of 42 incorporated colleges will meet SFEFC's definition of financial security by 31 July 2006. Of the remaining four, SFEFC are already directly engaged with two colleges and are monitoring recommendations for action at the other two.

12. SFEFC has revised its model for assessing the financial health of colleges to reflect its revised definition of financial security. By applying the revised moedl to financial information provided by the colleges, SFEFC has categorised the position of each college at July 2002 and has projected the forward financial position in terms of financial health. The revised projections show that by 31 July 2006, the number of colleges classified as secure will have risen from 24 to 37 and the number classified as very weak will have fallen from five to one.

Recent developments

13. Previous overview reports on the FE sector have highlighted a number of initiatives by which SFEFC had begun to address strategic issues concerning the adequate and efficient provision of further education in Scotland. The Scottish Parliament's Audit Committee subsequently called on SFEFC to report progress made in relation to these initiatives in time for progress to be detailed in this report.

Accountability

14. Both the Audit Committee and I have made recommendations in earlier reports on accountability and financial control in the FE sector. The Scottish Executive has responded positively to these recommendations and has undertaken a review of governance and accountability within the sector. Following public consultation the review has resulted in proposals for action on the membership of college boards (covering length of board membership, the appointment process and the mix of skills on college boards); guidance for the operation of college boards (covering improved guidance on roles and responsibilities and on the training available to board members); and the powers of Ministers, SFEFC and SFEFC's accountable officer.

15. The Audit Committee was particularly concerned that college boards, in time of difficulty, should have ready access to advice and guidance. SFEFC has in place, and is continually enhancing, financial appraisal and monitoring arrangements to oversee the financial health of colleges. Central to that activity is the early identification of colleges in financial difficulty, together with the provision of assistance to address the problems and speed up recovery.

Management review

16. Following evidence taken on the basis of my 2000/01 overview report, the Audit Committee recommended that SFEFC work with colleges to develop explicit agreements on when and how the results of the SFEFC's management review would impact on college performance. The management review established a baseline assessment of the quality and effectiveness of management in each college and a mechanism for identifying and addressing development needs expressed as a management action plan (MAP). Ownership of MAPs resides with colleges' boards of management who have direct responsibility for taking them forward. The broad aim was that in the medium term (ie, two to three years) colleges using their MAPs would make the necessary changes to their strategies, structures and processes in order to embed good practice where that was required. SFEFC has received from each college a progress report on implementation of the actions set out

2 Audit Committee 7th Report 2002

in the college's MAP which will be analysed in the latter part of 2004.

Supply and Demand

17. The Audit Committee called on SFEFC to complete research to establish the current level of supply and demand for FE in Scotland. The Committee recommended that SFEFC should publish a step by step program for finalising the mapping process underpinning the research and to ensure that the integral geographical and industry sector exercises were properly co-ordinated. Further details on timescale for completing the supply and demand work and for its implications in terms of future measurement of sector performance in matching skills with jobs is included in my report on SFEFC performance management.

Changes in the provision of further education

18. The FE overview report for 2000/01 recorded progress on a merger proposal for the three Glasgow Colleges by autumn 2002. The report also noted that two further colleges had also commissioned a merger feasibility study. Neither of these proposed mergers has gone forward as planned. One college decided against the proposal to merge the three city centre colleges and another college is taking time to consider the wider implications of FE provision in Glasgow before proceeding further with the second merger.

19. SFEFC has established a joint project with ten Glasgow colleges to rationalise the provision of further education in the city. The model being implemented involves a hub of mainly specialist facilities and provision in the city centre and more general learning in a ring of local community colleges.

20. As a result of supply and demand work to date, all colleges in Scotland are now engaged in SFEFC-supported activity to work together, on an area basis, to improve further education and to optimise the use of resources. For example, colleges in Edinburgh and the Lothians are undertaking a study of the potential sharing their non-teaching functions and considering scope for joint curriculum development.

College Estate

21. SFEFC has introduced a new estates funding model and revised its capital funding policy and guidance. The main priority for capital funding is the Glasgow colleges, colleges in Lanarkshire, Renfrewshire and Ayrshire also have priority needs. SFEFC is working with the relevant colleges to help them develop and implement capital investment plans that address their infrastructure needs over the next 5-10 years.

Conclusions and recommendations

Financial stewardship

Further education colleges continue to operate good standards of financial stewardship. Auditors' reports have, however, identified a number of important areas which need to be monitored carefully. Accordingly, I recommend:

- colleges' ability to comply with the going concern basis of accounting set out in their financial statements can depend on recurrent grants or on overdraft facilities. In view of the attention drawn to this issue by auditors of nine colleges, it is important that colleges take appropriate action to ensure continued financial support is in place;
- the administration of EU grant claims should continue to improve so that all valid claims are processed without undue delay;
- Each college should ensure that the provision for early retirement remains adequate for its purpose.

Financial health

Additional funding of £26 million is expected to accelerate the pace of recovery of financial health in the FE sector and I welcome SFEFC's new campaign for financial security. However, the assessment of the financial health of each college undertaken by SFEFC supports my concerns that colleges will require close monitoring as they move to financial recovery and financial security. SFEFC should therefore:

- ensure that colleges use additional funds to improve their financial position in the longer term;
- continue to monitor the position of each college closely to ensure that as far as possible the target for financial security for all colleges by July 2006 is met.

Progress on initiatives

Initiatives to improve financial accountability, restructure the provision of FE in areas such as Glasgow and invest capital funds to meet the needs of the college estate are important aspects of SFEFC's overall duty to secure the adequate and efficient provision of FE in Scotland. I note the action in each of these areas and will continue to monitor the progress made.

Part 1. Introduction

Exhibit 1

Sources of FE college income

Income for the 42 incorporated FE colleges in 2001/02 was £52 million higher than income in 2000/01.

Source of income	**2001/02 £m**	**2000/01 £m**
SFEFC grants	342	301
Education contracts and tuition fees	94	85
Other income	60	58
Total	**496**	**444**

Source: Audit Scotland

1.1 Further education colleges in Scotland provide education and training opportunities for a wide range of people from school leaving age upwards. There are 42 colleges incorporated as independent corporate bodies under the Further and Higher Education (Scotland) Act 1992 (the Act) to provide further education. A further four education colleges operate under the control of local authorities or independently but not as bodies incorporated under the 1992 Act. This report covers the 42 incorporated colleges.

1.2 In the year to 31 July 2002 the 42 colleges recorded total income of £496 million, including £342 million grant in aid provided by the Scottish Executive Enterprise and Lifelong Learning Department (the Department) via the Scottish Further Education Funding Council (SFEFC). This represents an increase of £52 million on income received in 2000/01, mainly attributable to a £40 million (13%) increase in grant in aid. The £154 million balance of college income was derived from a range of sources including European grants, tuition fees and income from the provision of consultancy and research services (Exhibit 1).

1.3 Under the terms of the Public Finance and Accountability (Scotland) Act 2000 (the PFA Act) the Auditor General for Scotland is responsible for securing the audit of each incorporated college. The special accountabilities which apply in the public sector require audits to be planned and undertaken in order to provide assurance not only on the financial statements but also on matters such as regularity, propriety and use of resources in accordance with value for money and best value. Accordingly this report, which I present under section 23 of the 2000 Act, provides an overview of the main issues arising from the 2001/02 audits of further education colleges and on the progress made by SFEFC in addressing recommendations made by the Scottish Parliament's Audit Committee as a result of previous overview reports of the FE sector. I have also published a separate report on the arrangements SFEFC has in place for measuring and managing the performance achieved from the public funds granted to the further education sector[3].

1.4 Part 2 of this report comments on financial stewardship within the FE sector on the basis of the results of audits of the 42 colleges for the 2001/02 academic year. Part 3 reviews the financial health of the sector and records the action SFEFC has taken and proposes to take relating to the elimination of college financial deficits, including details of a new Campaign for Financial Security for the sector. Part 4 of the report examines and comments on progress on a number of other SFEFC initiatives to address the adequacy and efficiency of the provision of further education in Scotland.

3 *Scottish Further Education Funding Council: Performance management of the further education sector in Scotland,* Audit Scotland, 2003

Part 2. Financial stewardship

2.1 This part of the report covers:

- completion of accounts and audits of the incorporated further education colleges
- governance and internal financial control
- other matters arising.

Completion of accounts and audit

2.2 Section 22(5) of the PFA Act requires Scottish Ministers to lay before Parliament a copy of every account, and any report on the account prepared by the Auditor General, not later than nine months after the end of the financial year to which the account relates. FE colleges' financial years end on 31 July, and therefore college accounts should be laid in Parliament by the following 30 April.

2.3 The 1999-2003 session of the Scottish Parliament ended at midnight 31 March 2003 and the accounts of 41 of the FE colleges were laid in Parliament by that date. However, due to a delay in securing assurances about Lews Castle College's status as a going concern, the college's audited accounts and auditors' report were not submitted to the Auditor General until 2 April 2003. The first meeting of the new parliamentary session was not due to take place until 7 May 2003. Scottish Ministers were therefore unable to lay the accounts before the Parliament within the statutory nine-month deadline. I have reported separately to this effect on the accounts of Lews Castle College.

2.4 None of the auditors' opinions on the colleges' accounts were qualified. However, the opinion on two colleges drew attention to matters of fundamental uncertainty. The opinion on Lews Castle College drew attention to the college's continued existence being dependent on completion and implementation of a financial security and efficiency review being undertaken by SFEFC. The auditor of Borders College drew attention to a fundamental uncertainty concerning the college's plans to recover its financial deficit. In view of the auditors' findings, I presented a report under section 22(3) of the PFA Act on the accounts of both colleges.

2.5 Auditors' judgements on going concern status focus on the extent to which colleges can be expected to operate within the finances available to them. Colleges' main sources of finance for day-to-day activities are SFEFC grants and bank overdrafts which are used to deal with cash flow fluctuations. Where the level of grant and available overdraft are less than the colleges' expected operating expenses, going concern status can be in doubt.

2.6 I also reported on the accounts of a further eight colleges (Inverness, John Wheatley, Kilmarnock, Lauder, Moray, North Glasgow, Perth and West Lothian) where auditors' opinions drew attention to the continuing dependence on overdraft facilities from a technical accounting perspective.

Governance and internal financial control

2.7 The colleges' accounts and audit reports indicate that overall financial stewardship in the FE sector is of a good standard. College boards of management produce statements on internal financial control and on corporate governance arrangements within the college. Auditors examine these statements and may comment where the content of the statement is not consistent with audit findings. For 2001/02 none of the auditors commented that the statements were inconsistent with audit findings.

2.8 Individual college corporate governance statements did, however, identify scope to improve aspects of corporate governance. Twenty-five colleges indicated in their statements that risk management arrangements had not been in place for all of 2001/02 and that procedures required further development to ensure compliance with good practice.

2.9 Each of the 42 college auditors produced reports on the findings of their annual audits. They generally found that the key financial systems in place at colleges were of a good standard. In many cases, external auditors have relied on work carried out by internal auditors to assess key financial systems and internal controls. Where external or internal auditors have identified weaknesses, they have agreed action plans with respective boards of management to implement the necessary improvements. I am pleased to report that colleges have generally responded well to important recommendations in the 2000/01 the action plans.

Other matters arising

European funding

2.10 The FE overview reports for 1999/2000 and 2000/01 noted changes to eligibility criteria for grants from the European Social Fund (ESF) and the European Regional Development Fund (ERDF) which were likely to have an impact on colleges' income. Most FE colleges continue to receive EU funding and auditors providing an analysis of variations in college income between 2000/01 and 2001/02 identified lower income from EU grants as having an impact on total income levels In 2001/02, 36 colleges recorded income of £11.9 million from EU grants (41 colleges recorded £18 million in 2000/01).

2.11 The 2000/01 FE overview report highlighted significant debtor balances recorded by some colleges resulting from delays in the payment of EU claims. Subsequently the Parliament's Audit Committee sought additional information from the Scottish Executive on the processing and timing of EU grant claims. The Executive's response indicated that changes to processes were expected to address the delays being experienced by the colleges.

2.12 Auditors of five colleges (Borders, Stevenson, Telford, Dumfries & Galloway and West Lothian) reported delays in the receipt of EU grant payments during 2001/02. The Scottish Executive acknowledged that there had been a consistent problem over the last two years in the administration of EU grants. This has been due to the large volume of claims received by the Scottish Executive, errors in grant applications and problems with the introduction of a new accounting system. The Executive's staffing levels have now been increased and a new web-based system has been introduced for the submission of grant claim forms. These steps have had a significant impact on the settlement of claims; at August 2002 some 450 claims had not been processed within 30 days. This had been reduced to 80 claims by April 2003.

Part 3. Financial health

3.1 My previous FE overview reports have highlighted the relatively poor financial position of some colleges and the steps SFEFC have been taking to improve the situation. Following evidence from SFEFC and others on the overview report for 2000/01, the Parliament's Audit Committee found that improvements in financial health depended on colleges taking appropriate steps to achieve their financial forecasts. The Committee signalled its intention to monitor progress through future overview reports. This part of the report records the financial position set out in the 20001/02 accounts, notes the progress made by colleges against financial forecasts, and highlights a SFEFC campaign to achieve financial security across the sector by focussing on colleges' ability to match their normal operating costs with recurrent funding levels.

Financial results for 2001/02

3.2 Exhibit 2 summarises the overall results recorded by the 42 incorporated colleges for 2001/02, and compares the results against those recorded for 2000/01 and against the overall results anticipated in financial forecasts provided by colleges to SFEFC.

Operating surplus/deficit

3.3 In 2001/02 the sector recorded an operating surplus of £2.3 million, which represents a significant improvement over the £14.1 million deficit recorded in 2000/01 and the colleges' own forecast of a deficit of £1.9 million. The improvement can be attributed to a number factors including:

- an increase in grant funding provided by SFEFC
- an increase in education contracts and tuition fees
- the effects of staff restructuring at a number of colleges
- special 'one-off' payments totalling £7 million awarded to nine colleges to speed up the pace of recovery. One college (Clydebank) received £2.5 million and the other eight received grants of between £250,000 and £1 million.

SFEFC forecasts suggest that the overall surplus for 2002/03 will be £1.3 million and that the sector will achieve an overall accumulated surplus of £7.3 million.

3.4 Exhibit 3 shows the annual operating surpluses/deficits recorded by each college at July 2002. Twenty-four colleges achieved operating surpluses in 2001/2002 of which 19 have turned their position around from a deficit in 2000/01. The number of colleges incurring operating deficits in 2001/2002 was 18 compared to 34 in 2000/2001, a significant improvement. Most colleges have met, or exceeded, forecast financial targets for 2001/02.

3.5 Three colleges (West Lothian, Kilmarnock and Lews Castle) incurred higher than forecast operating deficits. Factors contributing to the deteriorating position at each college, include:

- increase in premises costs due to PFI facilities management charge offset by a reduction in other areas of operating expenses (West Lothian)

Exhibit 2

Summary of income and expenditure results recorded by the 42 incorporated further education colleges

Consolidated item	2001/02 financial statements £m	College financial forecasts 2001/02 £m	2000/01* financial statements £m
Total income	495.8	488.3	443.5
Total expenditure	(493.5)	(490.1)	457.6
operating surplus/(deficit)	2.3	(1.8)	14.1
Performance indicators			
Operating surplus/(deficit) as a % of income	0.44%	-	(2.45%)

* adjusted to take account of the reduction of incorporated colleges from 43 to 42 following Bell College becoming a higher education institution on 1 August 2001

Source: SFEFC

- reductions in EU funding (Kilmarnock)
- exceptional re-structuring costs (Kilmarnock).

Accumulated deficits

3.6 Whilst an operating or underlying deficit of income over expenditure may be endured or even planned in the short term, it cannot be sustained in the long term as the college will eventually become insolvent. SFEFC's financial memorandum permits colleges to incur annual financial deficits where they have the approval of college boards of management in accordance with long-term strategic plans. SFEFC expects that accumulated deficits to be cleared within three years although, in practice, SFEFC seeks assurance that colleges have robust plans to recover deficits within a reasonable period.

Provisions for pensions and early retirements

3.7 The FE overview report for 2000/01 described how standard accounting practice required colleges to establish provisions in their balance sheets to meet the cost of enhanced pensions to former employees who had retired early. The total provision in 2000/01 was £36 million and all but one college had maintained a provision. Auditors have reported that the total provision across the sector in 2001/02 was £37 million and exceeds the total accumulated deficit of £4.9 million recorded by the sector at July 2002.

3.8 Early retirement provides a means by which college managers can restructure staffing levels to match future costs with income projections. It is evident from auditors' reports and college recovery plans that a number of colleges are dependent on restructuring as a means of achieving financial equilibrium. In view of this, it is essential that each college examines its provision for early retirements by having it professionally valued to ensure that it remains adequate for its purpose and that it is fairly stated in the college's accounts. SFEFC has recently commissioned the preparation of up-to-date actuarial tables to assist colleges with this task.

Recovery plans

3.9 The 2000/01 FE Overview report indicated that financial recovery plans were either in place, or at an advanced stage of preparation, at the 19 colleges whose financial health had been assessed by SFEFC as being of most concern at that time. Since then, three of the colleges have eliminated their deficits and a fourth no longer operates as a FE college. The recovery plans for the other 15 colleges forecast that individual colleges will take between three and ten years to eliminate the deficits accumulated at 31 July 2001. Exhibit 4 shows that at 31 July 2002 each of the 15 colleges was likely to meet or exceed its recovery plan target.

SFEFC's approach to monitoring college's financial position

3.10 The Scottish Parliament's Audit Committee and others have recommended that SFEFC should accelerate improvements in the sector's financial health. In December 2002 SFEFC launched a joint campaign for financial security. This included an allocation of £26 million additional funding to colleges to

Exhibit 3

Operating surplus/deficits 2001/02

The number of colleges recording operating deficits fell from 34 in 2000/01 to 18 in 2001/02.

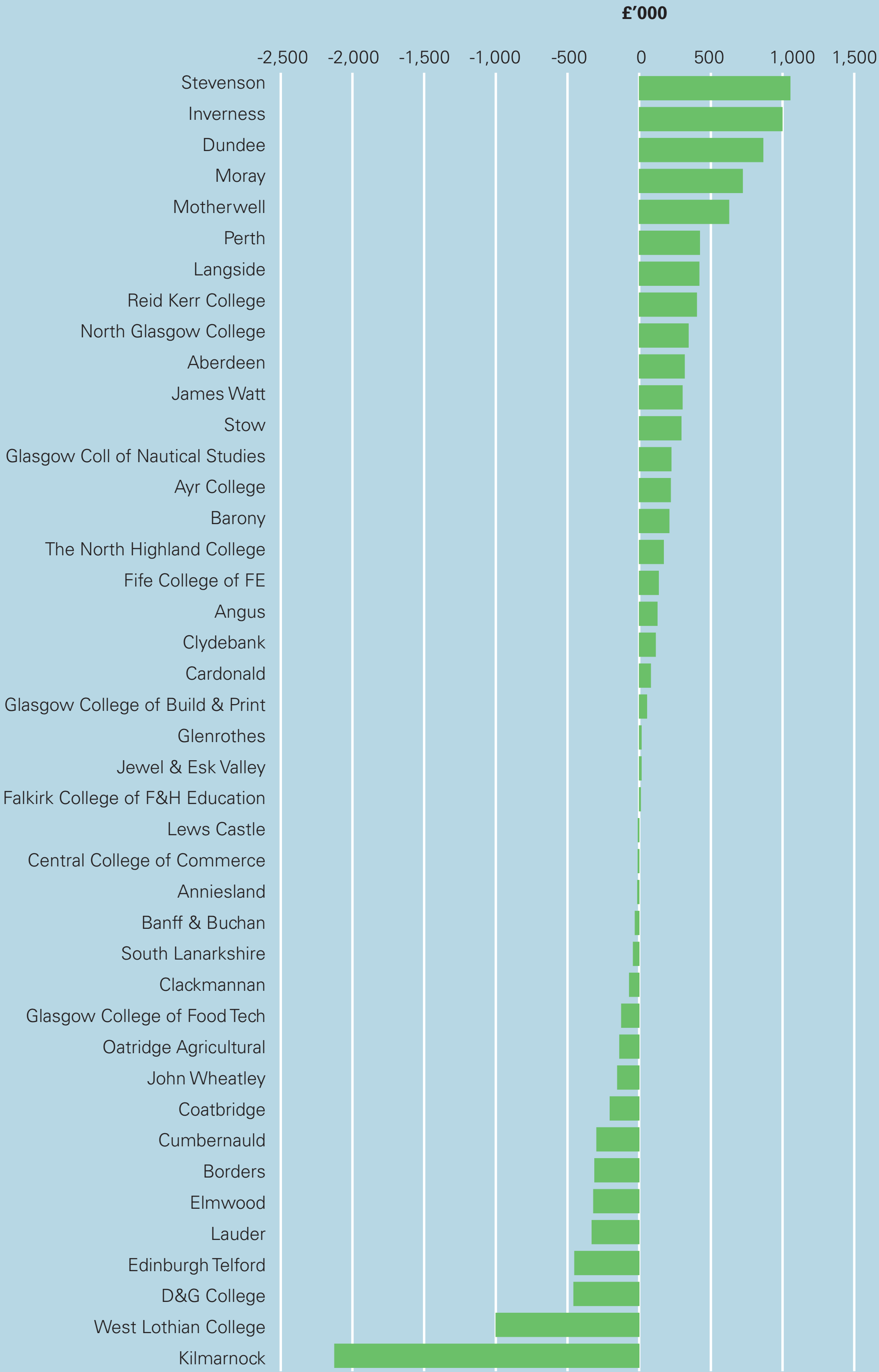

Exhibit 4
Progress against financial recovery plans

Colleges with recovery plans	Accumulated deficit July 2002	Position at 2001/02 (£m)	Accumulated deficit July 2001 (£m)	Original plan 2000/01
Clackmannan	(0.584)	Eliminate non pension element of the deficit by 2004	(0.643)	Reduce deficit by £0.5 million July 2004
Clydebank	(3.453)	Reduce deficit to £2.2 million by 2005	(3.567)	Eliminate deficit by 2008
Inverness	(3.709)	Eliminate deficit not later than 2009	(5.177)	Eliminate deficit within 9 years from 2001/02
Langside	0.377	Target achieved	(0.206)	Eliminate deficit by July 2002
Lews Castle	(0.522)	Plan still to be developed	(0.511)	Recovery plan to be finalised
Moray	(1.531)	Elimination of deficit by 2005	(2.467)	Elimination of deficit by 2007
North Glasgow	(1.266)	Elimination of deficit by 2006	(2.341)	Elimination of deficit by 2007
Perth	(0.240)	Elimination of deficit by 2004	(1.010)	Elimination of deficit by 2004
Reid Kerr	(2.347)	Elimination of deficit by 2006	(2.927)	Elimination of deficit by 2006
South Lanarkshire	(0.182)	Elimination of deficit by 2003	(0.327)	Elimination of deficit by 2003
Other colleges				
James Watt	(0.916)	Elimination of deficit by 2003	(1.552)	Elimination of deficit by 2003
John Wheatley	(0.580)	Elimination of deficit revised to 2005	(0.237)	Elimination of deficit by 2005
Lauder	(0.290)	Elimination of deficit revised to 2004	(0.166)	Elimination of deficit by 2005
Stow	0	Target achieved	0.458)	Elimination of deficit by 2003
West Lothian	(2.679)	Underlying operating deficits until 2004	(1.151)	No date set for elimination of deficit

achieve lasting improvement in the financial health of the sector and to support colleges in complying with disability legislation and in achieving local priorities in their strategic plans (Appendix 1). Colleges are expected to use their allocations to fund one-off investments rather than to meet recurrent expenditure. The first priority of the funding is to improve the financial health of the sector through a new strategy for financial security based on six elements (Exhibit 5).

Financial security

3.11 The definition of financial security recognises the need for colleges to match in-year income with expenditure, though this can be affected in any single year by the impact of significant one-off items, such as gains or losses from asset disposals. SFEFC has therefore directed college boards of management to ensure that by 2005/06 the underlying operating position of the college is sufficient to ensure costs are less than income and that the college has sufficient liquid assets. Colleges are also expected to eliminate any accumulated deficits directly related to previous overspending on recurrent operational expenditure. Pension provisions are considered not to threaten financial security provided a college maintains an operating surplus, taking one year with another.

3.12 Financial forecast information submitted by colleges at the end of June 2003 indicated that 38 of the 42 colleges will meet SFEFC's definition of financial security by 31 July 2006. For those colleges in most difficulty, SFEFC makes available the services of its FE Development Directorate (FEDD), a team of senior practioners who help colleges deal with specific difficulties that may have an adverse financial impact.

3.13 More generally, SFEFC provides various forms of support to colleges in difficulty. This includes:

- Developing benchmarking exercises to enable colleges to compare their costs in detail with each other on a robust and consistent basis

- Support to improve the strategic financial capability of the sector through the re-launch of a sector finance managers network and by establishing a working group to define scope for further improvements in financial and other management information across the sector

- Re-direction of recovery planning support provided by SFEFC's Financial Appraisal and Monitoring directorate to align it more closely with the financial security strategy

- The provision of £26 million through selective grant support to be released to individual colleges on the basis of proposals for improving their financial security.

Financial health

3.14 SFEFC has revised its model for assessing colleges' financial health to reflect the new definition. The new model places greater emphasis on the colleges' operating performance over the period to 2005/06 and replaces categories of financial health used in earlier years (good, stable poor and unsatisfactory) with revised categorisations for financial health (secure, weak or very weak).

3.15 SFEFC has used the revised model to establish the financial health of each college. By reviewing financial information provided by the colleges, SFEFC has categorised the position of each college at July 2002 and projected the forward financial position in terms of financial security by 2005-2006.

3.16 The results of applying the new categorisations (Exhibit 6) show an overall picture of improving financial health. Eight colleges categorised as very weak in 2000/01 reduce to five in 2001/02, of which two colleges have moved from very weak to secure. By July 2006, the number of colleges classified as secure is expected to rise from 24 to 37 and the number classified as very weak will have fallen from five to one (Lews Castle).

Exhibit 5

The six elements of SFEFC's campaign for financial security

1. A definition of the basic level of financial heath which all colleges should achieve and at least maintain. This has been defined as **financial security** which reflects the central task of FE colleges to use public funding to provide further education as effectively and efficiently as possible.

2. A **three-year target** by which the sector will achieve financial security: that is, by 31 July 2006;

3. The Council and the sector will establish a joint working group to procure comprehensive **benchmarking** of costs for every college in the sector. This exercise will provide each college with comprehensive cost data to assist them in establishing best practice;

4. The **strategic financial management** capability of the sector will be strengthened in two ways: the Council will fund a full-time post to increase the effectiveness of the finance managers network and a joint working group will investigate the options for significantly enhancing management information systems across the sector;

5. The Council's Financial Appraisal and Monitoring Service and the new Further Education Development Directorate will work with colleges as required to **help** them to develop their plans for financial security; and

6. The **funding** allocations announced by SFEFC, which may be used to support restructuring, must be applied in the first instance to achieving financial security.

Source: SFEFC

Exhibit 6

Assessment of college financial health and financial security

SFEFC's assessments show a picture of improving financial health

	Actual 2001-02	Probable Outturn 2002-03	Forecast 2003-04	Forecast 2004-05	Forecast 2005-06
Secure	24	31	29	33	37
Weak	13	7	11	8	4
Very Weak	5	4	2	1	1

Source: SFEFC

Part 4. Recent developments

4.1 Previous overview report on the FE sector have highlighted a number of initiatives which SFEFC had begun in order to address the adequacy and efficiency of the provision of further education in Scotland. The Scottish Parliament's Audit Committee subsequently called on SFEFC to report progress made in relation to these initiatives in time to detail in this report the progress made. This part of the report records the most recent position on these initiatives.

Accountability review

4.2 The Scottish Parliament's Audit Committee consideration of the Overview of FE College Accounts for 1999/2000 and my report on Governance and financial Management at Moray College resulted in a series of recommendations on accountability and financial control in the FE sector. The Scottish Executive responded positively to the recommendations and announced a review of governance and accountability arrangements within the sector to cover, inter alia, SFEFC's powers to intervene when colleges fall short of expected standards and the appointment and training of members of colleges' boards of management.

4.3 Following public consultation, Ministers have proposed a series of changes in the governance and accountability arrangements in the FE sector (Exhibit 7).

4.4 SFEFC has subsequently taken action on a number of the Ministerial proposals including:

- working with the Association of Scottish Colleges (ASC) to produce a guide for members of college boards. SFEFC is also supporting initiatives taken by individual colleges such as the development of a matrix for use in the selection of new board members and an training and personal development programmes for existing board members being developed by a group of Lothian colleges.
- Providing help and support to re-launch the colleges' finance managers network including a group selected from across the sector to develop and disseminate good practice.

4.5 The Audit Committee was particularly concerned that college Boards, in time of difficulty, should have access to all available advice and guidance. SFEFC has in place, and is continually enhancing, financial appraisal and monitoring arrangements to oversee the financial health of colleges. Central to that activity is the early identification of colleges in financial difficulty together with the provision of assistance to address the problems and speed up recovery. The introduction of the power of direct intervention by SFEFC at Board meetings, on occasions where that was judged to be appropriate should be useful additions to that process.

Management review of further education colleges

4.6 In March 1999 Ministers asked SFEFC to undertake a major review of the management of Scotland's further education colleges and to report to them. SFEFC appointed consultants to undertake fieldwork at a sample of 12 colleges. SFEFC's report concluded that there was much good governance and management practice although there was scope for most colleges to learn from good practice and the experiences of other colleges. As a result of the review SFEFC asked colleges to prepare management action plans (MAPs) addressing how they intend to respond to the report's findings.

4.7 Following evidence taken on the basis of my 2000/01 FE Overview report, the Audit Committee recommended that the Funding Council work with colleges to develop explicit agreements on when and how the results of the Funding Council's management review will be realised. The Scottish Executive has accepted the recommendation in principle. In practice this is achieved through the annual strategic plans for individual colleges, approved by board management and submitted to SFEFC. Ownership of MAPs resides with colleges' boards of management who have direct responsibility for taking them forward. The broad aim was that in the medium term (i.e. two to three years) colleges using their MAPs would make the necessary changes to their strategies, structures and processes in order to embed good practice that was required.

4.8 The management review established a baseline assessment of the quality and effectiveness of management in each college and a mechanism for identifying and addressing development needs. SFEFC has received from each college a progress report on implementation of the actions set out in the College's MAP. This will be analysed in the latter part of 2004 and appropriate follow-up action taken as necessary.

Supply and demand

4.9 In summer 2000 SFEFC completed a first review of links between the supply and demand for further education in Scotland. The primary purpose of this exercise was to provide information which will enable SFEFC to lead a strategic planning process across colleges and so increase the adequacy and efficiency of the sector.

4.10 The Audit Committee called on SFEFC to both publish a step by step programme, with appropriate timescales, for implementation of the mapping process and to ensure that the geographical and industry sector exercises are properly co-ordinated. Further details on timescale for completing the supply and demand work and for its implications in terms of future measurement of sector performance in matching skills with jobs is included in my report on SFEFC performance management.

Changes in the provision of further education

Glasgow

4.11 In previous overview reports, I have recorded progress on proposals to merge colleges in Glasgow. Since the 2000/01 overview report specific proposals for mergers of colleges in Glasgow have changed:

- A proposal to merge three colleges located in Cathedral Street (College of Building and Printing, Central College of Commerce and College of Food Technology) was to be presented to Ministers in autumn 2002. However, the board of Central College of Commerce decided against the proposal, leaving the other two colleges to produce a revised proposal which they expect to submit to Ministers by the end of 2003.

- A feasibility study on a possible merger of Stow College and North Glasgow College was undertaken during 2002 but the board of North Glasgow College subsequently decided it needed more time to reflect on how the overall supply and demand for FE in Glasgow could be best improved.

4.12 During 2003, SFEFC has been working all ten Glasgow colleges to consider a new model for the provision of further education in Glasgow. The model involves a hub of mainly specialist facilities and provision in the city centre and the remaining colleges operating as community colleges responsible for general learning at a local level. The colleges are forming steering groups to implement the model, and SFEFC will provide grants to support this major strategic change.

Other areas

4.13 As a result of earlier supply and demand, work all colleges in Scotland are now engaged with SFEFC-supported activity to work together, on an area basis, to improve further education and to optimise the use of resources. For example, colleges in Edinburgh and the Lothians are undertaking a study of the potential for sharing their non-teaching functions and considering scope for joint curriculum development.

Condition survey of college estates

4.14 The 2000/01 Overview report noted that SFEFC was developing a capital funding model to focus investment decisions on the strategic needs of the sector. The Audit Committee recommended that the SFEFC publish specific timescales for the finalisation and implementation of the new model.

4.15 The New Estates Funding Model was approved by SFEFC in September 2002 and a circular letter announcing SFEFC's revised capital funding policy, and criteria for assessing capital proposals, was issued in March 2003. SFEFC has also developed comprehensive guidance to enable colleges to assess the efficiency of their existing estates, to work out how much future space they will require to deliver their curriculum and to help colleges assess the financial impact of major capital programmes.

4.16 SFEFC has agreed that the main priority for its capital funding is Glasgow. This recognises the scale and depth of colleges' estate problems in that area. SFEFC has also agreed that colleges in Lanarkshire, Renfrewshire and Ayrshire have high priority needs. SFEFC are working with the relevant colleges to help them develop and implement capital investment plans that address their infrastructure needs over the next 5-10 years.

Exhibit 7

Measures proposed by Ministers as a result of the Review

- **Length of board membership**
  Ministers intend that, save in exceptional circumstances, members of college Boards will in future be able to serve a maximum of two terms (ie eight years).

- **Appointments process**
  Ministers propose a standardised approach to identifying and appointing new Board members, subject to safeguards allowing flexibility for colleges who face special circumstances. Ministers are also to consider some form of external scrutiny or involvement either in appointments decisions or through regular audits of the outcome of appointments exercises.

- **Appropriate mix of skills**
  Ministers intend to encourage Boards to address skills gaps by making greater use of the co-option of specialist skills and expertise. Ministers also intend to take steps to better utilise the public-spiritedness and expertise of citizens who wish to join the Board of a further education college.

- **Facilitating improvements**
  The Association of Scottish Colleges (ASC) and SFEFC are to be asked, by Ministers, to examine the training requirements for Clerks. Ministers will also ask ASC to define the role and responsibilities of the Clerk in their guidelines to Boards.

- **Guidance, induction, training and development**
  Ministers intend to ask ASC, SFEFC and SFEU to build on their recent work on a good governance Guide by devising and implementing a national training programme for Board members. Training events would complement the Guide but would have a broader focus on standards of conduct and behaviour expected of board members.

- **Ministers powers to remove board members**
  Ministers do not intend to seek further powers beyond those currently in the 1922 Act. Current powers allow Ministers to dismiss a Board, or individual Board members, if it appears that they have mismanaged the affairs of the college, and to appoint a replacement Board. A substantial number of consultation respondents felt that the greater use of Ministerial powers could result in weaker, rather than stronger, governance and accountability.

- **SFEFC powers to intervene**
  Ministers intend to consider giving SFEFC a new power to attend, at its discretion, and be heard at meetings of any college Board. This is likely to require legislation. There was agreement among respondents that there may be occasions where SFEFC attendance at Board meetings could be appropriate, though this is likely to occur only in exceptional circumstances.

- **Powers of SFEFC's accountable officer**
  No substantial case was identified in the consultation for any extension of the powers of SFEFC's Chief Executive as suggested by the Auditor General, nor was there support for the delegation to SFEFC of the powers which currently rest with Ministers to issue statutory directions to Boards or to dismiss Boards.

Source: Scottish Executive Enterprise & Lifelong Learning Department

Appendix 1

20 December 2002 - Circular letter FE/54/02

Financial security, disability legislation and other priorities

1. This circular letter announces allocations of one off funding to achieve lasting improvement in the financial health of the sector and to support colleges in complying with disability legislation and in achieving specific local priorities in their strategic plans.

Background

2. Improving the financial health of the sector has been a priority both for the sector and the Council since its inception. It has also been of concern to the Audit Committee of the Scottish Parliament on the basis of reports by the Auditor General. To a considerable extent, it has come to dominate perceptions of the sector so that sight has been lost of the very many significant achievements of the sector in recent years and the crucial role it plays in the lives of so many young people and adults.

3. All colleges are required to comply with the Special Education Needs and Disability Act 2001 whose provisions are being phased in between September 2002 and September 2005. In addition, all colleges will have their own local priorities for investment.

Funding support

4. These needs of the sector have been recognised by the Scottish Executive and in particular the Minister, Iain Gray. As a consequence, he has allocated a further £16 million towards these priorities to add to the £3 million already provided to the Council for restructuring. The Council has been able to increase these funds by a further £7 million from funds that had been provisionally set aside to support the area mapping strategy in 2002: it is now clear that the great majority of these funds will not be required until next year. The total for allocation is therefore £26 million. Allocation to individual colleges are set out in annex A.

5. The basis of distribution is each college's 2002-03 WSUM target. For Newbattle Abbey College and Sabhal Mor Ostaig the indicative targets in circular letter FE/28/02 have been used. The arrangements for drawing down and paying the grant are set out below.

6. These funds are not recurrent funds. Accordingly, colleges are expected to use their allocation for specific one-off investments in the purposes outlined in this circular. They may not be used to fund recurrent expenditure.

Financial security

7. The first priority use of these allocations is to improve the financial health of the sector. A strategy for doing this was discussed at a well-attended meeting of principals on 11 November in Stirling. I am grateful for the very positive response of the principals at that meeting both to the aim of addressing the financial health of the sector as a primary shared priority and also to the elements of the strategy discussed and developed at the meeting.

8. The resultant joint strategy to achieve financial security for all colleges is set out in annex B. It has the following six elements:

- a definition of the basic level of financial heath which all colleges should achieve and at least maintain. This has been defined as financial security which reflects the central task of FE colleges to use public funding to provide further education as effectively and efficiently as possible. The definition is given in full in annex B;
- a three-year target by which the sector will achieve financial security: that is, by 31 July 2006;
- the Council and the sector will establish a joint working group to procure comprehensive benchmarking of costs for every college in the sector. This exercise will provide each college with comprehensive cost data to assist them in establishing best practice;
- the strategic financial management capability of the sector will be strengthened in two ways: the Council will fund a full-time post to increase the effectiveness of the finance managers network and a joint working group will investigate the options for significantly enhancing management information systems across the sector;
- the Council's Financial Appraisal and Monitoring Service and the new Further Education Development Directorate will work with colleges as required to help them to develop their plans for financial security; and
- the funding allocations announced in this circular letter, which may be used to support restructuring, must be applied in the first instance to achieving financial security.

9. The elements of this strategy and the method of allocation of funds are intended not only to support colleges in financial difficulty but also to provide appropriate support to those colleges which have already taken action to secure their finances and plan to turn now to other priorities. In developing this strategy with the sector, the Council wishes to give a clear signal that now and in future good strategic management in colleges will be recognised and appropriately supported.

Compliance with disability legislation

10. The second priority for the use of these allocations is expenditure to enable colleges to comply with the disability legislation. The Special Education Needs and Disability Act 2001 (SENDA) amends part 4 of the Disability Discrimination Act 1995 (DAA). Under this legislation, it is unlawful for providers of post-16 education and other related services to discriminate unreasonably against disabled people. The next deadline for the legislation is 1 September 2003 by which time colleges must ensure that their provision of auxiliary aids and services does not discriminate unreasonably against disabled people. By 1 September 2005, colleges must ensure that the physical features of their premises do not put disabled people at a substantial disadvantage.

11. All colleges are required to comply with this legislation and the Scottish Executive and the Council recognise that compliance will incur costs for colleges to differing extents depending on their inheritance of equipment and premises and the investment they have been able to make already.

Other priorities

12. Where colleges have satisfied the Council that they have addressed effectively the first two priorities of financial security and compliance with disability legislation, they may use any remaining funds for other priorities requiring the investment of one-off-funds. For example, these could include minor works to buildings, replacement or acquisition of equipment, or financing particular time-limited projects designed to bring about a specific improvement in their operations.

Draw-down of funds

13. Funds will be released to colleges on receipt of sound proposals for their use for one or more of the priorities set out above. Colleges are likely to be in one of the three broad positions (i) those which know they have already achieved financial security; (ii) those which know they will achieve it relatively easily in the target period; and (iii) those which face significant challenges in achieving it.

Position (i)

Colleges which are already financially secure (that is, they achieved an operating surplus – excluding significant one-off-items – in 2001-02) should provide:

- an outline projection to 2005-06 showing how the underlying position of operating surplus will be maintained over the period including use of any of this allocation. An extended financial forecast return will be acceptable if more convenient;

- a commentary explaining the key issues and assumptions in the projection;

- confirmation by the chair of the board of management and the principal that the college shares and is committed to the objective of at least maintaining financial security as defined;

- an outline of the expenditure needed to meet the requirements of SENDA by 1 September 2003 and by 1 September 2005; the college's plans to finance the necessary expenditure over the period; and its specific proposals for the use of this allocation;

- where funds remain unused from these first two priorities, a broad indication of the college's plans to tackle its other priorities.

Position (ii)

Colleges which made an underlying operating deficit in 2001-02 (that is, excluding one-off items) but which expect to achieve an operating surplus relatively easily in the target period should provide essentially the same information as position (i) colleges as far as it is relevant. However, they should give greater attention to the first three items and the response to the first item must set out clearly and convincingly how the college will achieve an underlying position of operating surplus and subsequently maintain it.

These colleges are invited to indicate in their responses whether they would wish to have management support from the Council to assist them in drawing up or implementing their financial plans. Alternatively, John Burt or Liam McCabe may be contacted directly.

Position (iii)

Colleges which made an underlying operating deficit in 2001-02 and/or face serious challenges in achieving and/or maintaining financial security in the period should focus their efforts on preparing:

- a rigorous analysis of the main underlying factors which are adversely effecting their income and expenditure account;

- an outline plan of specific actions to tackle these underlying factors decisively so as to achieve financial security as soon as possible;

- a statement of how the allocation will be used to implement the plan;

- confirmation by the chair of the board of management and the principal that the college shares and is committed to the objective of at least maintaining financial security as defined.

12. These colleges will be contacted directly in the near future by the Council to ensure that they take appropriate action without delay. In some cases, they are implementing recovery plans agreed with the Council. The Council will expect these plans to be accelerated with the aid of the funding support now provided.

Timing

13. Colleges should send their proposals to the Council as soon as possible and, in any event, not later than 28 February 2003. Funds will be released without delay by the Council in response to a satisfactory proposal. They will be withheld until an acceptable proposal is agreed.

14. Proposals should be sent to Liam McCabe, Director of Financial Appraisal and Monitoring Service (tel: 0131 313 6524/email: lmccabe@sfc.ac.uk).

Monitoring

17. The financial performance of colleges will be monitored particularly closely during the target period. This applies especially to colleges which have yet to achieve financial security. The Council will require quarterly monitoring returns from any college which faces significant challenges to achieve financial security and will expect colleges to take immediate corrective action if performance begins to depart adversely from the agreed plans. Colleges will be notified individually of the monitoring returns required by the Council.

Further information

18. Contact: Liam McCabe, Director of Financial Appraisal and Monitoring Service (tel: 0131 313 6524/email: lmccabe@sfc.ac.uk) and John Burt, Director, FE Development Directorate (tel: 0131 313 6571/email jburt@sfc.ac.uk) with regard to financial security or Martin Fairbairn, Deputy Director of FE Funding (tel: 0131 313 6527/email mfairbairn@sfc.ac.uk) in relation to allocations of additional funds.

Conclusion

19. The very significant funding provided by the Minister to support these priorities provides an important opportunity for the sector to shake off the perceptions of its financial performance which are detracting from its educational achievements. The scale of the funding provided is in part in response to the unprecedented willingness of principals to unite behind a shared strategy to achieve financial security for the whole sector.

20. The success of this strategy is important for the sector and for all who benefit from further education. I hope that your energy, skill, and determination, supported to the best of our ability by the Council, will put firmly in the past all concerns about colleges' ability to manage their finances effectively.

Roger McClure
Chief Executive

Financial performance of the further education sector in Scotland

An update report

Audit Scotland
110 George Street
Edinburgh EH2 4LH

Telephone
0131 477 1234
Fax
0131 477 4567

www.audit-scotland.gov.uk

ISBN 1 904651 16 X

AGS/2003/9