1. The Committee considered its approach to the Auditor General for Scotland’s report *Scotland’s colleges 2013* at its meeting on 20 November 2013, following evidence being given by the Scottish Funding Council (SFC) and representatives of senior management in four colleges at its previous meeting. During the meeting on 20 November 2013, the Auditor General for Scotland offered to provide further briefing material on the establishment and operation of college arms-length foundations, including their links with college reserves.

**Background**

2. In October 2010, the UK Office of National Statistics (ONS) decided to reclassify incorporated further education colleges throughout the UK so that they would be treated as part of central government for financial budgeting and reporting purposes.\(^1\) The ONS’s reclassification decision is the consequence of the level of Ministerial control then in place over colleges; for example, the provisions which then existed under the Further and Higher Education (Scotland) Act 1992, enabling Scottish Ministers to remove members of college boards due to mismanagement.

3. Up until now what has counted as Scottish Government expenditure relating to colleges has essentially been the money allocated to colleges, most of which flows through the Scottish Funding Council (SFC). From April 2014, it will be what colleges actually spend that is included in the Scottish Government’s total expenditure figures.\(^2\) i.e. including expenditure funded from other income that colleges generate as part of their operations. On average across Scotland, this amounted to around 26% of colleges’ income in 2011/12.

4. In summary, what this means is that from 1 April 2014:

- All college income and expenditure will count as part of the Scottish Government’s own income and expenditure.

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\(^1\) Reference to ‘colleges’ from this point forward should be taken to refer to incorporated colleges. Unincorporated colleges are unaffected by the changes.

\(^2\) A consequence of the ONS reclassification decision is that incorporated colleges’ financial year will change from 1 August – 31 July (the academic year) to 1 April – 31 March with effect from 1 April 2014.
• All college expenditure (net of income) will be funded from the Scottish Government’s overall budget (often referred to as “budget cover”).
• Any expenditure funded from colleges’ reserves or commercial borrowing will also require budget cover.
• Any surplus reported by a college will be treated as an underspend against the budget limit in the year it is incurred, and would not be automatically available for spending in the subsequent year. Any underspend rolled forward will require additional budget cover to allow it to be spent. The spending of accumulated reserves will, therefore, also require budget cover from within the Scottish Government’s overall budget limit.

Arms-length foundations

5. Ministers have committed to maintain funding levels under reclassification and the SFC established a Project Board (including representatives from the Scottish Government, colleges and Colleges Scotland) and a project team to consider the implications of the ONS’s decision and help colleges plan for reclassification. The aim was to look at ways to minimise the impact of government budgeting rules on the college sector, specifically concerning the use of reserves, and identify potential mitigating actions. Arising from this, colleges are now planning to establish arms-length foundations (ALFs) as charitable organisations that have the purpose of advancing and promoting further education in their geographic areas. It is planned that ALFs will come into operation from 1 April 2014.

6. The intention in establishing ALFs is to negate the effect of colleges being subject to the Scottish Government’s budgetary control regime by the ALFs becoming a depository for the current level of accumulated cash reserves within the sector, and any annual surpluses made in subsequent years. The aim is for colleges to have access to this cash in future years without the expenditure counting against the Scottish Government’s budget limits.

How ALFs will operate

7. Scottish Ministers were initially keen that a single umbrella ALF be established to act as a depository for all colleges’ surplus cash, although they also allowed for colleges establishing their own ALFs. Our understanding is that seven colleges have indicated they wish to participate in the umbrella ALF. At the moment therefore, and in accordance with the SFC timetable, individual colleges are setting up their ALFs and appointing trustees for them. The SFC is proceeding with the establishment of the umbrella ALF for those colleges that prefer this option, and as a fall-back should individual colleges not establish their own ALFs by April 2014.
8. ALFs will be administered by a board. The board of each ALF is likely to consist of trustees appointed by the board, members of the relevant college board of management (which should be a minority), and individuals appointed by the college as trustees. For ALFs to achieve their purpose i.e. to continue to allow colleges access to cash reserves while not affecting the Scottish Government’s budgetary control regime, they must clearly sit outside the boundaries of public expenditure. Crucially, this means that ALF trustees must be independent of colleges and act in the interests of the charitable objectives. The SFC is encouraging colleges to seek expert legal advice on draft Articles of Association to ensure that ALFs are demonstrably independent from colleges.

9. The Articles of Association will dictate the way in which the resources of each ALF can be used. It is likely that colleges will prepare long term strategic plans setting out development priorities (estates, course provision, etc). Colleges will then use these plans in applying to the ALF board for funding to support development activities, demonstrating how the funding will meet the stated charitable objectives of the foundation.

10. The trustees will also be required to prepare accounts for the ALFs which will be audited in accordance with the requirements of the Charities and Trustee Investment (Scotland) Act 2005 i.e. not by the AGS. The independence of the ALFs would mean that their accounts will not be consolidated with those of the relevant college. The audit of ALF accounts and the role played by the Office of the Scottish Charity Regulator (OSCR) in regulating charities, should provide reassurance that trust funds are being used for the purposes intended. However, the approach being taken does involve a clear shift of accountability away from the Scottish Government and the Scottish Parliament for use of college cash reserves which, at least in part, have been generated from public sector funding.

**Funding ALFs**

11. Colleges will initially transfer an amount of money to their ALF based on an assessment of their “cash reserves”. This should not be confused with college Income and Expenditure (I&E) Reserve balances shown in their accounts. I&E Reserves are often called “cash-backed”, because they are usually the consequence of annual surpluses generated over a number of years, and to distinguish them from other reserves which are the result of accountancy conventions (e.g. the revaluation of assets). However, there is no direct correlation between the value of the I&E Reserve and the amount of cash a college may have at any one time.

12. Rather, a college’s cash balance at any one time is likely to have come from a number of sources, such as:
- Annual surpluses achieved over time, which have not yet been spent, some of which may be committed or earmarked for spending, on development projects for example.

- SFC grants and other income sources which have yet to be used to pay outstanding bills

- Commercial borrowings which have yet to be spent, most commonly planned for capital development projects.

13. As part of the establishment of ALFs, between now and the end of March 2014, colleges will need to examine a number of factors such as their current investment plans, current creditor levels, loan repayment schedules and the daily amount of cash needed to support on-going operations. Once immediate financial commitments and working capital requirements are determined, colleges will be able to transfer what cash is left to their ALF. Until this happens, the amount of college cash reserves that will be transferred to ALFs cannot be known.

14. In subsequent years, colleges will have to operate within an annual budget limit which reflects their income and expenditure, including Scottish Government funding. However, their net expenditure must avoid creating a surplus or deficit within Scottish Government budget limits. Colleges can therefore be expected to transfer surplus income generated from whatever sources to their ALF during the year it is generated to ensure they avoid an overall surplus or deficit, and with the proviso that the funds held within the ALF will eventually be used in line with the college’s strategic plan. What this means in practice, is that colleges are likely to operate within much tighter working capital envelopes than some have previously been used to, and they will need to keep a much closer eye on the timing of cash inflows and outflows.