Dear Convener

Thank you for your letter of 24 November. I am grateful also for you having shared the SFC’s response – I have no specific comments on Dr Kemp’s letter. I have set out below my comments on the issues you raised in your letter to me.

Differences in financial reporting between colleges and other public bodies

The way in which individual public bodies account for and report their finances varies from sector to sector. It is not possible, therefore, to always directly compare financial information between sectors. I have focused my response on the specific differences that arise as a result of colleges being required to present information in accordance with two distinct pieces of financial guidance. It is the differences in requirements between the two pieces of guidance that contribute to the issue on depreciation, on which I commented in my report Scotland’s colleges 2016.

The first piece of guidance is the Government Financial Reporting Manual (‘FReM’, developed by HM Treasury). This sets out how central government bodies should apply International Financial Reporting Standards (IFRS). Essentially, the FReM specifies how central government bodies should present their annual report and accounts.

The second piece of guidance is a ‘statement of recommended practice’ (SORP); the SFC referred to this during the Committee’s evidence session. SORPs are sector-driven recommendations on financial reporting, auditing practices and actuarial practices for specialised industries, sectors or areas of work. Because colleges are charitable bodies, colleges are required to follow the Charities Accounts (Scotland) Regulations 2006. The regulations require colleges to comply with the ‘Accounting for further and higher education’ SORP (FE SORP).

Colleges must also comply with the ‘accounts direction’ issued by the Scottish Funding Council (SFC) each year. The accounts direction specifies how colleges should prepare their accounts, including how certain items should be reported and the level of detail that should be disclosed. Where there are differences between the two pieces of guidance described above, the SFC can direct colleges as to the approach to use. The 2015/16 accounts direction required colleges to prepare their accounts in accordance with the FE SORP.

The FE SORP generally allows, or requires, colleges to process and report their finances in different ways from other central government bodies. There are two specific differences to which I would draw the committee’s attention:
Capital grants

The FReM requires public bodies to recognise grant income in their income and expenditure account in the year in which the income is received. The FE SORP previously did not allow colleges to do this and, instead, colleges had to credit the income as ‘deferred capital grant’ in their balance sheet. Colleges would then make annual transfers to the income and expenditure account, over the same period, and to the same value, as the depreciation which would normally be associated with the asset for which the grant was provided. The main effect of this is a lower level of income in the year of receipt compared with the amount that would appear in another public body’s financial statements. In the longer term, there will be no overall difference. The FE SORP now allows both methods to be used.

Net depreciation

My report Scotland’s colleges 2016 provided details of this issue; an extract of the relevant paragraphs of the report is included in the Annex to this letter for ease of reference. The main difference here between colleges and other public bodies is that the Scottish Government (through the SFC) provides colleges with cash allocations for budgeted depreciation (a non-cash cost), while other public bodies receive a non-cash allocation. The FE SORP requires colleges to show all of the funding they receive as part of income in a statement of income. General accounting rules do not allow a non-cash budget allocation to be recognised as income in the accounts. Under the FReM, other public bodies do not show government funding as income, as they present a statement of expenditure. In my report, I recommended that the Scottish Government and the SFC should introduce a better approach to allocating depreciation budgets to colleges.

Scrutinising deficits

The Committee also asked about the ability to scrutinise deficits. The surplus or deficit reported in the income and expenditure account provides a broad indication of the financial health of a body, it does not provide a complete picture. It is sometimes necessary to examine other areas of the financial statements and to apply some interpretation to the figures. There is no simple way to make that interpretation, particularly for those who may not be familiar with accounting terms and reporting. My report (Scotland’s colleges 2016) included an analysis of the underlying position for the college sector, alongside some further analysis of the financial statements, in order to provide a more detailed picture of the overall financial status of the college sector (paragraphs 59-62, and Exhibits 10 and 11).

It is worth noting that the financial statements of public bodies are subject to external audit. If an auditor had serious concerns about the financial position of a body, he or she would include a comment to that effect within his or her audit opinion in the financial statements. Further, the auditor comments on the body’s financial position in the annual audit report, and this will usually include further detail on the surplus/deficit position. Where there are significant concerns about a college’s finances, I prepare a separate report, under section 22 of the Public Finance and Accountability (Scotland) Act 2000, to draw these concerns to the attention of Parliament.

I hope the Committee finds this response helpful.

Yours sincerely

Caroline Gardner
Auditor General for Scotland
The Scottish Government’s approach to funding colleges for depreciation is complex, and creates a degree of uncertainty for colleges

69. Before reclassification in April 2014, the Scottish Government included an amount for depreciation within its funding allocation for colleges. As depreciation did not require a cash spend in the year of allocation, colleges were able to spend this cash or set it aside to meet future needs. Following reclassification, the Scottish Government provided a non-cash budget to cover depreciation. But the cash allocation to colleges still includes a sum equivalent to the amount previously set aside for depreciation. Colleges are potentially left with an amount of unspent cash (referred to in the sector as ‘net depreciation cash’) but require approval from the Scottish Government to spend it. In 2014-15, following discussions among the Scottish Government, the SFC and the college sector, colleges spent this cash on student support funding, loan repayments and ‘regional priorities’. Three colleges donated an element of the cash to ALFs.

70. Because the items on which this net depreciation cash may be spent are not approved until mid-way through the college financial year, colleges do not know if or how they will be able to spend it, creating uncertainty in determining how to spend their allocation. Additionally, while the SFC recommended that colleges disclose the impact of this spend on their operating position, this was not disclosed in all cases. The SFC worked with colleges to calculate a total spend of £17.5 million in 2014-15.

71. We acknowledge that reclassification has led to a mismatch between Scottish Government accounting rules and the further and higher education SORP (Statement of Recommended Practice). However, the current approach to addressing this mismatch is complex and creates uncertainty for colleges. It was also intended as a short-term measure. The mismatch has existed since April 2014. The Scottish Government, SFC and the sector are working together to develop a solution but have not set a date by which the issue will be resolved.