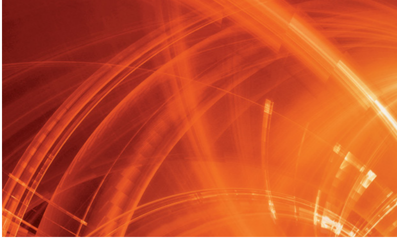
Executive Leadership and Development Programme

Self study unit: Finance



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The Executive Leadership Development programme has been developed by the Learning and Skills Improvement Service (LSIS). This self study unit is one of a series produced for the flexible Executive Leadership Development Programme. It is designed to support first and second tier managers and leaders in leading their institutions in a time of rapid and complex change for the sector and to strengthen the leadership capacity of the further education sector.

The qualifying programme has been developed using the LLUK benchmark role specifications for managers and leaders at these tiers. It will recognise formally the specific expertise required in FE leadership

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Introduction

This guide to strategic finance is aimed at Principals and senior managers working in the FE sector. If finance is a topic you are already familiar with, you may only need to skim the contents or dip into certain sections to check your understanding.

If your knowledge or experience of finance is more limited, the guide will give you a rapid overview of the function, help you identify the main strategic issues and provide you with more detailed information, if this is what you need in order to have greater confidence in handling financial information and making strategic decisions with a finance element.

Every college has a key financial officer (by whatever title) and a team of finance professionals to support them, as well as access to advice from auditors, accountants, the Young People's Learning Agency (YPLA) and the Skills Funding Agency. However, the finance director is not legally responsible for the financial wellbeing of the college, that responsibility lies with the principal.

If finance is not a significant part of your skill set and experience, this guide will help you understand the scope of the financial responsibilities and the work of the finance team, and assist in making financial judgements.

Why a grasp of finance is important

Firstly, the future of the college (and the wellbeing of the students and staff) is critically dependent on its financial health irrespective of how good everything else is. Secondly, the principal is the college's accounting officer and is accountable in law and to parliament via the House of Commons Committee of Public Accounts for the college's use of public funds.

The key challenges in finance are:

- understanding the language and core concepts of financial management;
- meeting the legal requirements and those prescribed by the funding bodies – particularly the YPLA and the Skills Funding Agency;
- budgeting, financial planning and risk management;
- making sense of, and having confidence in, the college's financial reports and
- making key strategic, investment or operational decisions which are informed by financial information.

Key documents

The following college documents are likely to be helpful to you in getting to grips with the financial context.

- The college's current three-year financial plan and commentary
- Annual financial statements for the past three years
- Recent periodic (probably monthly, but possibly quarterly) management account reports
- The Self-Assessment Report Questionnaire (SARQ)
- External auditors' reports
- Provider Financial Assurance (PFA) reports and guidance
- The financial memorandum
- Documentation describing the budget setting process.

You might also want or need to refer to financial regulations and other guidance documents on the YPLA and the Skills Funding Agency websites.

Understanding key financial terminology

Finance professionals use language in a very specific way so that even if you think you know what financial terms mean, you may need to confirm your understanding. Key terms include:

Accounting Officer - The statutory role of the Principal in the college's relationship with its primary funder and regulatory body, the Skills Funding Agency.

Capital - Transactions where the impact/ benefit will be enjoyed over several years. Includes things other than salaries and consumables and other running costs.

Revenue - Transactions where the impact/ benefit will be enjoyed within the current year (eg running costs, including salaries and overheads).

Going concern - Broadly, the ability of the organisation to continue to operate into the indefinite future. Auditors will have a series of more specific tests.

Prudence - The accounting principle that organisations must not anticipate the benefit from income until it has been earned and must always make provision for foreseeable expenses and losses.

SORP - Statement of Recommended Practice which provides standards of reporting for the annual financial statements.

Other common terms are highlighted in bold in the text and explained in the glossary at the end of the unit.

Section 1: Finance fundamentals

Self- assessment questions

If you can answer the following questions with confidence, feel free to skip this section and move onto Section 2:

1. What is an incorporated body and what has it got to do with a college?

2. What is the purpose of the financial memorandum?

3. What is the difference between management accounts and annual financial statements?

4. Could you explain the accounting terms "going concern", "cash flow", "capital" and "revenue" to a new Governor?

Overview

This section outlines the legal and financial context in which colleges operate. It explains some key accounting standards, concepts and conventions, and introduces the financial memorandum and the role of the Principal as accounting officer.

This section will help you to:

- understand your specific responsibilities in relation to the YPLA/Skills Funding Agency as the main funding bodies;
- explain some key accounting standards, concepts and conventions;
- explain the purpose of budget holder reports and monthly management accounts, and the members' report and annual financial statements (statutory accounts).

The statutory context

As **incorporated bodies** under the Further and Higher Education Act 1992 (FHEA), colleges are independent legal **entities**. For more detail about the relevant legislation see the technical annex.

Typically, most of a college's provision is funded under a **financial memorandum** which sets out the relationship between the statutory funders and the college. The Principal's role as accounting officer is a key feature of this relationship. The Principal has the same accountabilities for all funds, whether from public sources such as HEFCE or RDAs or private ones (eg. contracts with employers).

The financial memorandum confers a number of responsibilities on both the college and the funding bodies.

Significant responsibilities are placed on the Principal as accounting officer, and on the governing body or Board of the college. These responsibilities include ensuring:

- funds are used for the purpose for which they were intended;
- claims made for funding are accurate and in accordance with funding rules in place at the time;
- the adequacy of financial systems and controls and
- safeguarding assets and ensuring the solvency of the college.

Section 2 covers the financial memorandum in more detail.

Accounting standards, concepts and conventions

The purpose of financial reporting is to provide accurate financial information and to give stakeholders confidence that the information presented to them is complete, consistent and reliable.

The key financial information or statements consist of:

- internal (inward-facing) statements – periodic (usually monthly) **management accounts** and **budget holder reports** and
- external (outward-facing) statements – **members' report and annual financial statements** (statutory accounts).

The annual reporting cycle is covered in more detail in Section 4.

The accounting profession has standardised approaches to recording and reporting financial transactions. These **accounting standards** are published by the Accounting Standards Board (ASB). Accounting standards can be either national **(http://frc.org.uk/asb/) or international (http://www.ifrs.org/Home.htm)** in their coverage.

Accounting standards are based on concepts and conventions which are common to all organisations. When looking at or talking about the college's accounts, you will encounter the following terms and concepts.

- Entity
- Going concern
- Historic cost
- Income and cost recognition
- Prudence
- Consistency
- Capital and revenue
- Cash flow management.

You will find an explanation of these concepts in the annex.

Key financial statements

Financial statements provide a formal summary record of the organisation's financial transactions. They are used to judge the relative financial health of an organisation. They can be inward-facing or outward-facing, although internal documents may become public through Freedom of Information requests. Outward-facing financial statements (statutory accounts) are required by law, are subject to independent audit and are used by regulators and other stakeholders. They are prepared under strict rules.

Management accounts are typical inward-facing monthly financial reports. They provide detailed comparisons between actual and planned income and expenditure as shown in the college's budget. There will be various levels of reporting from budget holder level (budget holder reports) to college level. College level management accounts are used by the Board and management team to monitor the college's financial performance.

Management accounts are prepared by a college's finance team and provide:

- information on revenue from and expenditure on courses, faculties and/or schools;
- a basis for further investigation if planned activity differs from actual experience, eg income based on student numbers is lower than expected;
- key financial performance indicators relating to the Skills Funding Agency's definition of the financial health of a college and
- a cash flow statement showing all sources of cash flowing into and out of the college.

The members' report and annual financial statements (statutory accounts) are outward-facing documents which:

- are required by law;
- are subject to audit and include an auditor's report and
- provide a formal record of the financial performance for a year's activity, and of the assets and liabilities of the college as at a particular date.

These accounts must be prepared in accordance with the Statement of Recommended Practice (SORP) and formally signed at a college meeting.

The Skills Funding Agency guidance document Accounts Direction to Further Education Colleges for 2009/10

(http://skillsfundingagency.bis.gov.uk/providers/finance/financialmanagement/financialmanagement/accountsdirection/)

provides direction to colleges and financial statements auditors on the preparation of colleges' annual financial statements.

Key points - Summary

- As independent legal entities created by statute and accountable to parliament for the public money they receive, colleges are expected to take full control of their own financial affairs in compliance with the relevant regulations and guidance. The Principal, as accounting officer, is accountable to parliament, via the House of Commons Committee of Public Accounts, for the college's use of public funds.

- The financial memorandum sets out the relationship between the college and the Skills Funding Agency - the main funder and regulator for the sector; the Principal has the same accountability for other public and non-public funds received by the college.

- The Principal (as accounting officer) and Board must ensure that funds are used for the intended purpose, that funding claims made are accurate and in accordance with funding rules, that adequate financial systems and controls are in place and that the assets and solvency of the college are safeguarded.

- The college must adhere to accounting standards – standardised approaches to recording and reporting financial transactions which facilitate the reliability and comparability of financial reports.

- The key financial statements are the inward-facing (for internal use) monthly management accounts and the outward-facing (for external use) members' report and annual financial statements (or

Section 2: Compliance

Overview

As accounting officer, the Principal must be clear about his or her role in relation to the YPLA and/or the Skills Funding Agency, as regulator and core funders of the FE sector. From 1 April 2010, sixth form colleges are to be monitored by the local authority with the YPLA operating in a supporting role. Monitoring of FE colleges will fall under the Skills Funding Agency.

This section will help you to understand:

- the Principal's specific responsibilities in relation to the financial memorandum;
- the Skills Funding Agency's requirements for the three-year financial plan;
- the role of accounting officer;
- the different categories of financial health;
- the powers of the funding body to intervene in a failing college;
- the importance of audit and financial governance and
- the purpose and function of the college's financial regulations.

The Financial Memorandum

The financial memorandum sets out the roles and responsibilities of the Skills Funding Agency and the college being funded. It also establishes the conditions under which grants will be paid to the college and the college's responsibility to ensure that all these conditions are met.

Part 1 sets out key financial terms and conditions under which the YPLA and the Skills Funding Agency fund provision. The terms include compliance with the Joint Audit Code of Practice,

(see:http://www.aoc.co.uk/en/Policy_and_Advisory_Work/finance_and_statistics/finance_directors/framework_for_excellence_and_audit_issues.cfm)

which in turn requires sound systems of financial and management control.

In general, the financial memorandum requires the college to:

- keep proper audited accounts from which it must prepare annual financial statements;
- use funds for the purposes for which they were given;
- provide the funders with audited accounts within five months of the year end;
- ensure the audited accounts are signed by the Principal and the Chair of Governors;
- make the accounts available to the public;
- notify the funders of any serious deterioration in its financial position;
- inform Governors at least once each term of the college's financial position and
- apply for consent to borrow more than five per cent of total annual income (or £1m – whichever is the lower).

Part 2 is an annual document signed by the Skills Funding Agency and the Principal that fixes the contract between the college and the Skills Funding Agency to deliver an agreed plan of business for a certain contracted value.

The Financial Memorandum also obliges the college to:

- have an agreed development plan (in correct format and content) which forms part of the financial memorandum;
- accept a Skills Funding Agency review of the development plan;
- declare annually details of the bodies it will be contracting with for franchising delivery;
- deliver its provision to acceptable standards and seek continuous improvement through ongoing self-assessment;
- inform the Skills Funding Agency of injuries and diseases suffered by learners and provide assurances for learner health and safety;
- demonstrate its compliance with equal opportunities legislation;
- only use Skills Funding Agency funding to bid for any European funds with Agency permission;
- comply with Skills Funding Agency's requirements on branding and logos and
- have a proper complaints procedure in place.

The accounting officer

The financial memorandum identifies the **college Principal** as **accounting officer.** This means that in finance-related, reputation-critical and legal matters the responsibility lies with the Principal. The college Principal has significant personal responsibilities for the use of public funds and, in particular, carries responsibility for the accuracy of funding claims and the robustness of the systems which produce them.

An accounting officer is a person appointed by the Treasury, or designated by a government department, to be accountable for the operations of an organisation and the preparation of its accounts. An accounting officer is responsible for:

- ensuring the propriety and regularity of the public finances for which he or she is answerable;
- administering finances prudently and economically avoiding waste and extravagance and
- using all the available resources efficiently and effectively.'

Under the terms of the financial memorandum, the Principal has a duty to:

- ensure the accuracy and adequacy of systems;
- review the adequacy of the system of internal control;
- prepare a budget for consideration and approval by the Board;
- manage the college within the agreed budget;
- ensure that Skills Funding Agency funds are only used for the purpose they are given and in line with the terms and conditions attached;
- ensure that funding claims are accurate (and this implies active supervision of those preparing the claims);
- report any material weaknesses or breakdowns in internal control to the college Board;
- take an active role in the work of the finance committee (if there is one – see note below) and
- report any proposed actions of the Board that are incompatible with the financial memorandum.

Note: there is no statutory requirement to have a finance committee, but most colleges do.

In practice, the finance director will take day-to-day responsibility for the college's financial administration. The finance director is answerable to the principal and to the Board for the proper running of the finance function and the accuracy of financial and performance information. But the Principal is ultimately accountable to the Board and the Skills Funding Agency for the accuracy and reliability of information presented and funding claims made.

Financial health categories

The Skills Funding Agency's own financial memorandum requires it to keep colleges' financial health under review. The purposes of this ongoing review are to ensure that colleges can survive financially while the agreement with the Skills Funding Agency lasts and that learners do not suffer as a result of financial failure of the organisation.

Data on financial health is gathered through the three-year financial forecast (or plan) and through the actual results shown by the annual financial statements (the statutory accounts). Through the planning process the organisation carries out a self-assessment of its anticipated health during the period. The Skills Funding Agency carries out its own assessment using the same criteria. The college is assessed as financial health category A, B or C by reference to several financial measures, the most significant of which is the current and future solvency of the college.

As well as general descriptors of financial health, each category is characterised by key financial performance indicators. For a definition of these performance indicators see the annex.

Category A

Category A colleges have robust finances capable of delivering their strategic and three-year financial forecasts and also have carried out a rigorous **sensitivity analysis** on the areas most critical to success. There will also be effective contingency plans to deal with major negative shifts in the plans.

Key financial performance indicators include:

- positive cash flow from operations in each

year of the plan

- more than **25 days cash in hand**
- a **current ratio** above 1.5:1
- a **positive balance on the general reserve** (excluding provision for pension shortfall under FRS17)
- an **operating surplus** each year
- **borrowings** in total less than 15 per cent of total annual income.

Category B

Category B colleges have signs of financial weakness which may inhibit their plans if they meet negative circumstances during the plan period. These organisations may have made over-ambitious assumptions without a robust business plan to deliver them. They are likely to be less solvent than category A organisations but should be able to demonstrate the following key financial indicators:

- Positive cash flow from operations in each year of the plan.
- More than 15 days cash in hand.
- A current ratio of between 1:1 and 1.5:1.
- A positive balance on the general reserve (excluding provision for pension shortfall under FRS17).
- an operating **breakeven** position.
- borrowings in total between 15 and 40 per cent of total annual income.

Category C

Category C colleges are financially weak and dependent on the goodwill of others, eg they have bank loans to shore up their solvency problems. Consequently they are also at risk of failing to deliver their plans and will display the following characteristics.

- **Negative cash flow** from operations in one or more years of the plan.
- Less than 15 days cash in hand
- A current ratio of less than 1:1 in one or more years.
- An accumulated **negative balance on the general reserve** (excluding provision for pension shortfall under FRS17).
- An operating **deficit**
- Borrowings in total exceeding 40 per cent of total annual income.

The likelihood of intervention and damage to a college's reputation increases as the financial situation deteriorates. A weak financial position will undermine the college's ability to deliver its strategic plan, and may distract management from the core business of teaching and learning

Intervention

Under the Further and Higher Education Act 1992 (as amended by the Apprenticeship, Schools, Children and Learning Act 2009) the Skills Funding AgencyFA has statutory powers to intervene in college corporations.

(See: http://www.legislation.gov.uk/ukpga/1992/13/section/57)

These powers may be used where:-

- the board mismanages the college affairs;
- the board fails to discharge duties placed upon them;
- the board acts unreasonably in their use of powers granted or
- where inspection reveals likelihood of serious weaknesses or even failure.

If this is the case, the Chief Executive may:

- remove any or all of the members of the institution's governing body;
- appoint new members of the governing body if there are vacancies and
- give directions to the governing body (including directions to make collaboration arrangements and directions to consider the case for dismissal of a member of staff).

At the time of writing the Skills Funding Agency is consulting on a revised intervention policy.

Task 1

- What is your college's current financial health category?
- What were the scores against each of the 6 financial performance indicators when last rated and what are they now?
- What measures are in place to maintain (if in Category A) or improve the college's financial health?

Feedback

For feedback see end of unit.

Section 3: Strategic financial management

Overview

As accounting officer for the college, the Principal has a key role in leading the strategic financial management (including risk management) of the college, even though much of the day-to-day financial activity will be delegated to the finance director and others.

This section covers:

- the responsibilities of the accounting officer for the college's financial strategy;
- the relationship between the three-year financial forecast and the strategic plan
- preparing and approving the annual budget;
- the financial planning and management of major capital projects arising out of the strategic plan;
- the need to identify, assess and manage risks and
- the role of management information systems (MIS) in the financial management of the college.

The three-year financial strategy

All colleges are required to share their strategic plans with the YPLA and Skills Funding Agency as appropriate. An integral part of the strategic plan is the three-year financial forecast. This forecast should put monetary values against the strategic plan and include all of the resource implications of its targets. This is essential to ensure that the strategic plan is both affordable and realistic.

(see:http://www.aoc.co.uk/en/Policy_and_Advisory_Work/finance_and_statistics/finance_directors/finance_reporting_project.cfm for the financial planning template.)

In addition, colleges are required to submit financial plans based on the planning template for:

- capital project applications;
- reorganisations, such as college mergers;
- recovery plans and
- borrowing consent requests.

Key developments outlined in the strategic plan (for example, accommodation projects, new curriculum, workforce planning issues and student number targets) should be fully reflected in the financial forecasts. Similarly, any assumptions in the forecasts (for example, increases or decreases in public or private funding or changes to staff costs) need to be consistent with the strategic plan.

The Board has overall responsibility for setting the general strategic framework within which the college management and staff operate. The Principal should therefore actively support the Board in:

- the formation and adoption of the strategic plan, the annual operating statement and the associated financial forecast;
- dissemination of the plan throughout the college and to external stakeholders once it has received Board approval;
- making frequent reference to the plan in Board considerations;
- monitoring progress towards its objectives and targets on a regular basis and reviewing the whole plan annually to assess progress and
- updating the plan by producing a new operating statement and financial forecast for the coming year.

The three-year financial forecast is the long-term financial plan for the college and as such is probably the most important financial document that Governors are responsible for reviewing. The Principal and senior managers must ensure that they and Governors understand the key assumptions underlying the forecast and rigorously challenge any part of the plan they feel doubtful about. The forecast should be supported by a commentary that clearly states the underlying assumptions, a sensitivity analysis which reflects the key risks to the college's financial plans plus any other information requested by the Skills Funding Agency.

The trouble with the future is that it has not happened yet. Projections of future levels of activity, student numbers, etc. will feed through into the financial projections with varying degrees of certainty and confidence. They may also be derived from an aggregation of plans and projections developed first at departmental/faculty level where there may be little expertise in doing it. Expenditure can generally be projected more confidently than income and those who put forward growth plans rarely underestimate the income generated by them! The apparatus of sensitivity analysis, risk analysis, justifying commentary, etc. serves the purpose of testing those uncertainties as far as possible – but uncertainties will remain.

Colleges normally have to submit their three-year financial forecast to the Skills Funding Agency by 31 July. This forecast is reviewed

by the Agency along with information known about the college, including its strategic plan, accommodation strategy and other returns.

The Skills Funding Agency aggregates all the financial forecasts submitted in order to assess the overall financial health of post-16 education and training. This assessment contributes to advice given to the Secretary of State for Business, Innovation and Skills.

Once again the accounting officer is ultimately responsible for preparing the budget for consideration and approval by the Board and for managing the college within the agreed budget. The key assumptions made in the financial forecast must be robust and realistic.

Task 2

Look again at your college's latest three-year financial forecast.

- What are the key assumptions on which it is based?
- What evidence have you got to make you feel confident about these assumptions?
- Are there any critical assumptions on which the plan substantially rests (eg recruitment to a large new programme)?
- What would be the effect of one or more of your key assumptions being wrong?
- Is there a 'worst case scenario' sensitivity analysis with the three-year forecast? What does it show?

Feedback

For feedback see end of unit.

Preparing and approving the annual budget

In preparing the budget, typically starting in February or March, the finance department will usually take the projected financial performance for the current year as its starting point. It will then make adjustments for known or planned changes to the college's activities.

The college budget should be built up from the budgets of individual budget holders. Budgets should be seen as targets for income and as a maximum figure for expenditure, rather than just authority to spend money. If the target income is not likely to be reached then the expenditure will need to be capped proportionately.

Budget approval and monitoring of performance

The Governors have to approve the annual budget before the start of the new financial year, which is in August. This is a task that cannot be delegated to the finance committee. In most colleges, the budget is considered by the finance committee who then recommend it to the Board. As all Governors have a statutory responsibility for ensuring the solvency of the college, it is essential that they should all have the time to understand and to discuss the budget before approving it.

The budget must correspond to the first year of the college's three-year financial forecast and is an integral part of the college's operating plan and strategic planning process. It should provide a financial translation of the college's specific objectives and targets for the coming year at a 'whole college' level. This translation of the operating plan into a consistent, viable and agreed financial plan provides the framework for protecting the solvency of the college.

In order to approve the budget, Governors need to be aware of:

- key assumptions made in the budget preparation;
- key areas of risk and how these will be managed should they materialise and
- the process by which the budget has been built up.

As a minimum, the Governors should be provided with:

- an income and expenditure account;
- a balance sheet;
- a twelve-month cash flow forecast a capital expenditure plan and
- a supporting commentary for all of the above, which clearly states the key assumptions made in preparing the budget.

Planning for major strategic projects

Achieving strategic college objectives will at some stage require the upgrading of accommodation and/or facilities. Alternatively, strategic decisions may be taken to take over or merge with another college. These will be significant projects for the college to undertake, involving substantial resources in time and money. For instance, the merger with another college will require time and energy in performing due diligence to ensure that the reality matches the rhetoric. A crucial part of such due diligence is a robust appraisal of the current and future financial position of the other college, and the merged organisation.

Financial techniques in project appraisal

The financial viability of a project is an important aspect of the evaluation of proposals and options. Financial project appraisal techniques vary from the straightforward method of testing which option pays back the capital cost first, to which option generates the best return on investment (ie percentage profit to investment), to a more complex method (called discounted cash flow (DCF) or net present value) which takes into account the deteriorating value of cash flows over the life of the project. If you are applying for a Capital Grant from the Skills Funding Agency you will have to provide a five-year investment appraisal of the anticipated costs and cash flows using this technique. You will also need to provide a sensitivity analysis of the likely impact of changes in key variables such as interest rates or assumed student numbers.

DCF is based on a common sense understanding of the changing value of money: if inflation is running at five per cent, £1 received a year from now is equivalent to having 95p now. DCF applies this logic to the incoming cash flows from the project – cash flows received in earlier periods have a greater value in today's terms than later ones. The Skills Funding Agency requires a five-year investment appraisal of the anticipated costs and cash flows. See **http://readingroom.lsc.gov.uk/lsc/national/LSC_Capital_Handbook.pdf**

Management information systems (MIS)

The provision of accurate and timely management information is critical to the successful management of college affairs. In the region of 17,000 full-time equivalent posts costing £420m annually are involved in the sector, delivering corporate and learner MIS. It provides key management information both in terms of learners (for funding claims) and finance. A number of the more high profile problems which have occurred in the sector have been due to inadequate MIS resulting in inaccurate funding claims leading to significant financial problems.

A good MIS should enable the college to manage the essential elements of the 'business', ie student numbers, accommodation, timetables, finance and budgets in a way which provides accurate and timely information for good decision-making and for responding to requests for information both from within and from outside the organisation.

The college's systems should be capable of providing for the needs of staff (eg enrolling students, managing room allocation, student attendance records, processing registers), for managers (accurate, timely and effective management reports, providing accurate information for inspection, etc.) and for students (enrolment information, website, attendance monitoring, managing passwords and access to the college ICT, learning resources, assignments, etc.).

Key points - Summary

- The financial memorandum is a key document setting out the roles and responsibilities of the college and the Skills Funding Agency. It sets out the terms and conditions for funding, which include compliance with the Agency's Audit Code of Practice, and the contract between the college and Skills Funding Agency to deliver an agreed plan of business for a certain contracted value.

- As accounting officer, the Principal has a range of specific responsibilities for the college's solvency and financial probity. The Principal has ultimate responsibility for the college's use of public funds, but the day-to-day financial management of the organisation will usually be handled by the finance director.

- The Skills Funding Agency monitors the financial health of the college using a set of key financial performance indicators. Category A colleges have robust finances; Category B colleges show signs of financial weakness which may inhibit their performance if negative circumstances arise; Category C colleges are financially weak and risk failing to deliver their plans.

- The three-year financial forecast fully costs the strategic plan, including the resource implications of its targets. The financial forecast must be integrated within the strategic plan to ensure that the plan is both affordable and realistic. The forecast should be supported by a commentary that clearly states any underlying assumptions and by a sensitivity analysis that reflects any key risks to the plan.

- The three-year financial forecast is submitted to the local Skills Funding Agency by 31 July and is used to categorise the financial health of the college. Ultimately, at national level, it will contribute to the Agency's assessment of the overall health of the sector and thus influence the outcome of the annual spending review.

- The Principal is responsible for preparing an annual budget, although in practice this will normally be carried out by the finance director. The Board must approve the budget before the start of the new financial year (1 August).

- The annual budget will correspond to the first year of the three-year financial forecast and is therefore itself an integral part of the college's operating plan and strategic planning process.

- Major capital projects (eg the upgrading of accommodation) arising out of the strategic plan have significant financial implications for the college. A number of resources and tools are available to assist with planning and project management and for assessing the financial viability of projects.

- Colleges must strike a balance between minimising risks that will impact adversely on the reputation and financial health of the organisation and taking calculated commercial risks to develop the college and make it more competitive. A good management information system (MIS) is a valuable tool in the efficient management of the college but an inadequate MIS can itself be a significant source of risk.

Section 4: The reporting cycle

Overview

All the financial reporting discussed in the previous sections occurs within the context of an annual reporting cycle starting at the college year end, 31 July.

This section will help you to:

- understand your role in the annual financial reporting cycle;
- explain the relationship between the annual financial statements (statutory accounts) and the monthly management accounts;
- interpret financial information contained in the annual financial statements and
- assess the effectiveness of the finance function within the college.

What is the reporting cycle?

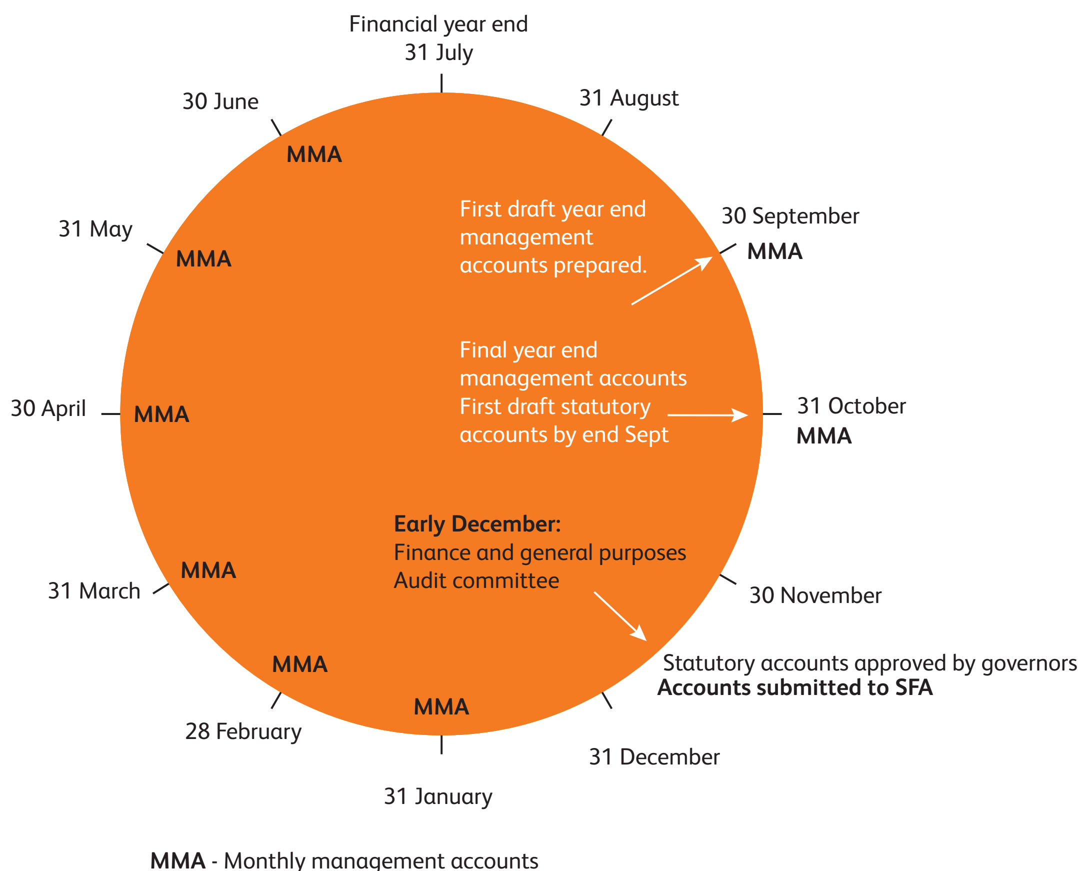
The reporting cycle shows the key milestones occurring in each financial year and provides an overview of the process of turning year end management accounts into audited and approved financial statements. It starts at the college year end, 31 July.

The reporting cycle consists of two separate strands as shown in Figure 1:

1. The process of preparing, auditing and approving the annual financial statements (the statutory accounts)
2. The monthly tasks of providing reports to budget holders and of preparing management accounts (the reports to budget holders are not the same as management accounts but underpin the budgetary control process).

There should be a clear and deliverable timeline from the end of the financial year in July to the sending of the annual financial statements to the Skills Funding Agency at the end of December.

Figure 1 The reporting cycle



The Principal is normally a member of the finance committee. For reasons of independence and probity, the Principal should not be a member of nor regularly attend meetings of the audit committee.

The opinion of the external auditors will be included in the statutory accounts. Any issues arising out of the auditors' work are set out in their annual management letter which provides details of material errors and areas for improvement. The letter is discussed by the audit committee with the internal auditors and key finance staff including the finance director.

Common areas of weakness may include:

- financial data shown to be inaccurate or incomplete;
- lack of planning, or poor planning, resulting in missed deadlines;
- management and financial reports that are inaccessible, too sparse or too detailed;
- information arriving either too late or incomplete weak or ignored financial controls and
- decision-making with only partial financial information, or without considering the full implications.

Annual financial statements (statutory accounts)

The college should prepare its annual financial statements in an audit-ready form by the end of September.

The statements which make up the statutory accounts are prescribed in the Universities UK Management Guidance Statement of Recommended Practice: accounting for further and higher education (SORP).

http://readingroom.skillsfundingagency.bis.gov.uk/sfa/200910_Accounts_Direction_handbook_3-FE-HE_SORP.pdf .

This interprets and explains relevant accounting standards. A college's statutory accounts should be prepared in accordance with these published standards and the fact that they are in accordance must be certified.

In addition the Skills Funding Agency publishes additional guidance in Accounts Direction to Further Education Colleges available at:

http://skillsfundingagency.bis.gov.uk/providers/finance/financialmanagement/financialmanagement/accountsdirection/

The SORP provides model financial statements based on 'Casterbridge College', examples of which are partly reproduced in the annex.

- Income and expenditure account balance sheet
- Cash flow statement.

The specimen accounts for Casterbridge College are available in full at:

http://readingroom.skillsfundingagency.bis.gov.uk/sfa/200910_Accounts_Direction_handbook_4b Model_Casterbridge_College_Financial_Statements.xls

Income and expenditure account

The purpose of the income and expenditure account is to show the sources of the college's

total income from grants, tuition fees, contracts and investments, etc. and how those funds have been used to cover staffing and operating costs, together with any interest or depreciation charges in arriving at the deficit or surplus for the year. This surplus or deficit is, in simple terms, the profit or loss of the organisation. Figures from the previous year are shown as a basis for comparison. Figures shown in parentheses () indicate negative values or deficits.

Balance sheet

The balance sheet shows the total values for assets and liabilities. Balance sheets show how the net assets of the college have been funded. The net assets and the sum of reserves, endowments, and deferred capital grants will therefore always be equal in value.

Assets are shown in different sections, notably fixed assets (land, building, equipment, etc.) and current assets (stocks, debtors, cash, etc.) – cash or near cash assets that will be converted into cash within 12 months. A few colleges may have endowment assets (from gifts) but these are not common.

Liabilities are divided into amounts payable within the next 12 months and amounts payable after 12 months.

One important viability test is the ability of any organisation to pay its immediate or short-term liabilities from its current assets, assuming normal trading conditions apply, ie the organisation is a 'going concern'.

Cash flow statement

A cash flow statement is an annual summary of the main sources and expenditure headings of cash.

The top half of the cash flow statement shows how much cash the organisation has generated or 'lost' during the period. In the example in the Annex, Casterbridge College has generated £1.9m in 2010, compared to a net outflow of £4.2m cash in 2009. Positive cash flows can be generated by normal operating activities, from income on investments, from new loans, from selling assets and from cashing in investments. Negative cash flows can also be generated from operations, capital expenditure and the repayment of loans. The bottom half displays changes in indebtedness to lenders.

Key performance indicators

Key financial performance indicators (the ones used by the Agency to judge a college's financial health) include:

- cash flow (positive or negative) from operations in each year of the plan number of days cash in hand
- current ratio
- balance on the general reserve operating surplus/deficit
- level of borrowings.

Details of how each of these measures is calculated are included in the annex

Other useful indicators include:

- enrolment levels – actual student numbers versus forecast numbers year outturn expected on management accounts;
- average funding per learner;
- actual versus planned cash flow and
- pay expenditure as a percentage of total Skills Funding Agency income as a percentage of total income staff numbers.

Tip: Comparing these indicators for different market segments can help you to decide which areas of provision to develop or expand and which to contract.

Task 3

1. To what extent do your college's existing management reports meet the needs of:

- the Board;
- the senior management team;
- curriculum leaders and
- other budget holders?

2. What evidence do you have for your response?

Feedback

For feedback see end of unit.

Key points – Summary

- The financial reporting cycle sets out the key milestones of the college financial year (1 August to 31 July). There are two separate strands to the cycle: the process of preparing (from year end management accounts), auditing and approving the annual financial statements (statutory accounts) and the monthly task of providing reports to budget holders and preparing monthly management accounts.
- The college is responsible for preparing its own annual financial statements in an audit-ready form by the end of September. Externally audited and Board-approved statutory accounts have to reach the Skills Funding Agency by 31 December.
- The statements which make up the statutory accounts are prescribed by the sector's Statement of Recommended Practice (SORP). All FE organisations must follow the accounting standards applicable to their particular circumstances.
- As accounting officer, the Principal must know how to read and interpret key annual financial statements – the income and expenditure account, the balance sheet and the cash flow statement.
- College management will decide which key performance indicators to use to assess its financial health. These may reflect the Skills Funding Agency health category indicators, but individual colleges will usually develop their own additional indicators; these are not necessarily financial (eg enrolment levels – actual students vs. forecast levels).
- The Principal will need to assess the effectiveness of the college's finance function/financial reporting to make sure that he or she is fulfilling their responsibility.

Section 5: Financial governance

Overview

As publicly funded independent organisations, colleges are expected to act transparently at all times and to demonstrate robust financial governance arrangements. This means they get audited – a lot.

Audit

There are two main types of audit, internal and external (sometimes called financial statements audit). Colleges may also be subject to:

- learner existence and eligibility audit (undertaken by the Skills Funding Agency to check funding claims);
- European Social Fund (ESF) audit (to ensure rules regarding ESF funds have been complied with);
- Skills Funding Agency audits on work-based learning tax audits on PAYE or VAT and
- visits from the Provider Financial Assurance (PFA) team as part of inspection.

Most colleges contract out the internal audit function to an accountancy firm. Its purpose is to provide college Governors and managers with an independent and objective opinion on risk management, control and governance processes. Internal auditors report to the college's audit committee who agree a programme of work to test the strength of financial procedures in practice. Over a period of time, all aspects of the organisation's financial protocols and procedures are tested and reported on.

External auditors report to the Board on whether or not the final statutory accounts can be relied upon. The external auditors also have to consider the regularity and probity of transactions undertaken by the college (regularity audit). The opinions are provided in their signed auditors' report which forms part of the published statutory accounts. If the auditors are unable to certify that, in their view, the statutory accounts present a true and fair view of the college's financial affairs, they may issue a 'qualified' report. This has the effect of saying to the world that there are financial problems in the college. It can have a knock-on effect on public confidence in the college and the Skills Funding Agency as regulator will be concerned that a college has such a report.

There are obvious implications for colleges if their planned activity leads to a prospective poor health category, including the likelihood of more regular reviews by the Agency and adverse comment and grading in the leadership and management element of inspection. All regulators like providers who can demonstrate their capacity to plan for success, and for those in weaker

categories to show how they intend to improve their standing. The likelihood of intervention increases as the financial situation deteriorates. A weak financial position will undermine the college's ability to deliver its strategic plan, and may distract management form the core issue of teaching and learning.

Financial governance

Good governance in financial matters requires that the Principal acts with probity (complete and confirmed integrity and fairness) and transparency at all times and that the Governors are sufficiently trained in finance to be able to question the accuracy of, for instance, the three-year financial forecast. Scrutiny of financial matters will be delegated to the finance committee and the Principal is expected to take an active interest in or, more usually, be a member of this committee.

Governors are expected to act always in accordance with the accepted standards of good governance, for example those produced by CIPFA:

http://www.cipfa.org.uk/pt/download/governance_standard.pdf

In addition to the financial health assessment described earlier, the Skills Funding Agency's PFA Service Centre reviews the effectiveness of a college's governance and financial management arrangements in up to 25 per cent of all colleges in each year, usually in parallel with an Ofsted inspection. As part of the process, colleges provide a Self-Assessment Report Questionnaire (SARQ), signed by the Principal. The key messages

from reviews carried out in 2002/03 are published in Outcomes of financial management and governance reviews at Further Education colleges (SFA, 2004b).

The Skills Funding Agency’s PFA grades colleges as follows:

Colleges graded 1 to 3 are satisfactory or better than satisfactory colleges graded 4 and 5 are poor or inadequate.

A college graded 1 to 3 displays some or all of the following features.

- Shows positive trends in financial health meets funding targets.
- Shows sound internal control systems has a strong finance team.
- Produces budget reports that are useful to budget holders.
- Produces comprehensive and timely management accounts.
- Undergoes regular financial scrutiny by senior management and Governors.
- has a track record of successful capital investment projects produces value for money initiatives using benchmarking.
- Has a resource allocation model that is understood by managers..
- Has skilled and committed Governors with a good attendance record (70 per cent or above).
- Has good systems for recruiting new Governors.
- Involves Governors in strategic planning and performance monitoring.
- Offers succession planning for Governors and induction and training based on self-assessment/skills audit.
- Has acted on any auditors’ recommendations and the audit committee has monitored the process.

A college graded 4 or 5 is likely to show some of the following features.

- Late and/or infrequent management accounts no or poor cash flow forecasts.
- Inaccurate or unrealistic financial plan forecasts poor commentaries on the financial position.
- Inadequate capital project reporting.
- An audit committee unable to monitor the implementation of auditors’ recommendations.
- Instances of systems failures impacting on funding – missing funding audit completion deadlines.
- Shortfalls in student recruitment not adequately monitored – budgets not amended to reflect reduction in resources.
- Poor quality of papers and support for Governors in considering the budget and three-year financial forecast.

Task 4

- What is your personal assessment of the quality of financial governance and management in your college?
- What information sources and/or people did you consult to make that assessment?
- How can you have confidence in those sources?
- How does your assessment compare with the last one undertaken by PFA?

Feedback

For feedback see end of unit.

Financial regulations

Each college has its own **financial regulations**. The purpose of the regulations is to:

- provide control over all resources and
- generate confidence that the resources are being properly used to achieve the objectives of the strategic plan including financial viability, value for money and safeguarding the college's assets.

However, how these objectives are achieved is a matter for the college. The financial controls have to operate with and within the college's overall systems of distributed leadership, delegation and control. There is a balance to be struck. You might aim to encourage flexibility and responsibility among, say, heads of department by giving them a budget and freedom in deploying it. But you need safeguards to control the risk of one or more heads using their delegated budgets foolishly (or fraudulently). Where this balance lies is a matter for the Principal to decide, in consultation with the Governors and the finance director. It is a mistake to believe that centralised control equals more control in total.

Financial regulations are based on notions of transparency and probity. The following are the regulations typically dealt with.

Governance arrangements

- The organisation's responsibilities and powers (as a corporation) to maintain solvency, set a pay structure for staff, ensure controls are adequate to safeguard assets, ensure that finance is considered in decision-making, approve the budget and strategic plan, appoint auditors, etc.
- The responsibilities of the Principal to prepare estimates of income and expenditure and for the management of budgets and resources
- The structure and roles of finance, audit and remuneration committees

- The responsibilities of the finance director, other directors, managers and staff regarding security and avoiding loss.

Financial planning

- The requirement to create financial plans in line with corporate objectives (the finance director's task).
- Compliance with YPLA and Skills Funding Agency requirements.
- The process for setting budgets and allocating resources including capital projects.

Financial control

- How budgets will be controlled, including regular reviews and reporting of significant changes to plan.
- How regular progress reports will be provided for the finance committee and the Board as a whole.
- Arrangements for auditors and their authority.
- Powers and limitations on the investment of surplus cash (or treasury management).
- The appointment of bankers.
- Protection of income and rules for procurement of goods and services.
- Rules regarding the appointment and payment of staff fraud policy.
- Risk management arrangements.

All staff should understand the elements of financial regulations which relate to them.

Risk management

Colleges must strike a strategic balance between minimising risks that will impact adversely on the reputation and financial health of the organisation and taking calculated commercial risks to develop the college and make it more competitive. Suitable procedures should be in place to identify, assess, manage and review key risks through a risk management group. It is not enough to simply identify the key risks. You must also:

- assess the likelihood of the risks occurring assess the impact if they do materialise;
- if possible, take action to reduce the likelihood of them occurring have contingency plans in case they do occur and
- review risks on a regular basis to take account of changing circumstances.

See the LSC's circular 04/05, Further Education Colleges: Financial planning and risk management 2004-07:

http://readingroom.lsc.gov.uk/lsc/National/Circular0405.pdf

Risks need to be managed via a risk register and a process of identification, prioritisation, analysis (for key themes) and the development, monitoring and regular review of a robust risk management action plan.

Risk management is a topic in its own right, but as a minimum, risks should be actively managed by named individuals.

Typically a risk register will include the following headings:

Risk	Likelihood (high medium or low)	Impact (high medium or low)	Management and lead	Contingency
Missing deadlines on returns	Medium	High	Ensure realistic delivery plan in place Vice-Principal - Quality	Notify SFA ASAP of potential delay, agree revised deadline and re-assign staff to ensure completion

Establishing the likelihood of a risk occurring and the impact if it does allows you to concentrate on likely events which will have a large impact.

Risk management also requires you to consider the hidden costs of financial decisions – for example, the long-term impact on adult learner recruitment of closing a childcare facility.

You have now completed your work on this unit and should now feel more confident in your role as college accounting officer. The unit should be a useful resource for you in your strategic financial leadership of your college.

Key points - Summary

- Internal auditors report to the audit committee with an independent and objective opinion on the college's risk management, control and governance processes. External auditors report to Board members on the reliability of the final statutory accounts and on the regularity and probity of the college's transactions.

- The financial governance of the college must comply with the financial requirements stipulated in SORP and with the provisions of the financial memorandum. The Skills Funding Agency's Provider Financial Assurance (PFA) Service Centre reviews and grades the governance and financial arrangements of colleges on a regular basis. Colleges complete a Self-Assessment Report Questionnaire (SARQ) as part of this process.

- Each college has its own financial regulations. These are detailed and specific instructions to all staff about any and all financial dealings they have with the college, its customers and suppliers.

- Colleges must identify, review and actively manage significant risks to student well-being, funding and reputation

Sources of more information

References

The Chartered Institute of Public Finance and Accountancy (CIPFA), Good Governance Standard for Public Services. Available at: **http://www.cipfa.org.uk/pt/download/governance_standard.pdf**

Audit code of practice: Circular 04/07. Available at: **http://readingroom.lsc.gov.uk/pre2005/funding/providers/circular0407-audit-code-of-practice.pdf**

Outcomes of financial management and governance reviews at Further Education colleges. Available at: **http://readingroom.lsc.gov.uk/lsc/National/FMGOutcomesInfoNote3.doc**

Circular 04/05, Further Education Colleges: Financial planning and risk management 2004-07. Available at **http://readingroom.lsc.gov.uk/lsc/National/Circular0405.pdf**

Capital Investment Appraisal Summary available at: **http://readingroom.lsc.gov.uk/lsc/2005/funding/providers/five-year-capital-investment-appraisal.XLS**

Accounts Direction to Further Education Colleges for 2009/10. Available at:

http://skillsfundingagency.bis.gov.uk/providers/finance/financialmanagement/financialmanagement/accountsdirection/

Universities UK Management Guidance Statement of Recommended Practice: accounting for further and higher education (SORP). Available at: **http://readingroom.skillsfundingagency.bis.gov.uk/sfa/200910_Accounts_Direction_handbook_3-FE-HE_SORP.pdf**

Websites

Association of Colleges – aims to provide a single voice for FE colleges (by subscription). **http://aoc.co.uk**

Chartered Institute of Public Finance and Accountancy (CIPFA) – specialists in public sector finance. **http://cipfa.org.uk**

National Audit Office – scrutinises public spending on behalf of central government. **http://nao.org.uk**

Accounting Standards Board – provides a guide to accounting standards. **http://frc.org.uk/asb/**

Suggestions for further reading

Broadbent, M. and Cullen, J. (1993) *Managing Financial Resources*, Oxford: Butterworth-Heinemann.

Lawrence, B, (1995) *A Guide to College Resource and Financial Management*, London: Falmer Press.

Preedy, M., Glatter, R. and Levačić, R. (1997) *Educational Management*, Buckingham: Open University Press.

Glossary	
Rating	**Definition**
Accounting officer	A statutory role for college Principals in their relationship with the SFA. The accounting officer is deemed responsible for the adequacy of internal control, the appropriate use of funds and the accuracy of funding claims. The accounting officer signs the financial memorandum on behalf of the college.
Accounting period	The specific time period represented by the annual financial statements. College accounting periods are usually for one year from 1 August to 31 July.
Accounting standards	National and international agreed standards of how specific situations are to be accounted for and shown in annual financial standards. In the UK, the Accounting Standards Board acts as the guiding body.
Auditors' management Letter	The college's external/financial statements auditors will write formally to the college at the end of the annual audit setting out issues they consider need to be addressed. This will be discussed with senior finance staff initially to gather the management's responses, then will be considered by the audit committee and Board.
Balance sheet	Shows the assets, liabilities and long-term funds of the organisation at a particular date and forms part of the annual financial statements and monthly management accounts.
Break-even	The level of activity where income equals expenditure. In the case of a course or programme, the income received just covers the cost of putting it on.
Budget/budgeting	The process of allocating anticipated resources for the forthcoming year, in detail, and used as the Principal benchmark in measuring actual activity (expressed financially and numerically) as the year progresses.
Budget holder reports	Detailed monthly reports for individual departmental budget holders underpinning the overall monthly management accounts.
Capital	Refers to transactions where the impact/benefit will be enjoyed over several years.
Capital projects	Major (typically building) projects.
Cash flow statement	Shows the main sources of cash flowing in and out of the organisation during a period (normally one year) and forms part of the annual financial statements. The college's management accounts will also show a detailed month-by-month cash flow projection, indicating where additional cash injections may be necessary.

Glossary	
Rating	**Definition**
Compliance	Compliance entails fulfilling the obligations to the main funder and regulator, the SFA, as laid out in the college's financial memorandum.
Consistency	A key accounting principle: transactions of the same type must receive the same accounting treatment to allow comparison between organisations and between financial periods.
Current Assets	Categories of assets which are either cash or bank balances, or are capable of being turned into cash relatively quickly.
Deficit	The amount by which expenditure (revenue) exceeds income for the accounting period (normally 12 months).
Due Diligence	The process of ensuring the accuracy and robustness of key financial and other data when considering a merger.
Economic benefit	Any expenditure conveys an 'economic benefit' ie provides a service or goods to be used by the organisation.
Economic life	Normally associated with long-term (fixed) assets, the economic benefit of expenditure should be spread over its useful life, eg plant bought with an expected life of ten years.
Endowment assets	Items (investments, land or legacies) gifted to the organisation. (These are not endowments but statutory transfers of assets.)
Entity	An organisation that has a legal identity in its own right, and can sue or be sued in its own name.
Financial health Categories	Key contractual document between the college and the SFA – this sets out the terms under which grant will be paid to the college and is signed by the Principal as accounting officer.
Financial Memorandum	The test of the financial health of a college. Colleges in Categories Category A are deemed to be strong and those in Category C are deemed to be weak.

Glossary	
Rating	**Definition**
Financial regulations	Detailed and specific instructions to all staff about any and all financial dealings they have with the college, its customers and suppliers.
Fixed Assets	Items of a permanent or extended life nature (eg long-term investments) where the intention is to hold or use them over a number of years. (See also tangible assets, economic benefit and economic life.)
Going Concern	Financial statements are presented on the assumption that the organisation has enough funds to carry on operations, ie is a going concern, unless the contrary is clearly stated.
Governance	In simple terms, the way a college manages its affairs for the good of its stakeholders, primarily its students. Good governance of publicly funded bodies like colleges is essential and brings in key principles such as equality, probity and transparency.
Historic cost	The original value of a financial transaction (ie value at the time it was made).
Income and expenditure account	Shows the Principal sources of income and expenditure for the organisation over a period of time (normally one year) and forms part of the annual financial statements. (It is the equivalent of the profit and loss account of commercial organisations.)
Incorporated body	FE Colleges have an independent legal status based on incorporation under the Further and Higher Education Act 1992 (FHEA).
Incorporated body	The procedures instigated to protect the organisation's assets and provide clarity for staff in financial matters. (See also financial regulations.)
Management accounts	Internal financial reports, prepared on a monthly basis for management purposes, generally in far greater detail than needed in the annual financial statements. Will show current and projected income and expenditure and the likely 'outturn' (ie the year end position). They will also include a cash flow forecast (see above) for the year.

Glossary	
Rating	**Definition**
Management Information System (MIS) Materiality	The college's MIS will collect the raw data from enrolments and provide critical information for funding claims.
Materiality	An item is 'material' if knowledge of it would influence someone who became aware of it. Thus if the Principal contracts for £30,000 worth of etchings for his/her office without referring it to anyone, the Governors might rightly feel concerned.
Members' report and annual financial statements	Annual report required by law and guided by SORP which colleges have to complete each year for publication. Also known as statutory accounts. Includes income and expenditure account, balance sheet and cash flow statement.
Negative balance on general reserves	Arises in the unlikely event of a college having a cumulative deficit from operations over the period since incorporation.
Negative cash flow	Normally viewed over a 12-month period, this means that more cash has flowed out of the college than has flowed in.
Overdrafts	Temporary borrowing facilities provided by the college's bankers.
Probity	Honesty in financial/business matters.
Procurement	The process of acquiring goods or services.
Prudence	The principle that organisations must not anticipate the benefit from income until it has been earned and must make provision for foreseeable expenses and losses.
Reserves	Surpluses accumulated over a number of years. The greater the level of reserves the stronger the organisation.
Revenue	Refers to transactions where the impact/benefit will be enjoyed within the current year.

Glossary	
Rating	**Definition**
Risk management strategy	The strategy will identify operational and strategic risk, their likely impact on the college, and detail how each risk will be monitored and actively managed, where appropriate.
Sensitivity analysis	The college's three-year financial forecast is a set of assumptions of student numbers and general economic conditions. Any or all of these assumptions may be inaccurate. A sensitivity analysis looks at the overall impact of key aspects of the college's financial position, eg student numbers lower than anticipated, building programme delayed, new faculty misses a year's intake, etc.
SORP	Statement of Recommended Practice: provides standards of reporting for the key public finance documents, ie the annual financial statements.
Statutory accounts	Also known as members' report and annual financial statement.
Surplus	The amount by which income (revenue) exceeds expenditure for the accounting period (normally 12 months).).
Tangible assets	Physical assets owned and used in the organisation such as land and buildings, motor vehicles and large plant. (See also fixed assets.)
Three-year financial forecast or plan	Colleges are required to provide the SFA with a three-year projection of their anticipated finances using assumptions formed in part by discussions with the local SFA. The forecast will also produce an indicative financial health category for the college.
Transparency	Timely and reliable information about an organisation's finances.
Treasury management	Positive management of cash to minimise cost of loans/overdrafts and maximise interest on cash balances, consistent with an agreed level of risk – treasury management is more than just investing cash.
Variance	A variance occurs when actual figures differ from planned/budgeted figures. They may be adverse or beneficial and may be caused, for example, by more/fewer students enrolling than planned or delays in expenditure.

Feedback on tasks

Feedback 1

The Skills Funding Agency wants to see continuous improvement in the health category of colleges which can be achieved by positive management of the college's financial position. As Principal, you have an interest in maintaining a good relationship with the Agency as regulator. By understanding how the health category of your college is arrived at, and what the underlying issues are, you can better assess whether plans to improve or maintain the category are likely to work

Feedback 2

A close reading of the SARQ, the PFA report (if this is fairly recent) and/or the latest external auditors' report will help you to develop your understanding of the college's financial and governance arrangements and how the quality of these arrangements is currently assessed both internally and externally.

The external assessments of college finances and financial systems are a valuable validation of internal processes. But it is important not to rely on any one information source or person no matter how authoritative they might appear to be.

Feedback 3

This activity should have helped you to decide whether you are comfortable with the key assumptions that underpin the financial strategy of your college. If you are concerned about assumptions that are not fully explained, you might wish to discuss them with the finance director and with other senior staff. Remember, you and your fellow Governors have a statutory responsibility for the financial solvency of the college, so you need to feel satisfied that the strategic financial plan is realistic and meets that objective.

A college's financial health depends on the overall strength of the college's key financial indicators for the forecast period, and on their sensitivity to areas of risk.

Feedback 4

In order to obtain evidence about the extent to which financial reports meet the needs of the various groups of stakeholders you will have needed to canvas their views and talk to them about their perceptions. You will probably already know what people outside the college think, from talking to the Skills Funding Agency and reading the PFA and auditors' reports. Having an objective view, and drawing on the perceptions and opinions of key stakeholders such as the Skills Funding Agency, Governors and managers, will enable you to see how effective and 'joined up' the finance function is, or could be.

If you uncover important differences in the finance story, this could be because a very competent finance function has not been adequately listened to by senior managers. If the information and views are easy to obtain and present a satisfactory or better position, then you may not need to take any remedial action. If the views of others are critical, and financial information is hard to come by, the finance function may not be providing the quality of information and support managers need. You may need to make it clear that you will require more accurate, timely, reliable or understandable information to be available to Governors and others.

Above all, you'll need to weigh up different views. You might uncover a closed culture where finance hides behind its technical knowledge and regulations rather than acting as support to the curriculum. However, some excellent finance teams have failed because the Principal did not support them or only listened to one view of the world. You may find the finance function does not have sufficient influence within the senior management team to help improve the college's finances.

Technical annex

The statutory context

See Section 1.

Under clause 15 of the Further and Higher Education Act 1992 (FHEA) (as detailed in statutory instrument (SI) 1992 number 2097), colleges already in existence at that time were given incorporated status. Clause 16 of the Act gave the Secretary of State power to grant the same status to new colleges after 1992.

The instrument and articles of government were established by statutory instrument at that same time, and set out the organisational and management procedures and responsibilities, including those of the Principal. These have been updated three times since: firstly, to reflect the requirements of the Nolan report (1995) and to amend certain membership requirements; secondly, to effect the change from the Further Education Funding Council (FEFC) to the (former) Learning and Skills Council (Learning and Skills Act (LSA) 2000); and, most recently, to remove the need for an Academic Board and to effect other procedural changes.

Colleges were also granted exempt charitable status under s.125A of the Education Reform Act 1988, as inserted by s.41 of the Teaching and Higher Education Act 1998, which means most college activities are not subject to corporation tax.

As independent legal entities created by statute and hence accountable to parliament for the public money they receive, colleges need to comply with regulations and guidance on how they account for their financial transactions. The Principal has specific responsibilities as the accounting officer and is accountable to parliament via the House of Commons Committee of Public Accounts for the college's use of public funds.

Equality and diversity

The Skills Funding Agency requires colleges to demonstrate compliance with equal opportunities legislation. This is best achieved by:

- ensuring maximum funding to support relevant or targeted provision
- ensuring optimal use of funding and resources
- ensuring maximum access to financial and other forms of learner support
- investing in institutional stability and equity.

Accounting standards

See Section 1.

Entity

An 'entity' means an organisation that has a legal identity in its own right, and can sue or be sued in its own name. In the context of financial reporting, the boundary of an entity is determined by the extent of the entity's control. For example, the business affairs and transactions of the organisation are separate from the personal affairs of staff and governors. The college will be assumed to have control over any subsidiary companies it owns and therefore will have to consolidate its financial results into the college's statutory accounts (group accounts). Care needs to be taken when the college engages in partnership to ascertain where control lies and hence how transactions need to be accounted for (e.g. if the college receives European grants on behalf of a consortium of colleges).

Going concern

The underlying assumption for all accounting statements is that the organisation is a going concern, i.e. it is in good or reasonable financial health and is not in immediate danger of bankruptcy. This is particularly important for the balance sheet of an organisation (see Section 4) where assets

(i.e. things owned) are shown as if they have an ongoing useful life as originally planned, rather than having to be sold immediately to raise cash. Where there is doubt about the going concern status of a college, the external auditors will probably ask the college to get a letter of continued support from the SFA.

For example, college X is to be amalgamated with college Y in six months time involving the effective closure of college X. Buildings which had a valuation in the balance sheet of college X of £1.2m are not needed and have an estimated site value of £650,000. Should the balance sheet of college X reflect the valuation used in the past or the anticipated site value? As college X is no longer a going concern in its own right, the estimated site value of £650,000 should be adopted in the balance sheet.

Historic cost

Financial transactions are usually recorded at their original (historic) value – their historic cost. The typical exceptions in the case of colleges are assets acquired on incorporation, for which colleges did not pay. These are usually valued at depreciated replacement cost. Although this is a reasonable and fundamental approach to recording transactions, it can be criticised as failing to reflect the changing value of money.

For example, after much deliberation about the merits of two suppliers, a college buys a new computer suite from supplier A at a cost of £63,000. Two weeks after the contracts are signed, supplier B announces a superior system at a cost of £51,000. Which value should the college use? The fact that supplier B announced a better, cheaper system is irrelevant and the value the college must adopt for the new suite is the sum contracted and paid for, i.e. £63,000.

Income and cost recognition

An organisation only generates income (revenue) when value is transferred to a third party and something (i.e. a payment or grant) is receivable in return. When this value is transferred, the income is 'recognised', i.e. it can be included in the accounts as having been earned. This principle can be described as bringing income into the accounts for the period it relates to. For instance, the college management realises that the college is likely to make a deficit for the year and, to avoid this, decides to treat as income the full value of certain new contracts, despite the fact that they extend into the next financial year. However, the accounts should only show the value of each contract in so far as it has been completed in the year i.e. from the start date of the contract to the financial year end.

The same principle applies to recognising costs: financial statements must include all known or anticipated costs relating to the period, whether or not payments have actually been made. For instance, utility bills are normally paid in arrears. An organisation's final quarter's gas and electricity bills might arrive two weeks after the end of the financial period but, as the gas and electricity were all consumed within the financial period, the accounts must include the costs.

Prudence

Financial prudence is based on the principle that organisations must not anticipate the benefit from income until it has been earned and must always make provision for foreseeable expenses and losses.

For example, a major college customer is in financial difficulties and has owed the college £100,000 for over six months. At the end of the financial year it would be prudent to assume that this sum will not be received and to amend the statutory accounts accordingly.

Consistency

A key potential benefit of financial reporting is the capacity to measure financial performance over different time periods. In order to make valid comparisons between time periods or between different organisations, however, it is imperative that transactions are recorded in a way that is consistent within each financial year and from one year to the next. Without consistency it is possible to manipulate the financial performance of the college just by changing accounting policies. In order to seek consistency between colleges the SFA issues guidance annually on the treatment of specific transactions. Normally any changes to the basis of accounting must be reported in the accounts.

Capital and revenue

It is important to understand the key differences between capital and revenue when preparing or reviewing key financial statements. College Principals are required to sign the college's balance sheet at the formal Board meeting at which the accounts are approved and after which they are sent to the SFA. These key statements must be prepared accurately and with absolute clarity about the distinction between capital and revenue items, otherwise the results will be distorted, possibly significantly.

Capital

Capital transactions are normally associated with longer-term events, e.g. the raising of basic funds for the organisation such as long-term loans or the purchase of long-term (fixed) assets with an expected useful life of more than one year.

Capital expenditure should be viewed in the context of strategic planning based on long-term objectives. In order to achieve those objectives, a college will require infrastructure in the form of physical (or tangible) fixed assets. The intention will be to hold on to and use these assets for a number of years. A key criterion for capital expenditure is that the economic benefit provided by the expenditure can be used (in accounting terms, 'enjoyed') over more than one year.

Typical tangible fixed assets of a college will be:

- freehold land and buildings
- long leasehold land and buildings
- equipment above a certain value, determined by the college (e.g. motor vehicles, general equipment, computer equipment, furniture and fittings).

Investments can also be fixed assets, where the intention is to hold them for more than one year. The college might have made long-term investments of its own or there might be endowment assets given to the college by a benefactor.

There is more detail on this aspect of accounting in Section 4.

Revenue

By contrast, all non-capital transactions are revenue and are captured by the organisation's income and expenditure account (the equivalent of the profit and loss account of commercial organisations).

Revenue receivable will arise from the normal trading activities – in the case of a college, the provision of academic, vocational and recreational courses and training.

Revenue outgoings are the day-to-day expenditure involved in running an organisation's activity, in other words in providing resources which generate income. The most significant item of revenue expenditure in a college will be its staffing costs.

Here are some examples of capital and revenue income and expenditure in a college.

	Capital	Revenue
INCOME	Legacies received from benefactors in the form of endowment assets	SFA funding or contracts
EXPENDITURE	New buildings New equipment	Staff salaries Property maintenance

Money from the sale of fixed assets, e.g. buildings, is income, but of a capital nature. Interest earned on bank balances is also income, but is revenue income because it is of a non-capital nature. The purchase of computer consumables is revenue expenditure, because the benefit is short-term, but the procurement of a new library or computer hardware is capital expenditure because the purchase will give long-term benefit to the organisation.

Cash flow management

It is important to understand that there is no direct link between cash (the term here includes all bank balances) and profit (or surplus). For example, if an organisation has made a surplus of £100,000 for the year it is commonly believed that this sum can be found somewhere in the bank. It is also believed that an organisation with a healthy bank balance is automatically profitable, whereas overdrafts and loans indicate loss-making organisations. However, the cash position of an organisation does not necessarily indicate how profitable or otherwise it is.

The cash position is liable to change during any 12-month period depending on the timing of payments and receipts. Although SFA funds are received monthly they are not paid in equal instalments. Other income such as fees will typically be received at the start of the year. On the other hand, most expenditure goes out in a fairly consistent pattern month by month, particularly in the case of salaries. The cash position will also be affected by any capital transactions, e.g. the acquisition or disposal of land and buildings and the receipt of capital grants and loans. So, for example, a college may be 'profitable' in that income exceeds expenditure but it may have to manage its cash very carefully perhaps because of a major building programme.

To give governors and senior management an effective oversight of cash management, the monthly management accounts include a 12-month cash flow forecast showing the main sources of receipts and payments.

Financial health performance indicators

See Section 2.

Key terms defined

A positive cash flow from operations means that over the year, more cash has been received than paid out, excluding cash flows from capital and financing transactions. As you saw in Section 1, this is not the same as income and expenditure.

Cash in hand days represents how long the college can last with its current bank balances but no further income, and spending at its usual rate. It is calculated by dividing all cash balances and short-term investments by total income and multiplying by 365.

The current ratio or 'quick ratio' is a commonly used measure of solvency. It is calculated by dividing total current assets (typically cash, stocks and debtors) by current liabilities (typically amounts due to creditors, overdrafts, loans repayable in 12 months and accrued expenditure). Any figure materially below a ratio of 1:1 means the organisation may not be able to meet its debts and could well face financial difficulties in the next 12 months.

A **positive balance on the general reserve** represents the accumulated surplus from trading operations, i.e. income has exceeded expenditure. It is helpful, but not essential, to have an annual surplus. If there happens to be a deficit one year, this is subtracted from the balance on general reserve brought forward from previous periods. (FRS17 is an accounting standard covering the treatment of surpluses or shortfalls in the provision for future pensions for staff. It currently only applies to staff who are members of local government pension schemes. You do not need to worry about this at the moment other than being aware that this indicator ignores any surplus or deficit identified under FRS17.)

An **operating surplus** is the excess of income over expenditure in any financial year.

Borrowings are overdrafts and long-term bank loans.

Model financial statements

See Section 4.
The statements over the page are for 'Casterbridge College', a fictitious example provided in SFA guidance to FE colleges, available on the SFA website.

Casterbridge College

Consolidated Income and Expenditure Account

	Notes	2010	2010	2009	2009
		£'000	£'000	£'000	£'000
INCOME					
Funding body income	2		32,944		36,921
Tuition fees and education contracts	3		4,661		4,944
Other grants and contracts	4		228		303
Other income			2,550		1,875
Endowment and investment income	5		2,256		2,089
Total income			**42,639**		**46,132**
EXPENDITURE					
Staff costs	6	26,006		28,875	
Exceptional restructuring costs	6	1,551		-	
Other operating expenses	8	11,418		13,557	
Depreciation	12	4,038		2,802	
Interest and other finance costs	9	108		-	
Total expenditure			43,121		45,234
(Deficit)/surplus on continuing operations prior to costs relating to the property strategy			(482)		898
Accelerated depreciation	31		-		-
Release of capital grants related to accelerated depreciation	31		-		-
Property strategy costs	xx				
Grant support for property strategy costs	xx				
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and before exceptional items and tax			(482)		898
Loss on disposal of assets	12		(9,420)		-

Continued

	Note		
(Deficit)/surplus on continuing operations after depreciation of assets at valuation, exceptional items and disposal of assets but before tax		(9,902))	898
Taxation	10	(12)	(12)
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and tax	**11**	**(9,914)**	**886**
Transfer from accumulated income within specific endowments		50	
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and tax		**(9,864)**	**886**

The income and expenditure account is in respect of continuing activities

Continued

Casterbridge College

Balance sheets as at 31 July

	Notes	Group 2010 £'000	College 2009 £'000	Group 2010 £'000	College 2009 £'000
Fixed assets					
Tangible assets	12	74,751	74,337	73,974	73,584
Investments	13	-	6	-	6
Total fixed assets		**74,751**	**74,343**	**73,974**	**73,590**
Endowment assets	**14**	**26,850**	**26,850**	**24,600**	**24,600**
Current assets					
Stocks		129	114	129	108
Debtors	15	1,170	1,116	1,290	1,317
Assets held for resale					
Investments		6,000	6,000	7,500	7,500
Cash at bank and in hand		2,512	2,512	585	585
Total current assets		9,811	9,742	9,504	9,510
Less: Creditors – amounts falling due within one year	16	(4,344)	(3,972)	(3,951)	(3,648)
Net current assets		**5,467**	**5,770**	**5,553**	**5,862**
Total assets less current liabilities		**107,068**	**106,963**	**104,127**	**104,052**
Less: Creditors – amounts falling due after more than one year	17	4,401	4,401	162	162
Less: Provisions for liabilities	19	3,498	3,498	2,124	2,124
Net assets excluding pension (liability)/asset		**99,169**	**99,064**	**101,841**	**101,766**
Net pension (liability)/asset	32	(1,460)	(1,460)	1,440	1,440
NET ASSETS INCLUDING PENSION ASSET/(LIABILITY)		**97,709**	**97,604**	**103,281**	**103,206**

Casterbridge College

Balance sheets as at 31 July

	Note				
Deferred capital grants	20	8,910	8,910	9,162	9,162
Specific endowments	21	18,750	18,750	17,100	17,100
General endowments	21	8,100	8,100	7,500	7,500
Total endowments		**26,850**	**26,850**	**24,600**	**24,600**
Income and expenditure account excluding pension reserve	23	17,359	17,254	8,793	8,718
Pension reserve	32	(1,460)	(1,460)	1,440	1,440
Income and expenditure account including pension reserve	23	15,899	15,794	10,233	10,158
Revaluation reserve	22	46,050	46,050	59,286	59,286
Total reserves		**61,949**	**61,844**	**69,519**	**69,444**
TOTAL		**97,709**	**97,604**	**103,281**	**103,206**

The financial statements on pages [19 to 48] were approved by the Corporation on [insert date] and were signed on its behalf on that date by:

[Name to be typed in] [Name to be typed in]

Chair **Principal**

The Learning and Skills Improvement Service (LSIS) is the sector-owned body supporting the development of excellent and sustainable FE provision across the learning and skills sector. Its aim is to accelerate the drive for excellence and, working in partnership with all parts of the sector, builds on the sector's own capacity to design, commission and deliver improvement and strategic change.

Friars House, Manor House Drive
Coventry CV1 2TE
t 024 7662 7900
e enqiries@lsis.org.uk
www.lsis.org.uk

LSIS 00000