NATIONAL AUDIT OFFICE

Report by the
Comptroller and Auditor General

Managing Finances in English Further Education Colleges

HC 454 Session 1999-2000
4 May 2000

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Ordered by the
House of Commons
to be printed 2 May 2000

LONDON: The Stationery Office
£0.00

HC 454 Session 1999–2000
Published 4 May 2000

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn
Comptroller and Auditor General

National Audit Office
18 April 2000

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Executive summary

1 The further education sector in England provides learning opportunities to students from the age of 16 upwards, offering over 12,000 qualifications from degree level to vocational training. The sector consists of 429 further education colleges with an income of over £4 billion a year, mostly provided by the Further Education Funding Council (the Funding Council), which also has responsibility for overseeing the sector and assessing the quality of education being provided by colleges. The Government sees the further education sector as a crucial part of its overall strategy to combat social exclusion, unemployment and skill shortages and sees widening participation in further education as critical to its economic and social agenda.

2 The proportion of colleges in poor financial health grew rapidly between 1993-94 and 1996-97. More recently, the proportion has started to decline but still stands at about 13 per cent. In the light of this and concerns expressed by the Committee of Public Accounts (63rd Report of session 1997-98), we examined the reasons why colleges have financial problems and how these could be improved.

3 We have three overall findings:

- some external factors play a significant role in determining whether a college will be in good or poor financial health, such as financial problems inherited at incorporation and the type of students it has. Some factors, like differences in funding, are diminishing with time. Others, such as the type of college or type of student tend to apply to restricted groups of colleges rather than right across the sector;

- the way in which colleges are managed and governed plays a large role in deciding their financial health. In particular, there are certain key elements of best practice in management which can do much to ensure a college's financial health. Our survey and visits showed that there are some managerial practices more characteristic of colleges in good financial health, which colleges in poor financial health should consider adopting;

- the Funding Council has a sophisticated system for monitoring colleges and assisting them from poor financial health to recovery. The Regional Review process, recently formalised, has significantly enhanced this system and it will be further enhanced by the work of the Quality

Monitoring Unit and funding from the Standards Fund. The Funding Council also provides valuable support to colleges in the areas of benchmarking and performance indicators. There are some areas, however, where our work showed scope for the Funding Council to give more effective assistance.

Recommendations on what more colleges can do to improve their financial health:

i) Colleges need good, accurate and timely management information so that the Principal and the governing body have a sound basis of information on which to make decisions affecting the college and to ensure they meet their Funding Council targets.

ii) Colleges in good financial health were producing in a number of respects, more detailed management accounts, producing them more quickly and distributing them more widely than colleges in poor financial health. Colleges in poor financial health should follow suit (paragraphs 2.17-2.20).

iii) Problems in predicting funding unit outturn can have a major impact on the income of colleges and can drive colleges into poor financial health by leading to unforeseen shortfalls in income. Colleges should seek to avoid these problems by ensuring that they have systems in place to monitor accurately their outturn against Funding Council targets and to forecast in good time any emerging problem so as to prevent unforeseen shortfalls in income (paragraphs 2.17-2.20 and Case study 3).

iv) Colleges should ensure spending and spending commitments on staff are centrally monitored monthly so that colleges can predict spending accurately (paragraphs 2.17-2.20 and Case study 4).

v) Where colleges are using European Social Fund money or other non FEFC sources of funding, they should ensure that proper records are kept, projects accord with applications and ESF or other rules are complied with so that colleges do not have to make large repayments (paragraphs 2.19-2.20 and Case study 5).

vi) It is important for colleges to know the costs of their college processes and provision so that they can make intelligent decisions about which courses to run. Colleges in good financial health were twice as likely to have a clear and consistent costing policy and process. Colleges should have systems in place to identify the costs of courses (including those that are running at a loss) and regularly report on these courses to the Governors (paragraphs 2.21-2.23 and Case studies 6-8).

vii) Governors need to monitor closely the financial position of the college in order to help management take remedial action should the financial situation require it (paragraphs 2.26-2.28 and Case study 10).

viii) Eighty per cent of colleges had undertaken some benchmarking activity but colleges in good financial health were more likely to have carried out benchmarking of costs and to have seen benefits from it. Colleges in poor financial health should explore further the scope for benchmarking (paragraphs 2.24-2.25 and Case study 9).

ix) Virtually all colleges reviewed their performance targets, but colleges in good financial health were more likely to have developed additional performance indicators, to be reporting on them frequently and to be taking remedial action as a result. Colleges in poor financial health should examine the merits of adopting similar approaches (paragraphs 2.26-2.28 and Case study 10).

Recommendations on how the Funding Council should improve their assistance to colleges:

x) The Funding Council monitors the financial health of colleges at least twice per year and more frequently should the Funding Council consider it necessary. In addition, all aspects of each college's activities are examined three times per year as part of a wider Regional Review Process. Colleges we visited would welcome more information about the Funding Council's conclusions. The Funding Council should consider providing fuller feedback of the process, results and implications for action of their monitoring to colleges (paragraph 3.8).

xi) The Funding Council assesses the solvency of each college as part of the review and informs the college Principal of the results, but does not inform the college governing body directly. In our view, the Funding Council should consider giving feedback in parallel on the results of reviews to college Governors and to Principals (paragraph 3.8 and Case study 12).

xii) The Funding Council provides colleges with a range of comparative benchmarking material, which the colleges we visited found useful. However, the data's usefulness was hampered by a lack of timeliness, caused largely by delays in colleges' sending in returns. The Funding Council should produce current benchmarking data on a more timely basis (perhaps by making greater use of IT) and produce additional data on topics which colleges have identified as useful (paragraphs 3.12-3.15).

xiii) When asked to do so, the Funding Council has put colleges in contact with structurally similar colleges, so that the colleges could make benchmarking comparisons to identify means and scope for financial improvement. Such groups of colleges are known as "benchmarking families" and have led to very positive results. Given this, the Funding Council should henceforth proactively promote these "benchmarking families" (paragraphs 3.16-3.17 and Case study 14).

xiv) Colleges we visited said that they would find additional advice and support from the Funding Council helpful. In particular, colleges wanted the Funding Council to provide a standard course-costing model and to recommend common financial and management information systems to colleges. The Funding Council intends to encourage the Further Education Development Agency to take this forward (paragraph 3.20).

Part 1: Introduction and Background

Background to the further education sector

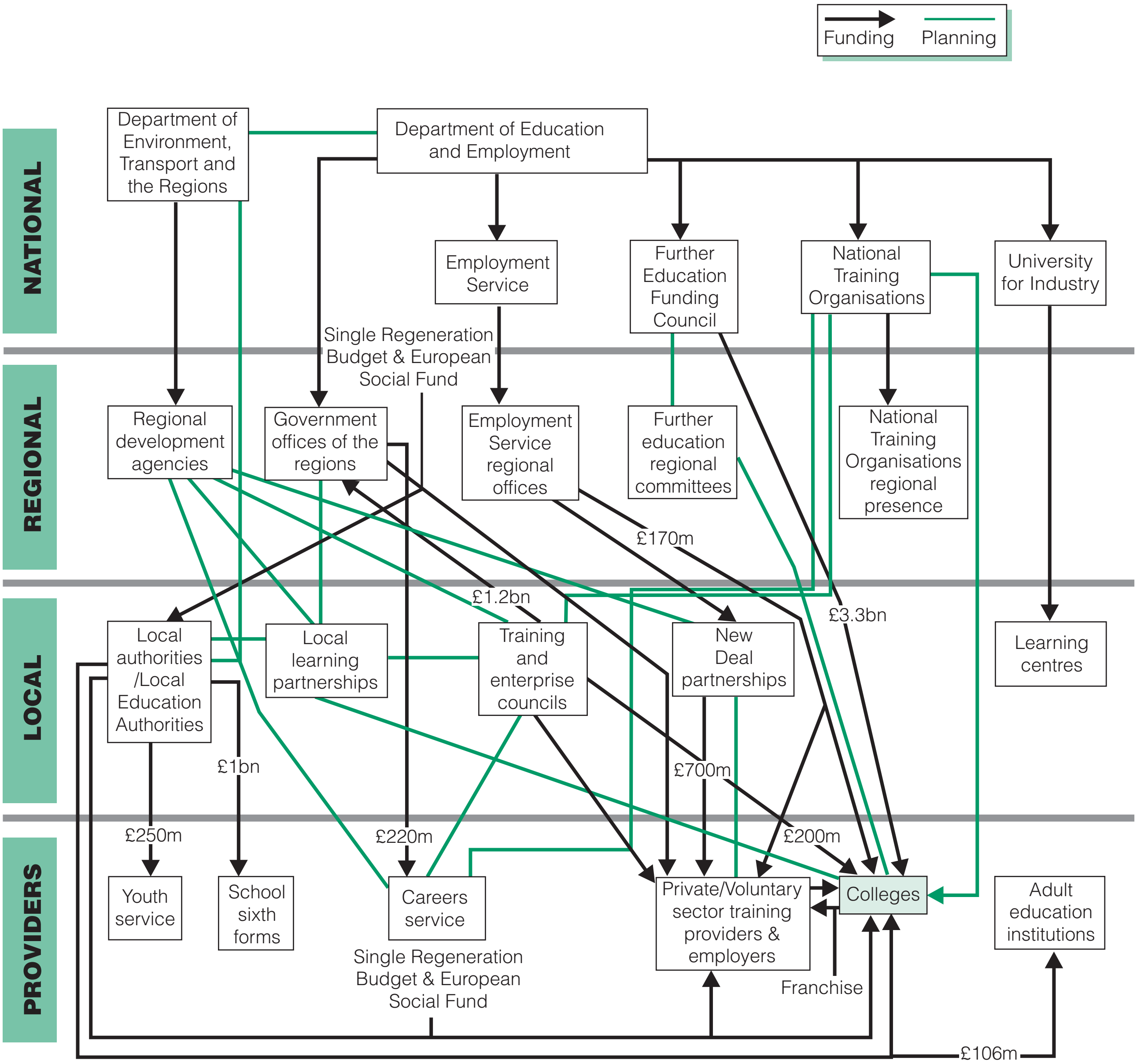
1.1 The further education sector in England provides training and learning opportunities to students from a wide variety of backgrounds from the age of 16 upwards, offering over 12,000 qualifications ranging from degree level to vocational training. The sector consists of around 429 further education colleges. They have an income of over £4 billion per annum, around £3 billion of which is provided by the Further Education Funding Council (the Funding Council) and the rest from a variety of sources including the European Social Fund, Training and Enterprise Councils, Employment Service and the private sector. Figure 1 shows a simplified illustration of the main bodies in the sector, the main funding streams and the interrelationships of the different organisations. Under the Comprehensive Spending Review, the further education sector is receiving from 1999-2000 an additional £725 million over three years from the Funding Council, linked to student achievement, widening participation and improving facilities.

1.2 Colleges fall into a number of types:

- **Tertiary colleges** provide for all students over 16 in a given geographical area;
- **General further education colleges** provide a wide range of education and training courses for full and part time students of all ages;
- **Agriculture and horticulture colleges**;
- **Colleges of art and design and the performing arts**;
- **Sixth form colleges** mainly provide full-time education to 16-19 year olds;
- **Designated institutions** include adult education colleges and specialist institutions.

Figure 1

System of post 16 education and training (until April 2001)



Source: Times Supplements Limited 1998, TES April 30, 1999

1.3 Under the Further and Higher Education Act 1992, colleges became independent corporations, owning their own assets and liabilities and run by their governing bodies which represent the local community, business and employers. There are about 30 institutions where different arrangements apply, where for example the institution is run by a religious organization or a charity. The governing body of a college is responsible for ensuring the solvency of the college, the safeguarding of the college's assets and that appropriate financial considerations are taken into account in reaching decisions.

1.4 The further education sector is a crucial part of the Government's overall strategy to combat social exclusion, unemployment and skill shortages. Widening participation in further education is critical to its economic and social agenda. Further education is also intended to contribute towards the Government's achievement of its National Learning Target for young people, which states that 85 per cent of 19 year olds should achieve National Vocational Qualification level 2 or equivalent by 2002.

Changes proposed to the organisation of post 16 education and training

1.5 While we were carrying out this study, the Secretary of State for Education and Employment published the White Paper, **Learning to Succeed** (Cm 4932), which contained proposals for a new framework for post 16 education. The key change to the structure of the sector proposed in the White Paper is the abolition of Training and Enterprise Councils and the Further Education Funding Council. Their roles and responsibilities for post 16 education and training will be rolled up into one new body, to be known as the Learning and Skills Council, which should be operational by April 2001. It will exist in shadow form before that.

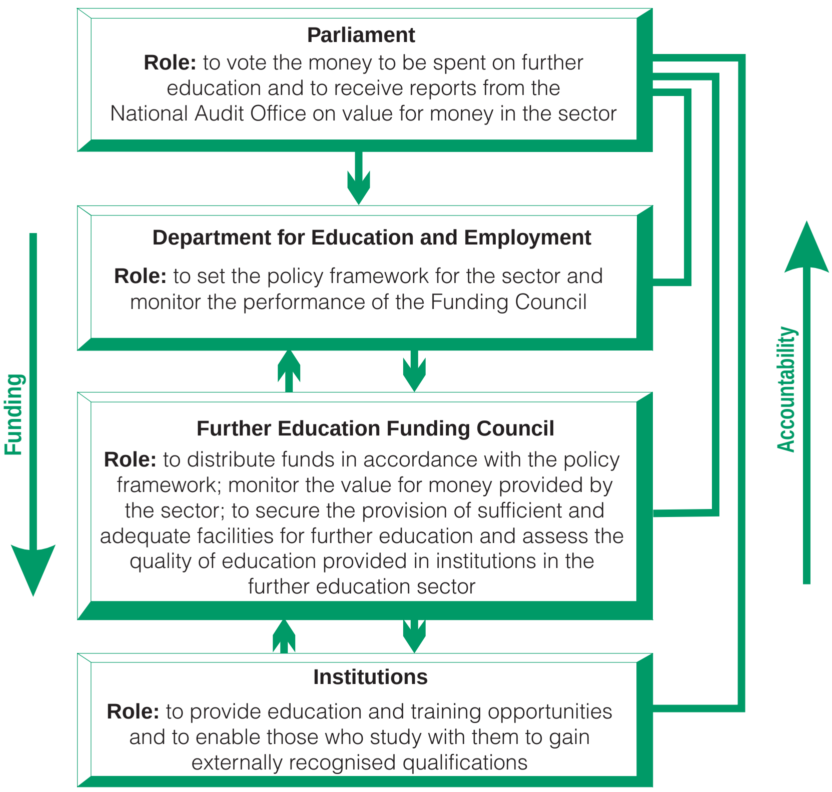
1.6 The effect of the creation of the new Learning and Skills Council and the other proposed changes is intended to clarify and simplify the mechanisms for planning and funding education and training provision, to streamline administration and to focus on the needs of the individual learner. The changes are also intended to improve accountability, efficiency and probity, with the underlying mission of promoting equality of opportunity.

The Funding Council

1.7 Under the Further and Higher Education Act 1992, the Further Education Funding Council was created in order to give financial support to the governing bodies of further education institutions. The Funding Council was also given the responsibility for overseeing the further education sector, administering central government grant and assessing the quality of education being provided by institutions. The Department for Education and Employment is responsible for monitoring the work of the Council. The financial relationship between the Funding Council and each college is set out in the Financial Memorandum. (See Figure 2 for an illustration of the various bodies' roles and responsibilities.)

Figure 2

Roles of the various bodies involved in further education in England



Source: National Audit Office

1.8 Each Memorandum sets out the respective responsibilities of the Funding Council, the governing bodies of colleges, the Chief Executive /Principal and the Clerk. Its key points are that the governing body is responsible for the solvency of the college, safeguarding its assets and ensuring that financially sensible decisions are made. The Chief Executive is responsible for the efficient, economical and effective management of all the College's income, assets and expenditure and for the proper and effective operation of financial controls.

Colleges in financial difficulty

1.9 The Funding Council classifies colleges into three groups (A, B, C) according to financial health: see Figure 3 below. Each college completes a self-assessment to identify the group it falls into, subject to review by the Funding Council. Colleges in group C are in financial difficulty or showing signs of financial weakness.

Figure 3

Criteria governing the Funding Council categories of financial health for colleges

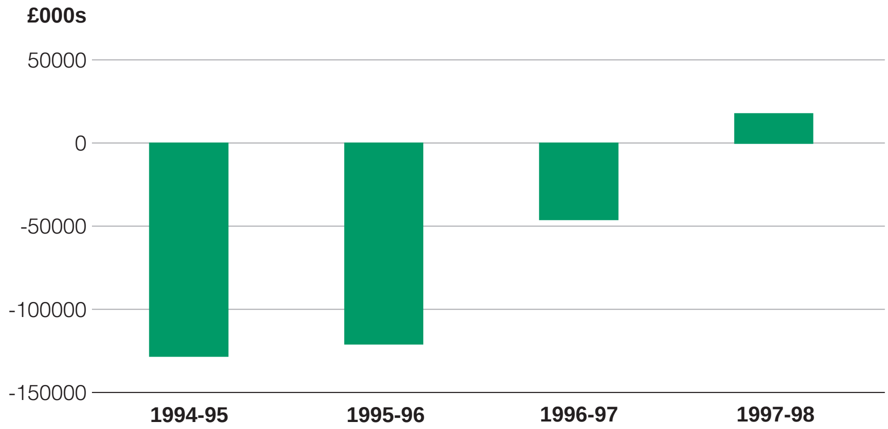
Group A **Financially robust**	**Group B** **Some signs of weakness**	**Group C** **Financially weak**
Positive cashflow from operations	May not have positive cashflow	May not have positive cashflow
Greater than 25 cash days in hand	Greater than 15 cash days in hand	Less than 15 cash days in hand
Positive balance on their general reserve	Positive balance on their general reserve	May not have positive balance on their general reserve
Current ratio better than 1:1	Current ratio better than 1:1	Current ratio worse than 1:1
Finances sufficiently robust to implement their strategic plan and deal with any likely circumstances during the planning period.	Signs of financial weakness that might limit their ability to carry out their strategic plan were they to meet adverse events during the planning period. Also, those colleges whose features are similar to those in Group A but whose assumptions appear unrealistically ambitious or optimistic.	Colleges that are financially weak and which are or may become, dependent on the goodwill of others.

Source: The Funding Council

1.10 Since 1994-95, the sector as a whole has achieved a considerable improvement in financial health (Figure 4). The proportion of colleges classified as financially weak grew quickly from incorporation in 1993-94 until 1997-98 and at its peak, nearly a quarter of all colleges in the sector were in poor financial health (Figure 5). By December 1999 the proportion that was financially weak had fallen to 13 per cent.

Figure 4

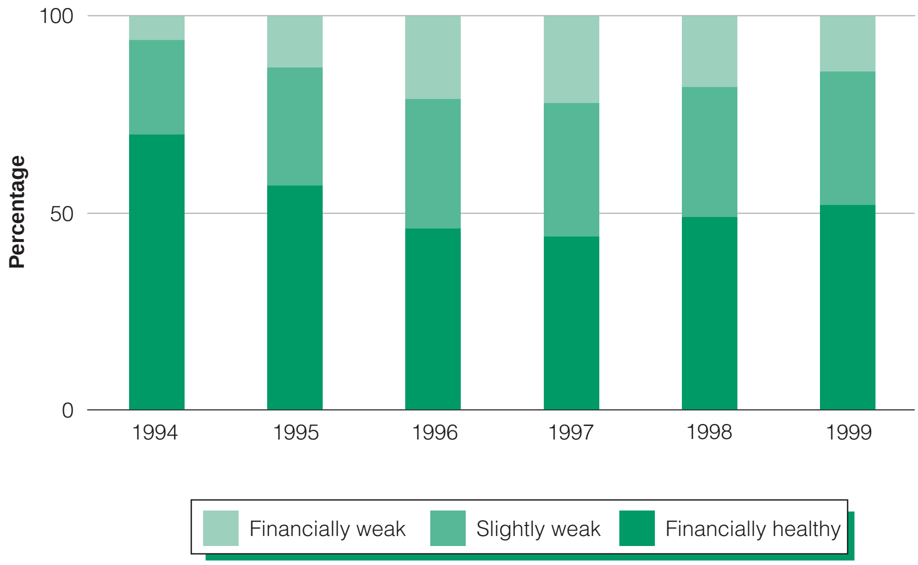
Surplus/deficit of further education sector since 1994-95



Source: The Funding Council

Figure 5

Trend in percentages of colleges in financial health groups since incorporation



Source: 3 year financial forecasts received by the Funding Council July 1994-99

1.11 Despite these encouraging trends, as at December 1999, there were still 56 colleges out of 429 in poor financial health, or 13 per cent of all colleges.

1.12 The Committee of Public Accounts said in their 63rd Report of session 1997-98,

> "We find it worrying that over one fifth of colleges are assessed as being in poor financial health and that the number of colleges in poor financial health may increase. Whilst we accept that the primary responsibility for ensuring the solvency of individual colleges lies with the college governing body, we look to the Department and the Funding Council to give urgent attention to improving the financial health of the sector."

NAO study methodology

1.13 Against this background we examined:

- why a large proportion of colleges remain in financial difficulty and what common factors may explain this;
- what scope there is for the Funding Council and colleges to improve the sector's financial position further by following best practice.

1.14 We addressed these issues by:

- working with the Funding Council to analyse their databases of information on colleges to see whether factors outside the control of colleges could be having an impact on their financial health;
- carrying out a survey of a representative sample of 138 colleges in good and poor financial health to identify any differences in their financial management, costing policies and use of benchmarking;
- visiting six pairs of colleges, similar apart from their financial health in order to identify differences in structure and management, key cost drivers and ways to manage them and examples of good practice;
- visiting three recovered colleges which had been restored to financial health to identify the key factors in their financial problems and those which led to recovery;

- discussing the financial health of the sector with the Funding Council together with their methods for monitoring, advising and helping colleges.

1.15 A full description of the study methodology is at Annex A.

Part 2: Factors influencing the financial health of further education colleges

Introduction

2.1 In this Part, we examine the key factors that influence colleges' financial health. First, we look at the impact of causes outside a college's control. To do so, we draw on analyses of Funding Council databases carried out by Funding Council staff and the findings from our visits to matched pairs of colleges (see Annex A, Visits to 12 colleges). We then go on to examine the impact on financial health of the strength of college management and governance, drawing out good practice which colleges in poor financial health could adopt.

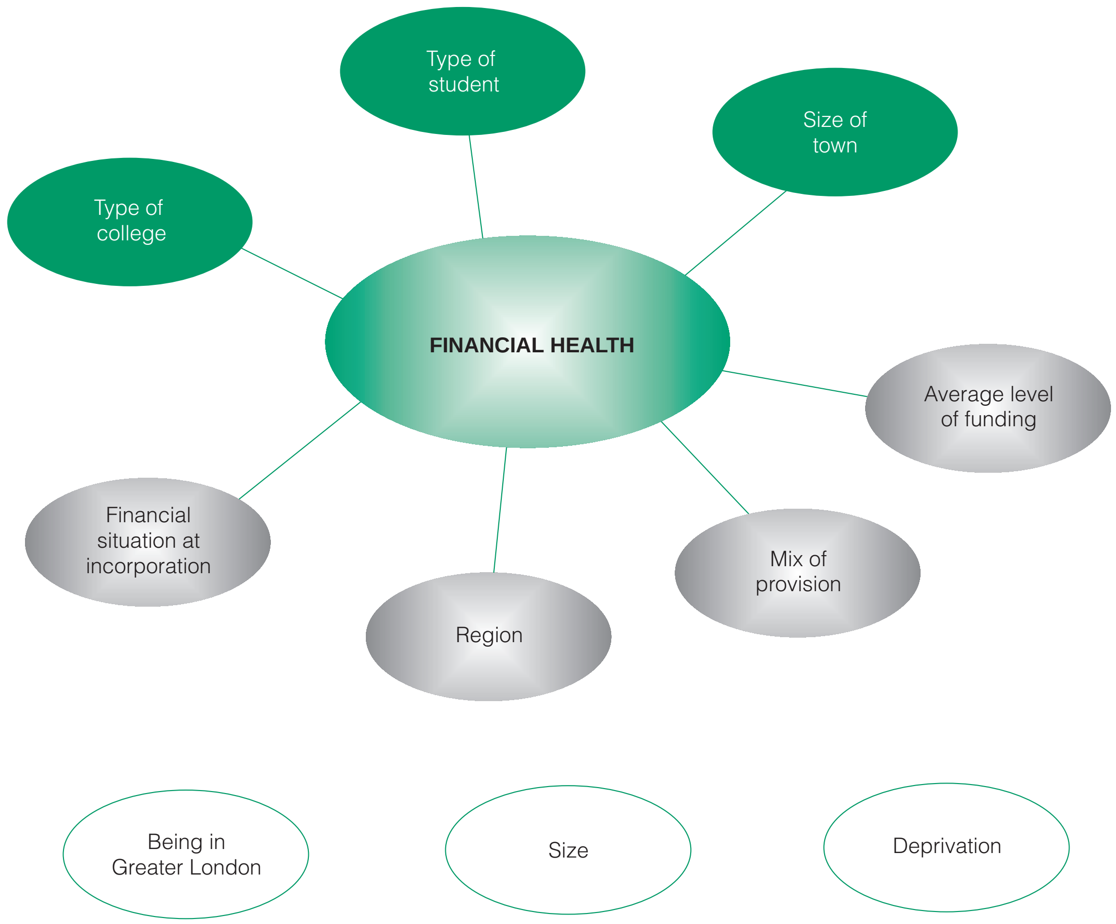
External factors

2.2 Our methodology for examining external factors is described in detail at Annex A. In brief: for each of a range of external factors, we examined the Funding Council's databases for all colleges in the sector to see whether colleges affected by the factor concerned were more likely to be in good or poor financial health. Figure 6 gives a graphical summary of the factors we examined and their effects. Our main findings were:

- some factors had no effect on colleges' financial health. These factors included:
  - whether or not a college was in Greater London;
  - whether or not a college had a high proportion of students from areas of economic and social deprivation;
  - whether a college was large or small.

Figure 6 Effect of external factors on college financial health

The factors which have the greatest impact on the financial health of colleges are shown in green. Those factors which have little or diminishing effect are shown in grey and those that have no effect in white.



Source: National Audit Office

- some factors did have an effect on colleges' financial health, but the effect was decreasing or only applied to a limited type or group of colleges. These factors included:
  - the rate of funding a college received from the Funding Council (known as Average Level of Funding: see Annex C);
  - the region where a college was located (other than being in Greater London);

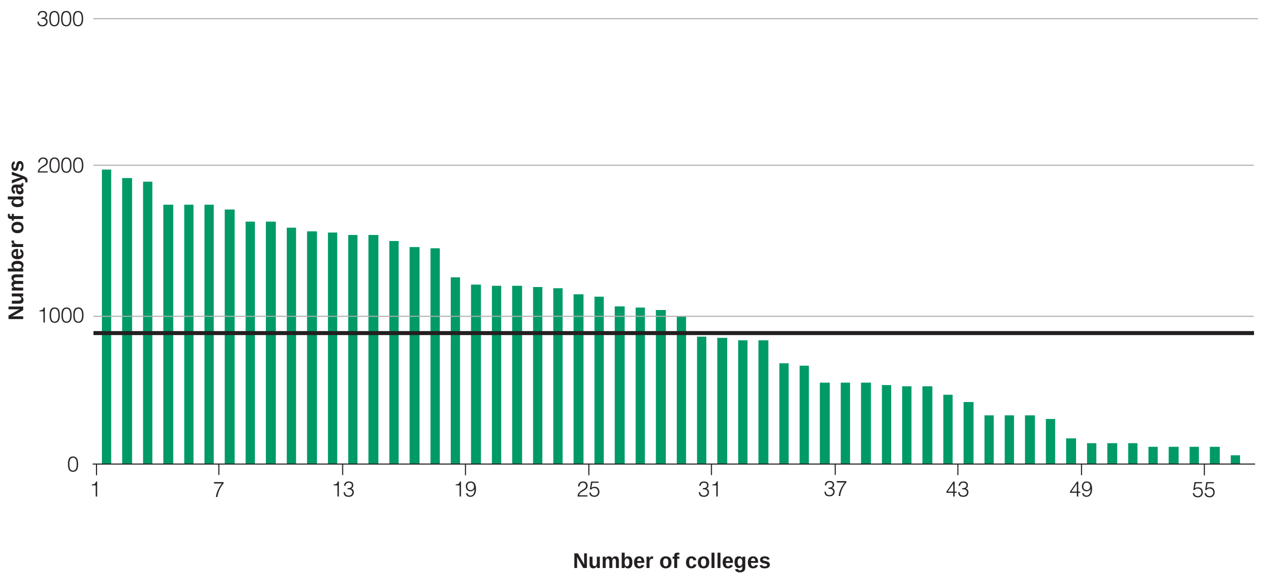
- a college's inheritance of assets and liabilities at incorporation;
- whether or not a college provided more expensive courses (such as engineering or jewellery-making).

Although the impact of some of these factors was decreasing, it was doing so slowly, because once colleges get into poor financial health, it takes them some time to recover, as Figure 7 shows. Problems such as poor accommodation, excess space and problems with staff structure can take years to correct. Also, some financial problems, such as large debts will take time to clear. These factors explain why the median length of time in poor financial health is 2.6 years.

- some factors were having a continuing effect on the financial health of colleges. These factors included what type a college was; the type of student the college enrolled and the size of town where a college was located.

Figure 7

Length of time a college stays in poor financial health



Note: The figure shows the length of time in days colleges spent in poor financial health against the average of 933 days shown by the black line, based on the 56 colleges in financial health group C in December 1999.

Source: National Audit Office analysis of Funding Council data

2.3 We examine the continuing factors and one of the more important of the decreasing factors (inherited position) in more detail in the following sections.

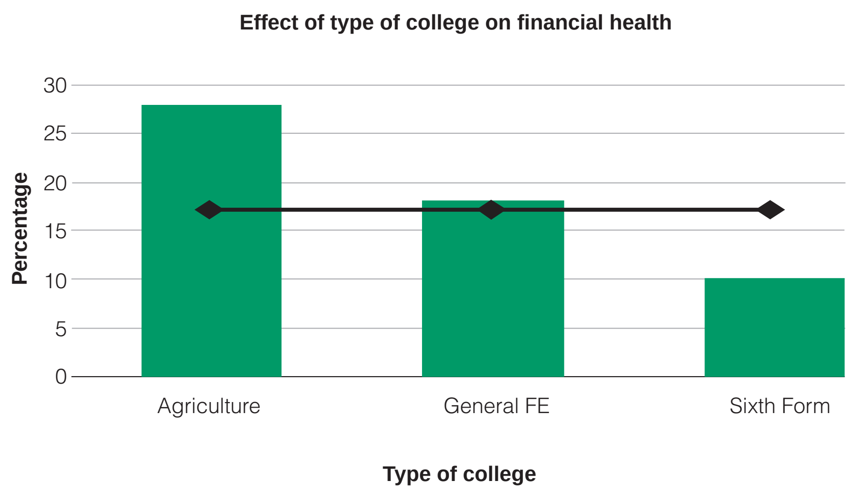
a) Type of college

2.4 At one end of the spectrum, our examination of the Funding Council's databases showed that a college was significantly more likely to be in poor financial health if it was an Agriculture and Horticulture College (see Figure 8). Reasons for this include the fact that agriculture as a sector has suffered a decline in income; that Agriculture and Horticulture Colleges tend to have higher fixed costs than other colleges; their retention and achievement rates are lower and they have a higher proportion of more expensive courses. The Funding Council's tariff for courses includes an element to compensate for the delivery of expensive courses.

Effect of type of college on financial health

Figure 8

This figure shows the percentage of colleges in poor financial health compared with the sector percentage (17 per cent in August 1999: shown by the thick black line). The percentage of agriculture colleges in financial difficulty is significantly greater than the sector percentage and that of sixth form colleges significantly less.



Source: Funding Council databases

2.5 At the other end of the spectrum, sixth form colleges are more likely to be in good financial health. The reasons for this include that these colleges have higher rates of funding; undertake a more limited range of provision; have higher rates of retention and achievement of students; have a lower proportion of more expensive courses and are less likely to have inherited a deficit.

2.6 For other colleges, what type of institution they were had no effect on financial health.

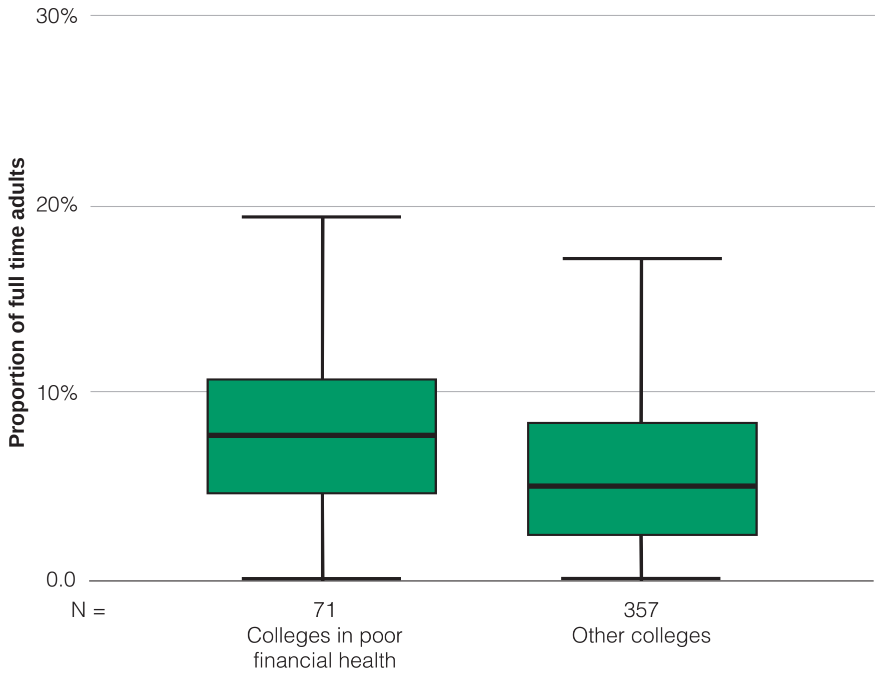
b) Type of student

2.7 Examination of the Funding Council's databases also showed that colleges with a high proportion of full-time adults (that is aged 19 or older) are significantly more likely to be in poor financial health (see Figure 9). This is because older students have a tendency to drop out of college in greater numbers.

Effect of type of student on financial health

Figure 9

This figure shows that there is a significantly greater proportion of colleges in poor financial health which have adult learners. The whiskers represent the range of proportions of adult learners at colleges, the black lines the median of each group of colleges and the green boxes the interquartile range.



Source: Funding Council databases

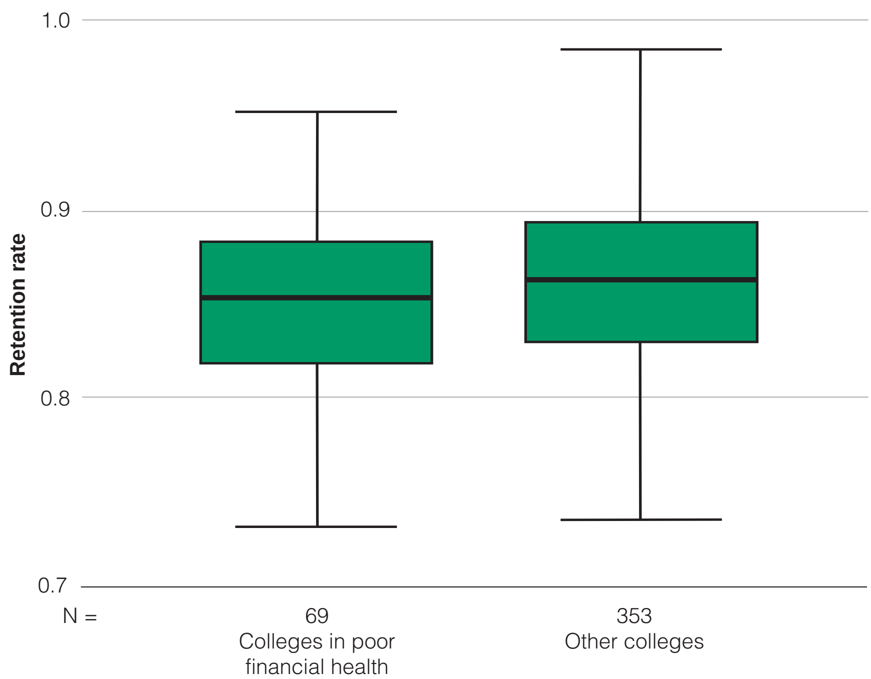
2.8 Rates of enrolment, retention and achievement have a material effect on the finances of a college because the Funding Council pays colleges according to the students they recruit, retain and help to get through their qualifications. Annex C gives a fuller description of the Funding Council's funding methodology.

2.9 Further analysis showed a correlation for the sector as a whole between retention and achievement rates and poorer financial health at colleges (Figure 10).

Effect of retention rates on financial health

Figure 10

This figure shows that there is a significantly greater proportion of colleges in poor financial health which have lower retention rates. The pattern is the same for achievement rates. The whiskers represent the range of retention rates at colleges, the black lines the median of each group of colleges and the green boxes the interquartile range.



Source: Funding Council databases

c) Size of town

2.10 From examination of the Funding Council's databases we also found that a higher than expected proportion of colleges in good financial health were situated in large towns with a population of 50,000-200,000 rather than in cities (population of 200,000+) or in small towns (population under 50,000).

2.11 The reason for the contrast between large towns and cities may be that colleges in cities face more competition. We found during our visits to the matched pairs of colleges (described in Annex A, Visits to 12 colleges) that out of six colleges in good financial health, four faced a lower level of competition from other general further education colleges. Out of six colleges in poor financial health, only one had a lower level of competition.

2.12 On the other hand, the reason for the contrast between large and small towns may be that more isolated, rural colleges are more difficult and expensive to get to. Colleges therefore have to provide travelling expenses, accommodation for students or in some cases a premium to attract staff. For example, one of the colleges we visited was located in a very rural area with a low population density and poor public transport. The College had to bus students in at a set time in the morning and out at a set time in the afternoon and ensure there were facilities and activities available to keep the students occupied throughout the day. Its freedom to vary the times of courses (for example, to put some on in the evening) was also very limited. (The Funding Council is currently looking at the costs of delivery at rural and isolated colleges.)

d) Financial situation at incorporation

2.13 Twenty eight per cent of colleges in the sector inherited a deficit on incorporation in 1992. These colleges are more likely to be in poor financial health. Among colleges which inherited a surplus, those which inherited a smaller reserve as percentage of income are also more likely to be in poor financial health. Case study 1 shows how the inherited situation affected one college.

Case study 1: The effect of inheritance on a college

One college we visited had considerable problems on incorporation. These included a large deficit, a surfeit of accommodation (all of which was in poor condition due to under investment), high costs (especially staffing) and downward pressure on Average Level of Funding. The college had 14 buildings in poor condition amounting to around twice the area it needed and could not afford the refurbishment costs.

The college decided to rationalise their estate and praised the Funding Council Regional Property Adviser for his help in putting together a strategy for reducing the size of the estate, selling some property and improving the remainder. They also took other action to cut costs, especially payroll by restructuring, negotiating a new contract with staff and voluntary redundancy.

The process of financial recovery has taken around six years and considerable amounts of senior management time.

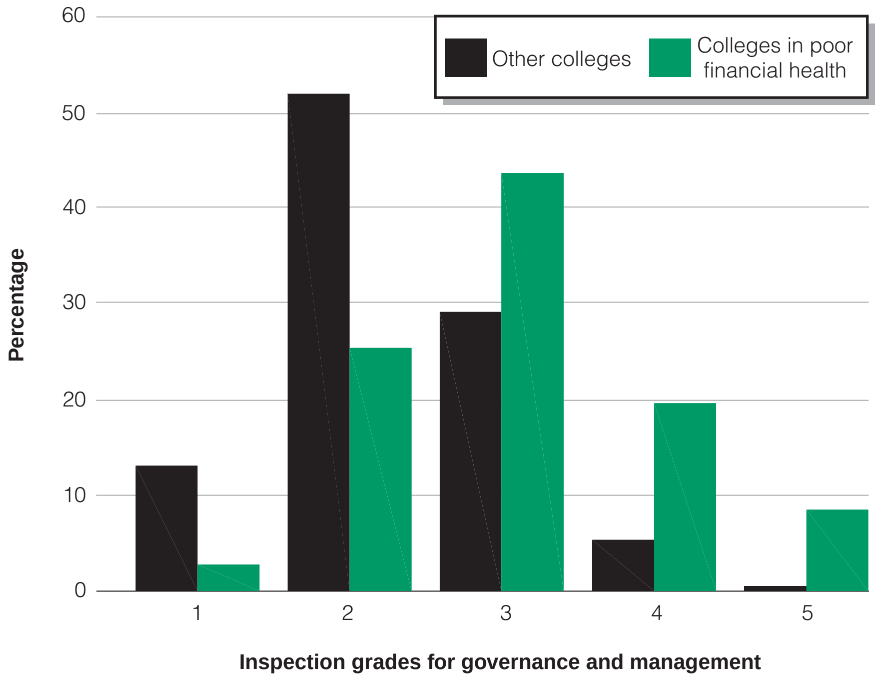
Governance and management at colleges

2.14 The Funding Council has its own Inspectorate, which inspects and reports on each college on a four-year cycle. As part of this process, the Inspectorate assesses aspects of each college's governance and management, awarding a grade from 1 (outstanding) to 5 (poor). The Funding Council's database showed that there was a very strong statistical correlation between the financial health of a college and the inspection grades it received for governance and management (see Figure 11).

Figure 11

Correlation between inspection grade for governance and management and colleges in poor financial health

The figure shows that there is a correlation between poorer inspection grades (4 and 5) and being in poor financial health.



Source: Analysis of Funding Council databases

2.15 Through a representative survey of 138 colleges, we therefore examined whether there were differences in management arrangements between colleges in good and poor financial health, which might help to explain the colleges' financial status. The survey covered the colleges' use of management information, costing, benchmarking, performance indicators and targets. A full description of survey methodology is provided at Annex A.

a) Management information

2.16 A college needs good, accurate and timely management information so that the Principal and the governing body have a sound basis on which to make decisions affecting the college.

2.17 Virtually all the respondent colleges in our survey said they produced monthly management accounts. We found that colleges in good financial health were in a number of respects producing more detailed information about the way the college was running, more quickly and distributing it more widely than colleges in poor financial health. In particular, we found that these colleges:

- were more likely to distribute the monthly accounts to the Finance Committee of the governing body;
- were twice as likely to include information in the monthly accounts on particular processes like admissions;
- were producing their management accounts significantly more quickly, that is, within two weeks of the end of the month.

2.18 As well as colleges needing good, accurate and timely management information on financial performance, they also need similarly accurate **Individualised Student Record (ISR)** data which records in detail the enrolment and progress of all students and is reported to the Funding Council three times per year. The Funding Council uses the data to calculate funding due to a college. Inaccurate and late data can have a detrimental effect on a college's finances some considerable time later (see Annex C on the Funding Methodology). Poor data was a factor in the serious problems suffered by one college, described in Case study 2.

Case study 2: Data problems at one college

In 1999, the Chief Executive of the Funding Council recommended to the Secretary of State for Education that the governing body of a college be removed. The college was on the point of financial collapse and the Funding Council Inspectorate had classed the quality of education as very poor. The Funding Council had been warning the college of the seriousness of its situation for several years and offering support and advice, including visits by the Chief Executive to the governing body.

The main factors in the college's decline were:

- uncertainty over income, including large under achievement on funding units, causing the college to refund large sums to the Funding Council;
- no clear college mission for its work and therefore no proper strategy was developed to take the college forward;
- delay in taking difficult decisions on property rationalisation and staff restructuring;
- no consensus among governing body on action to address problems leading to delay and lack of definitive action.

2.19 Case studies 3 to 5 drawn from our visits to colleges in poor or recovered financial health also show the effect that poor information can have on a college's finances.

Effect of poor management information

Case study 3: Poor ISR data

Several colleges we visited undershot their Funding Council delivery targets for provision of education and therefore had to repay substantial sums. One college's Management Information System had predicted that the college would meet its delivery targets right up until one month before the year-end, by which time it was too late to take remedial action. Another college undershot its delivery targets because of poor forecasting and data capture. A third failed to achieve its delivery targets in 1998-99 because of poor student retention and over-optimistic budgeting for growth.

Case study 4: Poor management information

One college exceeded its part-time staffing budgets because of inadequate control and monitoring in response to growth. In addition, part-time staff were allowed to wait several months before putting in claims for payment and there was little monitoring of outstanding claims. A large number of claims were made at the same time and this generated a serious cash-flow crisis for the college.

Case study 5: Failure to meet criteria for projects funded by the Education Social Fund

One college bid for and received very large amounts of European Social Fund funding in 1995-96 and 1996-97. Proper records to support the funding criteria were not kept; some projects were not started; others were altered so that they did not meet the funding criteria. When these facts were discovered, the college had to pay back the funding it had received.

2.20 The case studies also show that:

- **These events largely relate to the past.** These events occurred in the early years after incorporation when colleges were at the bottom of their learning curve, coming to terms with their new, more business-oriented role and the complexities of a new funding system. They therefore reflect the inexperience of the sector at the time and can be seen as a largely transitional phenomenon. All the colleges we visited showed a strong awareness of the need to avoid these kinds of mistakes in the future.

- **The failure to monitor student numbers and their implications for Funding Council funding was particularly significant.** All the matched pairs of colleges we visited were, by the time of our visits, alive to the need to have systems in place to monitor and frequently report on funding unit outturn and to make sure staff were accurately processing student data. One college, for example, had set up a system of monthly reports on funding unit outturn to ensure that it did not repeat the earlier mistakes it had made.

- **The mistakes were basic.** These management mistakes related to failures to monitor and control income and spending and would have been avoided if all the colleges in poor financial health we visited had access to qualified expert financial advice and had:

  - monitored their Funding Council funding;

  - made sure rules for European Social Fund funding were complied with;

  - ensured spending on staff was monitored centrally.

- **The role of Governors.** The role of Governors was important, as they could take action through their scrutiny of the affairs of a college. At one college we visited, the Governors took prompt and energetic action to deal with a financial crisis when it arose and managed to minimise the effects of it so that the college remained in good financial health.

b) College costing policy

2.21 One specific and important aspect of good management information is for colleges to know the costs of their college processes and provision.

2.22 From our survey, we found that only around a third of all colleges had a costing policy. Although colleges in good financial health said that their main problem was that they 'doubted the value of the exercise', our survey showed that colleges in good financial health were:

- twice as likely than colleges in poor financial health to have a clearly set out full costing policy and a consistent college-wide costing process;

- more likely than colleges in poor financial health to have a costing process which included data capture arrangements (such as staff time sheets), which would tend to be more accurate.

2.23 Colleges in poor financial health said that their biggest problem in adopting costing more widely was that they had 'higher business priorities'. However, our view is that colleges need to have some way of identifying their main cost drivers in order to be able to make good decisions about which courses to run and where to cross subsidise should that be necessary. Case studies 6 to 8 give examples of a variety of costing systems used in the colleges we visited.

Good practice in course costing at colleges

Case study 6

At one college, senior management provide their heads of faculties with a list of criteria which a course has to meet in order to recover its costs. These are:

- how many students there are on the course (e.g. a minimum of 12);
- the funding required per student;
- teaching hours required per course programme;
- consumables costs;
- accommodation/premises costs;
- contribution towards central overheads (administration costs).

Briefed with these criteria, one faculty head costed all of his courses termly using a specially designed costing schedule, which shows for each course:

- the duration of the course;
- lecturer costs (full and part-time);
- standard hourly charges for administration, accommodation, workshop usage and materials costs;
- income from the course (from the Funding Council and other sources);
- surplus/deficit.

Other departments used similar systems. If a department made a deficit two years running, the college would look at the department's portfolio of courses to see what needed to be changed to put the department in surplus. In addition, the college did not allow departments to run a course with an enrolment of fewer than 12 students.

Good practice in course costing at colleges (continued…)

Case study 7

One college had not considered it appropriate to cost down to individual course level because of the opportunity cost of carrying out the work and the increasing move to individual student learning plans, which reduces the focus on courses. However, college management introduced a Programme Approval Panel to review every new course proposal. All such proposals are now required to set out the costs and income for each new course and consider the resource and quality issues.

For existing courses, costs are examined at the school level and focus on the main cost drivers: class size, course hours and retention and achievement. Performance standards are set for each of these. Failure to achieve the standards is picked up by the college's strategic planning review process and the annual quality reviews. This means that an action plan would be required to address concerns over the following year, to ensure their cost effectiveness.

Case study 8

Another college focuses on the main cost drivers in its assessments of course costs to determine the viability of courses. The costing methodology in operation does not attempt to apportion overheads at course or faculty level because this is not thought to be worthwhile. Instead, the college considers the teaching costs inherent in providing particular courses and the income to be derived from Funding Council and student fee sources only. The college's entire course programme is subject to annual review to assess cost effectiveness and remedial action is taken as appropriate, according to these broad parameters.

c) Financial benchmarking

2.24 We asked colleges about their involvement in benchmarking activity. Benchmarking with other colleges can be a useful way for college management to focus on areas where costs are higher and to identify reasons why.

2.25 Our survey showed that about 80 per cent of colleges overall had undertaken benchmarking, but that colleges in good financial health were more likely to have benchmarked their costs against comparators than colleges in poor financial health. Even though a high proportion of colleges in poor financial health undertake benchmarking and they might have more to learn from best practice elsewhere, they tended to see significantly less benefit in benchmarking than their better off counterparts and saw 'pressure of other priorities' as a barrier. Colleges in good financial health rated improved awareness of costs and improved use of resources as important benefits of benchmarking (see Case study 9).

Case study 9: Benefits of benchmarking

One of the colleges we visited had recently commissioned a benchmarking exercise from a private sector firm. The exercise compared the college against comparators on the consultants' database of further education colleges.

The results of the exercise were generally favourable to the college, showing for example, that it had tightly controlled support costs and premises expenditure. However, it also identified areas where the college could improve:

- it suggested that there were not enough support staff in the Management Information, Finance and Marketing functions. The college then reorganized and increased its resourcing of support areas;
- it pointed out that the college's budgeting for part-time staff was open-ended. Thus the college introduced a cap on part-time staff and overtime;
- it showed scope for more efficiency in the use of photocopying and so efficiency targets were set;
- it showed the college's teaching costs while low compared to the sector average were higher than the lowest cost comparators. The college was considering addressing this by making more use of Training Supervisors to teach some courses and introducing salary banding.

d) Performance indicators and targets

2.26 Virtually all colleges in our survey said they were regularly reviewing business performance against targets. Fifty-four per cent did so monthly and 16 per cent did so quarterly. In most respects, there were no significant differences between the financial health of the respondent colleges with regard to use of targets.

2.27 However, colleges in good financial health were more likely than colleges in poor financial health to:

- have developed performance indicators or targets in addition to those suggested by the Funding Council;
- be distributing reports within a month;
- be distributing reports to key levels of management within the college;
- take remedial action as a result of the reports.

2.28 As with management information, colleges in good financial health were producing more detailed information about the way the college was running more quickly and distributing it more widely. Case study 10 shows how important good management information is to a college's financial health.

Case study 10: College structure and financial reporting

One college we visited attributed its good financial health in large part to its system of budgetary delegation combined with tight financial reporting. The college was organised into Academic Units and Support Departments. Heads of the Academic Units had autonomy over their budgets and could move budgets with these limitations:

- no recruitment of full-time staff without authorisation;
- no spend of £1,000+ without authorisation;
- no increase in their staffing budget at the expense of their non-staffing budget;
- no long term commitment to expenditure without authorisation.

In order to keep the senior management team and all budget-holders well informed, they received:

- an annual departmental budget, showing budget for the year and all staff (full-time and part-time) in the department and their projected salaries;
- a monthly financial report showing income and expenditure and committed spend for each month in the year to date against cost centres, with current variance against budget;
- a monthly standard report showing enrolments, funding units and other details about students and courses;
- a monthly staff list produced by Personnel which includes all full-timers and part-timers.

In addition, the college has a sophisticated system for monitoring student numbers and the funding unit implications, updated every day. The system is available on the college intranet and budget-holders and senior management team have access to it on-line.

Part 3: How the Funding Council have helped and could help colleges stay out of financial difficulty

Introduction

3.1 In this Part, we look at and evaluate the effectiveness of the principal measures the Funding Council takes to help colleges stay out, or get out, of financial difficulty:

- monitoring of colleges' financial health and the Regional Review Process;
- the use of the "Standards Fund" to assist colleges;
- benchmarking;
- performance indicators.

3.2 Colleges are however autonomous institutions and the Council's powers are limited to applying conditions of grant, guiding colleges, providing assistance, giving or withholding consent to borrow, withdrawing funding if a college fails to comply with the terms of the Financial Memorandum and, in the last instance, recommending to the Secretary of State that the governors of a college be replaced for mismanaging the college's affairs. The Secretary of State has replaced governors of a failing college once since 1992. In October 1999, the Secretary of State empowered the Funding Council to nominate two members to college governing bodies.

The Funding Council's monitoring of colleges' financial health

3.3 The Funding Council monitors the financial health of colleges to detect signs of emerging problems and to monitor the overall financial health of the sector. The Funding Council mainly does this by using the returns which each college is required to submit under the Financial Memorandum:

- a three-year financial forecast (submitted in July);

- the college's audited accounts (submitted in December);
- for colleges where the Funding Council has concerns regarding the colleges' financial health, a mid-year update to the forecast for the current year (submitted in February);
- at any point if information comes to light to indicate financial problems at a particular college.

3.4 In addition, the Funding Council gathers monitoring information on colleges through a variety of other means, such as visits to colleges, inspection of strategic plans, Individualised Student Record data returns, reports from college external auditors, reports from the Funding Council's Inspectorate and Audit Service and internal audit annual report. All of this information is systematically analysed.

3.5 Since April 1998, the Funding Council has strengthened this system by formally setting up a **Regional Review Process**, which existed previously only informally. As part of this process, the Regional Director and key staff in each Funding Council region meet at least three times a year to review in detail every college in the region. The process brings together a variety of disciplines including education provision, audit, accountancy, estates management, inspection and statistics.

3.6 As a result of monitoring:

- At least twice a year, colleges are categorised into one of the three financial health groups (A, B or C) discussed at paragraph 1.9 above. When a college is assessed as being in poor financial health, the Funding Council requires a mid year update on its financial position, monitors what action it is taking and will offer assistance to retrieve the position. The Funding Council can also require a college, as a condition of further funding, to produce a Recovery Plan, a detailed set of proposals for the college's recovery, which is reviewed and discussed with the Funding Council. Case study 11 gives an example of the recovery plan process.

Case study 11: The Recovery Plan process at one college visited by NAO

Background to poor financial health

After incorporation, one college reduced its core staffing by 45 lecturers and 25 business support staff, with the assistance of the Funding Council Restructuring Fund, but nevertheless incurred costs of £1.1m in redundancy payments and additional pension costs in the years 1994-95 and 1995-96. This, together with the fact that funding had to be repaid to the Funding Council for non-achievement of Funding Unit targets in 1995-96, meant that at the end of July 1996 the accumulated deficit on the college's income and expenditure account stood at £1.5m.

Financial situation

Financial projections indicated that, as the benefits of the redundancy programme were felt, the college's financial position would improve. However, the improvement was not sufficiently rapid to enable the college to comply with its Financial Memorandum with the Funding Council, which stipulated that deficits should be cleared within three years.

Recovery plan

As a result, the college drew up a Recovery Plan in consultation with the Funding Council. It was approved in March 1997 and envisaged that the college should break even in the year 2000. To achieve this result, the Plan proposed the following measures (some of which had already been adopted by the time the Plan was approved).

- Programmes of voluntary/compulsory redundancies.
- An Organisational Review.
- The establishment of income generating centres.
- An assessment of the viability of non-core services.
- The introduction of new flexible contracts and the curtailment of inflexible teaching contracts.
- Subjecting central services to tender testing.
- The use of marketing consultants to increase recruitment.
- The use of retention incentive schemes.
- An increase in teaching hours for new contract holders.
- The introduction of new model management career structure.
- The review of rates of pay for agency staff.
- The introduction of pay awards linked to surpluses.

- Three times a year, the Regional Review Process considers the financial position at each college together with audit and inspection reports, funding bids, data submissions and other information and grades the level of monitoring to be undertaken by the Funding Council on a scale of 1 to 4 (see Figures 12 and 13). The Funding Council sends a letter after the Review informing each college of the results. Most colleges receive a short letter simply stating that the "college gives no cause for concern". Where a college is graded as monitoring status 3 or 4, (87 at March 2000 or 20 per cent) assistance is offered to the colleges through a series of measures including visits by the regional director or college inspector and additional surgeries with the regional accountant or property advisor. Contact, advice and support to these colleges as part of Regional Review can be continuous if the college's problems are severe enough, with the Funding Council monitoring progress weekly. Figures 12 and 13 show how the process works.

Figure 12

Monitoring status levels awarded to colleges following Regional Review

Status 1	Status 2	Status 3	Status 4
No known concerns	Concern in one area; e.g. late with data returns.	Colleges requiring collaborative support.	Colleges in need of exceptional support.
Lighter touch monitoring	The Funding Council directorate responsible liases with college to sort out problem as normal.	Concerns within more than one area. 'Collaborative support' means a co-ordinated response from regional team. Review meeting agrees actions and situation reviewed at next meeting.	Problems so severe that capacity of the college to contribute to the Funding Council's duty to secure provision of adequate and sufficient facilities for further education is threatened. 'Exceptional support' means that Funding Council directors are given responsibility for these individual colleges to agree action for improvement.

Source: National Audit Office

3.7 We looked at how this system had worked at:

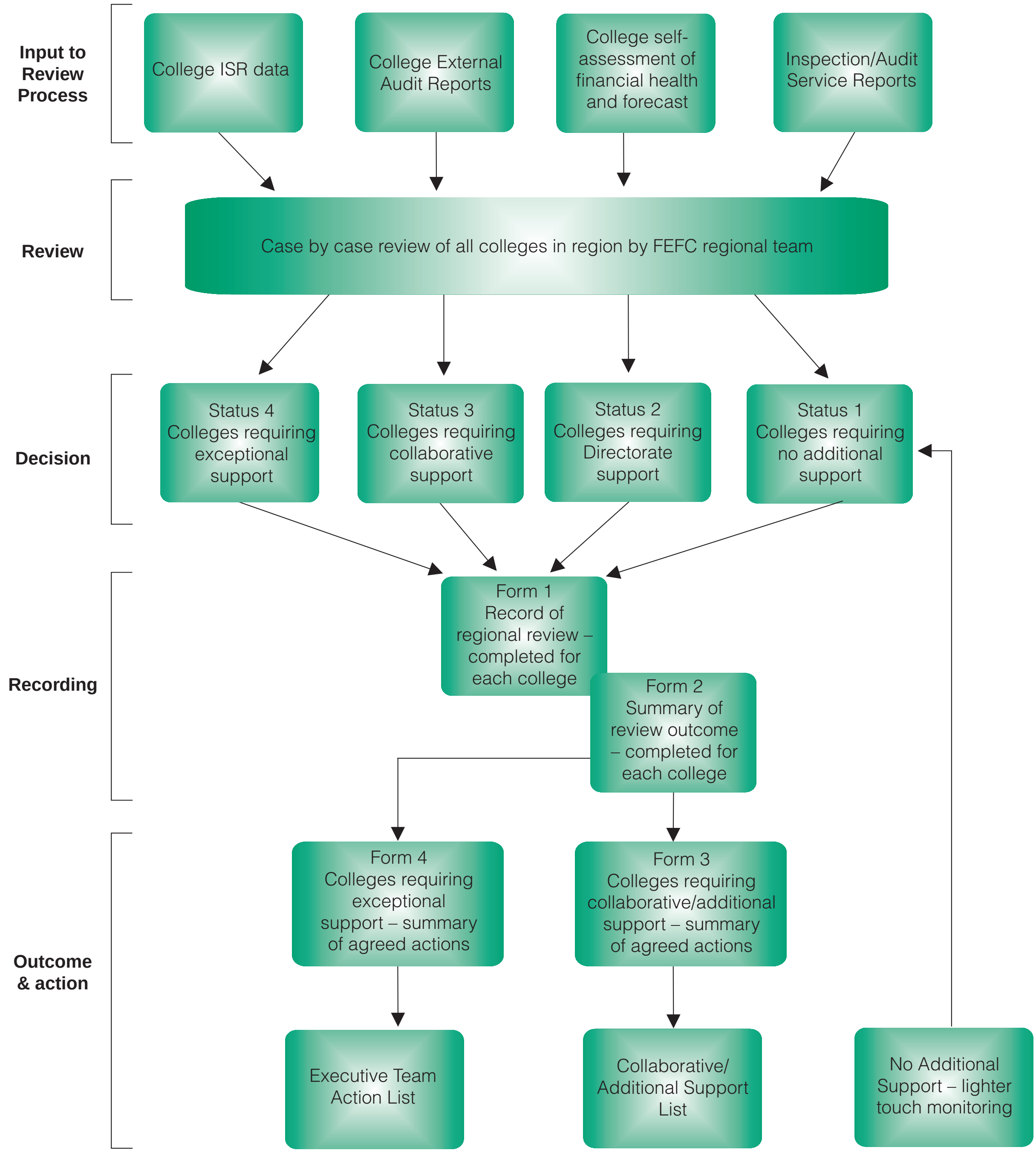
- the six colleges in poor financial health we visited as part of our visits to the matched pairs of colleges;
- the three recovered colleges.

3.8 Our main findings are set out below. It is important to recognise that these colleges had fallen into poor financial health before the introduction of the formal Regional Review Process, so their experiences do not entirely reflect what would happen now. Under the system of Regional Review in future, colleges in poor financial health should be identified sooner and receive much more support from the Funding Council.

- **The system is successful in identifying colleges that have fallen into poor financial health and making them take remedial measures.**

Figure 13

The Regional Review Process



Source: National Audit Office

- **However, in the past the system has not always been as successful in providing advance warning of financial problems.** At four of the six matched pair colleges in poor financial health, the colleges' underlying financial problems only became apparent both to themselves and the Funding Council when the colleges found themselves in financial crisis. This is at least partly because the colleges' returns to the Funding Council were inaccurate owing to poor management information, (often the result of inadequate software) which was partly why the colleges had got into trouble in the first place. Not all colleges wanted or needed a great deal of assistance. At the six colleges with poor financial health in our matched pairs, two had been able to take significant steps towards recovery without the need for much Funding Council assistance and without producing a Recovery Plan.

- **The Funding Council's support helps colleges recover financial health.** The three recovered colleges all stressed that they saw the process of recovery as something which had to come from the college itself (both governing body and senior management). However, they all commented favourably on the help they had each received from Funding Council Regional Offices to develop successful Recovery Plans (in the case of one college, this had taken around two years because of problems with lack of management information). One of the colleges acknowledged that the Funding Council's involvement had been particularly important in:

    - bringing home to each college the seriousness of its problems and the need for the college to take strong measures to assure recovery;

    - providing advice and help on the practicality and rigour of the Recovery Plan;

    - acting constructively as a "critical friend" in providing constructive criticism of recovery measures;

    - giving the Principal a lever (the prospect of the Funding Council pressure or action) to force the college to accept measures necessary to recovery.

Case studies 12 and 13 show how the actions of college management can be crucial in restoring financial health.

Case study 12: Effective intervention by a strong pro-active governing body

In early 1996, weaknesses in data recording and errors in income forecasting at one college contributed to a significantly worse financial performance than expected. The governing body 'walked through' the financial management systems themselves to identify the extent of shortcomings. They subsequently required management to take strong action to remedy the situation, including changes in senior and middle level staff and improvements in budget creation and budgetary control. The college's underlying financial strategy was sound and enabled the college to address the financial difficulties successfully.

The active role played by the governing body meant that remedial action was fast and effective once problems had arisen. They were quickly aware of the difficulties when they arose, and took positive and direct action to determine the underlying reasons and identify necessary action. One of the benefits of this is that the governing body has developed an improved understanding of the key underlying 'business' and financial processes that need to be in place to ensure effective financial management of the college.

Case study 13: Key role of the Principal

One of the colleges we visited had fallen into poor financial health because of:

- irregularities in funding claims to the Funding Council, which had led to loss of income;
- spending on capital projects outwith financial regulations;
- excessive overheads;
- falling income;
- local recruitment problems.

A key factor in the college's recovery from this situation was the appointment of a new Principal, strongly committed to financial recovery, who set out to change the culture of the college. Together with a new senior management team, he:

- instituted a cost cutting programme which included staff restructuring and redundancy;
- introduced new staff contracts and staff appraisal;
- rationalised the curriculum;
- increased student numbers via new programmes;
- underpinned the move towards financial recovery with improved ISR data and management information.

- **Feedback of information to colleges can be improved.** As part of the monitoring process, the Funding Council collects a wide range of information on colleges and performs a great deal of analysis on it. Routine feedback to colleges includes an annual letter to each college ratifying or amending the college's assessment of its financial health group together with an analysis of the college's financial forecast. Colleges also get regular letters informing colleges of the results of Regional Review and if the college is causing the Funding Council concern, they will get an explanation of the reasons for that decision. Many of the colleges we visited said that, in addition, it would be useful if the Funding Council provided more feedback drawn from the monitoring process; in particular, colleges would welcome a dialogue focusing on potential problems which the Funding Council might anticipate them facing. Colleges in difficulty also said that they would welcome suggestions for action by the Funding Council as well as reasons why the college is a cause for concern.

The Funding Council writes to the Principal, not the Governors, of the college and it is up to the Principal to pass the letter on to the Governors. We found several colleges where the Principal did not do this. These letters are crucial pieces of information about the solvency of colleges which Governors need to see, because the Government, through the articles of government, holds the governors accountable for the solvency of the college. In our view, the Funding Council should consider giving feedback in parallel to the Chair of Governors as well as to the Principal, so that all Governors can see the Funding Council's analysis alongside the views of college management.

The Quality Improvement Unit and the Standards Fund

3.9 In addition to the monitoring systems discussed at paragraphs 3.2 to 3.6 above, the Funding Council has set up, from 1st June 1999, the Quality Improvement Unit to:

- look at and monitor standards, both academic and managerial, in colleges;
- develop systems to improve those standards;
- disseminate good practice;
- allocate new funds to improve standards.

3.10 The new funds will be drawn from a Standards Fund which the Secretary of State for Education has recently introduced to underpin the initiatives announced in the White Paper, **Learning to Succeed** to raise standards at colleges. (The Fund will have £35 million to invest in 1999-2000 and £80 million in 2000-2001.)

3.11 We did not examine the work of the Unit and its use of the Standards Fund during the fieldwork stage of this study, because it was too early for their impact to be evident at colleges. The Department for Education and Employment is evaluating the use of the fund.

Benchmarking

3.12 Benchmarking against other colleges can be an extremely effective tool for a college to identify areas where it is underperforming and where there is scope for it to achieve greater cost-effectiveness. Our survey of colleges showed that around 80 per cent of them have undertaken benchmarking exercises on their own initiative and have reaped benefits from this activity. The Funding Council have also promoted and assisted benchmarking in a number of ways.

(a) Provision of benchmarking data

3.13 The Funding Council provides colleges with a range of comparative benchmarking data (see Figure 14).

Figure 14

Benchmarking data provided to colleges by the Funding Council

The Funding Council extracts a range of data from colleges' three-year financial forecasts and gives each college a line by line comparison of the college's income and expenditure against averages for the region and sector type of college. The Funding Council has recently started putting sector data on their website by quartile to enable college to benchmark themselves against the sector.

The list below gives some examples of the benchmarks published in this way:

- current ratio (current assets to current liabilities);
- payroll/income ratio;
- cash days in hand;
- borrowing;
- operating surplus;
- historic cost surplus;
- dependency on Funding Council income;
- student retention and achievement.

Source: the Funding Council

3.14 All the matched pairs of colleges we visited said that this benchmarking material was useful for making higher level comparisons at regional and sector level. The data assisted colleges in setting targets for strategic planning and in measuring the achievement of the targets. The Funding Council does not collect any data at faculty or departmental level; for this, colleges have to rely on their own bespoke benchmarking carried out in-house or by consultants. However, nearly all the colleges said that the usefulness of the Funding Council data was seriously limited by its lack of timeliness. Data could be over six months old before colleges received it, mainly because of delays in colleges submitting the base data to the Funding Council in the first place.

3.15 Colleges also said they would like the Funding Council to provide more benchmarking data, for example on:

- average hours taken in the provision of General National Vocational Qualifications and other courses;
- overall costs per student;
- staffing costs per student;
- average teaching load of staff.

Some of this information is not currently held by the Funding Council, but they have now included overall costs per student and staffing costs per student in the July 2000 forecast so that this data can be fed back to colleges as benchmarking data next year.

(b) "Benchmarking families"

3.16 A "benchmarking family" is a small group of colleges with similar characteristics, which agree to share detailed performance data with each other. It helps in making the process more useful if the colleges are geographically widely separated because then they probably will not be in competition with each other and will be happier to share commercially sensitive information.

3.17 We encountered one such benchmarking family during our college visits. It consisted of five colleges, three of which were among those we visited. The "family" had been set up in 1997 at the instigation of one college. One problem in setting up such a group is finding out which colleges have similar characteristics, particularly if the colleges are widely distributed. This is where the Funding Council had been able to assist. So far, the Funding Council has left it to colleges to approach them for this sort of help rather than pursuing a policy of encouraging colleges to form benchmarking families, so there may be scope for the Funding Council to take a more proactive role.

Case study 14: Benchmarking families

When one college fell into poor financial health, it asked the Funding Council for the names of colleges with similar characteristics against whom it could monitor its performance to assist its financial recovery. A benchmarking group of this college and four other colleges (all of which were in good financial health) was set up. The group meets 2 to 3 times a year and has met six times since April 1997 to compare performance statistics and share good practice.

The Director of Finance of the college provides reports to the college's Finance Committee on the outcomes of the benchmarking group meetings. Even though the college started off in the worst position in the group, it has shown the most improvement as a result of the benchmarking and the focus that has been brought to bear on the college's costs and performance differences.

Performance indicators

3.18 Setting performance indicators and targets is another means by which colleges can identify potential for improvement in their financial performance. Since 1994-95, the Funding Council has helped colleges to set performance indicators by collecting and distributing performance measurement data on five standard performance indicators (see Figure 15). The indicators relate to key areas of college activity and enable colleges to compare their performance with other colleges'.

Figure 15

The Funding Council's standard performance indicators

Achievement of funding target: an indicator of the degree to which a college has achieved its funding target

Change in student numbers: an indicator of the level of change in student enrolments at a college

In-year retention rates: an indicator of the effectiveness of a college's teaching and guidance and support process, as measured by the retention of students on their learning programmes

Achievement rates: an indicator of the effectiveness of a college in enabling students to attain their learning goals

Contribution to the national targets: an indicator of the number of students attaining one of the national targets for education and training by achieving an NVQ or equivalent at the appropriate level

Source: Funding Council

3.19 All the colleges we visited told us that these indicators were useful and that the Funding Council's assistance in this area was sufficient. Our view is that if colleges use these indicators as a means of monitoring their own performance internally on a regular basis, this would alert them to events which have a detrimental impact on financial health; for example, failing to meet their funding unit targets. Case study 3 shows the effect which this can have.

Other forms of assistance

3.20 We asked the 15 colleges we visited whether there were other ways, apart from those covered above, in which the Funding Council could help them. Four colleges suggested:

- a centrally provided common course-costing model to assist in the identification of the total costs of curriculum provision. The Funding Council intends to encourage the Further Education Development Agency take this matter forward;

- the recommendation of successful common financial and management information systems. Colleges told us that they had to assess the suitability of such systems for themselves and they felt that the Funding Council must be in a good position to advise them of the experiences of others.

Annex A: Study Methodology

Introduction

There are several layers to the methodology on this study as follows:

- consultation with expert panel;
- analyses of the Funding Council information;
- self completion postal survey of a representative sample of further education colleges;
- visits to 12 colleges;
- visits to 3 recovered colleges and examination of the Funding Council's advice to and monitoring of colleges;
- formal consultation with interested parties.

Expert Panel

We convened a panel of representatives from the further education sector in order to act as a sounding board for the development of study issues and methodology and to comment on the draft report. The panel met several times during the course and also commented in writing. The members of the panel are as follows:

Panel Member	Position
Steve Grix	Principal , Sir George Monoux College
Mark Dawe	Finance Director, Canterbury College
Peter Brophy	Director of Finance and Administration, Association of Colleges
Jeff Glasgow	Director of Corporate Services, Further Education Development Agency
Dr James Robertson	Director, Health Value For Money, NAO

Analyses by the Funding Council

The Funding Council holds a large amount of information on the individual institutions which it funds, relating to all aspects of the college's activities and infrastructure. In order to analyse whether external factors were acting on certain colleges in such a way so as to make it impossible for them to maintain financial health, we asked the Funding Council to test membership of group C against a number of variables. This was done as a series of bi-variate analyses, as regression analyses were of limited value because of co-variance between the variables. The hypotheses we were testing are set out below. They are based on the 71 colleges which had a financial health score of C at August 1999 (group C).

Region

Hypothesis: 'There may be a regional pattern to being in group C; e.g. that Greater London colleges have higher fixed costs and greater urban deprivation to deal with, hence costs are higher and they tend to be in group C'.

College Type

Hypothesis: 'The type of college may be a factor because some types of curriculum are more expensive than others, such as engineering, or because fixed costs are higher, as with agriculture.'

Location

Hypothesis: 'Rural colleges are more difficult and expensive to get to. Thus such colleges may have to provide travelling expenses, accommodation for students or may have to pay a premium to attract staff.'

Colleges were put into one of three broad categories, reflecting the population size of the town or city the main campus is located in:

(i) cities – population 200,000 and above (124 colleges of which 22 in group C)

(ii) large towns – 50,000 to 200,000 population (173 colleges of which 20 in group C)

(iii) small towns/villages – less than 50,000 population (136 colleges of which 27 in group C)

College Size

Hypothesis: 'A college with few students still has the same fixed costs to meet than a much larger one and a physically smaller college may not be able to expand to take more students without a large injection of capital.'

Type Of Student (mode of attendance, age)

Hypothesis: 'Students who are working and studying or who have significant family responsibilities may be more inclined to drop out and thereby deprive the college of revenue, thus making it more likely to be in group C.'

The proportion of provision in 1997-98 in each college in four categories was calculated: full-time 16-18 year olds, part-time 16-18 year olds, full-time adults (19+), part-time adults (19+).

Economic And Social Deprivation Index

Hypothesis: 'Students from areas of economic and social deprivation may need more learning and social support at College, and may be more likely to drop out – this may make the college more likely to be in group C.'

Two measures were examined:

(i) the proportion of students at each college in 1997-98 who would have been eligible for a widening participation funding uplift

(ii) the college's widening participation factor in [1997-98] which takes account of the percentage of students from deprived areas and their relative levels of deprivation.

Average Level of Funding (ALF)

Hypothesis: 'Colleges who were incorporated with a high ALF and have had to converge more abruptly than others may be more likely to be in group C. Colleges who currently have a low ALF are more likely to be in group C as they are poorer by comparison.'

Mix of Provision

Hypothesis: 'Colleges specialising in more expensive curriculum areas like engineering or jewelry-making have higher costs and may be more likely to be in group C'.

Inspection Grades

Hypothesis: 'Colleges in financial difficulty are also those with relatively poor inspection grades (quality, governance and management)'.

Retention and Achievement

Hypothesis: 'Colleges in financial difficulty are also those with relatively low student retention and/or achievement rates.'

Survey of Colleges in Group A and C

The National Audit Office commissioned a survey among a sample of English Further Education Colleges to gain insight into how colleges manage their costs. The key survey objectives were:

- To establish whether colleges are using appropriate management techniques to ensure they are financially healthy, in order to support corrective action.

- To profile the responding colleges into two groups: those which the Funding Council rates as "giving cause for concern", and those "not giving cause for concern", in order to see if there are common factors which cause colleges to fall into one category or the other, and what action might thus be suggested.

For the purposes of this survey and report, the following definitions are used:

Group A: are those colleges defined as being "reasonably robust": with positive cash-flow from operations, 25 or more cash days in hand, a net working capital of at least 2 per cent of income, and positive balance in their general reserve.

Group C: are those colleges defines as being "financially weak": which are dependent on the goodwill of others, have no cash in hand, a negative working capital, and an accumulated general reserve deficit.

For the purposes of this survey, none of the intermediate group, 'Group B' colleges, were sampled.

Methodology

The survey was conducted during July and August 1999, with a closing date for returns, after several 'chases', of the end of September. A questionnaire was sent, addressed to the named Principals of a sample of 138 English Further Education Colleges. The questionnaire was sent by post from the National Audit Office, together with a covering letter explaining the objectives of the survey, giving assurances on confidentiality, and explaining how the results would be used.

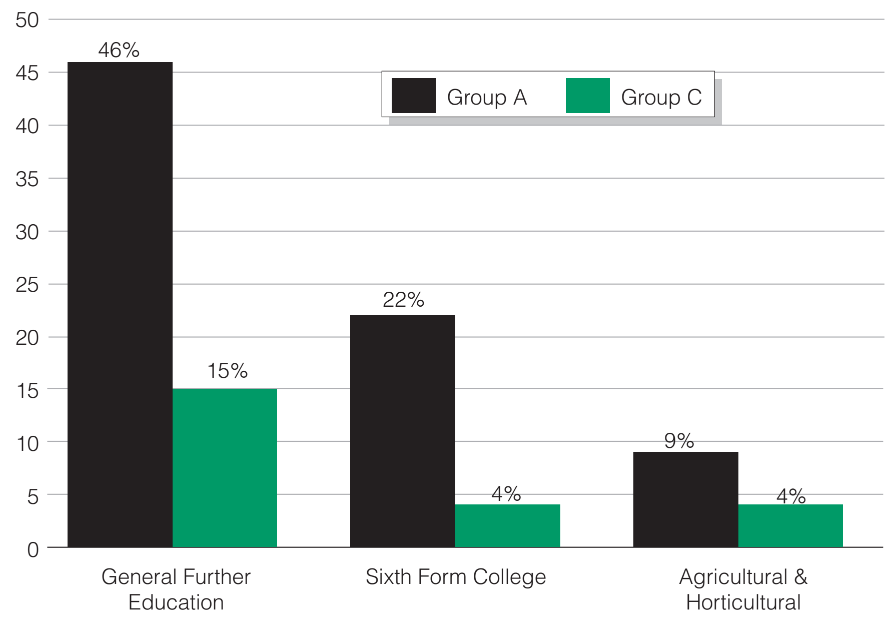
The sample is a random selection (within category) of 429 FE colleges in England. After chasing up non-responders, and allowing for the fact that two colleges subsequently ceased to exist as separate entities, a total of 136 completed questionnaires were achieved in time for analysis: a 100 per cent response rate. Responses were entered and analysed on an anonymised basis by Independent Data Analysis Ltd. to produce the aggregated tabulated results and grouped listings of verbatim responses to open questions. In statistical terms, the sample provided 67 per cent confidence limits of plus or minus three percentage points at the 50 per cent level, on average.

The questionnaire covered questions about:

- The college itself, and the respondent
- Financial management information
- College costing policy
- The college's approach to financial benchmarking
- Reviews of financial performance indicators and targets.

Sample

Of 138 English Further Education Colleges within category of financial robustness, 106 were in Group A, and 32 were in Group C. By type of college, the responses were:



Visits to 12 colleges

We visited 12 colleges in England to discuss in detail their current financial situation and the key factors in getting to that point; their financial management and planning systems; use of benchmarking; extent to which they carried out costing of courses; management information systems; use of performance indicators and targets. We sent each College a detailed management report with recommendations following the visit. The colleges were chosen with the help of the Funding Council's Research & Statistics Branch, who matched up 6 pairs of colleges for similarity. The pairs of colleges' only distinguishing feature was that one was in good financial health while the other was in poor health.

Visits to 3 recovered colleges

We visited 3 further colleges, which had been in poor financial health for some time previously but had recovered sufficiently to be classified as showing few signs of financial weakness. We discussed with the senior management of the college the reasons why the colleges had been in financial difficulty and what the key factors in the recovery had been. We also sought the views of the Funding Council's regional directors on the colleges and their recoveries.

Consultation with interested organisations

We had discussions with the Further Education Development Agency, the Association of Colleges and the College Finance Directors Network.

Annex B: Summary of recent relevant reports and recommendations made by the Comptroller & Auditor General

Managing to be Independent: Management and Financial Control at colleges in the Further Education Sector (HC 179 1994-95)

The National Audit Office concluded that most colleges had made good progress towards establishing secure systems of financial control, but that a minority had experienced significant problems in establishing adequate systems and controls. Most colleges had robust basic systems for recording student activity but some systems were fragmented and most did not integrate with financial accounting systems. The National Audit Office concluded that colleges needed to continue to develop their financial control processes and to ensure that robust student record systems were in place.

The Further Education Funding Council for England (HC 223 1996-97)

The National Audit Office concluded that colleges' financial position had worsened since incorporation and that long term debt was increasing although still comparatively low in the sector. Poor financial health at colleges appears to be the result of circumstances applying to individual colleges and their management rather than to sector wide factors. The Funding Council's financial monitoring procedure is based on relevant criteria consistently applies and has generally succeeded in identifying problems early. Arrangements for monitoring financial health have shown that the number of colleges in difficulty has increased and that it is important for the Funding Council to ensure that they receive timely and reliable financial returns from colleges.

Investigation of alleged irregularities at Halton College (HC 357 1998-99)

The National Audit Office recommended that all colleges should provided their governing bodies with termly statements of the financial position of the college and more frequent reports should be provided if a college's financial position starts to deteriorate. College governing bodies should ensure that they are meeting existing Funding Council requirements for them to approve financial forecasts and budgets amend to monitor financial performance.

Further Education in Wales (HC 641 1998-99)

The National Audit Office concluded that the financial health of the sector had been deteriorating since incorporation in such a way that half of all institutions were forecasting a deficit in 2001-2 and 28 per cent were in immediate difficulty. The Funding Council for Wales had generally sound systems for identifying institutions in trouble but needed to introduce formal reviews of each college termly as is done in England. Institutions need to improve their financial management, governance and procurement procedures.

Scottish Further Education Colleges: Managing Costs (HC 493 1998-99)

The National Audit Office concluded that since incorporation colleges had reduced costs by one and a half per cent and unit costs by 23 per cent due to greater student numbers, increased productivity of staff and lower cost staffing structures. However, the focus on managing costs at college level better is often lacking and sharing best practice is patchy and benchmarking has been constrained by competition. The National Audit Office recommended that the Department and the Funding Council promote benchmarking and best practice and develop performance indicators and targets.

Annex C: The Funding Methodology

Introduction

1 The following paragraphs only provide a snapshot description of the Funding Methodology. The Methodology is under continuous review and will change in many respects for year 2000-01.

2 Throughout this Annex, where we refer to Funding Council funding, we are speaking of what are known as "participation funds". It should be noted that the Funding Council pays other funds, outside the Funding Methodology, such as standards funds and access funds.

3 We refer throughout the Annex to the funding of colleges, but again it should be noted that the Funding Council also uses the Funding Methodology to fund external institutions and higher education institutions.

Background

4 Before the incorporation of the further education sector in April 1993, colleges were under the control of Local Education Authorities, which allocated funding to the colleges on the basis of the number of enrolments on courses each year. In the period immediately following incorporation, the Funding Council in their turn used the same method to allocate funding to colleges.

5 However, this method, although fairly simple, was subject to a number of serious deficiencies, as follows.

- It did not take account of the extent to which students dropped out from their courses or failed to achieve their qualifications. *Unfinished Business,* a report of a joint study by the Audit Commission and the Office for Standards in Education (OFSTED), published in 1993, estimated that the cost of courses taken by students aged 16 to 18 in schools and colleges who did not achieve their intended qualification aims was around £500 million each year.

- Part-time student enrolments were classified as block release, part-time day or part-time evening modes of attendance, and counted as proportions, with a variety of weightings used for funding and other purposes.

- The classifications used to define student modes of attendance did not adequately reflect the flexible ways in which institutions increasingly were delivering courses and wished to develop learning programmes in the future.

6 To address these shortcomings, the Funding Council, after consultation with the sector, introduced a revised method of allocating funding to colleges, known as the *Funding Methodology*. For example, the *Methodology* takes into account, in addition to student enrolments, both the initial guidance and assessment received by students and institutions' effectiveness in supporting student learning and achievement. The following sections explain the main elements of the Funding Methodology and how it affects colleges.

Funding Units

7 The Funding Council awards Funding Units to colleges for providing educational courses and support services. The Funding Units are awarded according to a tariff, which sets out the levels of funding which different types of provision will attract. The Funding Council publish the tariff about six months before the start of the academic year (beginning in August) to which it relates: for example, the tariff for the academic year 1999/00 was published in January 1999. The main principles governing the award of Funding Units are:

- different courses earn different numbers of Funding Units: for example engineering earns more Funding Units than social studies;

- Funding Units are earned for different stages of a student's progress through college:

  - when a student enrols (*entry)*;

  - if a student stays at the college (*retention*);

  - if a student gains a qualification (*achievement)*;

- there is a limit to how many units a college can be funded for in any one year, since the Funding Council do not have unlimited funds. At the beginning of the year, each college agrees a target for the number of Funding Units it will earn with the Funding Council. If it exceeds that target, there is no guarantee that it will be paid for the excess, although the Funding Council may choose to do so if they have funds available. If the college fails to meet the target, the Funding Council may recover funds in respect of the shortfall, although there is a system in place to allow colleges to offset overachievement in one year against a small amount of under-achievement in another.

Average Level of Funding (ALF)

8 Each college is paid a certain rate of funding per Funding Unit earned: this rate is known as the ALF. The funding a college receives from the Funding Council will therefore be the number of Funding Units it earns multiplied by the college's ALF.

9 ALF varies between colleges. Consequently, two colleges may earn the same number of Funding Units, but receive different amounts of overall funding.

10 The Funding Council reviews each college's ALF each year. ALF varied between colleges to the greatest extent immediately after incorporation. Since then, the Funding Council has been gradually making ALFs more and more uniform (a policy called "convergence") with the objective of making most colleges' ALFs the same in each year.

The tariff

11 Colleges earn Funding Units by making the following forms of provision for students. To understand how the tariff works, it is necessary to be familiar with the basic concepts defined in the box below.

Learning programme. This is all of a student's activities towards his or her primary learning goal where these involve the use of resources:

- **either** of the college at which the student is enrolled;
- **or** of another provider making provision on behalf of the college at which the student is enrolled.

Primary learning goal. This is the end-point qualifications or objectives set out in the student's learning agreement.

Guided learning hours. These are all times when a member of staff is present to give specific guidance towards the qualification or objective being studied as part of a learning programme. This includes lectures, tutorials and supervised study and time spent assessing a student's achievements (including when the student is present as, for example, in the assessment of competence for NVQs) but it does not include staff supervision or assistance of a general nature: for example, staff attendance during general study time in a library.

Census dates. These are 1st November, 1st February and 15th May or, where these dates are not working days, the next working day.

Tri-annual periods. These are:

- 1st August to 31st December;
- 1st January to 30th April;
- 1st May to 31st July.

Entry activities element

12 The Funding Council defines *entry activities* as *"all activities leading to the enrolment of a student on a learning programme"*. This includes all the activity incurred in recruiting the student to the programme. It will differ according to the course and the type of student. So, for instance, students with basic skills needs or those with learning difficulties and/or disabilities earn the college more entry units than a student on an A level course transferring from school: this reflects the greater resources deployed in outreach work and initial assessment and guidance for the students earning the higher entry units.

13 For a college to claim funding units for these activities:

- the college must enter into a learning agreement with the student, signed by both parties, setting out the student's primary learning goal and the support the institution has agreed to provide to help the student achieve the learning goal, and confirming that in reaching the agreement the student has had the benefit of adequate initial assessment and guidance;

- the student must **either** be enrolled and considered not to have withdrawn from his or her learning programme on the first census date following the start of the learning programme **or** have started and completed the learning programme between two census dates.

14 If a learning programme lasts more than a year, the entry activity element can only be claimed once; but if a student completes a qualification and, in the same year, starts another qualification, under a revised learning agreement, no additional entry units can be claimed. Colleges can claim a maximum of eight funding units per student for entry activity element (although the Funding Council is consulting on a change to the tariff for 2000-01 to allow colleges to claim up to 16 entry and guidance units for entry and guidance activity).

15 Colleges must, in addition, collect and retain evidence to support their claims for entry element funding units. This means that *for each student* they have to retain the following pieces of evidence:

- the student's name and address;
- (where provision for the student is franchised to another organisation) the name of the franchisee;
- the primary learning goal;
- the number of guided learning hours;
- the average guided learning hours planned in each year of the programme;
- the number of tri-annual periods planned to complete the programme;
- evidence of the assessment and guidance process gone through for each student. This should include evidence showing that the process has involved looking at the implications of the choice of the student's learning programme, the entry requirements of the student's learning programme, the suitability of the student's learning programme and the support the student was going to receive. There should also be a brief description of procedures followed and signatures from the student and staff to confirm the procedures have been carried out.

On-programme element

16 The Funding Council define the *on-programme element* as *"all activities of learning and accreditation of achievement, including assessment, general and specific student support services and enrichment activities"*. Colleges can claim Funding Units for on-programme element for various aspects of the execution of the student's learning programme, such as:

- the student's induction;
- the student's attendance;
- support to the student;
- accreditation of prior learning assessment;
- guidance and counselling.

17 The Funding Units awarded for each learning programme reflect two factors:

- "basic on-programme" units: these relate to the volume of activity needed to deliver a learning programme;
- the "cost-weighting factor": this reflects the different costs of delivering different learning programmes. For example, a learning programme for an engineering qualification might involve higher staff costs, building and equipment costs and so would be weighted more heavily than a learning programme for, say, a business studies qualification.

18 The number of on-programme units earned by any particular eligible qualification is determined in one of two ways:

- the Funding Council have listed individual tariffs for many qualifications;
- qualifications which do not have individually listed tariffs are assigned to one of six *loadbands*, depending on the number of guided learning hours in the learning programme.

19 Colleges have to provide auditable evidence to support their claims for on-programme element. This evidence includes a log of the activity of each student claimed for, as well as registers of attendance for the student or registers of tutor contact in the case of distance learning or Accreditation for Prior Learning (APL).

20 *Achievement element* Colleges may claim Funding Units (so-called *achievement units*) for students who achieve externally accredited qualifications approved by the Secretary of State. These qualifications include, in the main, qualifications externally accredited by validating bodies such as the Business and Technology Education Council (BTEC), City and Guilds of London Institute (C&G) and the GCE examining boards. However, in some cases, a college can claim Funding Units for certificates awarded by the college itself without external accreditation:

- certificates awarded to recognise the achievements of students with learning difficulties;

- certificates for certain other specialised qualifications.

21 The Funding Council are consulting on the proposal that Funding Units might be claimed for adult basic education and for ESOL (English for Speakers of Other Languages) students who achieve their primary learning goal linked to the national standards for literacy and numeracy. If this proposal is agreed, the Funding Council will implement it for 2000-01.

Tuition fee remission

22 Until recently, colleges were free to set their own tuition fee policies, subject to the requirement of the Secretary of State that fees could not be charged to students aged 16 to 18 in full-time education. In a recent circular (99/37), however, the Funding Council recommended a minimum tuition fee for employer-led provision funded by the Funding Council.

23 In addition, to promote access to further education for people on low incomes and to encourage basic education, the Funding Council allows colleges to claim Funding Units if the colleges remit 100 per cent of the tuition fee to certain groups of students. These students are:

- those receiving unemployment. benefit or means-tested state benefits and their unwaged dependants,

- students taking a programme of Adult Basic Education (ABE) or English for Speakers of Other Languages (ESOL).

Childcare support

24 Colleges can claim Funding Units for childcare support for:

- students who are either receiving, or who are unwaged dependants of persons receiving, unemployment benefit or means-tested state benefits;
- students taking programmes of ABE or ESOL.

25 The childcare support units may be claimed where an institution provides either crèche or playgroup facilities at no cost, or meets 100 per cent of the cost incurred in securing the provision of childcare during the student's programme of study.

26 The Funding Council are changing the tariff from 2000-01 onwards so that colleges will no longer be able to claim units for childcare support; instead, funding for childcare will be paid through an expanded access fund.

Additional support

27 Colleges can also claim Funding Units for this category, which the Funding Council define as *"any activity which provides direct support for learning to individual students, which is over and above that which is normally provided in a standard learning programme which leads to their primary learning goal"*. The additional support must be required to help students gain access to, progress towards and successfully achieve their learning goals. The need for additional support may arise from a learning difficulty and/or disability or from literacy, numeracy or language support requirements.

28 For a college to obtain additional support units for a student, the college must be able to provide the following evidence:

- the student's learning agreement showing a summary of the additional support which was to be provided to the student;
- an "additional support costs form", itemising expenditure and signed by the student and retained with the learning agreement.

Widening participation

29 Colleges can claim a *widening participation uplift* for any student who is recruited from an area with a postcode which is in a ward considered to be relatively more deprived. The Funding Council uses an index based on the index of local deprivation produced by the Department of Environment, Transport and the Regions (DETR) as a proxy measure for educational disadvantage. Students living in the 15 per cent most deprived local authority wards attract additional funding. The average uplift factor is 6 per cent in 1999-00 and is applied to entry, on-programme and achievement units. In addition, a widening participation uplift factor of 9 per cent may be claimed for people living in supported accommodation, irrespective of their postcode.

30 There is evidence that for some groups of people, participation and achievement in learning of all kinds is low, and, while some of these students will live in areas which qualify for the widening participation uplift, others will not. It is proposed that from 1999-2000, local provision from certain groups will qualify for a widening participation uplift of 6 per cent. These groups are:

- the homeless;
- those living in hostels and residential centres;
- those with mental health problems;
- travellers;
- those in care, or who have recently left care;
- those whose statutory education has been interrupted, for example, by pregnancy or parenthood;
- asylum seekers;
- refugees.

31 In addition, subject to consultation, students taking basic skills courses and students whose provision is part-funded by the European Social Fund (ESF) will be eligible for the widening participation uplift.

32 The Funding Council are exploring a proposal to replace the current widening participation method for 16-19 year old students with a system for determining eligibility based on previous educational achievement.

Sum of units

33 The total number of units generated by each student varies according to the type of programme followed; the student's progress through the programme followed; the student's success at the end of the programme; and the degree of financial and other support made available by the college. The total activity being supported by funding from the Funding Council at a college can then be expressed as the sum of units generated for each student. In the same way, the funding agreement between the Funding Council and each college specifies the minimum number of funding units which the college has agreed to generate in return for the funds allocated to it.

- The standard values of units available for each element of a student's programme are set out in a tariff. The Funding Council has established a Tariff Advisory Committee (TAC) to advise the Funding Council on the elements of provision to be differentiated for funding purposes and on the value of units to be assigned to each element in the light of research and consultation with institutions. Membership of the TAC is made up of senior staff from colleges funded by the Funding Council and representatives from local education authorities;

- adult education;

- higher education institutions;

- the Further Education Development Agency.

A representative from the Training and Enterprise Councils has also been invited to join the TAC.

Calculating funding entitlement

34 Where possible, the Funding Council gives each college a final funding allocation. However, the complexity of the Funding Methodology and its dependence on events occurring during the year (entry and retention) and at the year-end (qualification) mean that a college's entitlement to funding will not be settled until February, when the college submits a fully-audited return. This is several months after the academic year end in July. If a college's fully audited entitlement is then found to be short of its allocation, the Funding Council may (subject to the exceptions discussed at paragraph 7) recover the difference.

Monitoring Funding Units earned

35 If a college earns too few Funding Units and undershoots its target by more than 2 per cent, the Funding Council may recover funds in respect of the shortfall (see paragraph 7 bullet 3). If it earns Funding Units in excess of target, there is a risk that the Funding Council may not pay for them. Colleges therefore need to monitor the number of Funding Units they are earning during the year, so that they can take corrective action to avoid undershooting or overshooting their targets.

36 However, monitoring is difficult because the Funding Methodology is so complex. For example, to carry out monitoring, a college has to:

- accurately record actual enrolments of students: colleges have no way of predicting how may students will enrol and enrolment in further education can happen at almost any point in the year;
- accurately record students' attendance at classes;
- ensure that it (the college) has auditable records to prove that students enrolled and attended;
- calculate the Funding Units earned from a variety of different sources, some of which will be external providers who contract to deliver part of the college's provision;
- estimate the number of students who will achieve qualifications at the end of the year;
- obtain, from the very large range of awarding bodies, the numbers of students who have gained qualifications.