Overseeing financial sustainability in the further education sector
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Overseeing financial sustainability in the further education sector

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office
17 July 2015
This report examines whether oversight bodies can monitor the further education sector’s financial health in a way that allows them to protect public investment and maximise its value, and intervene effectively when problems arise.
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This report can be found on the National Audit Office website at www.nao.org.uk

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## Key facts

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>29 of 244</td>
<td>colleges had an ‘inadequate’ rating for financial health by the end of 2013/14 (Skills Funding Agency assessment)</td>
</tr>
<tr>
<td>110</td>
<td>colleges were in operating deficit in 2013/14</td>
</tr>
<tr>
<td>£45m</td>
<td>of cash advances from the Skills Funding Agency were outstanding as at February 2015</td>
</tr>
<tr>
<td>4 million</td>
<td>people in further education each year</td>
</tr>
<tr>
<td>£7 billion</td>
<td>public funding for further education each year</td>
</tr>
<tr>
<td>47</td>
<td>colleges with an operating deficit of more than 5% of their income, in 2013/14</td>
</tr>
<tr>
<td>22</td>
<td>colleges that needed the Further Education Commissioner to intervene because of their financial situation between November 2013 and June 2015</td>
</tr>
<tr>
<td>41%</td>
<td>proportion of colleges with a worse financial health classification in 2014 than they forecast 2 years earlier</td>
</tr>
</tbody>
</table>
Summary

1. Further education (FE) is formal learning outside of schools and higher education institutions. Around 4 million people learn in the FE sector (the sector) each year. These include young people continuing their academic or vocational learning outside school; adults and young people seeking basic skills; and others who want to develop skills or get formal qualifications. The sector also offers vocational and skills training for apprentices, and provides some higher education courses.

2. In England, there are around 1,100 providers, including around 240 FE colleges delivering education and training to more than half of the sector’s learners. Around 700 providers are commercial or charitable bodies, supporting most of the remaining learners.

3. Colleges are crucial for providing FE nationally, and have an important local presence as students traditionally learn relatively close to home. When colleges have financial difficulties, this can affect many stakeholders, including students, employers, lenders, and the funding and oversight bodies.

4. The sector gets around £7 billion of public funding each year, most of which comes from the Department for Business, Innovation & Skills (BIS) and the Department for Education. The Skills Funding Agency (SFA), which BIS sponsors, provides £3.8 billion for around 2.9 million adult learners and apprentices and around 185,000 apprentices aged 16 to 19. The Education Funding Agency, which the Department for Education sponsors, provides £3.0 billion for around 665,000 learners aged 16 to 19. Providers may get other public funding, and income from additional private or charity sector sources.

5. Under the Further and Higher Education Act 1992, colleges are statutory corporations with exempt charity status. They have financial independence and powers to own assets, employ staff, enter contracts and buy services, and may make financial surpluses or deficits.¹ The Education Act 2011 and subsequent policy documents – such as New Challenges, New Chances and Rigour and Responsiveness in Skills – have emphasised colleges’ independence, and their freedoms and flexibilities to manage their own affairs, with external intervention occurring only where a college is failing.

¹ Commercial and charitable providers follow the normal financial regulations of their sectors.
BIS is responsible for the regulatory framework and policy governing further education, but multiple bodies oversee the sector. They do this in order to protect public investment in the sector and maximise its value. The SFA monitors financial health and financial management, while Ofsted inspects and monitors the quality of further education and training, including the effectiveness of leadership and management. The SFA is also responsible for some direct intervention where it has concerns around financial health or control. Since 2013, the most poorly performing colleges have been referred to the FE Commissioner, a newly created post, who provides independent advice to ministers and to the chief executives of the funding agencies.

**Scope and approach**

We examined oversight of the financial sustainability of the sector in England, focusing particularly on FE colleges (excluding sixth form colleges). We did not audit whether the overall policy of strengthening colleges’ independence since 2011 is delivering value for money. Appendix One contains a detailed description of our audit approach. We assessed whether BIS and the SFA, working with other relevant bodies, are able to:

- monitor the sector’s financial health and control in a way that allows them to protect public investment and maximise its value; and
- intervene effectively when problems arise.

**Key findings**

**The financial health of the sector**

The financial health of the FE college sector has been declining since 2010/11. In 2013/14, the sector was in deficit for the first time and 110 colleges recorded an operating deficit, up from 52 in 2010/11. In the same period, the number of colleges assessed by the SFA to have ‘inadequate’ financial health rose from 12 colleges (5% of colleges) to 29 colleges (12%). The SFA defines a college with inadequate financial health as being in financial difficulty, with a significant risk of being unable to fulfil its contractual duties. Trends in financial health over the last 4 years vary substantially by college size and region (paragraphs 2.2 to 2.5 and 2.7, and Figure 2 to Figure 5).

The decline in the financial health of the sector has been quicker than indicated by colleges’ plans, and current forecasts suggest that the number of colleges under strain is set to rise rapidly. In particular, the SFA anticipates that the number of colleges it rates as financially inadequate will continue to grow. On current trends, it could be around 70 colleges by the end of 2015/16, based on the SFA’s modelling in May 2015 of the sector as a whole rather than forecasts for individual colleges. This estimate is sensitive to a number of assumptions around funding projections, recruitment levels and colleges’ ability to reduce costs (paragraphs 2.4 and 2.6).
Overseeing financial sustainability in the further education sector

**Summary**

10 Reductions and changing priorities in public funding, falling numbers of 16- to 18-year-olds, and more competition from schools and universities have combined to create a challenging educational and financial climate for many colleges. These factors affect colleges to differing extents, depending on their local circumstances and how far they have adapted their educational provision and finances to meet the new environment. Some colleges are also struggling with large debts or partially completed capital investment projects. The latter partly reflects weaknesses in the planning and financing of capital projects under the former Learning and Skills Council (paragraphs 2.8 to 2.14, Figure 6 and Figure 7).

**Identifying risks**

11 Some colleges’ forecasting has been over-optimistic, meaning they have not identified problems until a late stage. As independent organisations, colleges are responsible for identifying and managing their own risks. Some colleges have been consistently optimistic in their financial forecasts, particularly colleges with weaker financial health. In 2013/14, the financial health of 41% of all colleges was worse than those colleges had forecast 2 years earlier. Among the colleges with weaker financial health in the previous 4 years, 51% had financial health that was worse than they had forecast 2 years earlier. The reasons for optimistic forecasts vary and include overly positive expectations about income levels and ability to recruit students, unrealistic assumptions about the ability to cut costs over short timescales, and a desire to produce ambitious budgets to spur action (paragraphs 3.2 to 3.4, Figure 8 and Figure 9).

12 Many colleges are taking tough decisions to avoid financial difficulty while maintaining educational standards, but this requires skills that are in short supply. Common failings that the FE Commissioner has identified suggest that management capability in parts of the sector is not enough to fully address emerging risks. There is training and support for management and leadership within the sector, and sector-run bodies have an important role to play. However, stakeholders have pointed to the need to enhance the change-management and commercial skills required to manage colleges in a rapidly changing environment (paragraphs 3.5 to 3.7).

13 In recent years, the SFA has used the financial forecasts produced by colleges without always testing their realism, and as a result has not detected some problems until a late stage. The SFA’s analysis of year-end financial data has included an assessment of the type of financial ratios we would expect, allowing it to focus on colleges with weaker financial health. Its analysis of financial trends and forecasts, however, did not always include adequate testing of the realism of what was being presented. As a result, some problems, which might otherwise have been identified from questioning the data, were not always detected until a late stage (paragraphs 3.10 and 3.11).
In mid-2014, the SFA began developing a broader approach to examining financial and other risks. The SFA’s new approach, which it is still refining, takes a broader view of financial risk. It looks beyond current financial health to consider trends, and includes wider measures of education quality and governance. This should allow the SFA to better prioritise its efforts towards those colleges and other providers most likely to be at risk (paragraph 3.12 and Figure 10).

The effectiveness of the SFA’s new approach to risk assessment will depend on its ability to act on that assessment. As independent bodies, colleges and their governing bodies are responsible for managing their own affairs. Consistent with the policy of devolving responsibility to colleges, the SFA gets involved only when financial performance has deteriorated to a point where formal intervention is required, and problems are therefore already serious. Some stakeholders in the sector considered the SFA was not doing enough to prompt improvement during the crucial pre-intervention phase. There may be valuable lessons to be learned from other sectors. Monitor, as an independent regulator in the health sector, has started to work more proactively with NHS Foundation Trusts to reduce risk – for example encouraging partnering of high-performing trusts with those performing less well. There is more that BIS and the SFA could do to better support colleges considered at risk, while respecting their independence (paragraphs 3.13 to 3.15).

At times, the assessments undertaken by Ofsted and the SFA have the potential to send mixed messages to colleges. In one particular case, the FE Commissioner’s assessment highlighted the fact that Ofsted’s assessment of leadership and management and the SFA’s assessment of financial health had appeared to contradict each other (paragraph 3.16).

The SFA’s formal intervention, once it determines that a college’s financial health is ‘inadequate’, has often lacked sufficient impact. When the SFA assesses a college as financially inadequate, it issues a notification requiring the college to produce a recovery plan. Around half of the colleges that the SFA rated as ‘inadequate’ between 2010/11 and 2012/13 have since improved their position without more severe intervention, such as merger or FE Commissioner review. Colleges said they have generally found the SFA helpful and supportive, but the effectiveness of intervention at this stage can be hindered by: the ability of college management teams to prepare robust recovery plans; the change-management skills within management teams and governing bodies to address problems; and the SFA’s capacity to judge, with the limited resources that it has, whether a college’s recovery plan will be sufficient to put it on a sustainable footing (paragraphs 4.2 to 4.4).
The financial support that the SFA offers to struggling colleges has increased substantially since 2010, but most has not yet been repaid. Advances of funding, paid out by the SFA and previously the Learning and Skills Council and intended to be repaid in the short term, had risen to £49 million in September 2013. By September 2014, the SFA had converted advances of £40 million at 3 colleges to grants, meaning they would not be repaid. The outstanding balance, including new advances, stood at £45 million by February 2015, relating to 13 colleges. In November 2014, BIS announced a new policy under which long-term financial support will automatically trigger formal intervention. Most stakeholders we spoke to, including colleges and lenders, believe that this approach will be more effective. However, some expressed concern that the precise conditions for this financial support are not sufficiently clear (paragraphs 4.5 to 4.7, and Figure 11).

The FE Commissioner has prompted colleges in severe financial difficulty to take more concerted action, and given feedback on lessons learned to the sector. Between November 2013, when the Commissioner took up his role, and June 2015 he had visited 27 colleges, of which 22 were chosen because of their financial situation. College principals who implemented his recommendations were generally positive about the process. Many highlighted the impetus for change that the Commissioner and his advisers had provided. College principals and governors also welcomed the Commissioner’s efforts to disseminate lessons learned to the sector. However, it takes time to turn a college around. It is therefore too early to say whether the Commissioner’s interventions will result in sustainable solutions in most cases (paragraphs 3.8 and 4.8 to 4.11).

The SFA and FE Commissioner will need to use their limited resources well to manage an increasing workload, as more colleges are expected to experience financial difficulty. Recent changes to the structure and role of the SFA’s local area teams removed their dedicated local relationship managers. In 2015, the SFA responded by rearranging its local teams into distinct provider management and intervention functions. The FE Commissioner has also acquired additional advisers to deal with an increased number of cases. But as the number of struggling colleges increases, it could become more difficult to intervene in good time (paragraphs 4.4 and 4.12).

The FE sector is experiencing rapidly declining financial health, but lacks a clear process to inform decisions about local further education provision. With the number of colleges in financial difficulty expected to continue to rise, decisions about the long-term viability of individual colleges at local level should be informed by a robust assessment of likely local needs and capacity to meet those needs. A range of bodies may have a perspective on local provision, including a college’s governing body, the SFA, the Education Funding Agency, and Local Enterprise Partnerships, but none has a role to bring together such an assessment. In early 2015, BIS and the Department for Education began broader reviews of educational provision in a small number of areas (paragraph 4.14).
If structural changes such as college closure or merger are needed, enacting such changes relies on the cooperation of colleges’ governing bodies and the ability to find willing partners. Legal powers over corporate changes such as closure and merger generally sit with colleges’ governing bodies, following the 2011 legislation. No college can be closed and formally dissolved without first transferring its assets and liabilities to other willing parties, usually another education provider. In localities where other providers may also be under financial strain, finding such partners is not straightforward and can become drawn out (paragraph 4.15).

Conclusion on value for money

BIS and the SFA have taken steps to improve their analysis of risk in the sector. Also, the introduction of an FE Commissioner has filled a significant gap in the intervention arrangements. On their own, however, these actions are not likely to be sufficient to address a growing structural problem. BIS and the SFA now need to take a more strategic look at the implications of rapid growth in the number of colleges in poor financial health, bearing in mind that without advances of funds and additional grants some would be in an even worse position. What is needed is a more comprehensive and enduring approach. Without this, the oversight and intervention arrangements for further education cannot yet be regarded as value for money.

Recommendations

a BIS, working with the Department for Education, should consider whether the existing college-by-college approach to intervention will address the more fundamental structural problems faced by the FE sector. The number of colleges experiencing financial difficulty is expected to rise rapidly. The SFA and FE Commissioner intervene in individual colleges, but the scale of challenge may require more joined-up decisions to be made at a regional or sector-wide level.

b Where major decisions are taken relating to individual colleges, BIS, working with the Department for Education, should clarify roles and responsibilities for informing decisions about local provision. Decisions about whether to merge or close a college need to be supported by good information on educational and skills needs in the area, and the capacity available to meet them. No organisation currently has a specific role to make this assessment. The broader reviews of college provision that began in some areas in early 2015 may provide a basis from which to build a consistent mechanism that can be applied across the country.
c BIS should reconsider the extent to which the current approach to oversight of public investment in the sector, and the responsibilities of the various parties involved, helps to resolve problems quickly to the long-term benefit of students and taxpayers. The approach needs to be more effective at addressing problems at an earlier stage. At present too many cases have to await intervention by the FE Commissioner before effective action is taken. BIS and the SFA could look to how similar issues are being tackled elsewhere, for example the work being taken forward by Monitor in the health sector.

d BIS and the SFA, working with relevant sector bodies, should consider how they might better support the development of the management skills needed in this more challenging environment. There are already examples of successful change-management within the sector, but current trends suggest that strong change-management and commercial skills are likely to be at a premium in the near future.

e The SFA should build on the action it is taking to provide benchmark information to college governing bodies and their management teams. The feedback from the FE Commissioner on what governing bodies should be looking out for has been well received by colleges.

f BIS, working with the Department for Education, should ensure that there is capacity to deal with the expected increase in the number of colleges requiring support. Cost-effective intervention will rely on the ability of the oversight bodies to take effective action quickly.
Part One

The further education sector

Purpose

1.1 Further education (FE) broadly means formal learning outside of schools and higher education institutions. Around 4 million people learn in the further education sector (the sector) each year, including:

- young people continuing their academic or vocational learning outside of school;
- adults and young people seeking basic skills; and
- others seeking skills or formal qualifications.

1.2 The sector offers vocational and skills training for apprentices, and provides some higher education courses. It supports economic growth, helping employers to enhance their employees’ skills and giving learners the opportunity to pursue successful careers.

Providers

1.3 In England, the sector consists of around 1,100 education and training providers. This includes around 240 FE colleges, delivering education and training to more than half of the learners in the sector.2 Around 700 providers are commercial or charitable bodies, supporting most of the remaining learners. Many colleges subcontract with commercial or charitable providers to teach specific courses, or whole curriculum areas. Higher education providers and local authorities also provide FE opportunities to some learners. This report does not consider sixth form colleges, which operate under the same legal framework but are generally treated as part of the schools sector.

1.4 Providers vary in size, with the largest colleges having a turnover of more than £50 million and more than 15,000 students. Many commercial or charitable providers are smaller bodies, with contracts to deliver education and training to a few hundred students each year, although some are also very large.

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2 Unless stated otherwise, references to “colleges” in this report include specially designated institutions that are treated the same way for oversight, but operate as commercial entities. There were 9 such organisations in 2013/14.
1.5 FE colleges are crucial for the effective delivery of FE on a national scale. As individual bodies, they also have an important local presence, in a sector where students traditionally learn relatively close to home. When financial difficulties occur within a college, this can affect stakeholders in the following ways:

- Students – deterioration in quality of provision; disruption to study.
- Employers – reduced training quality; potential damage to the local skills base.
- Lenders – loss of return or confidence; cost of extra monitoring and support.
- Funding and oversight bodies – cost of extra financial support; cost of extra monitoring; risks to statutory responsibilities and objectives.

1.6 Under the Further and Higher Education Act 1992, colleges are incorporated with exempt charity status, giving them financial independence and powers to own assets, employ staff, award contracts and buy services. Colleges may make financial surpluses or deficits. In cases of financial difficulty, however, there is no provision for colleges to enter an insolvency regime such as administration. For a college to dissolve, it would first need to transfer its assets and liabilities to other willing parties as legally prescribed (most probably other education providers). Commercial and charitable providers follow the normal financial regulations of their own sectors.

Funding and oversight of the sector

1.7 The whole sector, including commercial and charitable providers as well as colleges, receives around £7 billion of public funding each year, mostly from the Department for Business, Innovation & Skills (BIS) and the Department for Education. The Skills Funding Agency (SFA), which BIS sponsors, provides £3.8 billion for around 2.9 million adult learners and apprentices and around 185,000 apprentices aged 16 to 19. The Education Funding Agency, which the Department for Education sponsors, provides £3.0 billion for around 665,000 learners aged 16 to 19.

1.8 Providers may get other types of public funding, such as through student loans, the European Social Fund and Local Growth Fund. They can also generate income from other sources – for example, from courses that employers fund, or existing activities such as catering.

1.9 BIS is responsible for the regulatory framework and policy governing further education. It is the department primarily responsible for monitoring and overseeing FE colleges and other providers, but it mostly delegates this to the SFA. Where a provider fails, BIS and the SFA must ensure continuity of provision for students. The Secretary of State for Business, Innovation & Skills has broader statutory responsibility for ensuring provision of adult further education and apprenticeships across England.

3 Except for specially designated institutions, which follow the same rules as commercial bodies.
1.10 The Education Act 2011 and subsequent policy documents – such as New Challenges, New Chances⁴ and Rigour and Responsiveness in Skills⁵ – have strengthened colleges’ independence, and emphasised both their freedoms and responsibility for managing their own affairs, transferring further powers from government to college governing bodies. In particular, many restrictions on colleges were removed in 2011, allowing them to borrow or invest without seeking consent. As such, external intervention occurs only where a college is failing.

1.11 At present, there is no comprehensive framework document setting out the roles, responsibilities and accountabilities of the funding and oversight bodies. Multiple bodies oversee the sector, in order to protect public investment and maximise its value (Figure 1). The SFA monitors financial health and financial management, while Ofsted inspects and monitors the quality of further education and training, including the effectiveness of leadership and management.⁶ The SFA is responsible for some direct intervention, but the most poorly performing colleges are now referred to the FE Commissioner. The FE Commissioner, an independent adviser to the Secretary of State for Business, Innovation & Skills and the chief executives of the funding agencies, took up his role in November 2013. These parties work together to decide when to intervene in colleges facing problems.

Scope of this report

1.12 This report examines oversight of the financial sustainability of the sector in England. We have focused on FE colleges because of the level of risk and the public investment in their facilities and infrastructure, recognising that commercial and charitable providers are also an important part of the FE landscape. We did not audit whether the overall policy of strengthening colleges’ independence since 2011 is delivering value for money. Appendix One contains a detailed description of our audit approach. We assessed whether BIS and the SFA, working with other relevant bodies, are able to:

- monitor the sector’s financial health and control in a way that allows them to protect public investment and maximise its value; and

- intervene effectively when problems arise.

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⁵ Department for Education and Department for Business, Innovation & Skills, Rigour and Responsiveness in Skills, April 2013.
⁶ The Higher Education Funding Council for England assures the quality of higher education provision in FE colleges.
Overseeing financial sustainability in the further education sector

Part One

Figure 1
Oversight of further education colleges

Multiple bodies oversee further education colleges

Department for Education
Policy for education of 16- to 19-year-olds

Department for Business, Innovation & Skills (BIS)
Overall policy and regulatory framework for further education

Skills Funding Agency
Monitors financial health; ensures regional provision of further education; early intervention in colleges

Ofsted
Inspects and monitors quality, including the effectiveness of leadership and management

FE Commissioner
Intervenes in poorest performing colleges, providing independent advice to BIS and the funding agencies

Education Funding Agency
Involved in joint decision-making on intervention

College
Differing performance in financial health and educational quality

Joint decision-making on intervention

Note
1 The two funding agencies have a core function to provide funding for FE provision, and oversee the sector in keeping with that function.

Source: National Audit Office analysis
Part Two

The financial health of further education colleges

2.1 This Part examines:

- recent patterns in the financial health of colleges; and
- factors influencing financial health.

Patterns in colleges' financial health

Surplus and deficit

2.2 In the 2013/14 academic year, the further education (FE) college sector as a whole was in deficit for the first time. Forecasts prepared by the Department for Business, Innovation & Skills (BIS) and the Skills Funding Agency (SFA) in early 2014 did not expect this to happen until the end of 2014/15. According to published accounts data, 110 colleges (45%) recorded an operating deficit in 2013/14, up from 52 colleges in 2010/11. By 2013/14, an increasing proportion of colleges had a deficit of more than 5% of their income (Figure 2).

Financial health according to Skills Funding Agency classifications

2.3 The SFA collects financial data from colleges each year, based on audited accounts and college forecasts. It uses this information to calculate ratios that assess solvency, profitability performance and gearing (debt relative to net assets). It then converts these ratios to scores, which it combines to produce an overall financial health rating (Figure 3). The SFA can moderate a provider’s rating in light of other factors, such as significant forthcoming changes in income.
Figure 2
College surpluses and deficits, 2010/11 to 2013/14

The financial position of colleges is declining, and the college sector as a whole was in deficit in 2013/14

<table>
<thead>
<tr>
<th>Operating surplus/(deficit) of whole FE college sector (£m)</th>
<th>2010/11</th>
<th>2011/12</th>
<th>2012/13</th>
<th>2013/14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of colleges</td>
<td>254</td>
<td>250</td>
<td>245</td>
<td>244</td>
</tr>
<tr>
<td>Number of colleges in operating deficit</td>
<td>52</td>
<td>62</td>
<td>89</td>
<td>110</td>
</tr>
<tr>
<td>of which: deficit more than 5% of income</td>
<td>17</td>
<td>12</td>
<td>33</td>
<td>47</td>
</tr>
<tr>
<td>Percentage of colleges in operating deficit</td>
<td>20%</td>
<td>25%</td>
<td>36%</td>
<td>45%</td>
</tr>
<tr>
<td>of which: deficit more than 5% of income</td>
<td>7%</td>
<td>5%</td>
<td>13%</td>
<td>19%</td>
</tr>
</tbody>
</table>

Notes
1. This analysis excludes sixth form colleges.
2. Surpluses and deficits are based on each college’s ‘adjusted operating surplus/deficit’ recorded in its accounts.

Source: National Audit Office analysis of college accounts data published by the Skills Funding Agency

Figure 3
Financial health ratings as defined by the Skills Funding Agency

<table>
<thead>
<tr>
<th>Rating</th>
<th>Summary of SFA definition</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding</td>
<td>Very robust finances to fulfil contractual obligations and respond successfully to</td>
<td>Normally, excellent/good indicators for solvency, performance and gearing.</td>
</tr>
<tr>
<td>Good</td>
<td>sufficiently or adverse circumstances.</td>
<td></td>
</tr>
<tr>
<td>Satisfactory</td>
<td>Sufficient resources to fulfil contractual obligations, but also likely to have limited</td>
<td>Normally, at least 2 satisfactory indicators for solvency, performance and</td>
</tr>
<tr>
<td></td>
<td>capacity to respond successfully to opportunities or adverse circumstances.</td>
<td>gearing.</td>
</tr>
<tr>
<td>Inadequate</td>
<td>In financial difficulty and very likely to be dependent on others’ goodwill. Significant</td>
<td>Normally, at least 2 inadequate indicators for solvency, performance and</td>
</tr>
<tr>
<td></td>
<td>risk of being unable to fulfil contractual obligations because of weak financial health.</td>
<td>gearing.</td>
</tr>
</tbody>
</table>

Source: Skills Funding Agency
2.4 Between 2010/11 and 2013/14, the proportion of colleges that the SFA assessed as having ‘inadequate’ financial health rose from 5% to 12%, an increase from 12 to 29 colleges (Figure 4). This decline in financial health occurred earlier than indicated by college plans, which predicted that 15 colleges would be financially inadequate by the end of 2013/14.

2.5 The SFA assessed a further 34% of colleges (84 colleges) as having ‘satisfactory’ financial health in 2013/14 (Figure 4). Using the SFA definition of ‘satisfactory’, this suggests some degree of financial stress and limited capacity to respond to adverse circumstances.

![Figure 4](image)

**Figure 4**

College financial health assessment ratings, 2010/11 to 2013/14

The financial health of further education colleges is declining

<table>
<thead>
<tr>
<th>Year</th>
<th>Outstanding</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Inadequate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010/11</td>
<td>32</td>
<td>32</td>
<td>23</td>
<td>5</td>
</tr>
<tr>
<td>2011/12</td>
<td>32</td>
<td>32</td>
<td>23</td>
<td>5</td>
</tr>
<tr>
<td>2012/13</td>
<td>28</td>
<td>32</td>
<td>32</td>
<td>9</td>
</tr>
<tr>
<td>2013/14</td>
<td>28</td>
<td>34</td>
<td>34</td>
<td>12</td>
</tr>
</tbody>
</table>

Note: Percentages may not sum to 100% due to rounding.

Source: Skills Funding Agency
2.6 The SFA expects that the rate of decline in colleges' financial health will continue. The SFA uses broad assumptions to model the future financial health of the sector as a whole, but not individual colleges. The SFA’s latest estimates, produced in May 2015, predict that, on current trends, there could be around 70 colleges rated as having inadequate financial health by the end of 2015/16. This estimate is sensitive to a number of assumptions, and the actual number of inadequate colleges, which could be higher or lower than this, will depend on funding and recruitment levels and the ability of colleges to manage their costs.

2.7 Our analysis of financial health trends between 2010/11 and 2013/14 found wide variation between colleges with different characteristics, such as size or region (Figure 5). In particular, we found the following:

- Colleges in the Midlands were significantly more likely to have declining financial health than colleges in the rest of England. By contrast, colleges in the North-East were, on average, most stable financially.
- The smallest and largest colleges, as categorised by the SFA, were most likely to see declining financial health, while those in between were more financially stable on average.

Figure 5
Proportion of colleges (by region and size) whose financial health in 2013/14 was worse, the same or better than in 2010/11

<table>
<thead>
<tr>
<th>Region</th>
<th>Worse (%)</th>
<th>Same (%)</th>
<th>Better (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>London</td>
<td>49</td>
<td>32</td>
<td>19</td>
</tr>
<tr>
<td>Midlands</td>
<td>61</td>
<td>33</td>
<td>7</td>
</tr>
<tr>
<td>North-East</td>
<td>31</td>
<td>36</td>
<td>33</td>
</tr>
<tr>
<td>North-West</td>
<td>41</td>
<td>51</td>
<td>7</td>
</tr>
<tr>
<td>South-East</td>
<td>38</td>
<td>45</td>
<td>17</td>
</tr>
<tr>
<td>South-West</td>
<td>41</td>
<td>51</td>
<td>8</td>
</tr>
<tr>
<td>Grand total</td>
<td>44</td>
<td>41</td>
<td>15</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Size of college</th>
<th>Worse (%)</th>
<th>Same (%)</th>
<th>Better (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>55</td>
<td>32</td>
<td>14</td>
</tr>
<tr>
<td>Medium</td>
<td>40</td>
<td>44</td>
<td>16</td>
</tr>
<tr>
<td>Large</td>
<td>42</td>
<td>42</td>
<td>16</td>
</tr>
<tr>
<td>Very large</td>
<td>48</td>
<td>40</td>
<td>12</td>
</tr>
<tr>
<td>Grand total</td>
<td>44</td>
<td>41</td>
<td>15</td>
</tr>
</tbody>
</table>

Notes
1 This analysis uses the Skills Funding Agency’s categorisation in 2013/14 for each college.
2 Percentages may not sum to 100% due to rounding.

Source: National Audit Office analysis of Skills Funding Agency data
External factors affecting the financial health of colleges

2.8 Colleges have primary responsibility for monitoring their financial health and taking action to deal with risks as they emerge. Several external factors affect the financial health of the sector.

Funding arrangements

2.9 Colleges are financially sensitive to changes in funding rates or learner numbers, and have had to respond to the challenge of reduced public funding since 2010. The funding methodologies used by the SFA and Education Funding Agency are designed to support delivery costs. Funding levels allow some colleges to produce small surpluses, but rarely more, which they can then retain or reinvest. Most colleges therefore do not build significant reserves as a proportion of their income. Public funding through grants has reduced by 11% from £5.7 billion in 2010/11 to a forecast £5.1 billion in 2014/15 (Figure 6). College funding levels have also been affected by the extent to which they have managed to increase apprenticeship provision in line with government priorities.

2.10 Complex funding arrangements can make it difficult for colleges to produce accurate financial plans, which can affect their overall financial health. In December 2014, we reported on BIS’s work to reduce bureaucracy in the FE and skills sector. We referred to the complexity of the current funding arrangements, with income from BIS and Department for Education sources being disbursed on a range of different bases, often for different students attending the same course. When coupled with uncertainties over whether courses will be filled and with whom, colleges told us that the complexities make it more challenging to ensure individual courses cover their costs.

Demographic factors and competition with other providers

2.11 Colleges in some localities are finding it increasingly difficult to recruit students to their courses. A large proportion of colleges’ public funding depends on learner numbers. The difficulties are partly driven by changes in local demographics, which will affect colleges in different regions to varying extents. In particular, many colleges have struggled with falling numbers of 16- to 18-year-olds, which is expected to continue until 2019 before it increases again (Figure 7 on page 22). Around half of all college income is grant funding for learners and apprentices in this age range.

2.12 Many colleges are competing for fewer students against an increasing diversity of provision. Most stakeholders we spoke to agreed that colleges’ biggest challenge to recruiting students is competition with other types of provider. For example, around 300 schools, including academies and free schools, have opened new sixth forms in the past 5 years, and many schools are trying to retain more 16- to 18-year-olds. Some colleges have also seen increasing competition for adult learners from higher education institutions and commercial training providers. This has been particularly affected by the raising of the cap on student numbers in higher education institutions, soon to be followed by a removal of the cap entirely. BIS was not able to provide us with evidence that it had assessed the impact this change would have on the FE sector.
Capital funding issues

2.13 Some colleges are managing the financial legacy arising from previous capital projects. In 2007/08, the Learning and Skills Council, predecessor to the SFA, made extra capital funding available to colleges, as part of its *Building Colleges for the Future* scheme. This was part of an initiative to upgrade premises and facilities in the growing FE sector. However, grant funding for the projects had to be scaled back unexpectedly when it became clear the programme had become overcommitted. The Committee of Public Accounts concluded in 2009 that there had been "a very serious failure in the management of the programme, with the Learning and Skills Council over-stimulating the demand for funding and mismanaging the approval process". Consequently, when funding began to diminish in 2009, earlier than expected, several colleges had invested or committed funds before receiving final approval.

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Figure 7
Estimated number of 16- to 18-year-olds in England

The number of 16- to 18-year-olds in England is expected to decline until 2019

Note
1 Estimated numbers do not include the impact of mortality or migration.

Source: National Audit Office analysis of estimated population data in 2013 published by the Office for National Statistics
2.14 Some colleges are struggling with debts incurred from these capital projects (Case study 1). In total, 144 capital project applications were outstanding when the scheme was suspended. Of these, 79 had been approved in principle, but only 22 subsequently received final approval. Reductions in funding since have left some colleges with new premises that are under-used, or large debts that they are struggling to repay.

Case study 1

Capital funding issues

In the late 2000s, Central Sussex College received capital funding from the Learning and Skills Council, alongside bank loans, in order to develop its facilities. In 2011, the SFA informed the college that it could not provide grant funding for the final phase of the development programme. However, it gave the college permission to secure a £16 million bank loan, which took its total borrowing to a very high proportion of income. The FE Commissioner’s review in January 2015 concluded that, while the college’s new management had realistic plans in place to generate surpluses and cash from operating activities, these were “taken up almost entirely to meet the interest and repayment commitments for its loans”.

A more cautious approach among commercial lenders

2.15 When considering whether to lend to a college, commercial lenders’ risk assessments consider the likelihood of repayment, alongside other factors. Lenders are aware of recent patterns in the sector’s financial health, and informed us that they were being more cautious while still lending to the sector. Some colleges we visited have found that accessing additional borrowing is no longer an option.
Part Three

Identifying risks

3.1 This Part examines:

- risk assessment and early action within colleges; and
- risk assessment and monitoring by the oversight bodies.

Risk assessment within colleges

3.2 As independent organisations, colleges have responsibility for managing their finances and taking necessary action to manage risks and exploit opportunities. To manage colleges effectively, management teams and governing bodies need to be able to look ahead, assess what their financial position might be and use the time available to make the adjustments to their course programme, cost base and market position. To achieve this, colleges require good quality, reliable information on their educational and financial performance, and realism when forecasting future performance.

Optimism in college forecasts

3.3 Some colleges are consistently optimistic when producing financial budgets and forecasts, particularly colleges with weaker financial health. Our analysis of the Skills Funding Agency’s (SFA’s) financial health assessment ratings found that the financial health of 28% of the 244 colleges in 2013/14 was worse than they had forecast a year earlier, and 41% were in a weaker financial position than they had forecast 2 years earlier (Figure 8). When restricting our analysis to the 94 colleges with weaker financial health in the previous 4 years, we found that optimism was more prevalent. The financial health of 30% of these 94 colleges was worse than they had forecast a year earlier, and 51% had worse financial health than they had forecast 2 years earlier (Figure 9).

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9 We defined colleges with weaker recent financial health as being rated ‘inadequate’ by the SFA at least once, or rated ‘satisfactory’ at least twice, or both, from 2009/10 to 2012/13.
Figure 8
College financial health compared with forecasts – all 244 colleges

Many colleges produce forecasts 1 and 2 years ahead that are substantially over-optimistic

<table>
<thead>
<tr>
<th>Percentage of colleges</th>
<th>2013/14 financial health rating compared with 2013 forecasts</th>
<th>2013/14 financial health rating compared with 2012 forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 ratings worse</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>2 ratings worse</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>1 rating worse</td>
<td>58</td>
<td>44</td>
</tr>
<tr>
<td>Same</td>
<td>24</td>
<td>32</td>
</tr>
</tbody>
</table>

Notes
1 Financial health ratings are as assessed by the Skills Funding Agency.
2 Percentages may not sum to 100% due to rounding.

Source: National Audit Office analysis of Skills Funding Agency data

Figure 9
College financial health compared with forecasts – 94 colleges with weaker recent financial health

Optimistic forecasts are more common among colleges with weaker financial health

<table>
<thead>
<tr>
<th>Percentage of colleges</th>
<th>2013/14 financial health rating compared with 2013 forecasts</th>
<th>2013/14 financial health rating compared with 2012 forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 ratings worse</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>2 ratings worse</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>1 rating worse</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Same</td>
<td>24</td>
<td>34</td>
</tr>
</tbody>
</table>

Notes
1 Financial health ratings are as assessed by the Skills Funding Agency (SFA).
2 Percentages may not sum to 100% due to rounding.
3 We defined colleges with weaker recent financial health as being rated ‘inadequate’ by the SFA at least once or rated ‘satisfactory’ at least twice, or both, from 2009/10 to 2012/13.

Source: National Audit Office analysis of Skills Funding Agency data
3.4 The reasons for optimistic forecasts varied according to individual circumstances and approaches but, based on our work, included the following:

- overly positive expectations about income levels and ability to recruit students. For example, the SFA and the Education Funding Agency release colleges’ funding allocations a few months before the start of the new academic year, and some colleges reported difficulty in accurately estimating future revenues;

- unrealistic assumptions over the extent and timescale to which costs could be cut to match expected income reductions; and

- a desire by the college management team or its governing body to aim for more ambitious budgets.

Early action taken by colleges

3.5 Addressing risks at an early stage is likely to minimise the cost of any action a college takes, and allows the college to manage the impact on learners, staff and educational quality. If, for example, a college is running a deficit, addressing it early allows the college to use the reserves it may have to take a structured and planned approach to any changes that are required. But if the college allows the deficit to persist, it risks running out of money and being forced to take more drastic action very suddenly. Colleges in such a position also face time-consuming and expensive intervention and subsequent monitoring from one or more oversight bodies.

3.6 Many colleges are taking tough decisions to help avoid significant deterioration in their financial circumstances while maintaining educational standards. Cost reduction measures have included rigorous curriculum review, where colleges consider their profitability course-by-course and determine the extent of their future provision accordingly. Many colleges have taken action to reduce costs, with significant staffing reductions in some cases. Some colleges are also making better use of assets, including generating funds by selling surplus estate. Others are looking at ways to reduce their reliance on public funding, including measures to grow their commercial income.

3.7 College principals, and other stakeholders, have reported shortages in the change-management skills required to help colleges adapt to a rapidly changing environment. The Further Education (FE) Commissioner’s reviews have identified common issues in management and governance among those colleges that have found themselves in difficulty – for example, not identifying financial or delivery problems in good time and not addressing problems as soon as they are identified. There is training and support for management and leadership within the sector and sector-run bodies have an important role to play. However, stakeholders have pointed to the need to do more to develop the change-management and commercial skills needed for the future.
3.8 The FE Commissioner has also identified shortcomings in management information as a key issue inhibiting the ability of colleges in a weaker financial position to manage their situation. Since early 2014, he has fed back lessons drawn from the cases he and his team have reviewed. In his March 2015 letter, for example, he urged college governors to increase their level of scrutiny if, among other things:

- financial forecasts are often different from reality;
- management accounts show significant monthly swings, or large variations between summer and year-end;
- borrowing exceeds 60% of turnover; or
- staff costs exceed 65% of turnover.

Risk assessment by the oversight bodies

Data analysis and monitoring

3.9 The SFA receives annual financial data from all colleges in December following the end of the academic year (to 31 July). It also receives forecast financial information for the coming 2 years in July each year. The SFA requests this information to allow it to monitor risks relating to funding and disruption for learners.

3.10 Our review suggested that the SFA takes a reasonable approach, based on calculating a set of financial ratios, to assessing current financial health based on the end-of-year data from individual colleges. Recent reviews by the Department for Business, Innovation & Skills (BIS) and the SFA identified potential improvements, such as assessing the affordability of debt with reference to income rather than net assets. Overall, however, the ratios used are broadly comparable to those used by other bodies, such as Monitor in the health sector, and allow the SFA to focus on colleges in a weaker financial position.

3.11 However, there have been weaknesses in the way the SFA has analysed future risks, particularly at individual college level. The SFA has relied on applying its financial ratios to forecasts produced by colleges, without always testing the realism of the data in these forecasts, which are often unreliable. The SFA’s interrogation of the data it collects, for example to look at financial trends alongside other risks, was often limited. The SFA also considered local intelligence from its regional teams, but not in a wholly systematic way. The financial model that the SFA uses to predict sector-wide financial health is more realistic, as it incorporates the SFA’s own assumptions about future funding levels and colleges’ likely response to those changes. However, this model does not allow the SFA to analyse financial risk at college level.
3.12 The SFA recognised the limitations of its approach to risk monitoring in mid-2014, and is now developing a broader approach to assessing risk. This is primarily intended to improve its ability to assess risk at individual colleges, but should also benefit its assessment of the sector as a whole. The new approach, which the SFA is still refining, combines a number of risk indicators based on financial, quality and other measures (Figure 10). It will extend the SFA's monitoring to cover all providers for whom it has responsibility, including commercial and charitable providers and local authorities offering FE courses. It also allows the SFA to prioritise its efforts towards those colleges and other providers most likely to be at risk.

**Figure 10**
Features of the Skills Funding Agency’s new approach to assessing risk

<table>
<thead>
<tr>
<th>Type of indicator</th>
<th>What the indicators cover</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 key financial risk indicators</td>
<td>In addition to an ‘inadequate’ financial health rating, these indicators are also flagged if:</td>
</tr>
<tr>
<td></td>
<td>• a provider is rated ‘satisfactory’ but only because of strong gearing;</td>
</tr>
<tr>
<td></td>
<td>• a provider’s financial health score is decreasing at a rate higher than a pre-determined threshold; or</td>
</tr>
<tr>
<td></td>
<td>• a college’s latest financial health was worse than forecast (for colleges only).</td>
</tr>
<tr>
<td>4 key quality risk indicators</td>
<td>The approach also looks at risk emerging from quality issues. Top-level indicators are based on Ofsted grades, minimum standards and qualification success rates. Underpinning each is a series of specific sub-indicators and thresholds – if any is flagged, the high-level indicator is flagged.</td>
</tr>
<tr>
<td>More than 20 other indicators</td>
<td>The SFA primarily uses the financial and quality indicators, but the approach includes other indicators for some or all providers. These indicators cover matters such as contracting and sub-contracting, data quality, and apprenticeships, as well as space for SFA staff to note other factors not covered by the indicators.</td>
</tr>
</tbody>
</table>

Source: National Audit Office analysis of Skills Funding Agency information

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### Action taken to mitigate emerging risks

3.13 The effectiveness of the SFA’s new approach to analysing and assessing risk depends on how far it can be used to manage emerging issues. The SFA formally flags concern with colleges when its analysis indicates that college performance has deteriorated below certain defined trigger points to prompt an ‘inadequate’ rating. At this point, it is able to attach additional conditions to its funding. Before this point, in recent years the SFA has taken a light touch approach to offering advice or intervening in the management of colleges. This approach is consistent with BIS policy since 2011, which has emphasised colleges’ freedom and responsibility for managing their own affairs.

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10 The approach does not cover sixth form colleges or higher education providers offering further education courses.
3.14 Some colleges considered that, while the SFA collects data from across the sector, they had received little or no feedback prior to 2015 on where they stood in key areas of risk. Some colleges had interpreted silence to mean the SFA had no concerns. Stakeholders we spoke to had nevertheless welcomed recent efforts by the SFA to feed back high-level benchmarking information to college governors. In particular, college governors appreciated generic feedback from the FE Commissioner to the sector (paragraph 3.8).

3.15 There has been a clear mismatch between the SFA's role in mitigating emerging risks since 2011 and the perceptions of many in the sector. Some colleges and other stakeholders considered that the SFA was not doing enough to prompt improvement during the crucial pre-intervention phase. As a result the SFA was only involved when problems had already matured, at which point complex and costly intervention is often required. There may be valuable lessons from other sectors. Monitor, as an independent regulator in the health sector, has started to work more proactively with NHS Foundation Trusts to reduce risk – for example, by providing training for boards and by partnering high-performing trusts with those performing less well. There is more that BIS and the SFA could do to better support colleges considered at risk, while respecting their independence.

3.16 At times, Ofsted's assessment of leadership and management and the SFA's assessment of financial health have the potential to send mixed messages to colleges, as highlighted in one instance by the FE Commissioner (Case study 2). In another case, however, awareness of financial problems has led Ofsted to issue a low overall grade on the basis of poor management, although academic quality was good. Ofsted’s latest guidance, for inspections from September 2015, emphasises the need to ensure that providers have the necessary resources to maintain high-quality provision but, as with previous guidance, it does not ask inspectors to make specific judgements about financial sustainability.\textsuperscript{11}

\textbf{Case study 2}
\textbf{Potential for mixed messages}

In June 2014, Ofsted published its inspection report of Bournville College, which rated the college “good” overall and “outstanding” for leadership and management. By this point, however, the SFA had rated the college’s financial health as ‘inadequate’, and asked the FE Commissioner to review the college. The Commissioner’s report, published in August 2014, identified a number of failings in financial management, including failure to address inefficiencies and serious cash flow issues. The Commissioner’s report noted that “Ofsted does not take into account in their judgements a college’s financial performance or how it is managed or monitored.”

\textsuperscript{11} Ofsted, \textit{Further education and skills inspection handbook}, June 2015.
Part Four

Intervention

4.1 This Part examines:

- early intervention and financial support from the Skills Funding Agency (SFA);
- intervention by the Further Education (FE) Commissioner; and
- decisions to close or merge colleges.

Skills Funding Agency intervention

‘Notice of Concern’ process

4.2 When the SFA assesses a college as having ‘inadequate’ financial health, it gives the college a ‘Notice of Concern’, setting out why the SFA believes the college’s financial position is weak. A Notice of Concern allows the SFA to impose additional conditions of funding, where it deems this necessary. For example, it may require the college to suspend starting new students on some learning programmes. A college subject to a Notice of Concern must produce a recovery plan describing how it will address its weaknesses, along with a timeframe for action. If the position is sufficiently serious, a college may also be referred to the FE Commissioner at any point.

4.3 Around half of the colleges that the SFA rated as financially ‘inadequate’ between 2010/11 and 2012/13 have since improved their position without more severe intervention, such as merger or FE Commissioner review. The SFA assessed 31 colleges as having ‘inadequate’ financial health between 2010/11 and 2012/13. Of these:

- 12 were no longer ‘inadequate’ in 2013/14 and had not been subject to further intervention;
- 14 were referred to the FE Commissioner, and around half of these had been rated ‘inadequate’ for at least 2 years;
- 2 have not yet been referred to the FE Commissioner but remained ‘inadequate’ in 2013/14; and
- 4 (including 1 also referred to the FE Commissioner) were incorporated into other education providers through mergers.
Colleges we visited reported that the SFA had been helpful and supportive when intervening, but several expressed doubts about the effectiveness of the Notice of Concern process. Our visits suggested a number of factors may be hindering the effectiveness of intervention at this stage:

- The confidence and ability of college management teams to prepare robust recovery plans. In some of the cases we examined, the preparation of the recovery plan was a lengthy process but still did not necessarily lead to a sustainable outcome. The SFA’s arms-length role places it at some distance from understanding the range and extent of the challenges facing individual colleges. Changes to the role and structure of the SFA’s teams, including the removal of dedicated local relationship managers, have meant reduced capacity to undertake such monitoring in recent years.

- The difficulty faced by the SFA in judging whether a college’s recovery plan will be sufficient to put it on a sustainable footing. The SFA responded in 2015 by rearranging its local teams into distinct provider management and intervention functions.

Recovery plans

**Case study 3**

After receiving a Notice of Concern for inadequate financial health in February 2014, Weymouth College was required to produce a recovery plan as part of the SFA’s normal process. It took the college a number of iterations to produce a recovery plan. When the FE Commissioner visited the college later in 2014, he concluded that the college’s recovery plan was unlikely to deliver the necessary return to a budget surplus and the repayment of the college’s loans within a reasonable time frame. In February 2015, the SFA responded to put the college on a sustainable footing.

**The difficulty faced by the SFA in judging whether a college’s recovery plan will be sufficient to put it on a sustainable footing.** The SFA’s arms-length role places it at some distance from understanding the range and extent of the challenges facing individual colleges. Changes to the role and structure of the SFA’s teams, including the removal of dedicated local relationship managers, have meant reduced capacity to undertake such monitoring in recent years.

The SFA responded in 2015 by rearranging its local teams into distinct provider management and intervention functions.

Recovery plans

**Case study 3**

After receiving a Notice of Concern for inadequate financial health in February 2014, Weymouth College was required to produce a recovery plan as part of the SFA’s normal process. It took the college a number of iterations to produce the recovery plan, during which time its financial position continued to decline. When the FE Commissioner revisited the college later in 2014, he concluded that the recovery plan was unlikely to deliver the necessary return to a budget surplus and the repayment of the college’s loans within a reasonable time period. In the SFA’s view, the college has more recently made significant progress.
Financial support

4.5 The financial support that the SFA offers to struggling colleges has increased substantially since 2010, but to date most has not been repaid. Until early 2015, the SFA, and previously the Learning and Skills Council, advanced funds to some colleges experiencing cash flow problems, intending that these sums would be repaid in the short term. Between April 2010 and February 2015, 30 colleges had outstanding advances from the SFA. However, many of the advances were either repaid late or not at all. In September 2013, outstanding advances had risen to £49 million (Figure 11). By September 2014, the SFA had converted advances of £40 million at 3 colleges to grants, meaning the advances would not be repaid (Case study 4). The outstanding balance stood at £45 million by February 2015, relating to 13 colleges.

Figure 11
Advances to colleges outstanding in September each year

Advances to colleges have increased rapidly, and large balances have been converted to grants

Advances to colleges outstanding in September each year (£m)

Source: National Audit Office analysis of Skills Funding Agency data
4.6 In November 2014, the Department for Business, Innovation & Skills (BIS) announced a new ‘Exceptional Financial Support’ policy, which it believes will be more effective in helping colleges in the longer term. Financial support is now accompanied by some sanctions, the details of which vary according to the expected timeframe for repayment. Where the SFA makes additional payments to be repaid within 12 months, it will raise the college’s risk rating and consider the need for further intervention case-by-case. Where the SFA does not expect repayment within 12 months, BIS can make a formal loan. If a college receives a loan, the SFA will automatically issue a Notice of Concern (if it has not already), and request review by the FE Commissioner.

4.7 Most stakeholders we spoke to, including colleges and lenders, support the fact that long-term financial support now automatically triggers formal intervention. However, some expressed concern about the clarity of the conditions attached to the loans, and whether colleges’ repayments to BIS will affect repayments on commercial borrowing. The impact of this new approach is yet to be seen.

Case study 4
Advances of funds

South and West Kent College, trading as K College, was formed in April 2010 as a merger of two colleges with significant financial challenges. At this point, the newly formed college had received around £10 million of funding advances from the Learning and Skills Council. However, the merged college continued to struggle, amassing significant debts including further advances from the SFA. By August 2014, when the college’s operations were transferred to two neighbouring colleges, the SFA had converted the outstanding balance of £30 million to a grant, meaning it was not repaid.

4.8 The FE Commissioner visits colleges in severe difficulty, either in terms of financial health or educational quality. His role is to assess the management and circumstances of each college he visits, and determine whether the leadership team and governing body can deliver rapid and sustainable improvement. The Commissioner publishes reports setting out his findings and recommendations. He also issues periodic letters to the wider sector that summarise important lessons from his interventions.

4.9 Between November 2013 and June 2015, the Commissioner visited 27 colleges, of which 22 were chosen because of their financial situation. Of these colleges, 4 had emerged from intervention by June 2015. In general, cases referred to the Commissioner represent those colleges facing the most urgent financial problems. The Commissioner also found financial management problems in some colleges that had been referred to him because of concerns about educational quality. His recommendations for addressing the problems encountered have ranged from closer monitoring by the oversight bodies to major structural changes (Case study 5 overleaf).
4.10 Almost all stakeholders we interviewed believe that the role is necessary, and that the Commissioner has offered practical advice in challenging times to colleges he visited. College principals responsible for implementing his recommendations were generally positive about the process, highlighting:

- the Commissioner and his advisers’ practical knowledge of the sector;
- the impetus for change that the Commissioner provided, including in leadership and governance arrangements; and
- the assurance offered when reviewing colleges’ draft turnaround plans.

4.11 It is too early to conclude whether the Commissioner’s interventions are bringing about fully sustainable improvements. First, it takes time for colleges to implement the full range of recommendations he makes. Second, even where recommendations are likely to have direct impact, this will not usually affect financial indicators in the short term.

4.12 The Commissioner is likely to face a sharp increase in workload, as more colleges find themselves in financial difficulty. In late 2014, the Commissioner acquired 5 extra advisers – taking the total to 11 – to deal with the increase. Despite these extra resources, the Commissioner may still struggle to continue to intervene in a timely way. Any delays could exacerbate problems, since colleges may defer key decisions when waiting for the Commissioner’s intervention.

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**Case study 5**

**FE Commissioner recommendations**

Stockport College of Further and Higher Education was one of the first colleges that the Commissioner visited, and he completed his report in December 2013. In it, he recommended a number of actions, which included:

- significant changes to the governing body, and members of the SFA and Education Funding Agency also joining the governing body as observers;
- changes to senior management, including an experienced interim principal and the addition of a director of quality; and
- a major review of whether the college could continue to operate with its existing structure.

BIS informed us that the college has made very good progress since the Commissioner’s review.
Overseeing financial sustainability in the further education sector  Part Four  35

Joined-up working

4.13 Colleges raised concerns about seemingly overlapping responsibilities among the oversight bodies during the intervention stage. In some cases, colleges in difficulty must deal with three separate strands of intervention or inspection activity – from the SFA, the FE Commissioner and Ofsted – over the same extended period. This can place significant demands on senior management, especially when visits from these bodies take place close together and require different information for each. Some of the colleges we spoke to were unsure about the method, and likely timing, by which they might exit from this scrutiny, and therefore where they should focus their resources.

Decisions to merge or close colleges

4.14 The FE sector has lacked a clear structure, akin to the role played by the regional school commissioners, for informing decisions about local further education provision. Where colleges face financial challenges, they may need to merge with other providers, or reduce the range and capacity of provision. With the number of colleges in financial difficulty expected to continue to rise, decisions about the long-term viability of individual colleges at local level should be informed by a robust assessment of likely local needs and capacity to meet those needs. At present, a range of bodies may have a perspective on local provision, but none has a specific role to bring together such an assessment. These bodies include a college’s governing body, the SFA, the Education Funding Agency, and more recently Local Enterprise Partnerships, which are setting priorities for growth in local areas including investment in skills. In early 2015, BIS and the Department for Education began broader reviews of educational provision in a small number of areas, to support more strategic decision-making (Case study 6).

Case study 6
Area-based reviews

In early 2015, 5 colleges in Norfolk and Suffolk (3 sixth form colleges and 2 general FE colleges) asked the funding agencies to bring in the Sixth Form College Commissioner and FE Commissioner to undertake a review of provision. The review has focused on how to ensure that the colleges are sustainable over the long term while meeting the economic and educational needs of the area. The report and recommendations are expected before August 2015.
4.15 Where structural changes such as college closure or merger are needed, enacting such changes relies crucially on the cooperation of college governors. Legal powers over corporate changes such as closure and merger generally sit with colleges’ governing bodies. In cases of severe failure or mismanagement, the Secretary of State has powers to direct changes, though to date there have been no circumstances in which the powers have been used. Any proposed changes are also complicated by the lack of any legal provision for a college\(^{12}\) to close without first transferring its assets and liabilities to other willing parties, most probably other education providers. In localities where other providers may also be under financial strain, finding such partners is not straightforward. It is unclear what would happen if no willing partners were found, but solutions may involve additional costs or liabilities for BIS. Since 2010, no colleges have closed, but 16 have merged with other colleges.

4.16 Many stakeholders we met reported uncertainty about BIS’s willingness and preparedness to tolerate financial failure and closure. They thought that colleges had traditionally perceived a safety net, which had influenced their expectations of support should they fall into major difficulty. This perception is likely to have affected their approach to taking difficult decisions. Given the action taken in recent years to restructure or merge colleges in difficulty, this expectation of a safety net has reduced.

\(^{12}\) Except for specially designated institutions, which follow the same rules as commercial companies.
Appendix One

Our audit approach

1. We examined oversight of the financial sustainability of the further education sector (the sector), with particular focus on further education colleges. We did not audit whether the overall policy of strengthening colleges’ independence since 2011 is delivering value for money. We assessed whether the Department for Business, Innovation & Skills (BIS) and the Skills Funding Agency (SFA), working with other relevant bodies, are able to:
   - monitor the sector’s financial health and control in a way that allows them to protect public investment and maximise its value; and
   - intervene effectively when problems arise.

2. We applied an analytical framework with evaluative criteria, to consider what arrangements would be optimal for funding and oversight bodies to identify and address risks in individual colleges and across the sector. By ‘optimal’ we mean the most desirable possible, while acknowledging expressed or implied restrictions or constraints. A restriction in this context is that colleges are independent incorporated organisations. Assessment and management of risk should, firstly, be the responsibility of the colleges and their governors.

3. We analysed trends in financial health across the sector. We also examined common reasons for colleges being in financial difficulty, and what oversight bodies have done to intervene.

4. Our audit approach is summarised in Figure 12 overleaf. Our evidence base is described in Appendix Two.
Figure 12
Our audit approach

The objective
Through the further education sector, support economic growth in the UK, help employers enhance the skills of their workforce and give learners the opportunity to have successful careers.

How this will be achieved
Through a market of further education colleges and other providers, working as independent organisations, with oversight by several government bodies.

Our study
The study examined whether oversight bodies can monitor the sector’s financial health and control in a way that allows them to protect public investment and maximise its value, and intervene effectively when problems arise.

Our evaluative criteria
Oversight bodies effectively monitor the sector’s financial health and control in a way that allows them to protect public investment and maximise its value.

Oversight bodies take effective action to intervene when problems arise.

Our evidence
(see Appendix Two for details)

We assessed ability to effectively monitor financial health and control by:
- analysing financial health and other data from the SFA;
- reviewing documents from the oversight bodies;
- reviewing previous NAO and Committee of Public Accounts reports relevant to the sector’s financial health;
- interviewing staff in the funding and oversight bodies;
- interviewing staff and governors in further education colleges;
- seeking views from stakeholder representative groups, commercial lenders, auditors and consultants in the sector; and
- comparing the SFA’s approach to those used by similar bodies in other sectors.

We assessed effective action by:
- analysing financial health forecast data from the SFA on providers;
- reviewing documents that set out the interaction between the main oversight bodies;
- interviewing staff in the funding and oversight bodies;
- interviewing staff and governors from further education colleges; and
- seeking views from stakeholder representative groups, commercial lenders, auditors and consultants in the sector.

Our conclusions
BIS and the SFA have taken steps to improve their analysis of risk in the sector. Also, the introduction of an FE Commissioner has filled a significant gap in the intervention arrangements. On their own, however, these actions are not likely to be sufficient to address a growing structural problem. BIS and the SFA now need to take a more strategic look at the implications of rapid growth in the number of colleges in poor financial health, bearing in mind that without advances of funds and additional grants some would be in an even worse position. What is needed is a more comprehensive and enduring approach. Without this, the oversight and intervention arrangements for further education cannot yet be regarded as value for money.
Appendix Two

Our evidence base

1 We reached our independent conclusions on whether the oversight of the further education sector delivers value for money after analysing evidence collected between February and May 2015.

2 We applied an analytical framework with evaluative criteria, which consider what arrangements would be optimal for colleges and oversight bodies to identify and address financial risks. Our audit approach is outlined in Appendix One.

3 We interviewed oversight bodies, colleges and other stakeholders, as follows:

- We carried out semi-structured interviews with the following funding and oversight bodies:
  - Department for Business, Innovation & Skills (BIS);
  - Education Funding Agency;
  - Skills Funding Agency (SFA);
  - Further Education Commissioner; and
  - Ofsted.
We carried out semi-structured interviews with senior leadership team members and governors of a sample of further education colleges. We selected a diverse sample of 14 colleges – by region, size, financial health history and intervention experience. The sample was not representative of the full population, but we selected it to cover our main areas of interest. The colleges were:

- Bradford College;
- Central Sussex College;
- City of Liverpool College;
- Heart of Worcestershire College;
- Kensington and Chelsea College;
- Lakes College, West Cumbria;
- Leeds City College;
- Moulton College;
- North West Kent College of Technology;
- Sandwell College;
- South Leicestershire College;
- Stockport College of Further and Higher Education;
- Strode College; and
- Weymouth College.

We spoke with commercial lenders, auditors and consultants in the sector:

- Barclays Bank plc;
- Deloitte LLP;
- KPMG LLP (UK); and
- Lloyds Bank plc.

We spoke with stakeholder and representative groups:

- 157 Group;
- Association of Colleges;
- Association of Employment and Learning Providers;
- Association of School and College Leaders;
- Education & Training Foundation; and
- National Institute of Adult Continuing Education (England and Wales).
4   To assess whether BIS and the SFA effectively monitor the financial health and control of the sector:

   • We analysed college financial data and financial health ratings, including forecast information, from the SFA, primarily from 2010/11 to 2013/14 (the most recent full-year figures available). This allowed us to understand trends in financial health, and evaluate common characteristics of colleges with poor or declining financial health.

   • We examined other data and documentation from the oversight bodies, including the SFA’s modelling of the financial health of the sector and new risk assessment tool. This helped us understand how the SFA and the organisations it works with monitor risk in individual colleges and the sector more widely.

   • We reviewed previous National Audit Office and Committee of Public Accounts reports to understand the history of financial health and related issues in the sector. These reports included our previous work on simplifying the further education sector and the Committee’s report on the physical infrastructure of further education colleges.

   • We carried out semi-structured interviews with staff in the funding and oversight bodies, primarily BIS and the SFA. The interviews discussed roles and responsibilities of the different oversight bodies, the financial health of the sector, the challenges colleges face and the approach to risk monitoring.

   • We carried out semi-structured interviews with senior leadership team members and governors in a sample of further education colleges. Job titles and roles varied across colleges, and mostly included principals, heads of finance and chairs of governing bodies. The interviews helped us understand their history of financial health, the challenges they face, their approach to preparing financial plans and forecasts, their interactions with oversight bodies and actions taken to identify and manage risks. We also spoke with a Welsh college to understand what challenges colleges in other parts of the UK are facing.

   • We spoke with stakeholder representative groups, commercial lenders, auditors and consultants. This allowed us to gather a range of views about the sector’s financial health, the challenges colleges face, the skills in the sector and the role and effectiveness of oversight bodies in monitoring financial health.

   • We reviewed published documentation, including our previous reports, on financial sustainability and monitoring of financial health in other sectors. This allowed us to make comparisons, where appropriate, between the SFA’s approach to monitoring risk and those used by similar bodies responsible for financial health.
5 To assess whether oversight bodies take effective action to intervene:

- We reviewed documents from the funding and oversight bodies that set out the interactions between each body and the process for decisions on intervention. Documents included departmental reports on intervention in the sector, SFA documentation on a sample of individual interventions, the FE Commissioner’s letters to the sector and assessment summaries, and ministers’ letters to colleges which the FE Commissioner reviewed.

- We analysed the SFA’s data on financial support to colleges from 2010/11 to 2013/14. This allowed us to understand the financial support process, the total amount the SFA provided to colleges and how much repayment it has received.

- We carried out semi-structured interviews with staff in the funding and oversight bodies. These helped us to understand the decision-making process, the role and responsibilities of each oversight body and the processes behind each form of intervention.

- We carried out semi-structured interviews with staff and governors from further education colleges. These allowed us to understand the college’s actions to identify and manage risk, their intervention experience and the importance of appropriate skills in both the senior management team and governing bodies.

- We spoke with stakeholder representative groups, commercial lenders, auditors and consultants. This gave us views about how well the oversight bodies intervene in colleges where problems have arisen.
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