National Audit Office

Report
by the Comptroller
and Auditor General

Department for Education

Financial sustainability of colleges in England

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Key facts

34%

proportion of colleges that reported an operating deficit in 2018/19, compared with 37% in 2013/14

23 of 247

number of colleges given a financial health rating of inadequate by the Education and Skills Funding Agency in 2018/19

£253m

value of exceptional financial support given to colleges with serious cashflow problems between November 2014 and March 2019

1.7 million	number of adults and young people learning in colleges each year
£5.1 billion	public funding for colleges in 2018/19
7%	real-terms decrease in funding per learner aged 16 to 19 between 2013/14 and 2018/19
£45.7 million	total operating surplus for the college sector in 2018/19, compared with an £8.5 million surplus in 2013/14
82%	proportion of colleges that Ofsted had graded as good or outstanding at August 2019
115	number of colleges in early intervention or formal intervention because of their financial health, at February 2020 (48% of all colleges)
£26.6 million	gross amount spent by the Education and Skills Funding Agency on two college insolvency cases, between April 2019 and May 2020

Throughout this report, central government financial years are written as, for example, '2018-19' and run from 1 April to 31 March; college financial and academic years are written as '2018/19' and run from 1 August to 31 July.

Summary

1 At April 2020, there were 242 colleges in England, comprising 192 further education (FE) colleges and 50 sixth-form colleges. Together they provide a wide range of academic education and vocational and skills training. They are involved in delivering many of the government's educational and training priorities, such as apprenticeships, GCSE retakes for English and maths, and the new technical T level qualifications.

2 Colleges educate and train around 1.0 million adults and 660,000 young people aged 18 and under each year. Students at colleges tend to be more disadvantaged than the general population. For example, in 2018/19, 54% of adult learners were from the 40% most deprived areas. In addition, 24% of students were from black, Asian or minority ethnic backgrounds, compared with 15% of the working-age population.

3 In 2018/19, colleges' income totalled £6.5 billion, of which £5.1 billion (78%) was public funding. Most of the public funding was provided via the Education and Skills Funding Agency (the ESFA), an executive agency of the Department for Education (the Department). Most college funding follows the learner. Colleges must attract students, competing with each other and with other types of education and training provider.

4 Colleges are autonomous bodies and make decisions independently of government. For example, government does not have the power to appoint or remove college staff, although the Secretary of State for Education can change the membership of a college's governing body in extreme circumstances. Colleges can borrow commercially, own assets, employ staff and enter into contracts, and they may make financial surpluses or deficits.

5 The Department is responsible for the regulatory framework and policy governing post-16 education and training, and is ultimately accountable for securing value for money from the public funding provided to colleges. It gains assurance mainly through the ESFA, which monitors colleges and intervenes where it has serious concerns, and the FE Commissioner, who acts as an independent adviser to the Secretary of State. In addition, Ofsted provides independent assurance about the quality of colleges' education and training provision.

Focus of our report

6 A financially sustainable college sector is vital to delivering the education and training that the country needs. Government expects colleges to play an increasingly prominent role in the coming years – to help meet the need for a more skilled domestic workforce following the UK's exit from the European Union, and to support the government's plans to develop national infrastructure, increase the number of public servants, and 'level up' skills and prosperity across the country. Colleges will also be important in developing the skills of people who retrain or change roles as a result of the economic impact of the COVID-19 pandemic.

7 We reported on the financial sustainability of FE colleges in 2015.[1] We concluded that government had taken steps to improve its oversight of the sector but that these actions were not likely to be sufficient to address a growing structural problem. Since then, government has made changes aimed at producing a more financially resilient college sector and improving its oversight and intervention arrangements.

8 This report focuses on the financial sustainability of FE and sixth-form colleges, providing an update to the assessment we made in 2015. We examined the financial health of the sector (Part Two), and the effectiveness of the oversight and intervention arrangements (Part Three). We set out our audit approach in Appendix One and our evidence base in Appendix Two. A timeline of key events relating to the financial sustainability of colleges is presented in Appendix Three.

9 We collected most of the evidence for this report between November 2019 and March 2020. With the exception of paragraphs 1.13 to 1.15, the report therefore reflects the position of the college sector and the Department's actions before the COVID-19 pandemic. The government has put in place measures to support colleges, but the impact of the pandemic is likely to be significant and the ESFA expects more colleges will face financial difficulties in future.

1 Comptroller and Auditor General, *Overseeing financial sustainability in the further education sector*, Session 2015-16, HC 270, National Audit Office, July 2015. The report covered FE colleges only, and did not include sixth-form colleges.

Key findings

Colleges' financial health

10 **The financial health of the college sector has fluctuated since 2013/14, but showed improvement in 2018/19.** Between 2013/14 and 2018/19, the proportion of colleges reporting an operating deficit fell from 37% to 34%. Over the same period, the total operating balance of the sector changed from an £8.5 million surplus to a £45.7 million surplus, which followed a £70.3 million deficit in 2017/18. The ESFA's financial health ratings indicate that the proportion of colleges with good or outstanding financial health increased from 61% in 2013/14 to 65% in 2018/19. In our 2015 report, we noted that the then Skills Funding Agency had estimated that, if no action was taken, around 70 colleges could have inadequate financial health by the end of 2015/16. In the event, 38 colleges were rated as having inadequate financial health at that point. Partly due to weaker colleges merging, only 23 colleges were in this position in 2018/19 (paragraphs 2.2, 2.5 and 2.6, and Figures 3 and 4).

11 **The Department's funding per learner aged 16 to 19 fell by 7% in real terms between 2013/14 and 2018/19.** Funding per learner aged 16 to 19 dropped by 9% for FE colleges and 4% for sixth-form colleges. The Department has kept the national basic funding rate for learners aged 16 to 17 at £4,000 since 2013. In 2014/15, it reduced the rate for students aged 18 to £3,300, even though the basic cost of teaching these learners is likely to be the same as for 16- to 17-year-olds. Colleges' total funding is largely determined by funding rates per learner and the number of learners in the sector. Total funding for 16- to 19-year-olds, which makes up around half of colleges' income, fell by 18% in real terms between 2013/14 and 2018/19. Part of this decrease reflects the fact that 24 sixth-form colleges converted to academies during the period. Excluding the amounts relating to these colleges, total funding for 16- to 19-year-olds fell by 14% in real terms. Total funding for adult education and support services (excluding apprenticeships) fell by 35% in real terms between 2013/14 and 2018/19 (paragraphs 1.7 and 2.12 to 2.16, and Figure 5).

12 **The Department's funding arrangements create extra financial pressures for some colleges.** In recent years, colleges have had to deal with increasingly complex funding formulae for different income streams. For example, funding for students aged 16 to 19 is allocated using a formula with multiple factors, including previous years' student numbers and retention rates. The use of previous years' data means that the amounts colleges receive may not fully reflect their current student numbers or characteristics. While colleges with fewer students than in the previous year benefit from this approach, colleges who recruit more students during an academic year than the number they were originally funded for may not receive full funding for those additional students during that academic year. The profile of funding gives colleges slightly more money early and late in the academic year, but less in February and March. This funding pattern may push some colleges into overdraft, particularly if they have cashflow problems (paragraph 2.10).

13 **Colleges have faced cost and competitive pressures that have hampered their financial sustainability.** There have been particular pressures in relation to staff costs, which typically account for around two-thirds of colleges' running costs, including significant increases in pension contributions. Teaching English and maths retakes can have a significant impact on colleges' staffing levels and costs. Since August 2015, students aged 16 to 18 who have not achieved GCSE grade 4 in English and maths have been required to continue studying for these qualifications. For many colleges, this requirement can apply to more than half of their students. Also, colleges have been competing for students from a shrinking pool of young people, and therefore competing for income with a range of other types of provider, including post-16 academies and independent training providers. Between 2013/14 and 2018/19, the number of learners in FE colleges fell by 17% (paragraphs 1.7 and 2.17 to 2.19, and Figure 6).

14 **Financial pressures have led to colleges narrowing their provision and reducing broader support for students, which is likely to have detrimental effects on students and skills development.** The Department's research has found that, in response to funding constraints, colleges have commonly reduced their curriculum (we found that typical examples of courses being dropped were modern languages and some science, technology, engineering and maths subjects) and significantly decreased enrichment activities for students. This was the case at several of the colleges we visited, which had cut careers advice and employability activities, and were particularly concerned about reduced mental health support for students. In addition, colleges often find it difficult to recruit and retain teaching staff, largely due to the unattractiveness of the salaries they can offer compared with those available in equivalent roles in schools, higher education and industry (paragraphs 2.22 to 2.24).

15 **Despite the financial pressures that colleges have faced, Ofsted had graded more than four in five colleges as good or outstanding at August 2019.** Ofsted's inspections indicate that the quality of college provision has remained generally high. The proportion of colleges graded as good or outstanding dropped from 82% at August 2014 to 74% in 2017, but recovered to 82% in 2019. However, some of these colleges have not been inspected for a long time because, under legislation, colleges graded as outstanding are exempt from routine re-inspection. Of the 39 colleges graded as outstanding in 2019, 23 had not been inspected for more than five years, of which 12 had not been inspected for more than 10 years. At August 2019, Ofsted had graded two colleges (with a total of 5,700 students) as inadequate and 35 (with 251,000 students) as requires improvement (paragraph 2.27 and Figure 7).

Oversight and intervention

16 **Area reviews are likely to have helped limit the financial deterioration of the sector, partly by providing substantial amounts to pay off colleges' debts.** Between September 2015 and March 2017, government oversaw a programme of 37 area reviews of post-16 education and training provision, each of which was led by local stakeholders. The area reviews led to 57 college mergers. In June 2020, the Department projected that the financial health of 11% of colleges would be rated as inadequate in 2020/21, but that this figure would have been 20% had the area reviews not taken place. Between 2015-16 and 2019-20, government provided 45 colleges with £431 million to help cover the costs of mergers and other structural changes, mostly in grants rather than loans. Some 46% of restructuring funding (£197 million) was used to help colleges reduce their commercial borrowing (paragraphs 3.2 to 3.8 and Figure 8).

17 **Initial departmental research indicates that stakeholders are sceptical that the area review programme will achieve its intended long-term impact.** The area reviews aimed to ensure there was the right capacity to meet the needs of students and employers in each area, provided by institutions that were financially stable and able to deliver high-quality provision. However, stakeholders involved in the area reviews are not convinced about the likely long-term impact of the programme. Research commissioned by the Department and published in September 2019 found that many stakeholders: perceived that too much focus was placed on financial efficiency at the cost of other issues such as leadership, governance and learning provision; were uncertain that the area review would deliver improvements in the FE provision in their area; and did not believe that local mergers had resolved the concerns about financial sustainability (paragraph 3.9 and Figure 8).

18 **The Department has not had an overall strategy for the college sector but is drawing up a 10-year reform programme.** The Department considers that the FE system prevents strategic planning of provision to meet local and national labour market needs, with local FE markets not well organised or equipped to deliver national and regional priorities. During 2019, it began to develop a 10-year reform programme intended to address the fact that, in its view: colleges are not incentivised to focus on long-term goals, cannot take advantage of economies of scale, and cannot risk investing in high-cost provision; too many learners are on courses that are not well valued in the labour market; there are parts of the country where learners are not well provided for; and learners, parents and employers are not sufficiently clear about what colleges offer. This initiative was continuing at the time of our work (paragraphs 3.10 and 3.11).

19 **At February 2020, government was intervening in nearly half of colleges for financial health reasons, and intervention often takes a long time.** At February 2020, 84 colleges (35% of open colleges) were in early intervention because of their financial health, while 31 (13%) were subject to the more serious formal intervention. Our analysis shows the following:

- **Early intervention.** The then Skills Funding Agency introduced early intervention in November 2015 with the aim of facilitating swift mitigating action in colleges that were at risk of getting into financial difficulty. Since then, 149 of 322 colleges have been in early intervention once, 65 colleges for two separate periods and 10 for three periods. The average length of completed periods of early intervention was 12 months, with the maximum being 50 months. Seven colleges remained in early intervention in February 2020, having entered it when the policy was introduced.

- **Formal intervention.** Government intervenes formally when colleges meet published criteria or when those in early intervention fail to improve or to demonstrate sufficient progress in resolving problems. At February 2020, 42% of colleges that were in formal intervention because of their financial health (13 of 31) had been there for longer than three years. More than half of colleges that go into formal intervention end up merging with other colleges. Of the 46 colleges that entered formal intervention for financial health reasons in August 2014 or later, and have since come out of intervention, 27 merged with another college within a year of intervention ending (paragraphs 3.19, 3.21, 3.23, 3.25 and 3.26, and Figure 9).

20 **The ESFA paid £253 million to 36 colleges with serious cashflow problems, much of which will not be repaid, as was originally intended.** Between November 2014 and March 2019, colleges could apply to the ESFA for 'exceptional financial support' to help them maintain their teaching and other services for learners. Guidance published when the scheme was introduced made clear that the money would be repayable. The Department revised the guidance in 2017, saying that grant support would be considered in very limited circumstances, with the grant becoming repayable in certain situations. The ESFA has categorised £99.9 million (39% of the total) as non-repayable, of which £91.9 million was waived as part of restructuring funding connected with the area reviews; £61.6 million of the total had been repaid at March 2020 (paragraphs 3.27 to 3.29).

21 **Two colleges have been through the new insolvency process, at a gross cost of nearly £27 million from April 2019 to May 2020.** In January 2019, the Department introduced an insolvency regime, in light of concerns that some colleges were not dealing with emerging financial problems early enough. Hadlow College entered 'education administration' in May 2019, and West Kent and Ashford College in August 2019. Educational provision continued during education administration, and the administrators' objective was to minimise disruption for existing students. Ofsted visited both colleges during the process and found they were making reasonable progress with regard to educational performance. Arrangements to transfer all learners to new providers were finalised in August 2020. Between April 2019 and May 2020, the ESFA spent £26.6 million dealing with these two colleges, although it expects to receive some money from the sale of assets no longer required for educational provision. The ESFA recognises that, depending on the types of case involved, the cost and effort of handling colleges in education administration mean that it may need to limit the number of colleges in the insolvency regime at any one time (paragraphs 3.31 to 3.37 and Figure 10).

Conclusion on value for money

22 A thriving college sector is crucial to developing the knowledge and skills that the country needs, and therefore to the success of the economy and society more generally. However, the combination of funding constraints and uncertainty, along with cost and competitive pressures, present significant challenges to colleges' financial sustainability. Since we last reported on this topic in 2015, the Department has strengthened its oversight and intervention arrangements, and now has a range of options aimed at preventing colleges from getting into financial difficulty and supporting them when they do. However, these approaches have absorbed considerable amounts of public money, while many colleges remain in financial difficulty.

23 Overall, the financial health of the college sector remains fragile. Ofsted inspection ratings suggest that colleges are generally maintaining educational quality, but other evidence shows that financial pressures are affecting wider aspects of provision such as the breadth of the curriculum and levels of student support. The programme of area reviews led to structural change and had some success in making the college sector more financially secure. The Department is now formulating a strategic reform programme intended to remedy systemic long-term weaknesses in the sector. This is a welcome development but, until such a programme is in place and achieving results, we cannot conclude that the Department is responding effectively to the financial sustainability challenges that colleges are facing.

Recommendations

24 In light of our findings and the fact that more colleges are expected to face financial difficulties following the COVID-19 pandemic, we recommend that the Department and the ESFA should take the following actions:

a **Set out a clear vision for the role, structure and funding of the college sector as part of the long-term reform programme.** The Department and the ESFA have spent considerable sums helping colleges in financial difficulty to survive. But colleges now need a better understanding of government's strategy for them, and confidence that funding arrangements will support them to fulfil that role.

b **Assess systematically how far colleges are responding to financial pressures by narrowing their provision and reducing student support services.** This work should include identifying colleges that have made efficiency savings without curtailing provision, and sharing this good practice across the sector.

c **Reduce the complexity and uncertainty of the college funding arrangements.** Dealing with complex funding rules takes up college staff time, and amplifies the risk of mistakes which may result in the ESFA recovering funding that colleges have claimed incorrectly. The lagged nature of funding for students aged 16 to 19 may add to uncertainty and financial pressures, if the number of young people studying in colleges rises in line with demographic trends.

d **Evaluate, and take action to improve, the effectiveness of the early and formal intervention regimes in improving colleges' financial sustainability.** At a time of significant funding and cost pressures, intervening successfully is particularly challenging. However, it is important for the ESFA to identify the factors that make intervention more likely to lead to sustained improvements in colleges' financial health.

e **Learn lessons from the first two college insolvency cases.** This work should include evaluating the cost, timeliness and impact of the education administration process and identifying improvements for future cases.