National Audit Office

Report
by the Comptroller
and Auditor General

Department for Business, Innovation & Skills

Overseeing financial sustainability in the further education sector

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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.

6 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

7 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

8 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).

9 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).

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).

14 **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).

15 **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).

16 **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).

Intervention

17 **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).

18 **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).

19 **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).

20 **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).

21 **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).

22 **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

23 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.