National Audit Office

Report
by the Comptroller
and Auditor General

Department for Education

Financial sustainability of colleges in England

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National Audit Office

Department for Education

Financial sustainability of colleges in England

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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This report focuses on the financial sustainability of further education and sixth-form colleges, providing an update to the assessment we made in 2015.

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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.

Part One

The college sector

1.1 This part of the report sets out background information about the college sector, including funding and accountability arrangements.

Colleges

1.2 At April 2020, there were 242 further education (FE) and sixth-form colleges in England, comprising:[2]

- 167 general FE colleges offering academic courses, and vocational and skills training, to young people and adults;
- 25 specialist FE colleges, comprising: 14 land-based colleges providing education and training for rural economies; two art, design and performing arts colleges; and nine other institutions designated as being in the FE sector; and
- 50 sixth-form colleges offering mostly academic education to 16- to 18-year-olds.

1.3 Colleges form an important part of the education and skills infrastructure. They educate and train around 1.0 million adults and 660,000 young people aged 18 and under each year. Colleges are involved in delivering many of the government's educational and training priorities. For example, each year they:

- provide off-the-job training to around 215,000 apprentices (around 30% of all apprentices);
- enable around 161,000 students to retake GCSE English and/or maths; and
- teach A level courses to around 146,000 16- to 18-year-olds.

Colleges will also be key bodies in delivering T levels, new technical qualifications that the government plans to introduce from September 2020.

2 Numbers of colleges referred to throughout this report relate to numbers of college corporations – the legal entities that run colleges. Some corporations operate more than one college.

1.4 FE colleges have a broad role in skills development, working with local employers to identify the need for, and provide, skills training in particular sectors or trades. They also teach courses that prepare people for employment. In addition, some colleges deliver higher education courses at undergraduate and postgraduate level.

1.5 Students at colleges tend to be more disadvantaged than the general population. In 2018/19:

- 54% of adult learners were from the 40% most deprived areas, and 31% were from the 20% most deprived;
- 21% of learners had a learning difficulty or disability, compared with around 19% of the working-age population;
- 24% of learners were from black, Asian or minority ethnic backgrounds, compared with 15% of the working-age population; and
- 53% of learners were female, rising to 66% at specialist colleges.

1.6 Government expects colleges to play an increasingly prominent role in skills development, given the challenges facing the country. The UK's exit from the European Union is likely to create growing domestic demand for technical skills in a range of sectors. In addition, some of the government's plans – for example, developing national infrastructure and increasing the number of public servants such as nurses and police officers – will require the deployment of a more skilled workforce. Given their focus on more disadvantaged groups, colleges are likely to play a key part in the government's ambition to 'level up' skills and prosperity across the country. They 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.

Funding

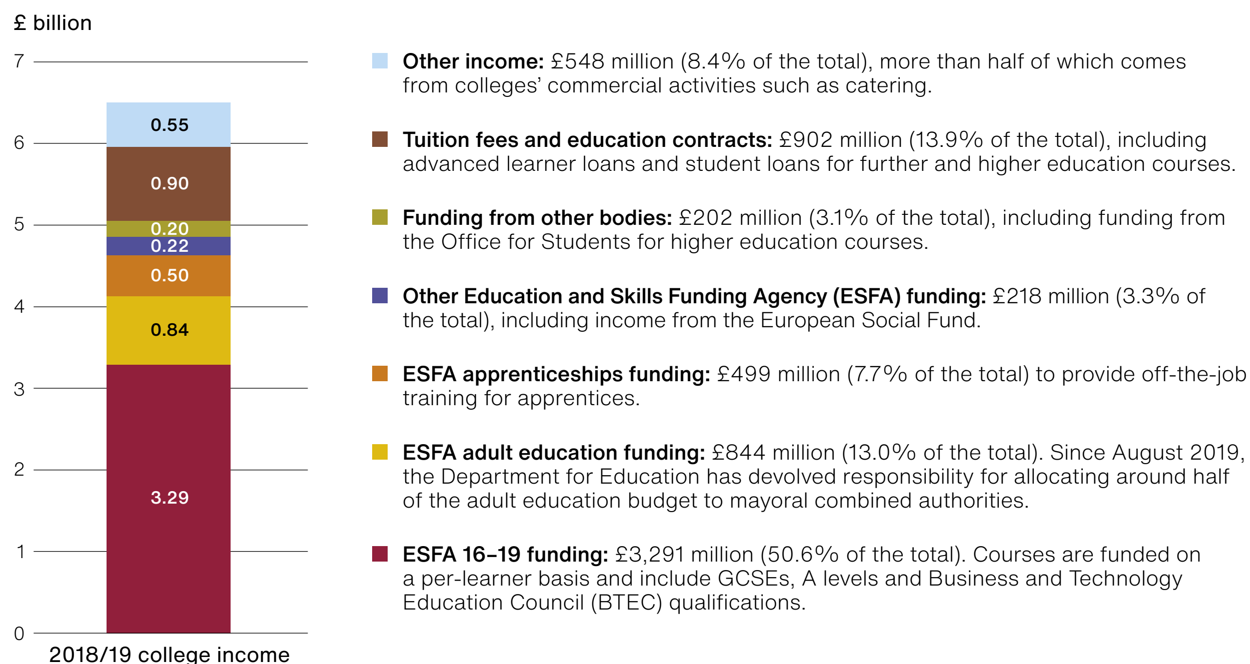
1.7 Most college funding follows the learner. Colleges' total funding is largely determined by funding rates per learner and the number of learners in the sector. Colleges must attract students, competing with each other and with other types of education and training provider. Depending on local arrangements, these other providers may include school sixth forms, post-16 academies, higher education institutions and independent training providers.

1.8 In 2018/19, colleges' income totalled £6.5 billion. Of this, £5.1 billion (78%) was public funding. Most of this public funding was provided via the Education and Skills Funding Agency (the ESFA), an executive agency of the Department for Education (the Department). By far the largest funding stream was for students aged 16 to 19 (**Figure 1** overleaf).

Figure 1

College income by source, 2018/19

Colleges in England received income of £6.50 billion in 2018/19



Note

1 Advanced learner loans are available for learners aged 19 or over to undertake approved qualifications at levels 3 to 6, at an approved training provider in England. They are paid directly to the training provider on behalf of the learner.

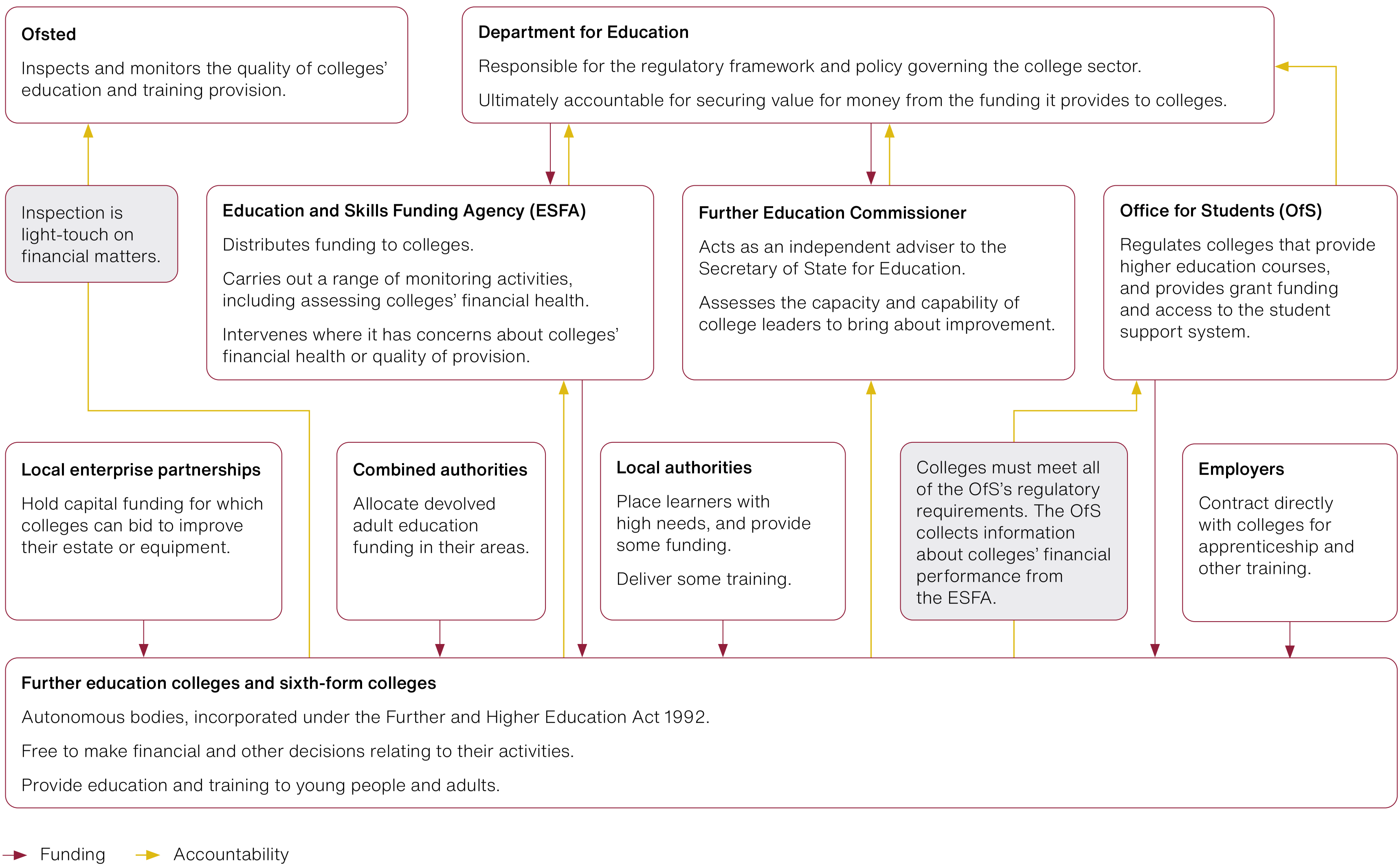
Source: National Audit Office analysis of college accounts data collected by the Education and Skills Funding Agency

1.9 Local enterprise partnerships award capital funding to colleges from the government's Growth Deals to support projects in their area. Colleges may bid for funding to enhance their estate or equipment. They may also borrow commercially to fund capital projects.

Accountabilities

1.10 The Department is responsible for the regulatory framework and policy governing post-16 education and training (**Figure 2**). It is responsible for teaching, learning and training, for young people and adults, in the college sector.

Figure 2
Funding and accountability arrangements for colleges in England



Source: National Audit Office

1.11 The Department 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 for Education. The FE Commissioner and his deputies have extensive experience of working in colleges as teachers and leaders. In addition, Ofsted provides independent assurance about the quality of colleges' education and training provision.

1.12 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 can change the membership of a college's governing body in extreme circumstances. Under the Further and Higher Education Act 1992, colleges have considerable financial independence. They can own assets, employ staff and enter into contracts, and they may make financial surpluses or deficits. The Education Act 2011 further strengthened colleges' independence, in particular allowing them to borrow or invest without seeking consent.

Response to the COVID-19 pandemic

1.13 On 23 March 2020, the government announced movement restrictions (lockdown) in response to the COVID-19 pandemic. College buildings closed, except for students who were vulnerable or whose parents were key workers, meaning that, where possible, teaching had to be delivered online instead of face to face.

1.14 Colleges were able to access government support for businesses, such as the Coronavirus Job Retention Scheme to furlough staff. In addition, the government put in place a variety of measures to support colleges and other training providers and protect provision for learners. These included:

- a commitment that the ESFA would continue to pay grant funding in full for the remainder of 2019/20. Colleges were also assured that adult education funding would not be 'clawed back' where provision was lower than planned, if they had made reasonable attempts to maintain provision. At the time of our work, the ESFA was planning additional checks to address the risk of colleges being funded twice for the same costs – for example, by receiving full grant payments when they had also furloughed staff;
- the provision of advice from Ofsted in relation to improving educational quality and from LocatEd in relation to estates issues, in addition to the advice already available from the FE Commissioner;[3]
- a support scheme for organisations that deliver adult education or apprenticeship training for smaller employers, and that are at risk of financial failure. The aim of the scheme is to support providers to maintain provision, and to retain capacity for after the pandemic; and
- funding to provide small-group tutoring for disadvantaged students whose studies were disrupted by the pandemic.

1.15 The ESFA expects that more colleges will face financial difficulties and require emergency funding in future, as a result of the pandemic. It intends to collect additional information from colleges, such as revised cashflow forecasts, to enable it to assess what support might be required both at sector level and for individual colleges.

3 LocatEd is an arm's-length body of the Department, whose primary role is to buy and develop sites for new schools in England. Its other activities include providing advice on property issues to education providers.

Part Two

Colleges' financial health

2.1 This part of the report covers trends in the financial health of the college sector, the financial challenges that colleges have faced, and the impact of financial pressures on provision and quality.

Trends in financial health

Surpluses and deficits

2.2 Colleges' surplus or deficit position has fluctuated over the past five years (**Figure 3**). In 2018/19, 34% of colleges reported an adjusted operating deficit (which excludes exceptional items in order to allow more reliable comparisons between years), down from 37% in 2013/14.[4] The total operating balance of the college sector changed from an £8.5 million surplus in 2013/14 to a £45.7 million surplus in 2018/19, which followed a £70.3 million deficit in 2017/18.

2.3 In addition, analysis of colleges' accounts data shows that, in 2018/19:

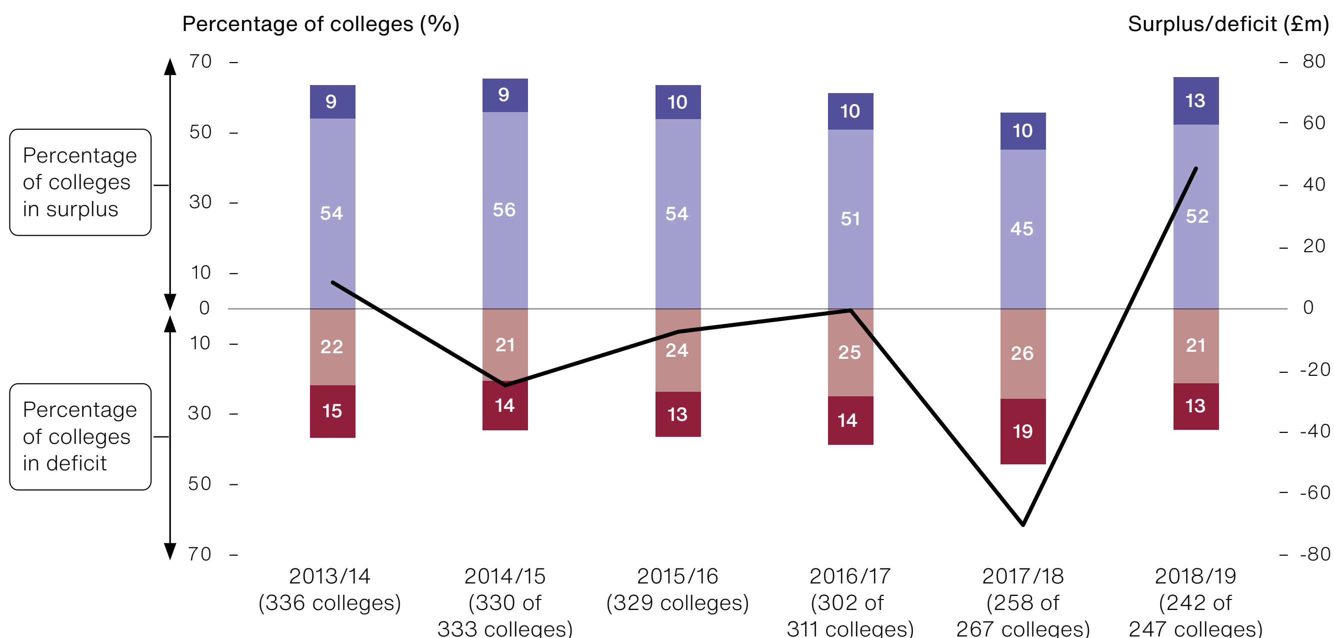
- 13% of colleges had a deficit equivalent to more than 5% of their income, compared with 15% in 2013/14;
- 13% of colleges had a surplus equivalent to more than 5% of their income, up from 9% in 2013/14;
- a larger proportion of specialist further education (FE) colleges (43%) was in deficit than general FE colleges (35%) or sixth-form colleges (28%); and
- of the 123 colleges that had been in deficit in 2013/14, 46 (37%) no longer existed as standalone entities, 41 (33%) were in deficit and 34 (28%) were in surplus.

4 This analysis excludes five colleges that had not submitted accounts data for 2018/19 at the time of our work. The ESFA told us that these colleges were likely to have reported operating deficits. The colleges include Hadlow College and West Kent and Ashford College, which both entered the insolvency regime during 2019 (see paragraphs 3.33 to 3.36).

Figure 3

Proportion of colleges in England with adjusted operating surpluses or deficits, 2013/14 to 2018/19

The proportion of colleges in deficit, and the overall surplus or deficit of the college sector, have varied across the period



Notes

1. Percentages may not sum to 100% due to rounding.
2. In some years, not all colleges submitted accounts data in time for publication of the Education and Skills Funding Agency's dataset (as shown on the horizontal axis).
3. The method that we used to calculate the adjusted operating surplus or deficit is the one used in college accounts from 2016/17 onwards. This is different from the method that was used in previous years, and in our 2015 report on *Overseeing financial sustainability in the further education sector*, in that it excludes taxation and the net pension finance cost.

Source: National Audit Office analysis of college accounts data collected by the Education and Skills Funding Agency

Financial health ratings

2.4 The Education and Skills Funding Agency's (the ESFA's) financial health ratings are its most important indicator of colleges' financial sustainability. The ESFA calculates the ratings from information in colleges' accounts, using financial ratios that indicate:

- solvency (current assets compared with current liabilities);
- financial performance (education-related earnings[5] as a percentage of adjusted income); and
- borrowing (as a percentage of adjusted income).

On the basis of these ratios, the ESFA rates colleges' financial health as outstanding, good, requires improvement (known as satisfactory before 2018/19) or inadequate.

2.5 The ESFA's ratings indicate that the sector's financial health has changed relatively little in recent years, although the proportion of colleges rated as good or outstanding increased by four percentage points between 2013/14 and 2018/19 (**Figure 4**). The proportion of students attending colleges with financial health ratings of inadequate or requires improvement fell, from 45% (1,030,000 students) in 2013/14 to 40% (660,000 students) in 2018/19.

2.6 The ratings also suggest that the sector's financial health has not declined as significantly as expected. In our 2015 report, we noted that the then Skills Funding Agency had estimated that, if no action was taken, there could be around 70 colleges rated as having inadequate financial health by the end of 2015/16, up from 32 colleges in 2013/14, although this estimate was sensitive to a number of assumptions.[6] In the event, 38 colleges were rated as having inadequate financial health in 2015/16. Partly due to weaker colleges merging, only 23 colleges were in this position in 2018/19.

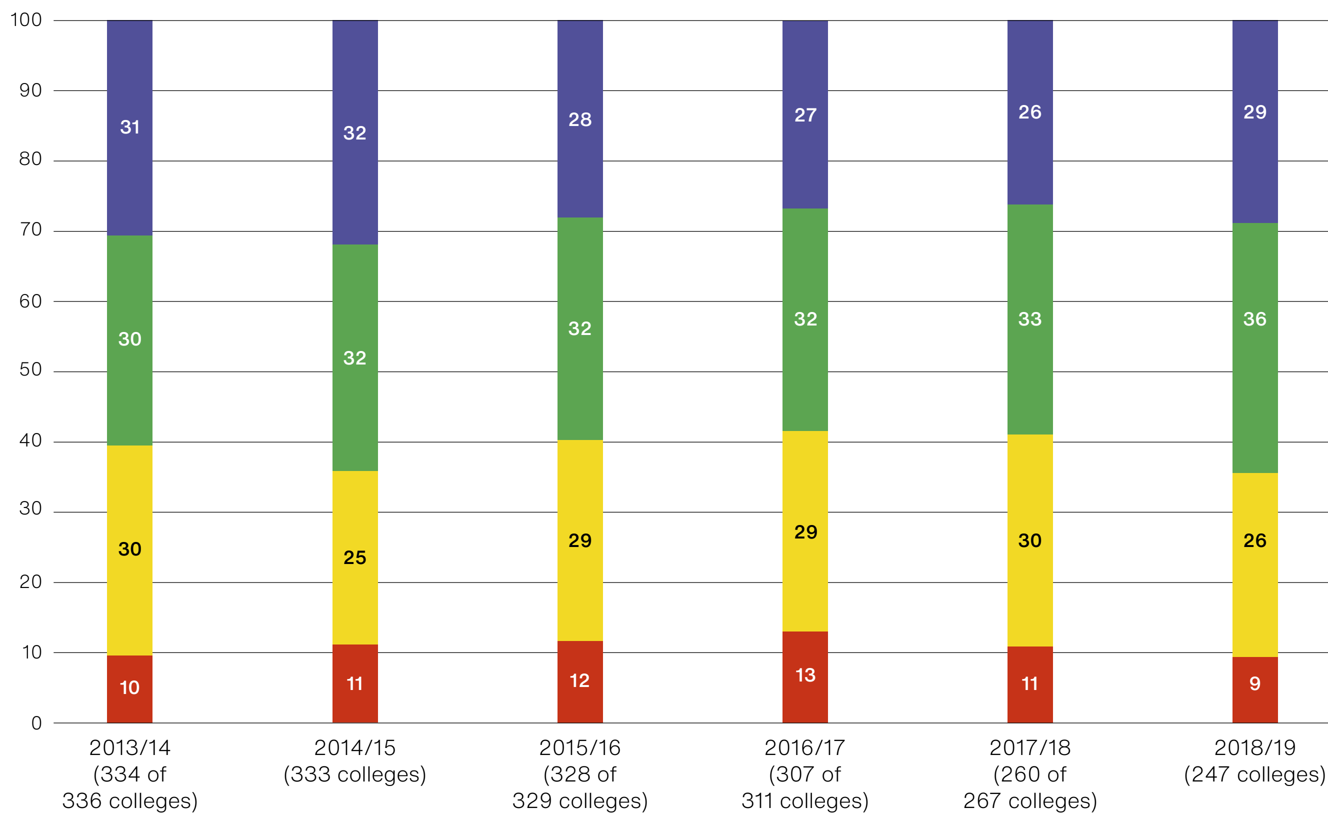
2.7 However, colleges in financial difficulty generally struggle to improve their financial performance. Our analysis of the ESFA's financial health ratings shows that, of the 23 colleges rated as inadequate in 2018/19, nine had also been rated as inadequate in the previous year, and six of those had been rated as inadequate for at least three years. More generally, the ESFA rated the financial health of 64% of colleges as less than good at some point between 2013/14 and 2018/19, with almost half (46%) being rated as less than good at least twice.

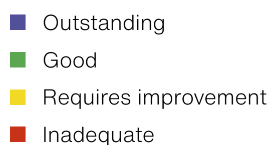
5 This is earnings before interest, tax, depreciation and amortisation.
6 Comptroller and Auditor General, *Overseeing financial sustainability in the further education sector*, Session 2015-16, HC 270, National Audit Office, July 2015.

Figure 4

College financial health ratings, 2013/14 to 2018/19

The financial health of colleges in England, as rated by the Education and Skills Funding Agency, has remained relatively stable since 2013/14





Notes

1 Percentages may not sum to 100% due to rounding.

2 Before 2018/19, the requires improvement rating was known as satisfactory.

3 Financial health ratings were not available for all colleges for all years, as shown on the horizontal axis.

Source: National Audit Office analysis of data produced by the Education and Skills Funding Agency

Other indicators of financial health

2.8 The amount that colleges have borrowed has fallen. Total borrowing decreased by 24% from £1.7 billion in 2013/14 to £1.3 billion in 2018/19. High levels of borrowing can indicate poor financial health. The proportion of colleges whose borrowing was more than 45% of income (the level above which, when combined with similar performance for the other two financial ratios, the ESFA may rate a college's financial health as inadequate) fell from 13% in 2013/14 to 7% in 2018/19. As well as action taken by colleges themselves, substantial amounts of government funding have helped to reduce colleges' debts (see paragraphs 3.5 and 3.6).

2.9 Colleges' cashflow is an important indicator of financial sustainability. A college with a poor cashflow position – more cash going out than coming in – is likely to have difficulty servicing its debts. The sector's cashflow position fluctuated between 2013/14 and 2018/19, although there are some positive indicators.

Financial challenges for colleges

Funding arrangements

2.10 The Department for Education's (the Department's) funding arrangements present colleges with particular challenges. The colleges and other stakeholders we consulted highlighted the following factors which can impede colleges' efforts to achieve financial sustainability:

- **Funding based on lagged data:** The funding formula for students aged 16 to 19 is based on data lagged for one year for student numbers, and two years for other factors such as student retention. As a result, the amounts that colleges receive may not reflect their current performance or student numbers and 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. This will become an increasing problem for colleges if learner numbers start to rise in line with demographic trends for 16- to 18-year-olds (see paragraph 2.17).

- **Uncertainty about long-term future funding:** Funding based on lagged data provides colleges with some assurance of funding for the next one or two years. Beyond that, factors such as local competition for students (see paragraphs 2.17 and 2.18) mean that colleges do not know how much funding they will receive. Lack of certainty about future funding limits colleges' ability to plan ahead, for example to borrow for capital projects or expansion.

- **Capped adult education funding:** The ESFA allocates funding to providers for adult learners using a 'cap' based on previous 'learning delivery' at each provider. Learning delivery is based on the volume and type of learning undertaken, with adjustments for other things such as learner disadvantage. Funding falls if colleges deliver less learning than previously, but increases by a maximum of only 3% if they deliver more.[7]

- **Funding profile:** The profile of funding gives colleges slightly more money early and late in the academic year, but less in February and March. It provides 6% less 16–19 funding and 4% less adult education funding by March than it would do if funding was evenly distributed throughout the year. This funding pattern may push some colleges into overdraft, particularly if they have cashflow problems.

- **Complexity of funding arrangements:** In recent years, colleges have had to deal with increasingly complex funding formulae for different income streams, as formulae have been adjusted to reflect policy priorities. For the 16–19 funding formula, there are up to 13 different elements for each programme. An independent review in 2019 concluded that adult education funding arrangements were complex and inflexible.[8] For colleges, this complexity takes up staff time, leads to extra administration costs and increases the risk of mistakes which may result in the ESFA recovering funding that colleges have claimed incorrectly.

2.11 In terms of capital funding, colleges sometimes compete for funding from local enterprise partnerships against other local projects. Many colleges do not have the required financial resources if their local enterprise partnership asks them to co-contribute funding. In addition, local enterprise partnership funding tends to be used for new buildings rather than maintaining colleges' existing estates. Covering ongoing maintenance or small capital works can be a particular challenge for many colleges (see paragraph 2.25).

7 Funding falls if colleges deliver less than 97% of the learning for which they were funded. The scope to increase funding to 103% if additional learning is provided was introduced in 2018/19; in previous years, colleges received no additional funding if they delivered more learning.

8 *Independent panel report to the Review of Post-18 Education and Funding*, CP 117, May 2019. The panel was chaired by Dr Philip Augar.

Funding levels

2.12 The Department's total funding for colleges reduced from £5.5 billion in 2013/14 to £4.8 billion in 2018/19, a drop of 20% in real terms.[9] Funding for 16- to 19-year-olds, which makes up around half of college income, fell from £3.8 billion in 2013/14 to £3.4 billion in 2018/19, a drop of 18% in real terms (**Figure 5**).[10] Part of the decrease reflects the fact that 24 sixth-form colleges converted to academies during the period. Excluding the amounts relating to these colleges, total funding reduced by 18% and funding for 16- to 19-year-olds fell by 14% in real terms.

2.13 Within the overall decreases in funding, high-needs funding for 16- to 19-year-olds increased from £210 million to £320 million over the same period, a rise of 44% in real terms.[11] The Children and Families Act 2014 extended support for young people with special educational needs and disabilities in education, meaning that more students are eligible for support.

2.14 Funding per learner has also dropped in real terms. The decrease in total funding for 16- to 19-year-olds (excluding additional high-needs funding) was equivalent to a drop in real terms of 7% per learner for all colleges between 2013/14 and 2018/19. The decrease was greater for FE colleges – 9%, compared with 4% for sixth-form colleges.

2.15 The underlying programme funding, which applies to all students aged 16 to 19, has fallen by 9% per student in real terms since 2013/14 (Figure 5). 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. In August 2019, the Department announced that the national funding rate for full-time 16- and 17-year-olds and students aged 18 and over with high needs would increase by 4.7% in 2020/21.

9 Based on our analysis of the ESFA's funding allocations for 16- to 19-year-olds, adult education and skills, including apprenticeships. The 2018/19 figure differs slightly from the total ESFA funding shown in Figure 1. This is because categories within the college accounts sometimes include income from different funding streams.

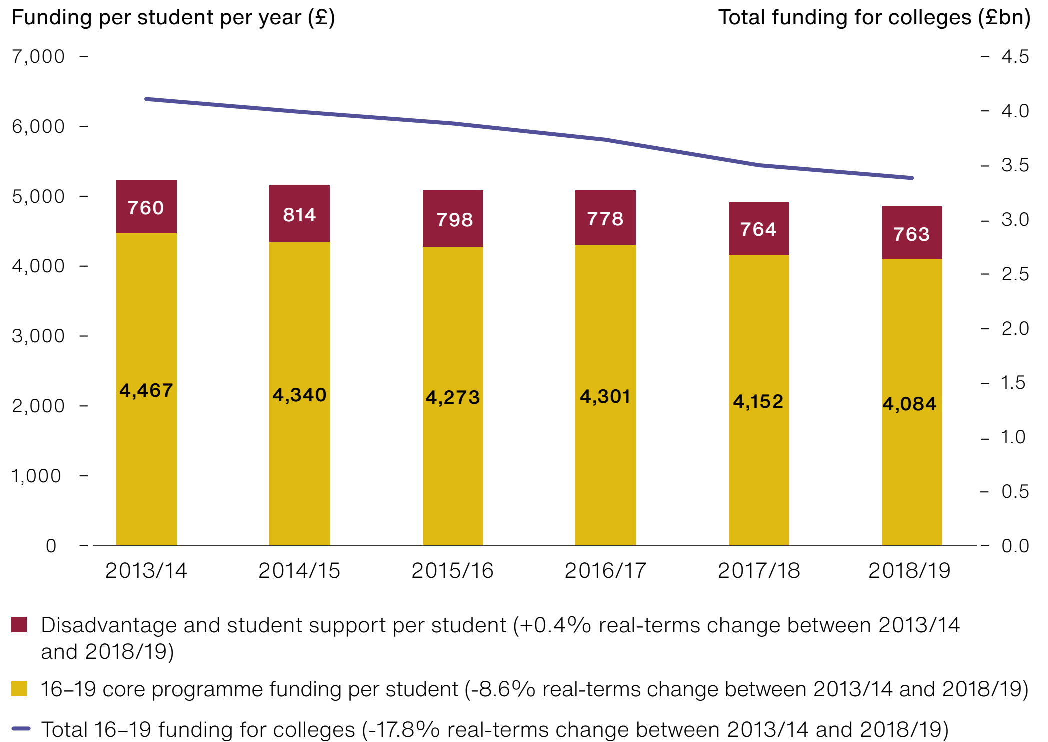
10 Adjusted for inflation, using HM Treasury's gross domestic product deflators, published in April 2020, at 2018-19 prices.

11 This covers two specific elements of high-needs funding: additional education support funding for students with high needs (usually £6,000 each year); and top-up funding provided by local authorities to colleges on a per student basis.

Figure 5

Real-terms funding for 16- to 19-year-olds in colleges in England, in total and per learner, 2013/14 to 2018/19

Total funding and core programme funding per learner have decreased in real terms since 2013/14



- Disadvantage and student support per student (+0.4% real-terms change between 2013/14 and 2018/19)
- 16–19 core programme funding per student (-8.6% real-terms change between 2013/14 and 2018/19)
- Total 16–19 funding for colleges (-17.8% real-terms change between 2013/14 and 2018/19)

Notes

1. Figures are in real terms at financial year 2018-19 prices, calculated using HM Treasury's gross domestic product deflators published in March 2020.
2. Our calculations of per-learner funding use all students as the base population.
3. Total funding for colleges includes core programme funding, disadvantage funding, targeted high-needs funding (including high-needs top-up payments from local authorities) and student financial support. Total funding does not include capacity and delivery funding of £54 million in 2018/19. Its purpose was to help colleges build capacity ahead of the introduction of T levels. Since this funding related to preparations for future functions rather than ongoing activity, we excluded it from our analysis of total funding.
4. Core programme funding includes the core element of high-needs funding but excludes more targeted elements.
5. Disadvantage funding is made up of two blocks: one to account for students' economic deprivation; and another to account for low prior attainment in English and maths.
6. Student financial support is made up of discretionary bursary funding and free meals funding. Discretionary bursary funding is given to institutions to support financially disadvantaged students to overcome specific barriers to participation in education. Free meals for disadvantaged further education students were introduced in 2014/15.
7. In addition to the fall in funding per student, a fall in the number of students also contributed to the fall in total funding.

Source: National Audit Office analysis of: the Education and Skills Funding Agency's (ESFA's) 16–19 funding allocation data; local authority and school finance data; Education Funding Agency Annual Reports and Accounts for the periods 1 April 2013 to 31 March 2014 and 1 April 2014 to 31 March 2015; and ESFA data on full-time equivalent learners on 16–19 funded courses

2.16 The Department's other funding to colleges has also fallen. For example:

- funding for adult education and support services (excluding apprenticeships) declined from just under £1.3 billion in 2013/14 to £0.9 billion in 2018/19, a fall of 35% in real terms; over the same period, the number of adult learners dropped by 26%, from 1,248,000 to 919,000;[12] and
- funding to colleges for training apprentices increased from £467 million in 2013/14 to £498 million in 2018/19, a fall of 2% in real terms, although a significant amount of apprenticeship funding is now provided directly by employers.

Competitive pressures

2.17 Colleges have been competing for students from a shrinking pool of young people. The number of 16- to 18-year-olds in education fell from 1.50 million in 2013 to 1.37 million in 2018, a drop of 8% (**Figure 6**). This follows the pattern in the population of young people aged 16 to 18 in England, which fell from 1.95 million in 2013 to 1.86 million in 2018. The population was projected to reach a minimum of 1.83 million in 2019, but then to increase each year to more than 2 million by 2024.[13]

2.18 Competition from other types of education and training provider has reduced the proportion of learners who attend colleges. The percentage of 16- to 18-year-old students in FE colleges fell from 38% in 2013 to 34% in 2018. The shrinking population of young people, and the smaller share attending FE colleges, means that the number of learners at FE colleges fell by 17% from 572,000 in 2013/14 to 472,000 in 2018/19. Over the same period, the number of learners in sixth-form colleges fell from 158,000 to 118,000, because 24 colleges converted to academies and 13 merged with general FE colleges. The number of learners in institutions that remained sixth-form colleges increased by around 7,500.

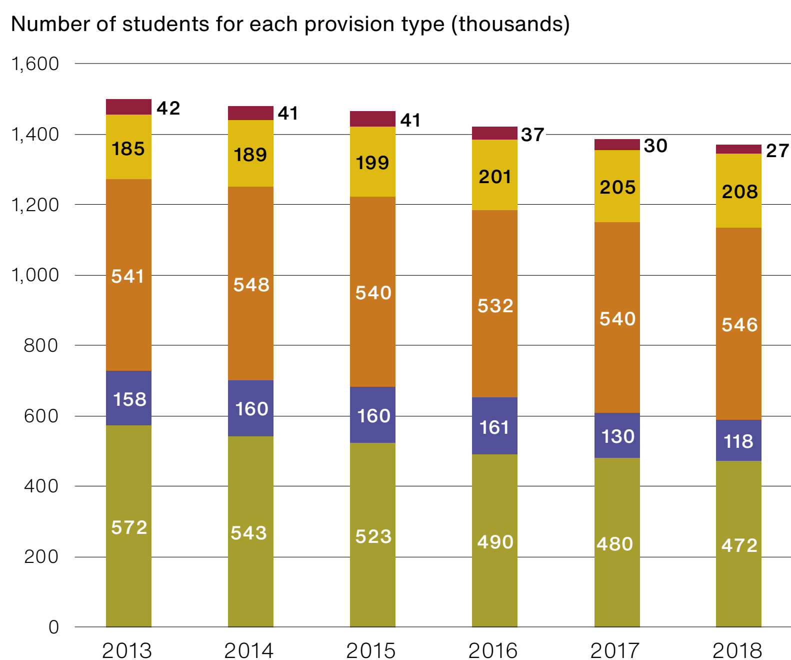
12 Learners aged 19 and over in education and training or community learning.

13 Office for National Statistics, *Estimates of the population for the UK, England and Wales, Scotland and Northern Ireland*, datasets: 'Mid-2019: April 2020 local authority district codes', and 'Mid-2013: Superseded'.

Figure 6

Numbers of students aged 16 to 18 by provider type, 2013 to 2018

Colleges in England have a smaller proportion of the shrinking pool of students aged 16 to 18



	2013	2014	2015	2016	2017	2018
Independent and other learning providers (%)	2.8	2.7	2.8	2.6	2.2	2.0
Higher education institutions (%)	12.3	12.8	13.6	14.2	14.8	15.2
Schools (%)	36.1	37.0	36.9	37.4	39.0	39.8
Sixth-form colleges (%)	10.5	10.8	11.0	11.3	9.4	8.6
General further education and specialist colleges (%)	38.2	36.7	35.8	34.5	34.6	34.4

Notes

1 Data are at the end of the calendar year shown. Ages of learners are at 31 August each year.

2 Figures include full-time and part-time learners. In 2013, 93% of learners aged 16 to 18 were full-time; in 2018, 96% were full-time.

3 Schools comprises state schools and independent schools.

4 Independent and other learning providers includes independent learning providers, local authorities, special post-16 and charitable providers.

5 Percentages may not sum to 100% due to rounding.

Source: National Audit Office analysis of Department for Education data: *Participation in education, training and employment, 2018* and unpublished data supplied by the Department

Cost pressures

2.19 Colleges' key costs have been rising, particularly those relating to staff. Staff costs typically account for around two-thirds of colleges' running costs. Examples of rising costs include:

- colleges' employer contributions to the Teachers' Pension Scheme rose from 14.1% to 16.48% in 2015 and to 23.68% in 2019. The government is providing extra funding to FE providers to cover increased contributions in 2019/20 and 2020/21. Several of the colleges we spoke to expressed concern about the affordability of contributions after that date;
- National Insurance costs rose from 10.4% to 13.8% in 2016; and
- spending on staff to teach English and maths retakes: 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, so it can have a significant impact on their staffing levels and costs.

2.20 Colleges also face some cost pressures that competing institutions do not necessarily share:

- Colleges pay VAT, while post-16 academies and schools with sixth forms do not.
- Public sector pension employer contributions mean costs are higher for colleges than for private training providers. As well as the Teachers' Pension Scheme discussed above, colleges offer the Local Government Pension Scheme to their support staff. This scheme has had a deficit in recent years, and colleges have had to make payments to help cover the deficit in addition to their standard contributions.
- Many college courses are in technical subjects, meaning they may require dedicated equipment and be subject to constraints – for example, teacher:student ratios for courses such as catering may be limited for health and safety reasons. As a result, colleges tend to have higher costs than school sixth forms, and class size restrictions limit their ability to generate extra income by taking on more learners.

2.21 Colleges often face additional costs and complexity as a result of government policy changes and new programmes. The Department has not always fully assessed the financial implications, or colleges' capacity, before changes have been introduced.

- **Apprenticeships:** The Department introduced reforms to the apprenticeships programme in April 2017, including requiring training providers to engage directly with larger employers rather than contracting with the ESFA. In its business case, the Department acknowledged that the reforms would require training providers to invest and change their business models to develop commercial relationships with a much larger number of bodies than previously; colleges have not traditionally been set up to market themselves in this way. However, the business case contained no consideration of colleges' or other providers' capacity to make these changes.
- **T levels:** In contrast, the Department's business case for the introduction of T levels from September 2020 did consider colleges' ability to deliver the new qualifications. It identified a number of requirements that would need additional funding, including increased teaching hours and an appropriately skilled workforce. The business case also identified the need for fit-for-purpose equipment and premises and acknowledged that, as a result of a lack of capital funding and low recurrent funding, colleges would not be able to provide all this themselves. The Department committed to providing an extra £500 million a year to meet the costs of additional teaching hours and industry placements. However, some of the stakeholders we spoke to expressed concern about colleges' ability to attract sufficient students to make T level provision sustainable.

Impact of financial pressures on provision

2.22 Feedback from the colleges and stakeholders we consulted, alongside other evidence, indicates that the steps colleges take to remain financially sustainable can adversely affect staff recruitment and retention, the breadth of provision and the maintenance of assets.

Staffing

2.23 Evidence suggests that some colleges find it difficult to recruit and retain teaching staff. In a 2018 survey, 53% of FE college principals reported recruitment difficulties.[14] Research for the Department, published in 2020, also found that general FE colleges, and sixth-form colleges to a lesser extent, were increasingly losing staff and finding it difficult to recruit, across all curriculum areas.[15] It found the main reason for the FE sector's difficulties in recruiting and retaining staff was the unattractiveness of salaries compared with those available in equivalent roles in schools, higher education and industry. Our analysis indicates that average real-terms salaries for FE teaching staff increased by 0.1% between 2013-14 and 2018-19, and were consistently at least £4,000 below secondary school teaching salaries until 2018-19.[16]

Breadth of provision

2.24 Financial pressures have caused some colleges to narrow their range of provision, reduce the length of courses, and cut back on enrichment and support activities for students. The Department's 2020 research found it was common for colleges to reduce their curriculum as a response to the many years without an increase in the funding base rate.[17] We found that typical examples of courses being dropped were modern languages and some science, technology, engineering and maths subjects. In addition, FE colleges contributing to the Department's research said that, for funding reasons, they had significantly reduced 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.

Buildings and equipment

2.25 Financial pressures make it more difficult for colleges to maintain their buildings and facilities, which can lead to additional financial pressures in the longer term, as assets deteriorate. A lack of maintenance can also have a detrimental effect on students' learning environments and the quality of IT and other equipment they use. Some of the colleges we visited explained that, where they had been able to fund new capital projects in recent years, short-term pressures prevented them from investing in the upkeep of their estate. Departmental research in 2019 found that colleges' capital investment had fallen by about 60% in real terms, from an average of around £1 billion a year between 2010 and 2015 to £400 million in 2016/17.

14 Department for Education, *College staff survey 2018*, November 2018. The survey was carried out by Kantar Public, working with RCU.

15 Department for Education, *Costs and cost drivers in the Further Education sector*, February 2020. The research was carried out by *a*cl consulting.

16 National Audit Office analysis of Office for National Statistics *Annual Survey of Hours and Earnings*, datasets for 2014 to 2019.

17 See footnote 15.

2.26 In the March 2020 Budget, the government committed capital investment of £1.5 billion over five years to refurbish FE colleges.[18] In June 2020, it announced that £200 million of this funding would be brought forward to allow colleges to undertake immediate repairs and upgrades.

Impact of financial pressures on quality

2.27 Despite the financial pressures that colleges have faced, the quality of provision has remained generally high. The proportion of colleges that Ofsted had graded as good or outstanding dropped from 82% at August 2014 to 74% at August 2017, but recovered to 82% at August 2019 (**Figure 7** overleaf). 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 at August 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.

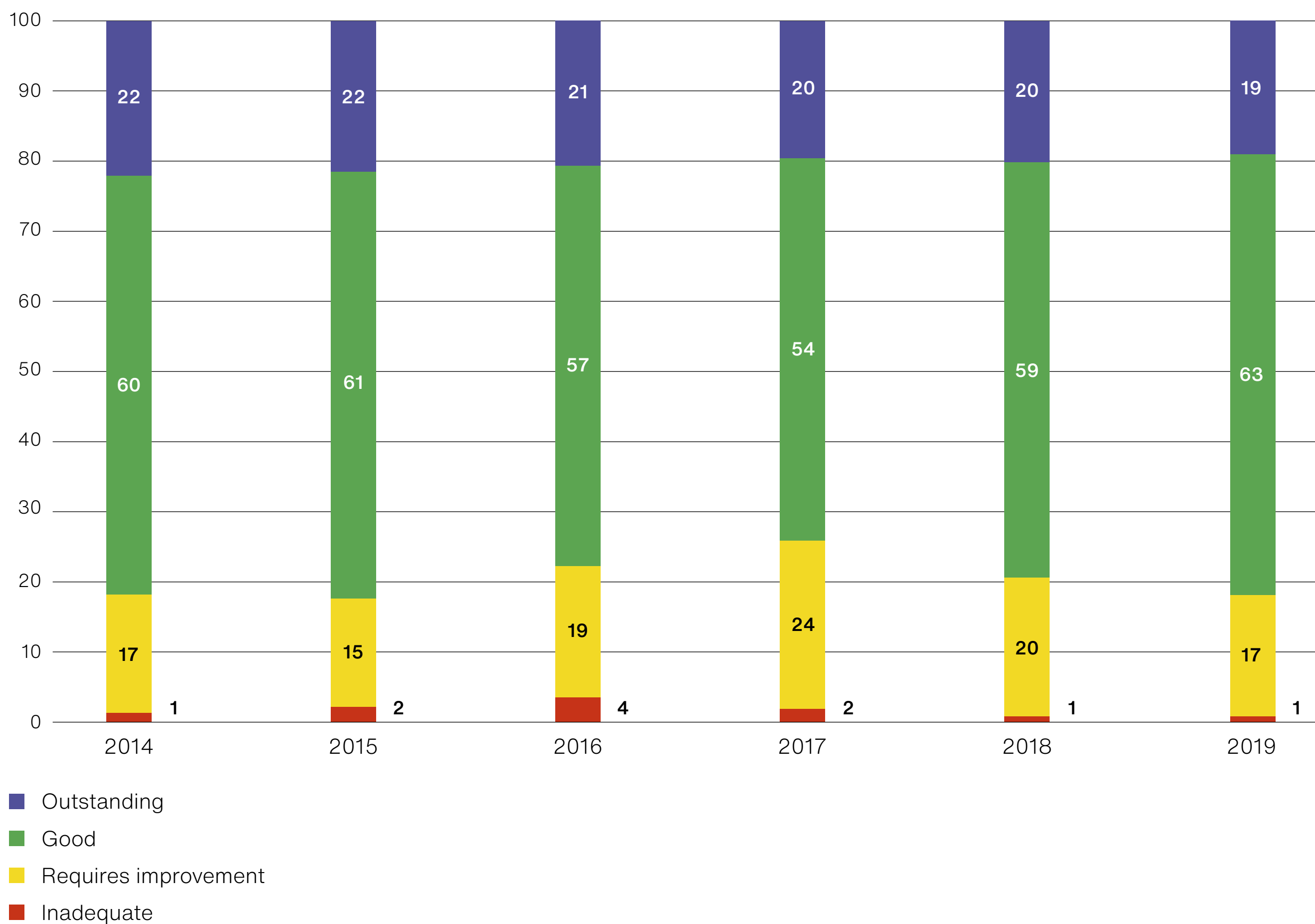
2.28 The pattern of generally good or better provision applies to all college types. At August 2019, a lower proportion of general FE colleges (77%) was graded as good or outstanding than sixth-form colleges (88%) or specialist colleges (92%). Ofsted does not assess colleges' financial health as part of its inspections but has noted that, where colleges have improved their inspection grade, good financial management has been at the heart of that improvement.

18 HM Treasury, *Budget 2020*, HC 121, March 2020.

Figure 7

Ofsted inspection grades for colleges in England, 2014 to 2019

Ofsted has graded the large majority of colleges as good or outstanding



Notes

1 The inspection grades are at August of each year.

2 The data for 2018 and 2019 exclude colleges that have not been inspected in their current form, for example following a merger. For 2018, 40 colleges did not have inspection grades; 39 of these colleges were the result of mergers and the remaining one was in the process of merging. For 2019, 43 colleges did not have inspection grades; all were the result of mergers. Merged colleges are normally inspected within three years of the merger. Before September 2017, Ofsted's policy was to carry forward the inspection judgement for the continuing college entity. For years up to and including 2017, a maximum of two colleges did not have inspection grades.

3 Percentages may not sum to 100% due to rounding.

Source: National Audit Office analysis of Ofsted data

Part Three

Oversight and intervention

3.1 This part of the report covers the work of bodies that oversee and intervene in colleges' financial health, at sector level and individual college level. As colleges are autonomous, in normal circumstances government does not have the power to impose change when it intervenes; rather it has to negotiate with senior staff and governing bodies to secure improvements.

Sector-level oversight and intervention

Area reviews

3.2 **Figure 8** overleaf sets out details of the area review programme. Although the reviews were intended to cover all post-16 education and training provision, their actual scope was more limited. In 2015, the Committee of Public Accounts emphasised that the area reviews should be sufficiently comprehensive and should generate agreed solutions to meet local needs.[19] In practice, the reviews' recommendations focused specifically on colleges. This made the reviews deliverable within a reasonable timeframe, but prevented them from making a comprehensive, joined-up assessment of the pattern of provision that would work best across a geographic area.

Implementation

3.3 As colleges are independent of government, the Department for Education (the Department) had no power to mandate the changes that the area reviews recommended. Some colleges decided not to implement the recommendations or looked for other options. In such cases, the Department encouraged colleges to take part in a 'structure and prospects appraisal', led by the Further Education (FE) Commissioner, to identify the best way forward. The FE Commissioner sometimes endorsed changes to the area reviews' recommendations.

19 HC Committee of Public Accounts, *Overseeing financial sustainability in the further education sector*, Thirteenth Report of Session 2015-16, HC 414, December 2015.

Figure 8

The programme of area reviews of post-16 education and training provision

Between September 2015 and March 2017, government oversaw a programme of 37 area reviews of post-16 education and training provision across England.

The 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. A key assumption underpinning the reviews was the need to move towards fewer, often larger, more resilient and efficient providers.

Each review was led by a steering group of local stakeholders, such as college chairs of governors and representatives from local authorities and local enterprise partnerships.

The reviews' recommendations included structural changes such as college mergers, and proposals intended to improve local collaboration and efficiency. The programme also offered sixth-form colleges the option of becoming academies.

The programme contributed to a significant reduction in the number of colleges. At September 2015, there were 241 general further education colleges and 93 sixth-form colleges. At April 2020, there were 167 general further education colleges and 50 sixth-form colleges.

Source: National Audit Office

3.4 Most of the mergers recommended by the area reviews and subsequently endorsed by the FE Commissioner have taken place. At the end of the process, in March 2017, 55 mergers had been recommended, involving 114 colleges. The FE Commissioner subsequently increased the number of recommended mergers to 68. By the end of March 2019, 57 mergers, involving 116 colleges, had been completed, nine were not being progressed and two were still being implemented. As a result, 17 of the 32 colleges whose financial health the Skills Funding Agency had rated as inadequate at the time of our 2015 report no longer exist as standalone institutions.

3.5 Between 2015-16 and 2019-20, government provided 45 colleges with £431 million from a 'restructuring facility' to help cover the cost of mergers and other structural changes. The process for allocating funds involved the Department producing formal investment papers and consulting an external panel, before sign-off by HM Treasury. The Department had intended that funding should generally be in the form of loans. However, it found that many colleges had a pressing need to reduce their debts and, in such cases, it considered there was a strong argument for grant rather than loan funding. As a result, it gave 82% of restructuring funding as grants. Grant conditions often required colleges to repay the money if their financial performance improved to a specified extent, but several of the colleges we spoke to told us that such improvement was unlikely.

3.6 Some 46% of restructuring funding (£197 million) was used to help colleges reduce their commercial borrowing. Colleges also used restructuring funding for purposes such as maintaining cashflow, covering estates-related costs and, in the case of sixth-form colleges converting to academies, meeting VAT liabilities.

Impact

3.7 Our analysis suggests that the mergers did not generally drag the financial performance of new colleges down to the level of the weaker colleges involved. We found that 14 of the 56 new colleges for which data were available saw a pattern of decline in their financial health ratings in the years after the merger. This finding should be treated with caution, however, since many mergers are too recent to have established a trend in financial performance.

3.8 The Department's analysis has concluded that the area reviews helped limit the financial deterioration of the college sector. In June 2020, it projected, for example, 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. Similarly, it expected the sector to make an operating surplus of £478 million in 2020/21, but this figure would have been £114 million without the area reviews, although there were broad ranges around these projections.

3.9 However, stakeholders involved in the area reviews are less positive about the likely long-term impact of the programme. Initial research commissioned by the Department and published in September 2019 found that:

- steering group members perceived that too much focus was placed on financial efficiency at the cost of other issues such as leadership, governance and learning provision; in particular, those who felt their college did not need to consider merging as it was in good financial health saw this as a missed opportunity for improvement;
- more than three-quarters of steering group members were uncertain that the area review would deliver improvements in the FE provision in their area; and
- many steering group members were not convinced that local mergers had resolved the concerns about financial sustainability.[20]

20 Department for Education, *Further Education sector reform case studies: area reviews*, September 2019. The evaluation was carried out by CFE Research and based on: an online survey of steering group members from 35 of the 37 area reviews; and in-depth interviews with steering group members from seven case study area reviews.

Long-term strategy

3.10 The Department has not had a clear long-term strategy covering the college sector's role, structure and funding in an integrated way. During 2019, however, it began to develop a 10-year reform programme intended to address fundamental weaknesses in the FE sector specifically.

3.11 At the time of our work, the Department was developing the reform programme with a view to publishing a white paper later in 2020. It considers that the key problem is 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. The Department intends that the reform programme will address four main challenges:

- **Sustainability:** 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.
- **Relevance:** Too many learners are on courses that are not well valued in the labour market.
- **Accessibility:** There are parts of the country where learners are not well provided for.
- **Clarity:** Learners, parents and employers are not sufficiently clear about what colleges offer.

3.12 The aims and approach of the reform programme overlap to some extent with those of the area review programme. This indicates that the area reviews had only limited success in achieving their aim of restructuring post-16 education and training provision to meet local needs better and make the college sector more financially robust.

College-level oversight and intervention

3.13 In 2015, the Committee of Public Accounts recommended that the Department should review and simplify the oversight and intervention arrangements for colleges.[21] In April 2019, the Department published a policy paper which set out a strengthened regime.[22] Its aim was to incentivise and support college leaders to take early action well before colleges got into serious financial difficulty, and for intervention arrangements to be clear and proportionate. The paper set out clearly the respective roles of the Education and Skills Funding Agency (the ESFA), the FE Commissioner and Ofsted, as well as triggers for early and formal intervention.

21 See footnote 19.
22 Department for Education, *College Oversight: Support and Intervention*, April 2019.

3.14 In July 2020, the government published Dame Mary Ney's review of college financial oversight, the work for which was carried out during 2019.[23] The review made a number of recommendations with a view to improving the support individual colleges and the sector receive, and enhancing oversight and intervention arrangements. Dame Mary proposed a new, more nurturing relationship between government and colleges. In response, the government undertook to make a number of changes, including moving the FE Commissioner's team into the ESFA in order to encourage better sharing of expertise.

Monitoring and risk assessment

3.15 The ESFA uses its financial health ratings (see paragraph 2.4) as a key indicator of colleges' financial health, and they also feed into a wider risk assessment, which is complemented by local intelligence. However, the stakeholders we consulted told us that the ratings provide only a partial view of financial health, and that financially strong colleges can appear weak, and vice versa. At the time of our work, the ESFA was reviewing how the ratings are calculated.

3.16 For its monitoring to be effective, the ESFA relies on colleges providing information that is timely, complete and accurate. It has historically required colleges to submit financial information each July and December, allowing it to update the financial health ratings twice a year. In November 2019, it introduced a new 'integrated financial model', with the aim of obtaining a more complete, detailed and forward-looking view of the sector. Colleges in good financial health now submit only one annual return, but others must submit some data more frequently – in some cases as often as monthly, depending on the ESFA's level of concern.[24]

3.17 Under the new system, the ESFA will calculate college financial health ratings once a year. It expects the model will provide it with better quality information and help it to identify colleges with potential cashflow problems. However, it is not clear how these arrangements will enable it to spot colleges whose finances deteriorate part-way through the year, and take steps to avoid those colleges declining further. In addition, colleges tend to be over-optimistic about their likely future financial health, making it more difficult for the ESFA to identify difficulties and intervene early.

23 Dame Mary Ney DBE, *Independent review of college financial oversight*, October 2019.
24 The ESFA asked colleges to submit additional data in 2020/21, in response to the COVID-19 pandemic (see paragraph 1.15).

3.18 Evidence indicates that colleges' initial experience of completing the return has not been positive. Colleges told us that the return is unnecessarily complex and detailed, and it was not clear to them how the ESFA would use the information. Several colleges were sceptical about how accurate the data were likely to be; in particular, they did not believe that monthly cashflow forecasts two years ahead would be meaningful. The ESFA expects that, after their first submissions, colleges will find it easier to update their data for future returns.

Early intervention

3.19 In November 2015, the then Skills Funding Agency published its first early intervention strategy.[25] Its aim was to engage with colleges showing signs of declining financial health or educational quality. The Skills Funding Agency hoped that early engagement would facilitate swift mitigating action, reduce the likelihood that it would need to intervene formally, and achieve more rapid turnarounds at a lower cost to public funds.

3.20 The ESFA's criteria for early intervention include a financial health rating of requires improvement or two successive Ofsted grades of requires improvement. Early intervention is led by the relevant ESFA local team, who will require the college to produce an improvement plan. The FE Commissioner may also carry out a diagnostic assessment. The ESFA may make some of the college's improvement actions additional conditions of funding. Colleges stay in early intervention until the ESFA has evidence that they no longer meet the criteria.

3.21 Many colleges remain in early intervention for a long time or move in and out of intervention several times, which suggests that the process could be made more effective. Between November 2015, when early intervention was introduced, and February 2020:[26]

- the average length of all completed periods of early intervention was 12 months, with the maximum being 50 months;
- 149 of 322 colleges had been in early intervention once, 65 colleges for two separate periods and 10 for three periods;[27] and
- 46 colleges went from early intervention into formal intervention.

At February 2020, 89 colleges were in ongoing early intervention, including seven which had been there since November 2015 (53 months). Of the 89, 84 (35% of open colleges) had entered early intervention because of their financial health.

25 Skills Funding Agency, *Early Intervention Strategy*, November 2015. The Skills Funding Agency merged with the Education Funding Agency in April 2017 to create the ESFA.
26 This analysis of the numbers of colleges in early intervention includes those in intervention for either financial or educational quality reasons.
27 The remaining 98 colleges had not been in early intervention during the period.

3.22 Colleges and their representative bodies told us that the proliferation of oversight bodies can be confusing and that the intervention regime can feel threatening rather than supportive. An ESFA survey of college principals in December 2017 found that 38% considered that the early intervention process had been supportive and effective in helping the college to improve.

Formal intervention

3.23 The ESFA intervenes formally when colleges meet published criteria or when those in early intervention fail to improve or to demonstrate sufficient progress in resolving problems. Other triggers for intervention include a financial health or Ofsted rating of inadequate, or any request for new emergency funding. Colleges can also be escalated to formal intervention by the FE Commissioner, following a diagnostic assessment, or by the ESFA if the college does not make enough progress while in early intervention. When a college enters formal intervention for financial reasons, the ESFA issues a 'notice to improve'.

3.24 Formal intervention is managed by the ESFA's local team, who may commission assessments from the FE Commissioner or others. There are regular meetings between staff from the Department, the ESFA and the FE Commissioner. Ofsted also attends some meetings and shares risk information and other intelligence with the ESFA. However, some of the colleges we consulted told us that, in practice, the activities of the ESFA, the FE Commissioner and Ofsted do not always seem to be well coordinated. Some colleges said that visits from the FE Commissioner were supportive but felt that they risked duplicating the work of the ESFA or Ofsted.

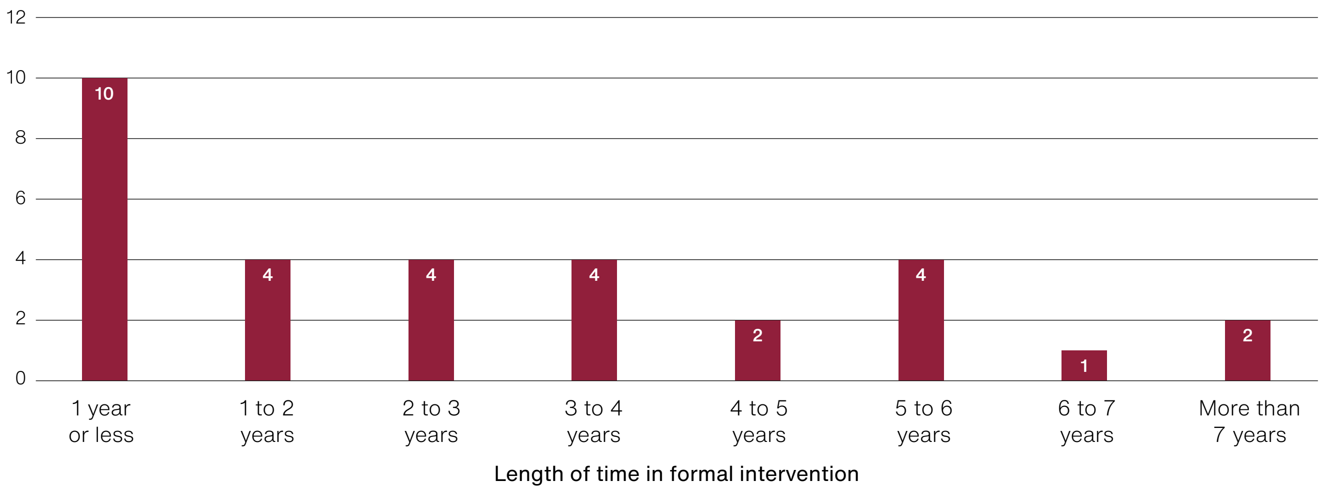
3.25 Formal intervention can be a lengthy process (**Figure 9** overleaf):

- At February 2020, 31 colleges (13% of open colleges) were in formal intervention because of their financial health. Of these, 13 (42%) had been there for longer than three years.
- Of the 46 formal intervention cases that opened in August 2014 or later and were closed at February 2020, eight (17%) lasted longer than three years. The average duration was 20 months.

In general, the longer colleges remain in intervention, the greater the cost, in terms of the oversight bodies' resources and, in some cases, emergency funding for the college.

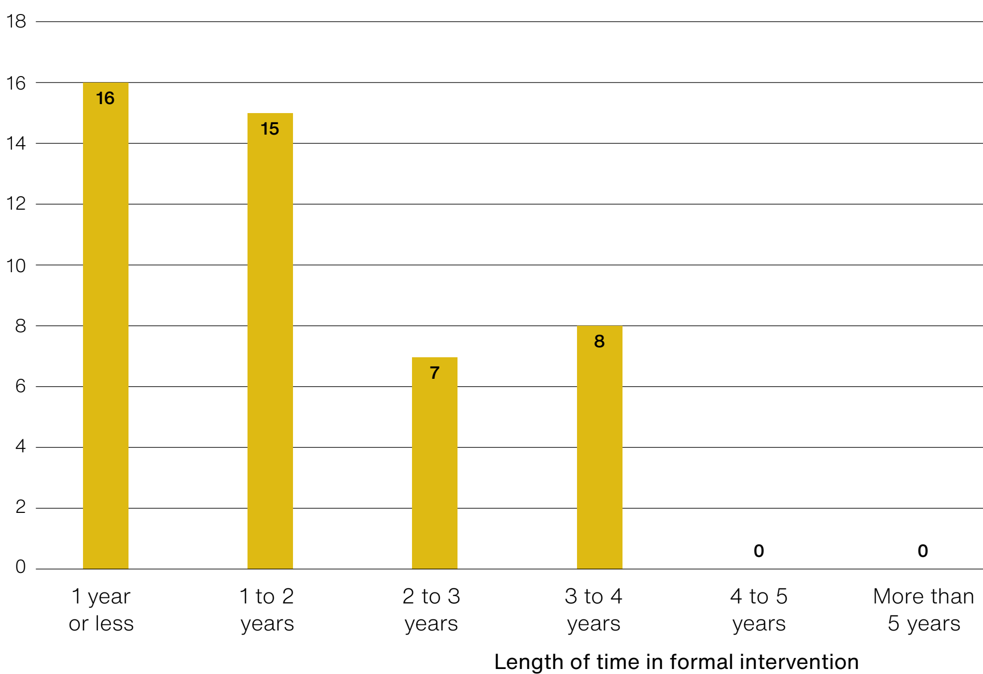
Figure 9
How long colleges in England spend in formal intervention

42% of colleges in formal intervention for their financial health at February 2020 (13 of 31) had been there for longer than three years



Formal intervention cases open at February 2020

17% of closed formal intervention cases for financial health (eight of 46) lasted longer than three years



Formal intervention cases that started in August 2014 or later and were closed at February 2020

Source: National Audit Office analysis of Education and Skills Funding Agency data

3.26 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. Of those colleges that did not merge, the ESFA rated the financial health of four as inadequate and eight as requires improvement in the year they came out of intervention. This indicates that these colleges still faced significant financial challenges even after formal intervention.

Exceptional financial support

3.27 Between November 2014 and March 2019, FE colleges with severe cashflow problems could apply to the ESFA (or its predecessor, the Skills Funding Agency) for 'exceptional financial support' (EFS) to help them maintain their teaching and other services for learners. The Department intended that EFS would address short- and medium-term cashflow issues that colleges could not tackle through steps such as reductions in spending, increases in income, commercial borrowing or asset sales. EFS could also support longer-term actions to improve colleges' sustainability, such as delivering a recovery plan. The ESFA put any college applying for EFS into formal intervention.

3.28 In total, 36 colleges received £253 million in EFS. Guidance published when EFS was introduced made clear that all amounts would be repayable.[28] 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.[29] The ESFA decided whether monies were repayable or not, based on the financial circumstances of the college in question.

3.29 The ESFA appears unlikely to recover a large proportion of the EFS money it has paid to colleges. It has categorised:

- £73.8 million (29% of the total) as loans;
- an additional £79.3 million (31%) as long-term, which represents loans with a term of longer than 12 months; and
- £99.9 million (39%) as non-repayable. Of this, £91.9 million has been waived as part of restructuring facility agreements (see paragraphs 3.5 and 3.6).

At March 2020, just less than a quarter of total EFS (£61.6 million) had been repaid.

28 Department for Business, Innovation & Skills (BIS), *FE college: exceptional financial support*, November 2014. Responsibility for further education transferred from BIS to the Department for Education in July 2016.
29 Department for Education, *FE College Financial Intervention and Exceptional Financial Support*, September 2017.

3.30 Following the introduction of the insolvency regime, the ESFA withdrew EFS in March 2019. It intended that the insolvency regime would remove the need for long-term EFS. It has, however, retained a budget for emergency funding (see paragraph 3.37).

Insolvency regime

3.31 In January 2019, the Department introduced an insolvency regime for colleges in light of concerns that some colleges were not dealing with emerging financial problems early enough. The regime applies aspects of corporate insolvency law and involves a special administration regime known as 'education administration'. The Department believes the risk of insolvency will motivate colleges to deal with problems earlier and deter them from seeking financial support unless it is unavoidable. However, we also heard concerns that the possibility of insolvency may make financial institutions less likely to lend to the sector.

3.32 Protecting students is the overriding priority while a college is in the insolvency regime. The court, responding to an application by the Secretary of State for Education, appoints an education administrator who has a legally defined 'special objective' to avoid or minimise disruption to the studies of existing students, through means including:

- rescuing the college as a going concern;
- transferring some or all of the college's undertakings to another body;
- keeping the college going until existing students have completed their studies; or
- arranging for existing students to complete their studies at another institution.

3.33 Two colleges entered education administration within seven months of the insolvency regime being introduced:

- Hadlow College, a specialist land-based college in Kent. In January 2019, the college was referred for FE Commissioner intervention. The college principal, deputy principal and several board members subsequently resigned. The college was placed in education administration in May 2019.
- West Kent and Ashford College, also part of the Hadlow College Group. The college was subject to intervention by the FE Commissioner in February 2019, leading to the resignation of the college principal, deputy principal and several board members. It entered education administration in August 2019, after requesting the process to improve its prospects of long-term sustainability.

3.34 In both cases, the High Court of Justice appointed partners from BDO LLP as the education administrators. The FE Commissioner reviewed both cases and concluded there was a need for continued provision in the area. The education administrators therefore began to negotiate with local organisations that might take on elements of the insolvent colleges' provision. The ESFA also considered whether the colleges might exit insolvency by making voluntary agreements with creditors.

3.35 Ofsted visited both colleges during the education administration process and found they were making reasonable progress with regard to educational performance. In June 2019, it carried out a monitoring visit to Hadlow College, having graded it as outstanding at its previous inspection in June 2010. In September 2019, it carried out a monitoring visit to West Kent and Ashford College, having graded it as requires improvement at its previous inspection in October 2018.

3.36 In August 2020, the education administrators finalised arrangements to transfer all learners from Hadlow College and West Kent and Ashford College to three local providers. Work continued on other aspects of the process.

3.37 Between April 2019 and May 2020, the ESFA spent £41.8 million dealing with colleges in, or close to, education administration (**Figure 10** overleaf). It spent most of this amount (£26.6 million) on the two insolvency cases, although it expects to receive some money from the sale of assets no longer required for educational provision. It also provided emergency funding to five colleges in serious financial difficulty that it decided to handle outside the insolvency regime. 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.

Figure 10

Gross spending on the insolvency regime and associated activities, April 2019 to May 2020

The Education and Skills Funding Agency spent £41.8 million, mainly on the two insolvency cases

Activity	**Spending (£m)**	**Spending (£m)**
Handling the two insolvency cases:		
Financial support relating to secured creditors	18.1	
Emergency funding	5.0	
Payments to cover education administrator fees	2.3	
Solution funding	1.3	26.6
Emergency funding for five other colleges in serious financial difficulty		14.4
Independent business reviews to provide advice on solutions to financial problems		0.8
Total		**41.8**

Notes

1 The Education and Skills Funding Agency expects to receive some money from the sale of assets no longer required for educational provision, so net spending on the two insolvency cases is likely to be lower than the gross spending presented in the table.

2 Individual amounts may not sum precisely due to rounding.

Source: Education and Skills Funding Agency

Appendix One

Our audit approach

1 This report examines whether the Department for Education (the Department) is responding effectively to the financial sustainability challenges that colleges are facing. The report covers further education (FE) colleges and sixth-form colleges. It provides an update on developments since we reported on the financial sustainability of the FE sector in 2015.[30] The report examines:

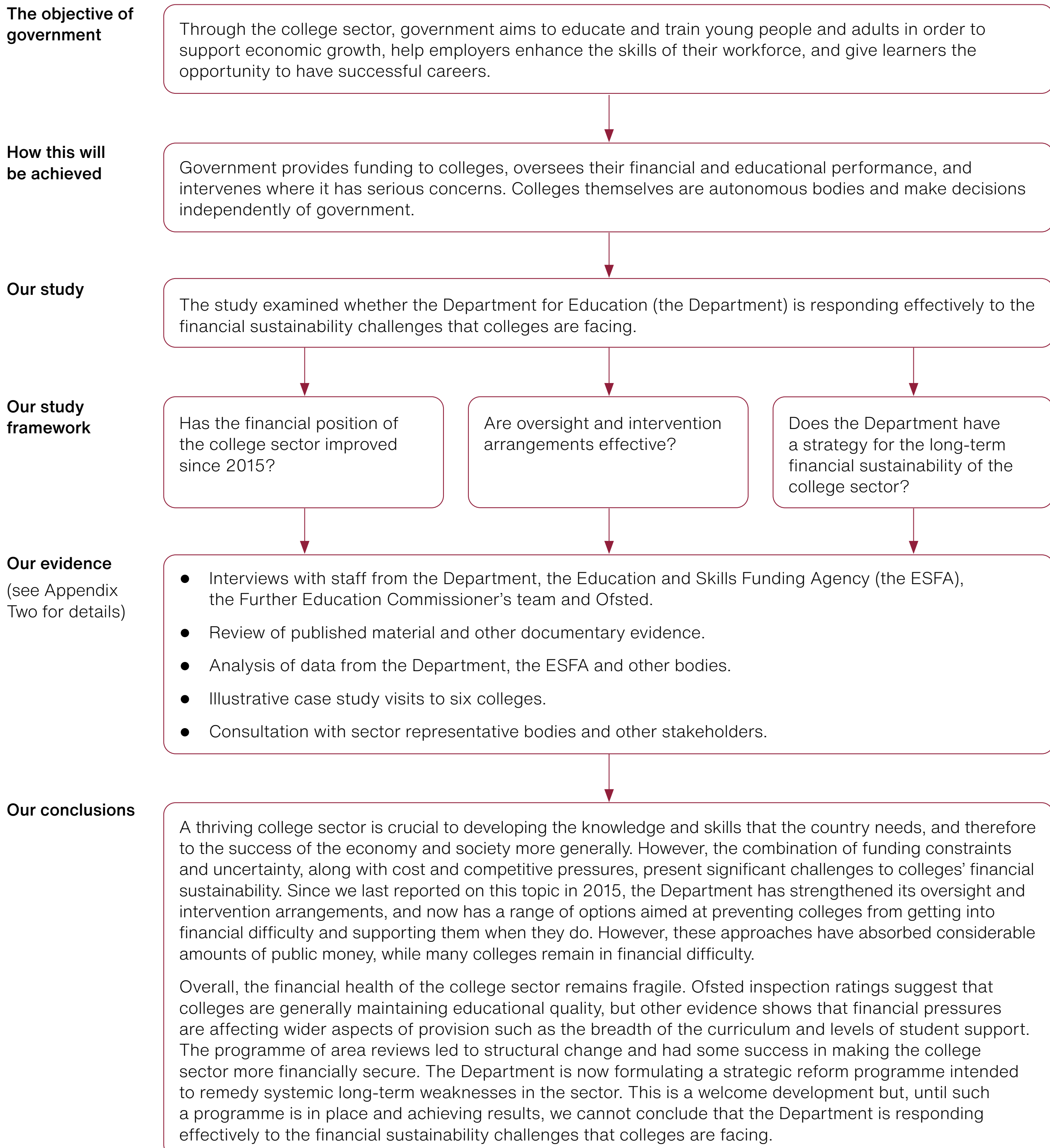
- the financial health of the college sector; and
- the effectiveness of the oversight and intervention arrangements.

2 We applied an analytical framework with evaluative criteria, which considered what arrangements would be optimal for achieving value for money. 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, free to make decisions about their operations and finances. For the Department to achieve value for money, the college sector needs to be financially sustainable and delivering high-quality provision, and the oversight and intervention arrangements need to be effective, in relation to both individual colleges and the sector as a whole.

3 Our audit approach is summarised in **Figure 11** overleaf. Our evidence base is described in Appendix Two.

30 Comptroller and Auditor General, *Overseeing financial sustainability in the further education sector*, Session 2015-16, HC 270, National Audit Office, July 2015.

Figure 11
Our audit approach



Appendix Two

Our evidence base

1 We reached our independent conclusions on whether the Department for Education (the Department) is responding effectively to the financial sustainability challenges that colleges are facing, after analysing evidence collected between November 2019 and August 2020. Our audit approach is outlined in Appendix One.

2 Our report covers the college sector in England, including: general further education (FE) colleges; specialist FE colleges, which deliver courses in topics such as agriculture, art and design, and the performing arts; and sixth-form colleges.

3 In designing and carrying out our work, we took account of previous National Audit Office reports on financial sustainability in various sectors. These included our 2015 report on the oversight of financial sustainability in the FE sector,[31] and the subsequent Committee of Public Accounts report.[32]

4 We used accounts data from the 2013/14 college financial year (the latest year covered by our 2015 report) through to 2018/19 (the most up-to-date data available).

5 **We interviewed staff from the Department, the Education and Skills Funding Agency (the ESFA), the FE Commissioner's team and Ofsted.** The people we interviewed at the Department included those responsible for funding policy and strategy in the FE sector. The ESFA staff we interviewed included those responsible for monitoring and intervening in colleges, including providing additional financial support and implementing the college insolvency regime. We interviewed the FE Commissioner and some of his deputies who had particular expertise in finance matters. We spoke to senior staff at Ofsted who were responsible for national oversight of FE provider inspections.

31 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.

32 HC Committee of Public Accounts, *Overseeing financial sustainability in the further education sector*, Thirteenth Report of Session 2015-16, HC 414, December 2015.

6 **We reviewed published and unpublished documents from the Department and the ESFA.** We used this information to understand how these bodies exercise their funding and oversight responsibilities, and the results of recent initiatives. These documents included material relating to:

- funding policy;
- detailed funding arrangements;
- monitoring and intervention arrangements;
- FE Commissioner reports;
- the area review programme;
- the college insolvency regime; and
- the emerging strategy for the sector.

7 **We analysed a range of financial and demographic data:**

- College financial returns and accounts. We used these data to analyse trends in the financial position of the sector, with regard to factors such as surpluses and deficits, borrowing and cashflow. In some years, the accounts for a small number of colleges are missing from the published dataset, usually because of late submissions to the ESFA. In 2018/19, accounts were missing for five of 247 colleges.
- Departmental data on the funding allocated to colleges for: 16–19 learners; adult education; and apprenticeships provision.
- Departmental data on student numbers, and the demographic characteristics of learners in the college sector. These included data provided by the ESFA on the number of full-time and part-time learners, and the full-time equivalent number of learners attending each college in each year, based on the data in individualised learner records.
- The ESFA's financial health ratings. We used these ratings to present the ESFA's assessment of colleges' financial health over time. Where colleges' accounts are missing from the published dataset, their financial health ratings may also be missing from our analysis.
- The ESFA's records of which colleges have been in early or formal intervention and for how long.
- Records of the sums given to colleges in the form of exceptional financial support, and restructuring funding associated with the area review programme.
- Ofsted data on the outcomes of its inspections of colleges. We used these data to indicate the quality of provision.

8 **We carried out illustrative case study visits to six colleges.** We selected the colleges to cover a range of regions, size, financial health history and experience of intervention by the ESFA or the FE Commissioner. The sample was not designed to be representative of the full population of colleges. During the visits, we interviewed leadership team members and governors, in order to understand their views on issues such as funding practices, cost pressures and the effectiveness of oversight and intervention arrangements. The colleges we visited were:

- Blackburn College, a general FE college;
- Moulton College, a specialist land-based college in Northamptonshire;
- New City College, a general FE college in London;[33]
- Queen Elizabeth Sixth Form College in Darlington;
- South Essex College, a general FE college; and
- Wiltshire College & University Centre, a general FE college.

9 **We interviewed a commercial lender to, and external auditors of, colleges.** These interviews provided additional information on the financial health of the sector, and the impact of recent government initiatives. The bodies we interviewed were:

- Barclays Bank;
- Mazars; and
- RSM UK.

10 **We invited stakeholders to respond to a consultation exercise.** We asked stakeholders for their views, and any supporting evidence they had, on the following issues:

- the main factors that had affected colleges' financial health, and the impact of these factors;
- the roles and responsibilities of oversight bodies;
- the effectiveness of monitoring and intervention;
- the impact of the area review programme; and
- the extent to which the Department had a vision for the college sector.

33 We were not able to visit New City College in person because of the COVID-19 pandemic, so we spoke to senior leaders from the college by telephone.

11 We met, or received formal consultation responses from:

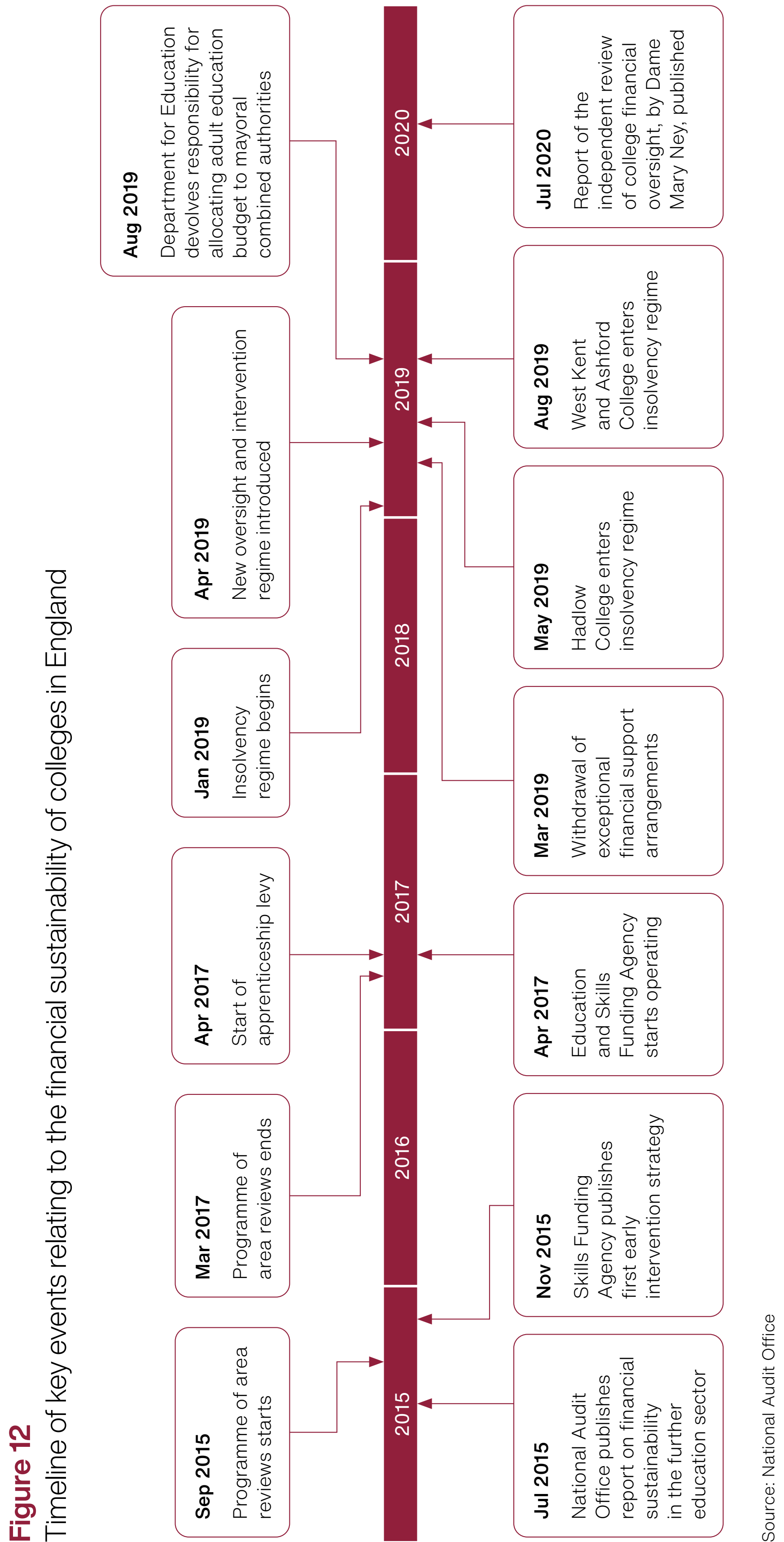
- the Association of Colleges, including members of its college finance directors' group;
- the Association of Employment and Learning Providers;
- the Association of School and College Leaders;
- the Education & Training Foundation;
- HOLEX, a professional body for adult community education and learning;
- the Local Enterprise Partnership Network;
- Dame Mary Ney DBE, who conducted an independent review in 2019 of how the government monitors colleges' finances and financial management;
- the Sixth Form Colleges Association; and
- West Suffolk College.

Appendix Three

Timeline of key events relating to the financial sustainability of colleges in England

1 See **Figure 12** overleaf.

Figure 12
Timeline of key events relating to the financial sustainability of colleges in England



Source: National Audit Office

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