Financial sustainability and governance of the college sector: Analysis of the 2020-21 annual accounts

- To summarise the college sector's financial results for 2020-21 and to update our assessment of colleges' financial sustainability and governance.

Recommendations

- To discuss and comment on the Council executive's assessment of:

- The 2020-21 annual accounts.
- Colleges' financial sustainability and governance.
- Colleges' compliance with the fundable body criteria.

Financial implications

- There are no specific programme fund or running cost implications arising from this paper that are not already allowed for in the Council's programme fund or running cost budget.

Financial sustainability and governance of the college sector: Analysis of the 2020-21 annual accounts

Purpose

1. To summarise the college sector's financial results for 2020-21 and to update our assessment of colleges' financial sustainability and governance.

Background

2. Colleges make the following financial returns to the Scottish Funding Council (SFC) in the course of the year:

- Financial Forecast Return (FFR), normally submitted at the end of June, comprising an outturn forecast for the current Academic Year (AY) and forecasts for the following five years;

- Mid-Year Return (MYR), enables continued monitoring of the forecast outturn for the current AY by drawing comparisons with the original FFR provided in the previous year;

- Annual accounts, submitted at the end of December, comprising the audited financial statements and supporting reports by the college's audit committee, internal and external auditors (also on an AY basis);

- Monthly cash flow returns (incorporated colleges only) for Scottish Government budgeting and accounting requirements; and

- Colleges experiencing heightened challenges to their ongoing sustainability also provide quarterly and monthly returns.

The following 5 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{5x paragraphs}

3. It should be noted that, at the time of writing this report, final sets of 2020-21 accounts and associated audit reports had not been received from three colleges.

The following paragraph is withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{1x paragraph}

4. We have received draft results for the above colleges which are reflected in this paper and it is not anticipated that the final results will be materially different.

5. All sector totals include incorporated colleges, non-incorporated colleges and Glasgow Colleges' Regional Board (GCRB).

Analysis of 2020-21 Annual Accounts

6. The financial sustainability and governance analysis is based upon a review of:

- The audited financial statements for 2020-21, including corporate governance statements; and
- Issues raised in external auditors' management letters, internal auditors' annual reports to audit committees and the annual report of audit committees to governing bodies, which may impact on colleges' ability to maintain or achieve financial sustainability.

Adjusted operating position

7. The return includes an adjusted operating position section. The methodology for calculating the adjusted operating position, or underlying operating position, has been agreed following sector consultation with a view to ensuring consistency of approach and interpretation of colleges' financial performance.

8. Depreciation and pension adjustments (non-cash items that are beyond a college's immediate control) account for most of the difference between the operating position and the adjusted operating position. Incorporated colleges receive a 'non-cash' budget to cover depreciation but this additional budget is not recognised under the FE/HE Statement of Recommended Practice (SORP) accounting rules. Annually Managed Expenditure (AME) pension adjustments may also impact on the reported operating position. Consequently, we would expect to see operating deficits reported across the college sector.

9. The adjusted operating position is therefore intended to reflect the financial performance after allowing for non-cash adjustments and other material one-off or distorting items required by the SORP. The adjusted operating position is designed to smooth any volatility in reported results arising from the implementation of Financial Reporting Standard 102 and also to recognise that some of the reported costs do not have an immediate cash impact on the college. This should give a better indication of the college's operational cash generating capacity and a clearer picture of a college's short-term financial health.

Key messages

10. The key messages from the analysis are set out below:

- As a result of an additional one-off injection of £15 million SFC grant to address the challenges of the global pandemic, Coronavirus Job Retention

Scheme (CJRS) income of £9.5 million and lower staff and other operating costs, the sector adjusted operating position has improved against forecast with a surplus of £19.3 million being recorded during the year ending 31 July 2021. Three colleges reported adjusted operating deficits in 2020-21;

- The sector reported cash balances of £122.9 million at the end of July 2021. The cash position at the end of July 2021 is higher than previous forecasts due to a combination of the more favourable operating position and unspent balances of 'ring-fenced' SFC monies. It is expected that unspent 2020-21 funds will be spent or recovered during 2021-22. No college reported a negative cash position at the end of July 2021;

- As a result of additional funding from SFC and CJRS, and their own mitigating actions, colleges managed the impact of the COVID-19 pandemic more positively than anticipated during 2020-21 but the financial climate remains challenging, with the sector forecasting deficits over the next two years;

- While the additional funding made available to the college sector through COVID-19 support has helped to stabilise institutions' finances through the pandemic, it is important to note that this is non-recurring funding. One-off cost savings generated during 2020-21 will not be repeated and staff and other operating expenses are expected to increase reflecting a return to pre-COVID levels of activity with a return to full campus operations;

- Colleges remain heavily dependent on SFC grant funding which amounted to 79% of total income at a sector level in 2020-21; and

- The aggregated sector position masks varying degrees of challenges across all individual colleges.

Adjusted operating position

11. The sector adjusted operating position for the sector, both forecast and actual for 2020-21, and also including the previous year's result, is set out in the following table:

	2020-21 Actual £'000	**2019-20 Actual £'000**	**2020-21 Forecast £'000**
Adjusted Operating Surplus/(Deficit)	19,261	4,020	16,720

12. The sector's 2020-21 annual accounts show a sector adjusted operating surplus of £19.3 million which represents an improvement on the previous year's result (£4 million surplus) and is improved on the October 2021 forecast (£16.7 million deficit). The surplus is due to additional one-off injection of £15 million SFC grant to address the challenges of the global pandemic, Coronavirus Job Retention Scheme (CJRS) income of £9.5 million and lower staff and other operating costs, helping to mitigate against the reduction in commercial and international income. Three colleges reported an adjusted operating deficit in 2020-21.

The following 2 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{2x paragraphs}

Dependency on SFC grants

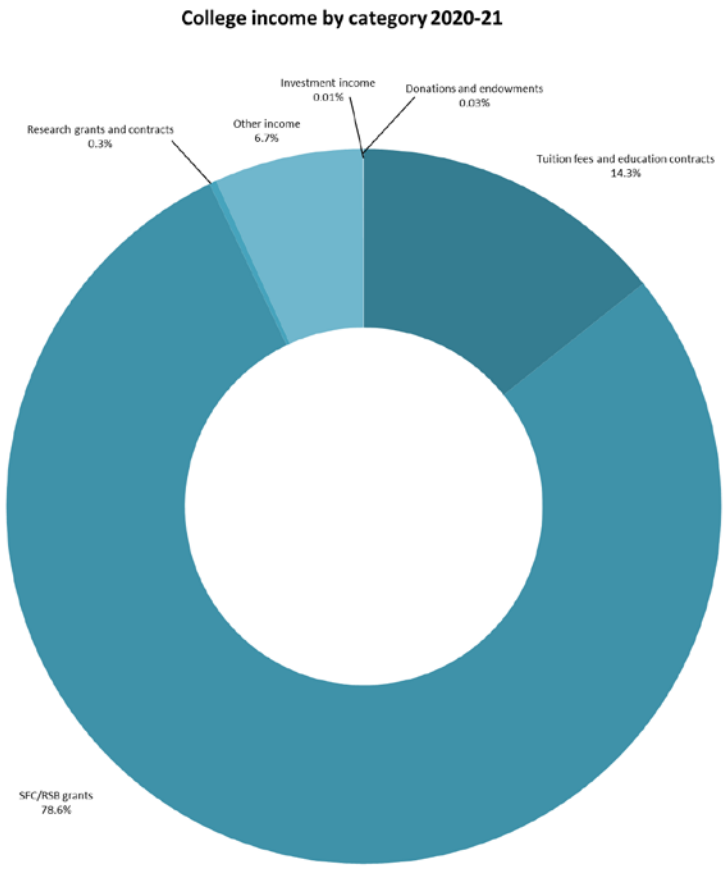
13. SFC grants accounted for 79% of total sector income in 2020-21. There is a large variation in grant dependency across the sector as illustrated in the table below:

Funding Council grants as % of total income	Actual 2020-21	Actual 2019-20	Forecast 2020-21
Lowest	51%	48%	53%
Average	76%	74%	76%
Highest	100%	87%	100%

The following paragraph is withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{1x paragraph}

14. Sources of income for the college sector, in 2020-21 are shown in the chart below:



15. Colleges benefited from non-recovery of SFC funds for COVID-19 related shortfalls against core activity targets during 2020-21. The 2020-21 results also reflect the additional SFC 2020-21 financial sustainability funding of £15 million, announced in March 2021, which was allocated to colleges in proportion to their respective main teaching grant allocations, recognising that all colleges were facing financial pressures. Conditions of the funding included supporting students in finishing their courses and achieving their qualifications, minimising deferrals, and enabling necessary organisational change to be implemented fairly and reasonably. In addition, a further c£300,000 was allocated to three colleges for income lost during 2020-21 in providing student accommodation rent rebates.

16. It is evident that the impact of the COVID-19 outbreak on colleges' financial sustainability has been significant during 2020-21. COVID-19 accounted for reductions of around £10 million in commercial income against 2019-20 levels even after taking account of Coronavirus Job Retention Scheme (CJRS) income of £9.5 million which helped to mitigate the reduction in this revenue stream. However, there are limited opportunities for colleges to generate commercial income, and surplus thereon, and as a result they are heavily dependent on SFC grant. Developing income streams has become more challenging as a

result of increases in staff costs following the implementation of National Bargaining harmonisation and job evaluation in recent years.

Staff and other operating costs

17. Staff costs represent the largest element of expenditure for colleges and constituted 70% of total sector costs in 2020-21.

The following paragraph is withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{1x paragraph}

The results reflect the cost pressures impacting on the college sector including increased employer contributions to pension schemes. Thirteen colleges spent £6.5 million on staff restructuring costs in 2020-21.

18. Many colleges operated a freeze on non-essential recruitment during 2020-21 but this represented a one-off saving and staff costs are expected to increase as vacancies are filled and activity returns to pre-COVID levels. Similarly, colleges generated significant non-staff cost efficiencies (academic materials and consumables; utilities; property costs; photocopying; and travel and subsistence) during the year but these too are expected to increase with a return to full campus operations.

Cash balances

19. Colleges' cash and equivalent balances increased from £73.3 million in 2019-20 to £122.9 million in 2020-21 due to a combination of the more favourable operating position and unspent balances of 'ring-fenced' SFC monies, some of which relate to additional funding provided during the pandemic. This included colleges placing on hold capital works because of restrictions enforced through the COVID-19 lockdown and unspent student support funds. It is expected that unspent 2020-21 funds will be spent or recovered during 2021-22.

The following 3 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{3x paragraphs}

20. No college reported a negative cash position at the end of July.

The following paragraph is withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{1x paragraph}

Net cash inflow from operations

21. This measure provides an indication of the financial health of an institution in terms of its day-to-day operations, as it does not include any items of non-cash expenditure (such as depreciation, amortisation and, most importantly, adjustments for pension liabilities), or income from and expenditure on financing activities.

22. None of the colleges reported a negative net cash inflow from operating activities during 2020-21 which was an improvement on forecast (one college) and an improvement on 2019-20.

The following paragraph is withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{1x paragraph}

23. Across all colleges, the net cash inflow from operating activities as a proportion of total income moved from 6% in 2019-20 to 11% in 2020-21.

Borrowing

24. Total long-term borrowing (including NPD/PFI commitments) for incorporated colleges decreased from £254.5 million at the end of July 2020 to £244.1 million by the end of July 2021. Excluding NPD/PFI commitments, total borrowing decreased from £29.1 million to £26.8 million over the same period. Fifteen colleges reported outstanding borrowing at the end of July 2021 and no college reported any breach of bank covenants in 2020-21. Capital expenditure amounted to £22.8 million during 2020-21.

Pension liabilities

25. The vast majority of college staff belong to one of two pension schemes, the Scottish Teachers Superannuation Scheme (STSS) or the relevant Local Government Pension Scheme (LGPS). The STSS is a notional fund and so colleges are unable to identify and report their share of the underlying assets and liabilities. Pension liabilities reported in colleges' financial statements

therefore relate to the LGPS multi-employer defined benefit schemes. Pension liabilities decreased during the year due to a partial recovery from the economic downturn brought about by the pandemic. The overall sector liability moved from £468.0 million at the end of July 2020 to £354.5 million by the end of July 2021.

Trend analysis

26. The sector has recorded an overall adjusted operating surplus in each of the last four years. The methodology for the calculation of the adjusted operating position changed with effect from 2017-18 so it is not possible for the trend analysis to cover a longer timeframe on a like for like basis. The sector surplus of £19.3 million for 2020-21 was substantially higher than those recorded in previous years with colleges benefiting from additional SFC grant, CJRS income and non-recovery of SFC funds for COVID-19 related shortfalls against core activity targets. Five colleges recorded a deficit during 2017-18, increasing to eight colleges in each of 2018-19 and 2019-20 before reducing to three colleges in 2020-21. Five colleges reported deficits in more than one year, three of which were non-incorporated colleges.

27. Colleges' cash balances have increased substantially each year from £45.4 million at the end of July 2018 to £122.9 million by the end of July 2021. It should be noted that cash balances were inflated in 2020-21 and to a lesser extent in 2019-20 due to unspent SFC ring-fenced funds and it is expected that balances will reduce during 2021-22 as these funds are either spent or returned to SFC. Only one college reported a negative cash balance during the period under review.

28. Sector borrowing has reduced steadily over the four-year period reducing from £278.5 million at the end of July 2018 to £244.1 million at the end of July 2021. Three colleges' NPD/PFI commitments account for the vast majority of sector borrowing. Excluding these commitments, borrowing reduced from £39.3 million at the end of July 2018 to £26.8 million by the end of July 2021.

<u>The following 7 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.</u>

{7x paragraphs}

Sector governance

29. An assessment has been undertaken of overall governance in the sector based on the corporate governance statements within the annual report and accounts and any supporting audits undertaken during the year of colleges' compliance with the 2016 Code of Good Governance for Scotland's Colleges (the Code).

30. SFC considers that any departures from the Code need to be explained and justified by colleges. Twenty two colleges had provided final versions of their corporate governance statements, as part of their annual report and accounts, at the time of writing this report. Based on the returns provided to date, four colleges provided such an explanation for departures from the Code during 2020-21.

31. Our overall assessment of the governance in the sector, based on the evidence set out above, is generally good.

Fundable body criteria

32. Section 7 of the Further and Higher Education (Scotland) Act 2005 lists the criteria which the Council must consider in relation to proposing or approving any modification to the list of fundable bodies contained in Schedule 2 of the Act and requires the Council to ensure that the bodies listed on Schedule 2 meet the criteria at all times.

33. The Council's executive undertakes an annual review of all colleges listed in Schedule 2 taking evidence from existing sources to minimise any additional burden on institutions. Our 'test' with regard to each criterion is to confirm that there was no evidence from the identified sources that indicates that the criterion was not being met in all material respects.

34. On the basis of the financial returns and audit reports received to date, there was no evidence from the identified sources that indicate that the fundable body criteria were not being met.

The following 2 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{2x paragraphs}

Next steps

35. Work is ongoing to finalise funding allocations for Academic Year 2022-23 and it is anticipated that indicative allocations will be announced in late March with the final allocations being announced towards the end of May. Work is also continuing on the longer-term Spending Review. SFC does not have any information on future years' budgets beyond 2022-23 and will continue to provide advice to Scottish Government on the financial sustainability of the sector and engage appropriately in the Spending Review process.

36. SFC will also continue to liaise closely with particularly vulnerable colleges in addressing financial sustainability challenges. In the first instance, we will ensure that all colleges have sufficient cash to meet their liabilities. SFC will work closely with colleges and, where relevant, Regional Strategic Bodies to ensure that they remain on a sustainable trajectory.

37. Colleges are continuing to provide SFC with regular financial updates. Mid-Year Returns (MYRs) are due to be provided at the end of March which will provide an update on the forecast for the current Academic Year. We will also issue further Calls for Information nearer the summer to request colleges' financial forecasts covering the outturn forecast for the current Academic Year 2021-22 and forecasts for the following five years.

38. Colleges' MYRs, along with additional financial returns over the coming months, will continue to further develop our understanding of the financial health of individual colleges and the overall sector and enable provision of further advice to Scottish Government.

The following 7 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

{7x paragraphs}

Key risks

39. In preparing the financial returns, colleges identified a number of risks that could adversely affect their financial performance and sustainability. The most significant risk areas for colleges relate to:

- Increasing staff costs arising from cost of living pay awards, increases in employer contributions to pension schemes and national insurance, and the outcome of the National Bargaining job evaluation exercise for support staff.

- Inflationary pressures will put significant added pressure on the ability of colleges to continue to deliver similar levels of activity without an increase in funding.

- The continued impact of the COVID-19 pandemic including the potential consequential failure to achieve student activity and other income targets;

- Maintaining short-term liquidity;

- Changes to the SFC funding model and colleges' ability to deliver regional outcome agreements and Government priorities;

- The impact of cost efficiencies, including reduced staff numbers and frontline student services, on both the quality of student experience, student outcomes, and on the health and wellbeing of college staff;

- Future arrangements for funding Foundation Apprenticeships;

- The requirement for colleges to self-fund the cost of staff restructuring programmes while not being able to hold reserves.

- The uncertainty of the UK Government's policies designed to mitigate the effects of leaving the EU, in particular the development of the Shared Prosperity Fund;

- Addressing the increasing level of backlog estates maintenance and ICT/digital requirements to deliver a 21st century learning and teaching environment;

- Challenges of diversifying income due to increased competition from external providers reducing colleges' ability to generate commercial surpluses; and

- Delivering against multiple funding streams and programme requirements.

Risk assessment

40. There is a risk to the achievement of the Council's strategic plan priorities and/or a risk of reputational damage from failures in college and university governance, leadership and management, including financial failure.

    The following 7 paragraphs are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.

    {7x paragraphs}

Equality and diversity assessment

41. There are no equality and diversity issues associated with this paper.

Recommendations

42. To discuss and comment on the Council executive's assessment of:

- the 2020-21 annual accounts;
- colleges' financial sustainability and governance; and
- colleges' compliance with the fundable body criteria.

Financial implications

43. There are no specific programme fund or running cost implications arising from this paper that are not already allowed for in the Council's programme fund or running cost budgets.

Publication

44. This paper will be published on the Council website in edited format (to remove references to specific institutions or forecast information which, if disclosed, would be likely to prejudice 'substantially' the commercial interests of a person, company or a public authority (Freedom of Information (Scotland) Act 2002, Section 33).

Further information

45. Contact Claire Taylor, Senior Financial Analyst (tel: 0131 313 6604, email: ctaylor@sfc.ac.uk).or Andrew Millar, Assistant Director (tel: 0131 313 6538, email: amillar@sfc.ac.uk).

Annexes A-E are withheld from publication on the Council website under the Freedom of Information (Scotland) Act 2002, section 30, Prejudicial to the effective conduct of public affairs.