Financial sustainability and governance of the college sector: Analysis of the Mid-Year Returns for Academic Year 2021-22

1. To summarise the Council executive's analysis of colleges' Mid-Year Returns for Academic Year 2021-22 and to update our assessment of colleges' financial sustainability and governance.

Recommendations

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

- the Mid-Year Returns for Academic Year 2021-22; and
- colleges' financial sustainability and governance.

Financial implications

3. 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.

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Purpose

1. To summarise the Council executive's analysis of colleges' Mid-Year Returns for Academic Year (AY) 2021-22 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):

- Interim Financial Forecast Return (FFR). The interim FFR is normally submitted at the end of June, comprising an outturn forecast for the current AY and forecast for the following year;

- Mid-Year Return, submitted at the end of March for continued monitoring of the forecast outturn for the current AY;

- Final Financial Forecast Return (FFR); The final FFR is normally submitted at the end of September comprising an outturn forecast for the AY just ended and forecasts for the following five years:

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

- Monthly cash flow returns (incorporated colleges only) for Scottish Government budgeting and accounting requirements on a Financial Year basis; and

- Quarterly and monthly returns for colleges experiencing heightened challenges to their ongoing sustainability.

Structure of paper

3. There are two annexes that support the main section:

- **Annex A:** Summary of colleges' 2021-22 financial forecast position; and

- **Annex B:** {1x paragraph}

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

Analysis of 2021-22 Mid-Year Returns

5. Colleges provided a Mid-Year Return (MYR) financial forecast at the end of March 2022 for continued monitoring of the forecast outturn for the current AY.

Adjusted operating position

6. The adjusted operating position, or underlying operating position, reflects the financial performance of colleges after allowing for non-cash adjustments and other material one-off or distorting items required by the FE/HE Statement of Recommended Practice (SORP). It is designed to smooth any volatility in reported results arising from the implementation of Financial Reporting Standard 102 and to recognise that some of the reported costs do not have an immediate cash impact on the college. This gives a better indication of the college's operational cash generating capacity and a clearer picture of a college's short-term financial health.

7. The methodology for calculating the adjusted operating position has been agreed following sector consultation to ensure consistency of approach to 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 SORP accounting rules. Annually Managed Expenditure (AME)[1] pension adjustments may also impact on the reported operating position. Consequently, we would expect to see operating deficits reported across the college sector.

Key findings

9. The key messages from the analysis of the MYRs are set out below:

- The sector **adjusted operating position** shows a deficit of £8.3m for AY 2021-22; a worsening from the original FFR (£5.7m deficit).

  Many colleges do not expect to achieve student activity and other income targets and have factored in recovery of SFC grant into their latest forecast. Savings in staff and other operational costs have failed to offset

[1] Annually Managed Expenditure is spending included in departmental budgets but which is difficult to predict, manage or forecast, so, is not subject to multi-year spending limits set in Spending Reviews.

the reduction in SFC grant and the fall in income from tuition fees and education contracts.

Fourteen colleges are forecasting an adjusted operating deficit for the current AY;

- The sector held **cash balances** of £122.9m at the end of July 2021.

  These balances were inflated by unspent balances of SFC 'ring-fenced' grants and cash reserves are forecast to reduce to £75.2m by the end of July 2022 as the 'ring-fenced' grants are either spent or returned to SFC.

  The projected fall in cash balances also reflects the weak operating position.

  {2x paragraphs}

  Sector borrowing remains in line with forecast.

- The **financial climate** for the college sector remains extremely tough. It is evident that colleges are finding it increasingly challenging to achieve student activity and other income targets in the context of the continued impact of the pandemic.

  Colleges have highlighted that the rising cost of living is increasing pressures in relation to pay settlements and running costs. Energy costs are expected to increase sharply while inflationary cost pressures are also impacting capital projects.

  Colleges have indicated that non-staff cost efficiencies have been exhausted and their only option to reduce the cost base and maintain financial sustainability is to restructure their staffing. However, staff reductions will have operational impacts in terms of student outcomes, the quality of student experience and on the health and wellbeing of remaining staff.

Adjusted operating position

10. The overall adjusted operating position for the college sector is a deficit of £8.5m for AY 2021-22. This represents a downturn on the original forecast (£5.7m deficit) and is largely due to a forecast reduction of £11m in SFC grant. Many colleges have assumed recovery of SFC grant as a result of anticipated shortfalls against student activity and other income targets. Overall income from tuition fees and education contracts is also £1.6m lower than FFR projections though a small increase in other grant and commercial income is anticipated.

11. A full return to campus operations has been disrupted by the outbreak of the new COVID variant mid-way through the AY and while there have been reductions in staff costs (£2.3m) and other operating costs (£6.4m) against the FFR projections, these savings have not been sufficient to offset the reduction in SFC grant and lower income from tuition fees and education contracts. Staff restructuring costs of £2.8m (across nine colleges) are projected in the current AY, in line with the original forecast.

12. Fourteen colleges are forecasting an adjusted operating deficit based on the latest returns (FFR: twelve colleges). Across the sector, thirteen colleges are showing an improved position and thirteen a deteriorating position, with one unchanged. Seven colleges are reporting a worsening in excess of £0.5m of their adjusted operating position.

13. The College sector has reported adjusted operating surpluses for the last four years and the current AY forecast represents a sharp decline against the 2020-21 result (£19.3m adjusted operating surplus inclusive of additional financial sustainability funding of £15m and Coronavirus Job Retention Scheme income of £9.5m). However, the 2021-22 funding allocation includes additional COVID-related 'consequentials' of £28.2m in the form of one-off funds.

Balance sheet

14. The sector held cash balances of £122.9m at the end of July 2021. These balances were inflated by unspent balances of SFC 'ring-fenced' grants and cash reserves are forecast to reduce to £75.2m by the end of July 2022 as the 'ring-fenced' grants are either spent or returned to SFC. The projected fall in cash balances also reflects the weak operating position. It should be noted that capital spend in 2021-22 is expected to be higher than FFR projections.

{5x paragraphs}

15. Total borrowing is expected to decrease from £244.1m at the end of July 2021 to £232.1m (28% of total income) by the end of July 2022, in line with forecast. Excluding NPD/PFI commitments, total borrowing is relatively low and is expected to decrease from £26.8m to £23.5m (3% of total income) over the same period. No college has reported any breach of bank covenants during the current AY.

Cash inflow from operating activities

16. Net cash inflow from operating activities is an important measure for 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. It shows an institution's ability to generate sufficient cash to repay debt and for estates investment.

17. Based on the latest returns, eighteen colleges are forecasting negative net cash inflow from operating activities (FFR: nineteen colleges). Across all colleges, the sector net cash inflow from operating activities is forecast at -£10.7m (-1.3% of total income) for AY 2021-22 reflecting the weak sectoral operating position.

18. The movements against the FFR for the adjusted operating position, cash and borrowing, by college, are shown in **Annex A**.

Next steps

19. Colleges continue to provide SFC with regular financial updates. Following the recent publication of the final 2022-23 funding allocations, colleges have been asked to provide an interim FFR (covering updated forecasts for AY 2021-22 and AY 2022-23) by the end of June 2022.

20. Colleges will also be asked to provide a final FFR, covering the outturn for AY 2021-22 and forecasts for the following five years, by the end of September 2022. Planning guidance provided with the request for this return will reflect the outcome of the longer-term Spending Review. These financial returns are continuing to develop our understanding of the financial health of individual colleges and the overall sector enabling the provision of advice to Scottish Government.

21. SFC works closely with individual colleges to understand the risks of non-delivery against student activity targets in the current AY. We wrote to college Principals on 21 March 2022 setting out our approach to:
    a. Continued support to colleges in providing a supportive environment to enable students to succeed (including additional flexibilities to SFC's 2021-22 credit guidance);
    b. SFC's in-year redistribution process; and
    c. SFC process for managing potential recovery of funds where activity targets have not been met.

22. SFC will scrutinise the individual circumstances of colleges before deciding on the most appropriate action for those colleges unable to meet core targets (even with the additional flexibilities).

23. SFC will 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.

{6x paragraphs}

Key risks

24. The colleges' financial returns identified a number of risks that could adversely affect their financial performance and sustainability as well as ability to achieve student activity and other income targets. The most significant risk areas for colleges relate to:

- Increasing staff costs due to 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;

- The continued impact of the COVID-19 pandemic;

- Changes to the SFC funding model;

- 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

25. 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.

26. Overall, for the college sector, the Executive's assessment of this risk is very high.

Equality and diversity assessment

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

Recommendations

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

    - the Mid-Year Returns for Academic Year 2021-22; and
    - colleges' financial sustainability and governance.

Financial implications

29. 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

30. This paper will be published on the Council website in edited format (to remove references to specific institutions or forecast information) as it includes 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

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