FINANCIAL SUSTAINABILITY OF THE COLLEGE SECTOR: ANALYSIS OF 2023 FINANCIAL FORECAST RETURNS

PURPOSE

1. The purpose of this paper is to report on the current financial sustainability of the college sector based on an analysis of the 2023 Financial Forecast Returns covering the years 2022-23 to 2025-26. The forecasts were received at the end of June 2023.

RECOMMENDATIONS

2. The Finance Committee is invited to note and comment on the update on the college sector's 2023 Financial Forecast Returns and the updated assessment of colleges' financial sustainability.

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.

RISK ASSESSMENT

4. 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 governance, leadership, and management, including financial failure.

5. This risk is mitigated by regular monitoring of colleges. Any colleges facing heightened challenges to their sustainability are subject to a higher level of engagement.

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

IMPACT ASSESSMENTS

Equality and diversity

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

Island communities

8. The paper discusses the financial sustainability of island colleges but makes no recommendations in relation to them.

Carbon reduction

9. There are no carbon reduction issues associated with this paper.

PUBLICATION

10. 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 prejudicial to the effective conduct of public affairs (Freedom of Information (Scotland) Act 2002, Section 30).

FURTHER INFORMATION

11. Contact: Andrew Millar, Assistant Director, Institutional Sustainability and Governance, or Peter Ward, Senior Financial Analyst.

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BACKGROUND

13. Colleges submit the following financial returns to the Scottish Funding Council (SFC) during the academic year (AY):

- Mid-Year Return (MYR) at the end of March for continued monitoring of the forecast outturn for the current AY;
- Financial Forecast Return (FFR) at the end of June, comprising an outturn forecast for the current AY and forecasts for the following three AYs;
- Annual accounts at the end of December, comprising the audited financial statements for the AY and supporting reports by the colleges' audit committees, 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 financial sustainability.

STRUCTURE OF PAPER

14. This paper comprises key messages, key risks, mitigating actions and next steps. The paper is supported by five annexes:

- **Annex A:** Detailed analysis of 2023 Financial Forecast Returns;
- **Annex B:** Provisional college and regional strategic body performance against 2022-23 credit targets;

- **Annex C:** Summary of colleges' adjusted operating position, liquidity and borrowing;

- **Annex D:** Engagement framework including rationale for the categorisation of colleges' engagement assessment and financial update; and

- **Annex E**: Planning assumptions used in Financial Forecast Returns

15. Sixteen colleges (64%) submitted their FFRs after the submission date of 30 June 2023. Eleven colleges (44%) returned their returns after 14 July (two weeks after the submission date) are listed below:

{2x paragraphs}

16. All sector totals include incorporated colleges, non-incorporated colleges and Glasgow Colleges' Regional Board (GCRB). For 2022-23, the individual colleges that make up the newly incorporated UHI North, West and Hebrides[1] are included as individual colleges. The forecasts from 2023-24 onwards are for UHI North, West and Hebrides alone.

KEY MESSAGES FROM OUR ANALYSIS OF COLLEGES' 2023 FINANCIAL FORECAST RETURNS

- **Colleges continue to operate in an extremely tight fiscal environment** alongside many challenges such as increasing staff costs (being the largest factor and are likely to remain a significant pressure as they constitute just under 70% of college spend), general inflationary pressures, high energy costs and rising interest rates impacting on loan repayments.

- **The financial position of colleges continues to deteriorate.** The sector is forecasting an adjusted operating deficit of £27.2m for 2022-23. While this is in line with the previous forecast provided at the end of March 2023, it represents a significant deterioration (477%) against the 2021-22 outturn (£7.2m surplus). This reflects flat cash in SFC grants and reduction in tuition fees not matched by the same level of reductions in costs. **Twenty-four colleges (92%) forecast adjusted operating deficits in 2022-23.**

- **Further substantial adjusted operating deficits are forecast over the remainder of the forecast period**. Seventeen colleges (68%) are forecasting adjusted operating deficits in 2023-24, reducing to thirteen colleges in both 2024-25 and 2025-26. **It is clear that many colleges are not sustainable on the basis of these forecasts**.

[1] Lews Castle College, North Highland College and West Highland College

- **Colleges remain highly dependent on SFC grant which is projected to be 78% of total income across all forecast years.** Due to forecasts of flat cash SFC grant, many colleges have highlighted that savings required to balance their operating position would have catastrophic impacts on curriculum delivery, students, staff and local communities. **Some colleges have reported that savings of that scale would not be achievable.**
- Staff costs remain the largest element of colleges' spending (just under 70% of total costs) and are the main focus of savings as colleges try to balance their budgets in the current fiscal environment. **The sector is forecasting staff restructuring costs of £13.2m in 2022-23 and £8.2m in 2023-24. Significant staff reductions of 2,387 FTEs are projected over the planning period, equating to the removal of 21% of FTE staff employed in the sector.** Staff reductions are expected to be achieved through a combination of vacancy management, voluntary severance schemes and compulsory redundancy. Compulsory redundancies of 154 FTE are projected over the forecast period.

  {1x paragraph}
- Sector cash balances are forecast to decrease by 103% on last year (from £141.4m to a cash deficit of £4.2m) by the end of July 2026, reflecting the weak operating positions. **There is an imminent risk of some colleges becoming insolvent in the coming months and six colleges are projecting cash deficits by the end of July 2026.** The projected deterioration in liquidity will make it increasingly challenging for SFC to manage cash advances and reprofiling of grant to ensure colleges have sufficient cash to manage their liabilities. It will also become increasingly difficult for colleges to self-fund staff restructuring activity and rebalance their cost base.
- As expected, borrowing is forecast to reduce from £232.2m at the end of July 2022 to £186.4m (19.7% reduction) by the end of July 2026. Most of the sector's borrowing is in the form of NPD/PFI commitments relating to three colleges. The borrowing figures exclude cash deficits projected by many colleges. **The weakening liquidity will increase the risk of a covenant breach and heighten the risk of colleges defaulting on debt repayments.**
- **Colleges' approaches to completing the FFRs are inconsistent.** Not all colleges have included restructuring activity and other mitigating actions to rebalance their operating position, and some have only included mitigation in the earlier years of the FFR. This means that the extent of restructuring reported in this paper may be understated. Some colleges have not provided detailed plans of how savings will be achieved.
- **The position beyond 2023-24 is uncertain until more guidance is provided by Scottish Government on future year allocations.** The assumptions used included

flat cash SFC grant, 3.5% annual pay awards in the latter years of the forecast and Office for Budget Responsibility (OBR) forecasts for inflation to non-staff costs (3%-5% p.a.) as per the Scottish Government's advice. **Several colleges have provided SFC with alternative scenarios based on more pessimistic planning assumptions which show an even greater deterioration in the sector's financial position.**

- **It is important to note that:**
  - **the sector is not homogeneous** and there continues to be variation between colleges in terms of financial performance that is not reflected in the aggregate indicators.
  - **the financial sustainability of the sector remains extremely fluid with assumptions being constantly updated as circumstances change.** The returns are forecasts and are not a guarantee of future performance and are highly likely to change over the planning period.
- Colleges are due to provide their annual accounts for 2022-23 at the end of December 2023 and our analysis of these returns will be reported to the Committee in early 2024.

KEY RISKS FOR COLLEGES

17. The colleges identified several risks in their returns which could adversely affect their financial health and 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 which are still to be negotiated, increases in employer contributions to pension schemes, and the outcome of the job evaluation exercise for support staff;
- **Difficulties in meeting activity thresholds** due to demographic impacts and prospective students securing employment or obtaining places at universities instead of going to college (see **Annex B** for update on current position), leading to changes to funded activity levels from 2023-24 onwards;
- **Uncertainty over funding recovery** due to the lower levels of recruitment across the sector and ongoing discussions with colleges around potential mitigations;
- **The requirement for colleges to self-fund the staff restructuring costs** could substantially diminish colleges' available cash balances following the withdrawal of £26m transformation funding;
- **Further unanticipated reductions in funding.** Further in-year reductions would put significant added pressure on colleges to maintain a sustainable trajectory;

- **Macro-economic outlook is still uncertain** with inflation reducing but remaining high by historic standards, and rising interest rates;
- **Rising energy costs** with the centrally negotiated contract for college energy costs ending across 2022-23 to 2023-24 with colleges moving onto a new contract. Changes to government support are also proposed for 2023-24 which are likely to make this support less generous;
- **The impact of cost efficiencies** (including reduced staff numbers, frontline student services and potential closure of campuses) on the quality of student experience, the health and wellbeing of college staff, and breadth and width of the curriculum offered to students;
- The impact of the outcome of the **Independent Review of Skills Delivery** and **Purpose and Principles** on the sector as the Scottish Government continues to develop its response;
- 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 **backlog estates maintenance and ICT/digital requirements** to deliver a 21st century learning and teaching requirement;
- The requirement for colleges to invest in the achievement of public sector **net zero targets** with the recent estimate of the costs of achieving net zero targets across the UK FE sector being £6.7bn[2];
- The impact of **reinforced autoclaved aerated concrete (RAAC)** on the college estate with potential building closures and expenditure required to make affected buildings safe for use;
- Challenges of diversifying income due to **increased competition** from external providers reducing colleges' ability to generate commercial surpluses; and
- Delivering against **fragmented funding streams** and programme requirements.

MITIGATING ACTIONS

18. Colleges remain heavily dependent on SFC grant and generating commercial income is very challenging for them in the current fiscal environment. This is mainly due to:

    - the challenges with pricing offers competitively against private sector providers with lower fixed cost bases;

[2] The Cost of Net Zero | EAUC

- cash reductions forecasts limiting the sector's ability to expand their offer which may require additional investment; and

- the lack of fiscal flexibilities to exploit further commercial opportunities.

19. Colleges have provided assurances that they are addressing the risk of not achieving student activity targets through undertaking scenario and contingency planning, proactive budget monitoring, effective curriculum planning and management, developing stronger partnerships (with schools, universities, employers and industry), increased marketing activity, implementation of business process improvement initiatives, and shift in delivery patterns.

20. From 2023-24, SFC has extended the following flexibilities to colleges to help limit their exposure to recovery of 2023-24 funding:

    - a reduced credit threshold while maintaining broadly the same level of funding as in 2022-23;
    - a 2% tolerance on the reduced credit threshold;
    - the alignment of the required date with universities for claiming credits; and
    - the decoupling of 20% of the value of credits to represent semi-fixed costs that colleges suffer.

21. Staff costs represent the largest element of college expenditure and are therefore the main focus of savings. Colleges have indicated that the capacity for the generation of non-staff cost savings is limited because of past actions to reduce costs and current inflationary pressures. Many colleges have raised the possibility of compulsory redundancies as their capacity to achieve savings via voluntary severance schemes becomes more limited. They have also highlighted that operational impacts of staff reductions are serious in terms of both reputation and impact on student outcomes (quality, retention and other performance indicators) and in relation to the mental health, morale and turnover of remaining staff. Other mitigating actions include curriculum reviews, not filling vacancies or removing posts, and freezing non-essential spend.

22. It is important that colleges continue to adapt to specific challenges and other uncertainties. Financial challenges will affect individual colleges differently and each college will have its own range of mitigating actions available. We expect colleges to be alert to the risks to their financial health and have contingency arrangements in place to address them. We encourage colleges to constantly review and consider the range of options available to them so they can take corrective action rapidly as and when risks begin to emerge.

NEXT STEPS

23. SFC does not have definitive information on future years' budgets beyond 2023-24. SFC will continue to provide advice to Scottish Government on the financial sustainability of the sector and engage appropriately in the Spending Review process.

24. Given continuing pressures on Scottish Government budgets, SFC may be asked to look for further in-year savings in college budgets with an adverse impact on the availability of funding to the sectors.

25. SFC will continue to engage closely with particularly vulnerable colleges in addressing financial health challenges. Colleges are continuing to provide SFC with regular financial updates. In the first instance, we will enhance monitoring of colleges' monthly cashflow forecasts to ensure that all colleges have sufficient cash to meet their liabilities. Colleges are also due to provide their annual accounts for 2022-23 at the end of December 2023 and our analysis of these returns will be reported to the Committee in early 2024.

RECOMMENDATIONS

26. The Finance Committee is invited to note and comment on the college sector's 2023 Financial Forecast Returns and the updated assessment of colleges' financial sustainability.

{Annex A-E}