

Local government

National report

Education funding

The impact and effectiveness of measures to stabilise school funding



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Summary

- 1 In spring 2003 the government was faced with the allegation by schools and councils that there was a major funding crisis for schools. Ministers, in turn, were concerned that councils may not have passed on to schools ('passported') the full funding increases in what they felt was a good settlement for councils. In response to the dispute, the Secretary of State announced measures designed to bring stability to schools' funding for 2004/05 and 2005/06 and to achieve earlier notification of budgets to schools. This report examines the background to the concerns that arose in 2003 and the impact of the measures designed to address them. It arises from a study undertaken before the publication on 8 July 2004 of the government's Five Year Strategy for Children and Learners, embracing a further announcement about future funding arrangements for schools. However, its main conclusions are unaffected by that announcement. Although the pledge of greater stability for school budgets over a three-year period is welcome, the new measures do not address all the concerns expressed in our report. Nor do they detract from the crucially important role that councils have in relation to schools funding and financial management, covering £24 billion of public funds annually.
- 2 There was a great deal of confusion around the preparation of school budgets for 2003/04. There was a late announcement of changes to major specific grants (particularly the Standards Fund), which were transferred to mainstream education funding. This was a major (although not the only) factor in causing the confusion. Although this transfer did not affect the overall level of funding available to schools, it did affect the distribution at school level, leaving some schools better off than expected and some with less funding than anticipated. The latter gave rise to concerns about potential redundancies among teachers and classroom assistants.
- 3 This study has looked at the experiences in a sample of 15 out of the 150 councils with education responsibilities in England. **It has five key findings:**
 - **There was not a widespread funding crisis in spring 2003. Government action was prompted by perception and assertion rather than accurate information.** In any financial year a number of schools will face individual financial difficulties. However, in responding to significant concerns expressed by many schools and councils, the government did not have reliable information about the state of school finances. Nowhere in the system, neither at government nor council level, is there reliable, consistent and up-to-date information about schools' budgets and financial positions. Forecasts made in spring 2003 that there would be significant reductions in overall school balances have not been realised.

- **There is no evidence from this review that councils failed to allocate to schools funding made available by the government.** Five of the councils in the study had been originally identified by the Department for Education and Skills (DfES) as not passporting in 2003/04. However, in three cases fieldwork has confirmed that this information was incorrect. Two of the fifteen councils in our study were unable to passport the funding for justifiable reasons. In none of the councils in the study did schools consider that the council was responsible for their perceived funding difficulties by failing to passport allocated funding to schools. All councils in the study intend to passport funding in 2004/05.
- **A minimum funding guarantee for schools and transitional funding for councils do not tackle areas of greatest need and represent an inefficient use of resources.** Even though our study has confirmed that some schools are significantly overspending their budgets, schools in most financial difficulty are not necessarily in the one-third of councils that are to benefit from transitional funding support. Such 'one size fits all' measures are inconsistent with the government's published principles of fair funding, which promote transparency, equity and consistency in the way in which schools should be funded. This approach also constrains councils from tackling funding inequalities within their areas. By specifically attempting to support schools in deficit or likely to go into deficit an unintentional message has been given to schools that working within a budget is not a priority.
- **The overall level of schools' unspent revenue balances is substantial and increasing. The growth of the size of surpluses is matched by increases in deficits.** Surpluses dominate the primary sector while deficits are much more frequent in secondary schools. However, the surplus balances in one-half of all primary and well over one-quarter of secondary schools now exceed the maximum levels suggested by DfES guidelines. In total, balances continue to exceed £1 billion. This represents an inefficient use of public money, which needs to be addressed. Delegated funding arrangements inevitably create the build up of a large number of discrete balances, and there is a tendency for surpluses to grow as a response to uncertainty about future funding.
- **The level of engagement with schools by councils on financial management, challenge, support, and intervention overall is inadequate.** Schools spend directly £24 billion¹. This represents one-third of the local government revenue budget. Councils are actively involved with schools in relation to their performance and improvement. But this is not the case in relation to schools' budgets and financial position. Councils have very limited up-to-date knowledge of the state of schools finances. They have responded to requirements in the past to delegate funding to schools and to support school autonomy. Government restrictions on centrally incurred education expenditure by councils have limited their capacity to fulfil the crucial role of monitoring, challenge, support, and intervention in relation to schools' budgets and financial management. This has been a false economy. The statutory Code of Practice on LEA-School relations has reinforced this distance between council and schools in relation to financial management. This limits public accountability for a significant proportion of public expenditure.

¹ Approximately £20 billion in planned budget shares and £4 billion through grants and standards fund.

4 School funding is a very complex area. The Audit Commission knows that there are no simple solutions to resolve difficulties. But there are changes to the present arrangements that we believe are necessary. Without action, schools' funding arrangements and financial positions will remain an area for which poor intelligence is available to councils and government. Policy decisions relating to schools funding will continue to be based on inadequate data and schools balances will represent an inefficient use of scarce resources. **We have three key recommendations.** These are not designed to reduce school autonomy. Schools with sound financial management will require minimal attention. But the new challenges arising from the integration of children's services, children's trusts and extended schools will make it even more important in the future that there is significantly improved use of intelligence and clearer accountabilities than at present.

- **Councils need to have robust, accurate and up-to-date information about the state of school budgets.** They should adopt a formal budget reporting structure to give an accurate indication of overall school spending within the financial year as well as at the outset and year end. The government in its announcement on 8 July 2004 envisaged a continuing important role for councils in ensuring appropriate monitoring, challenge and support to schools. It should go further by amending the statutory Code of Practice on LEA-School relations to remove ambiguity about the role of the council in relation to financial management issues.
- **Schools and councils need greater certainty about the basis upon which education funding will be calculated.** On 8 July the Secretary of State in announcing his five-year strategy guaranteed three-year budgets for every school from 2006/07 based on pupil numbers, with a minimum per pupil increase each year. The potential for schools to know well in advance the level of resources available to them is welcome. This could end the profound uncertainty that has characterised the schools' funding system to date. The Audit Commission will contribute to the consultation and debate about how this can be achieved in practice.

However, the continuation of a minimum guarantee for all schools will prevent councils and School Forums from tackling funding inequalities in their area as quickly as they would wish to or should. The government should focus on restoring confidence through developing a rolling three-year programme that confirms the basis upon which allocations will be made. It should move away from short-term funding arrangements that undermine fair funding and provide a disincentive to schools to operate within their budgets. Councils and School Forums should ensure through the implementation of their fair funding formulas that resources are matched to needs.

- **The processes for monitoring, providing challenge and support, and intervening in schools on financial management issues should be closely aligned to the processes already in place in relation to school improvement performance.** Councils need to concern themselves with schools' budget planning and use of resources alongside their role in supporting schools' improvement. They need to be more actively engaged with schools and have an important role to play, for example, in enhancing financial management skills within schools. Councils should develop and act upon a financial classification of schools as used by other areas of the education service, for example, light touch, schools of concern. Councils should actively engage with schools that have excessive deficits and surpluses and, if necessary, exercise their statutory powers to ensure that they are addressed as quickly as possible.

2

Background to the study

- 5 In response to reported widespread concerns about the impact of recent changes in funding arrangements for schools, the Secretary of State for Education announced measures in July and October 2003. They were intended to bring stability to the funding arrangements for councils and schools for 2004/05 and 2005/06. These are summarised in appendix 1. Some of the main features involved:
 - setting a guaranteed increase in funding of around 4 per cent per pupil in 2004/05 and 2005/06;
 - bringing forward deadlines for the school budget setting process and settling the teachers' pay award over a two-year period;
 - not making further changes in specific grants, for example, Standards Fund;
 - limiting certain centrally retained education budget increases to no more than the schools' budget increase; and
 - targeting help of £120 million to one-third of councils that would otherwise receive the smallest increase in their education funding over the two years 2003/04 and 2004/05.
- 6 This study, undertaken following consultation under Section 33 of the Audit Commission Act 1998, has addressed two key questions:
 - To what extent will the changes in the arrangements for funding compulsory education in councils and schools for 2004/05 and 2005/06 announced by the Secretary of State address the problems experienced at the beginning of the 2003/04 financial year?
 - What practical steps can councils and schools take, or are they taking, to plan and manage finances better under the new arrangements?
- 7 The study has drawn on evidence from recent inspections of LEAs undertaken jointly with Ofsted but has been largely informed by detailed fieldwork at 15 councils from December 2003. The councils (Gateshead, East Riding, Liverpool, Rotherham, Leicestershire, Luton, Birmingham, Essex, Brent, Islington, Westminster, Oxfordshire, West Sussex, Poole, and Devon) comprise a broadly representative group in terms of geography, size, and type, as well as including five identified initially by the DfES as having not appeared to have passported increased funding to their schools.
- 8 The study's fieldwork has covered:
 - a review of council and government documentation;
 - interviews with Chief Executive, Chief Education Officer, Director of Finance, Senior Education Finance Officers, Leader/Portfolio holder, Headteachers' focus group, Chair of School Forum, representative from Governors' Forum;

- the observation of School Forums;
- an analysis of Section 52 data, including school balances data for the four years 1999/2000 to 2002/03; and
- an analysis of provisional outturn school balances for 2003/04.

3

Question 1: To what extent will the changes in the arrangements for funding compulsory education in councils and schools for 2004/05 and 2005/06 announced by the Secretary of State address the problems experienced at the beginning of the 2003/04 financial year?

Analysis

The study was completed in advance of the publication on 8 July 2004 of the Five Year Strategy for Children and Learners. This announced further measures aimed at providing future funding stability for schools. Some of the measures are welcome and start to address some areas where we believe action is necessary. However, a number of key issues raised in the study have yet to be tackled. What follows in this report are the findings as they arose from the study, which have not been modified in the light of the further government measures.

- 9 The report has two sections. The major part of the report addresses the impact of the measures. The second section briefly rehearses what practical steps can be taken by councils and schools.

Has the requirement to provide information earlier assisted schools in the budget making process?

- 10 The intention to require councils to bring forward the announcement of school budgets has been welcomed by schools. Earlier announcement provides for more certainty to support budget planning and the preparation of indicative budgets. However, the impact at school level is likely to be felt in the longer term only when schools and councils are able to experience a reliable and consistent pattern of information flow.
- 11 In 2003 the announcement of school funding plans for 2004/05 year and the provisional local government revenue finance settlement made in November 2003 were both earlier than the announcements in previous years. The confirmation of the teachers' pay award, covering two years, and earlier than in previous years, helped budget planning and the preparation of indicative budgets.
- 12 However, this did not lead to actual budgets being finalised consistently earlier than in the past. This is because budgets are dependent on confirmation of numbers of pupils on roll in January as well as councils' overall budget decisions. Some councils also needed to await some specific spending permissions from the DfES.
- 13 The date of confirmation of actual budgets may not be significant in the future if there is a close relationship between the **indicative** income budget a school has been notified of and the **actual** budget confirmed later. In the past many schools have felt unable to place reliance on the indicative income budgets. Nevertheless the government's explicit statement of the costs that it expects schools to have to meet has been helpful. This builds confidence in the reliability of forecasts as a basis for planning.

- 14 Primary headteachers involved in the study, who generally do not have dedicated financial support, have emphasised the limited time available to interpret and understand indicative budgets. It is essential therefore that the indicative figures are realistic.
- 15 Some of the reasons for the delay in finalising budgets arise from the characteristics of fair funding formulae. These relate to the use in full or part of the January pupil count data as the basis for setting individual school budgets. This information, although collected from individual schools in January, is usually not available until early February. This is a long standing feature of the calculation of school budgets, which is well understood by schools as a potential factor that may result in final budget adjustments. Although there may be merit in reviewing the practice, this feature should not generally prevent schools planning for the coming year.
- 16 However, some features that were part of the measures introduced have contributed to uncertainty. Some are related to the transition period but they provide an indication of the issues that need to be avoided in the future in order to build confidence in the information that schools and councils are given.
- 17 Councils remained uncertain about how the detail of the minimum funding guarantee would work until December 2003. The government was seeking to recognise the particular difficulties faced by schools with falling rolls and to build some support into the guarantee. However, most council fair funding schemes already have a factor within their formula to limit year-on-year changes at individual school level. It took time to ensure that both the local arrangement and the national prescription were sensibly integrated. As a result councils needed to surround messages to schools with caveats.
- 18 The arrangements also introduced a new step in the budget process. Councils have needed in some circumstances to apply for a dispensation from the DfES – for example, to increase special education needs (SEN) budgets or other centrally retained pupil support budgets by more than the individual school budget increase. The dispensations were not made by the DfES until mid February 2004. Although in the event of the DfES refusing the application the probability was that school budgets would increase in a particular council, this was a new uncertainty for schools.
- 19 Councils that were able to access additional funding to be targeted on schools with deficits were required to submit a plan setting out how money would be targeted over the next two years to address actual or anticipated deficits. This delayed planning by schools that might have expected to benefit because of the need for applications and for the councils to decide how they would use the new money.

How have the changes to specific grants (for example, Standards Fund) affected school budget planning and budget management?

- 20 The speed and short notice of changes to specific grants in the build up to the 2003/04 education budget settlement were main contributors to last year's budget uncertainties. However, the reduction in the number of funding streams for schools will assist better planning in the longer term.
- 21 A single stream of funding without prescription is welcomed as a sensible basis upon which schools can plan. In recent years, schools have combined their various income streams to address the broad agenda of school improvement and social inclusion. For example, they quite reasonably have merged revenue budgets with formula capital allocations to enhance the building stock. Additional teaching and support staff have been employed on established contracts in order to service the 'Standard Fund' areas of focus as well as the 'mainstream' agenda.
- 22 The absence of specific exit strategies and time to disentangle funding streams that schools received through different formulae with different criteria was a major factor in the confusion in spring 2003. The difficulty was compounded by neither government nor councils having a detailed awareness of the cost structures of schools. They were not able to model and forecast the impact of funding changes. This remains the case.
- 23 The decision to reduce further turbulence by suspending the announced transfer of further Standards Fund grants into mainstream funding for two years has been positively received. Last year's experience emphasised the need for more detailed knowledge and monitoring of current spending at school level. Although aggregate funding at national level may be maintained, changes in the method of distributing the funding create uncertainty. The current holding measures need to be accompanied by clarification of next steps if schools and councils are to be able to make sensible medium- and longer-term planning decisions.

Has the guarantee of a minimum funding increase in 2004/05 and 2005/06 helped?

- 24 The minimum funding guarantee for 2004/05 and 2005/06 has offered a degree of stability in the short term. It has also been accompanied by an explicit statement of what the government regards as the costs that schools are facing in the current financial year. This represents an important improvement in managing schools' expectations.

- 25 The government has acknowledged that the guarantee is related to an assumption that costs will increase on average by 3.4 per cent in 2004/05. The minimum funding guarantee will result in schools having a minimum per pupil funding increase of around 4 per cent in 2004/05 and 2005/06. Schools with declining numbers will receive slightly more to take account of fixed costs (such as cleaning, repairs and heating), while those with increasing numbers will receive slightly less, on the ground that their fixed costs form a proportionately smaller part of their budgets.
- 26 However, minimum guarantees are not sensitive to differences at both school and council level. They do not target resources to need. There is an inherent inconsistency in government prescribing how councils should use increases in funding while not defining what the base level of expenditure should be or recognising the specific local patterns of expenditure.
- 27 The minimum guarantee does not resolve issues of funding inequalities that might exist at school level. It has the potential to embed them and postpone them being tackled. A section later in the report describes the position in relation to schools' balances, which in many cases are substantial. This will be due to a number of local, management and distribution factors. It is not the best use of resources to give additional guaranteed resources to schools that are already well resourced and are carrying substantial surpluses.
- 28 For councils the use of minimum funding increases (floors) and maximum improvements (ceilings) by government in the funding settlement rightly dampens what might be significant swings in funding between councils. But they do, of course, slow down the speed with which the funding differences between similar councils, and the needs of schools within individual council areas, can be addressed.
- 29 A minimum guarantee overrides existing fair funding formulae. It diminishes the role of the School Forum in reviewing local funding arrangements, which includes matching resources to needs.
- 30 A similar guarantee was dropped by the DfES at the end of 2002/03 in recognition of the restrictions it imposed on local decision making. This study has identified councils that have now suspended proposed changes to their funding formula, including deferring the implementation of SEN and sector reviews. The guarantee has resulted in the shelving of immediate action. Because it is not clear whether it is the government's intention to continue it in 2006/07 it inhibits both council and schools' longer-term planning.

Did councils passport to the School Block the full increase in allocated funding in 2003/04?

- 31 Councils were expected in 2003/04 to passport increased funding to the overall schools budget. Five of the councils in the study had been originally identified by the department as not passporting. However, in three cases fieldwork confirmed that this was incorrect. Of the two councils in the study that had not passported in 2003/04, one was for justified reasons. The other determined that it would not do so because the SFSS increase exceeded the increase in its overall grant settlement for the council. All the councils in the study have budgeted to passport fully in 2004/05.

What has been the impact of the government expectation that councils should use any 'headroom' in its funding settlement mainly to alleviate specific, individual school funding difficulties?

- 32 Education ministers have encouraged councils to make best use of any headroom available by targeting schools in financial difficulty. They expect councils to give first call on any headroom in the councils' settlements (that is, funding above the allocated minimum funding guarantee level) to schools in deficit.
- 33 In our study we found no evidence that councils have taken this course of action, or at this stage intend to. Their concern has been that this has the potential to further override fair funding formulae. To do so would contradict a principle of fair funding, which is that schools work within their given budget. All schools should be accountable for managing within their allocated budget. (Appendix 2 provides guidance on fair funding.)

Will the measure to target transitional funding at the councils that have received the lowest increases address funding difficulties in situations where need is greatest?

- 34 Following the 2003/04 settlement, the government decided to provide transitional support in three ways. The first and most straightforward was an uplift of £28 million in the settlement for 36 local education authorities (LEAs) that received the lowest increases in their 2003/04 Education Formula Spending Share (EFSS). Councils in London were also allocated an extra £11 million to offset increases in teachers' pay.
- 35 The second more significant transitional funding initiative involved a grant of £120 million in 2004/05 allocated to 51 councils. These were the councils that had received the lowest increase in EFSS and relevant DfES grants in the two years 2003/04 and 2004/05. The amount of the grant was the amount required to bring their total increase per pupil over the period up to 12 per cent (13 per cent inner London, 12.4 per cent outer London). The table below illustrates how the funding has been distributed.

Table 1
Distribution of transitional funding to 51 councils with the lowest increases in EFSS and relevant DfES grants in the two years 2003/04 and 2004/05

2003/04 to 2004/05 increase per pupil %	Number of councils pre-transitional funding	Number of councils post-transitional funding
9%	6	
10%	31	
11%	14	
12%	22	73 ^I
13%	21	21
14%	26	26
15%	26	26
16%	4	4
Total	150	150

Source: DfES transitional funding guidance 2003

- ³⁶ To obtain the grant the 51 councils were required to submit a plan to the DfES to identify how they would target the grant at schools currently in deficit or likely to move into deficit. All councils within the study that were eligible submitted a plan and all were allocated grant. As a result, schools in deficit will benefit from some respite from financial difficulties however they may have been caused.
- ³⁷ This transitional measure is a very crude one. It addresses some immediate difficulties. But it adds to bureaucracy by requiring another plan at a time when the DfES has been promoting the reduction of plans. It does not target resources at greatest need. Councils that are eligible are not necessarily those that are lowest funded; nor those that have the greatest number of schools with deficits. The position of the councils in the study is set out in **Table 2, overleaf**.

^I All councils with increases of 12 per cent or less than 12 per cent per pupil pre-transitional funding.

Table 2
Distribution of transitional funding to councils in the study and deficits at 31 March 2003

Council	Increase in EFSS and DfES grants 2003/05	Transitional grant available (£)	Schools' total deficit	Percentage of schools in deficit	Average deficit (£)
A	13.5%	not eligible	-3,087,769	22%	-280,706
B	13.1%	not eligible	-2,794,649	22%	-164,391
C	13.4%	not eligible	-1,049,838	11%	-149,977
D*	11.8%	628,000	-2,708,784	17%	-75,244
E	12.7%	not eligible	-212,863	4%	-70,954
F	14.0%	not eligible	-623,047	7%	-69,227
G	14.1%	not eligible	-4,226,281	14%	-68,166
H*	10.5%	9,833,000	-2,057,366	6%	-62,344
I*	10.7%	3,712,000	-2,900,086	19%	-52,729
J*	12.3%	not eligible	-145,356	7%	-48,452
K*	10.4%	4,386,000	-3,159,718	26%	-41,035
L*	13.9%	not eligible	-280,832	10%	-31,204
M	13.1%	not eligible	-471,312	12%	-24,806
N*	10.6%	4,946,000	-674,493	9%	-24,089
O	12.5%	not eligible	-268,181	7%	-9,933
Average				12%	-62,274

Note: Councils marked with an asterisk had EFSS raised to the funding floor

Source: Audit Commission

- 38 There is no relationship between grant available and levels of current deficits. Councils that appear to have the largest deficits have not been assisted (for example, councils A and B) while those with more limited problems have been given access to transitional grants in excess of the current cumulative deficits (councils H, I and N). In addition as a result of the mechanics of finalising the EFSS to reduce the range in settlements, councils in the study that had access to the transitional grant had already benefited from being lifted to a funding floor while the majority of the others had been reduced to a funding ceiling.

- 39 Looking at the process from another perspective the arrangements take no account of whether schools have taken hard and necessary decisions to manage within limited resources. The measures risk being perceived as arbitrary, unfair and a disincentive to long-term strategic budget planning at school level.
- 40 Critically the transitional funding did not take account of existing deficits and surpluses and the capacity of schools to handle funding changes. As a result some councils that have more schools in deficit, which may be less well funded overall and have their overall funding limited by a 'ceiling', have not been given access to the transitional grant while other councils in a comparatively better position have.
- 41 Transitional funding made available to the 51 councils may well reduce budget pressures in targeted schools. However, this runs contrary to the principles of fair funding, transparency of allocation and the responsibility that a school has to operate within its budget.
- 42 The third element of transitional funding involved offering councils the opportunity to draw in 2004/05 up to £300,000 additional funding from the 2005/06 indicative allocation. Councils have not seen this as particularly helpful and there is little evidence from the study or other contacts with councils that they have made use of this facility.

What is the likely effect of limiting certain central retained budget increases to no more than the schools' own budget increases?

- 43 Since the early days of local management of schools (LMS) governments have sought to limit councils' centrally retained education budgets. They have wanted to maximise the level of resources that school managers have at their disposal. As part of the new measures in 2003 Ministers have further prescribed that certain centrally retained funding within the schools budget block should not increase by more than the delegated school budget increase. Details of the constituent elements of the 'LEA' and 'Schools' funding block are described in Appendix 3.
- 44 This prescription adds to the complexity of education funding with potentially unforeseen consequences. Fieldwork for this study has confirmed that the restriction is having an impact on the way in which budgets are set. It has also resulted in additional bureaucracy and delay in finalising schools' budgets.
- 45 The need for councils to apply to the DfES for dispensations to spend on centrally retained items within the schools budget block has already been referred to. Overall 23 out of 150 councils that requested them have been granted dispensations (including five within the study). It remains to be seen if the constraint can be delivered in practice. Whereas budgets can be set, spending pressures are considerable. Concentrated within this expenditure are activities that councils have found great difficulty in managing. The most notable are SEN expenditure and out-of-area SEN placements.

- 46 The experience of one council in the study highlighted the additional pressures on councils' budgets as a result of the 'gearing' effect within the overall schools budget (expenditure funded through the Schools Formula Spending Share (SFSS)). The increase in centrally retained expenditure funded through the SFSS is restricted to the same increase in the schools delegated expenditure. This meant that in order to target £1 at a centrally provided pupil support service (which would potentially reduce pressure on delegated school budgets) the council would have to put an additional £8 into the overall delegated individual school budget. The dilemma is partly addressed through applying for a dispensation. It does nevertheless illustrate the tensions caused by the exercise of such controls.
- 47 Councils have an incentive to promote more effective use of centrally retained expenditure budgets within the LEA block. There is, however, no similar incentive in relation to the schools block where there is the expectation that funding will be passported in full.

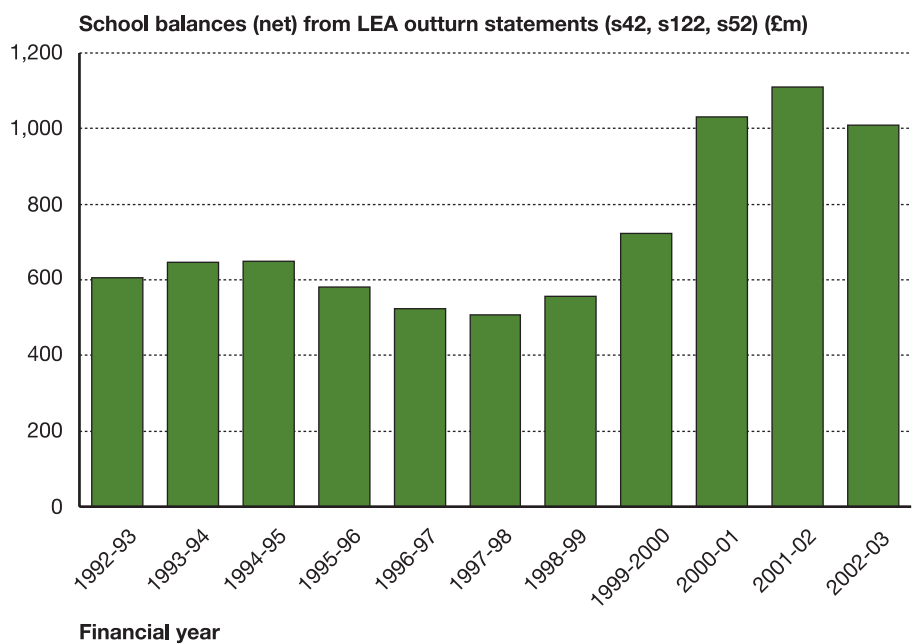
What was the financial situation of schools at the start of 2003/04?

- 48 Schools are required to submit a detailed budget for the financial year to their council by the middle of May. In 2003 as a result of the budget plans submitted in May 2003 or not submitted in May 2003 (due to schools having difficulties setting a balanced budget), significant financial difficulties were reported at school level.
- 49 At the beginning of 2003/04 all 15 councils in the study reported a significant number of schools using balances to set their budget. All were predicting both a significant overall reduction in the balances and an increase in the number of schools projected to be in deficit at the end of 2003/04.
- 50 The measures introduced for 2004/05 and 2005/06 were in response to a perception that the changes made for 2003/04 to schools funding had not taken adequate account of spending needs at school level. Ministers felt that mechanisms for passing funding from councils to schools were not secure.
- 51 However, there is no evidence of funding being retained by councils other than for normal in year contingency purposes. Resource management by schools themselves is a significant element in the education funding picture. The action taken by the government to develop further support and guidance for schools on budget management has recognised the need to strengthen capacity in this area.
- 52 Devolved management arrangements where funding is allocated to a number of discrete operating units brings the potential for increased performance and better response to local circumstances. However, it also means that funding is split down into separate pots and where the funding is not spent, separate balances accumulate. Schools have operated with delegated budgets since the late 1980s. School balances provide a significant cushion, which can absorb funding turbulence. The debate about why schools need balances is well rehearsed. Balances are necessary to cope with uncertainty, to anticipate known fluctuations in pupil numbers and to contribute to capital and other schemes within schools.

53 Funding that is locked up in school balances is significant. Their growth has been sharply upwards since 1999. It has been steepest in the primary sector. A growing number of schools have very large balances of several hundreds of thousands of pounds. Although there was a fall in 2002/03, the net balances held at 31 March 2003 by schools in aggregate are in excess of £1 billion and represent 5 per cent of annual planned budget shares controlled directly by schools. The net aggregate balances position includes the schools holding both deficit and surplus balances. Surplus balances represent 6 per cent of annual planned budget shares controlled directly by schools.

Exhibit 1

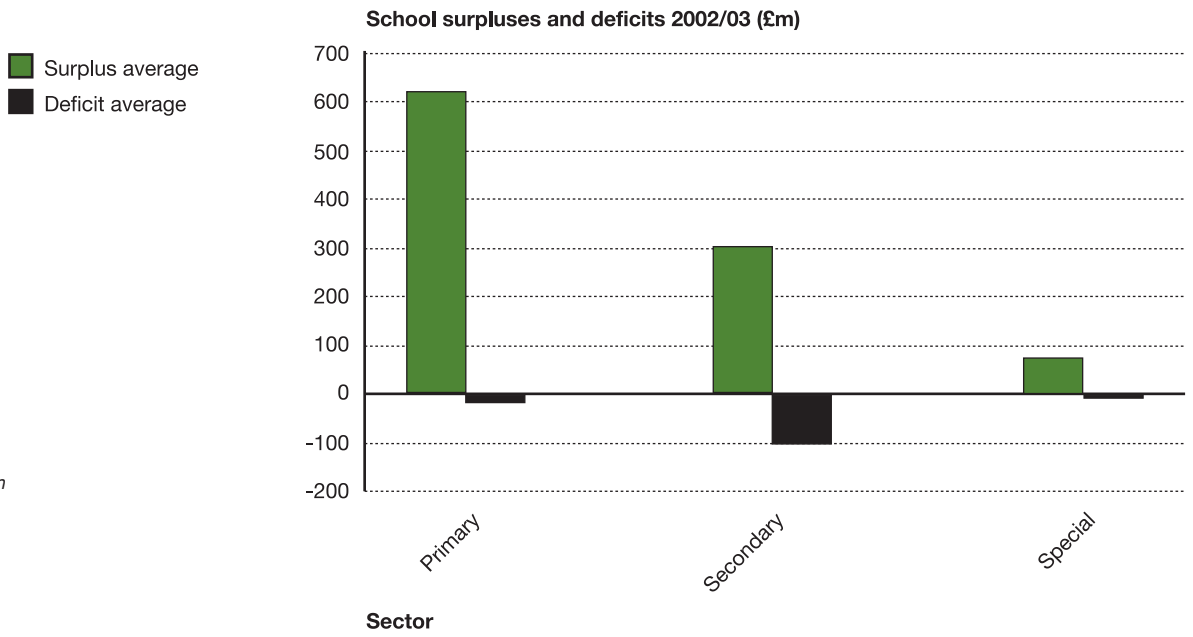
Aggregate school balances (net) from LEA outturn statements 1992/93 to 2002/03



Source: Audit Commission

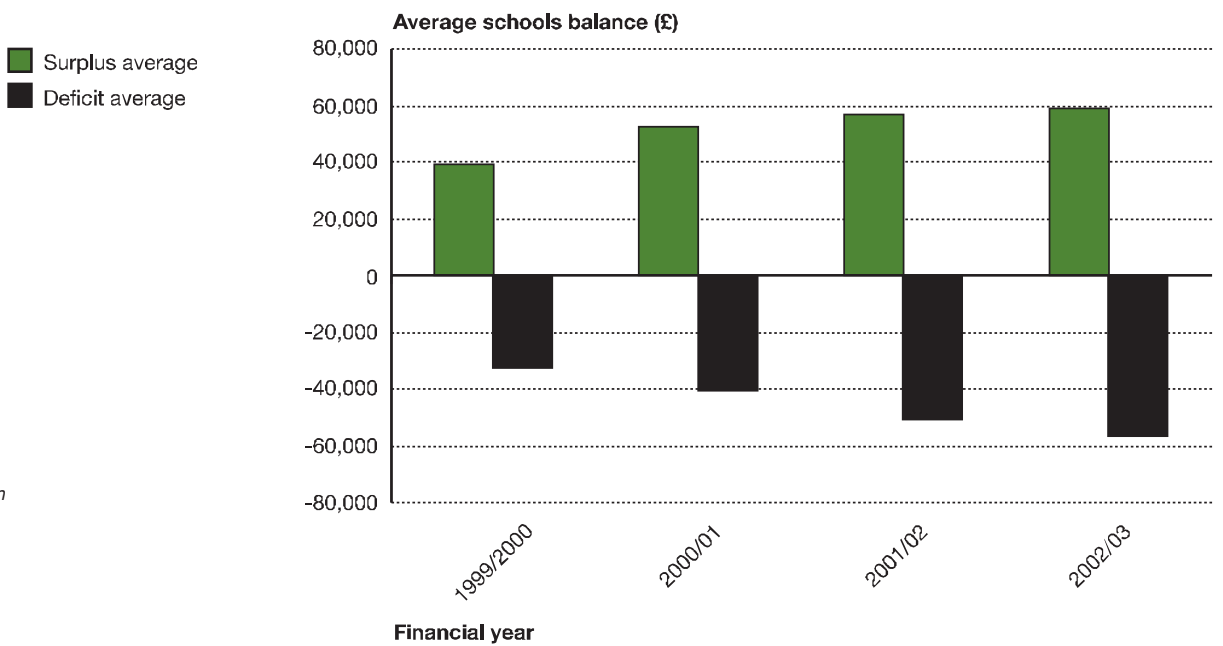
- 54 The school balances picture is not a uniform one. There is substantial variation between and within council areas. Neither is the picture static.
- 55 School deficits are increasing, both in the size of the deficit, and the number of schools in deficit. School surpluses are also escalating in aggregate and on average. By 31 March 2003, two out of five schools had balances in excess of 8 per cent of the planned budget share. This had increased from one-third of all schools in 1999/2000. One in every seven schools had surpluses in excess of 15 per cent (increased from one in 12 in 1999/2000) (**Exhibits 2 and 3, overleaf**).

Exhibit 2 Aggregate school surplus and deficits 2002/03



Source: Audit Commission

Exhibit 3 Average schools balance



Source: Audit Commission

- 56 Councils have powers to intervene or to direct funding where surpluses are excessive, but there is limited evidence that these powers are being exercised. Government announcements about schools' entitlement to receive minimum increases in funding are important here. Of the councils involved in the fieldwork two were intending to introduce a policy to claw back excessive school surpluses using powers available since 2002. Most pointed to the uncertainties around the funding picture overall as a significant reason not to do so.
- 57 There is no consistent guidance on how much schools should hold in balances. However, the DfES does indicate the maximum limits for councils to use when considering clawing back excessive surpluses from schools – 5 per cent of a secondary school budget and 8 per cent of a primary school budget. However, over one-half of primary schools and well over one-quarter of secondary schools now appear to be exceeding these maximum limits.
- 58 School balances when analysed by size of school highlight the stark contrast between larger and smaller schools (based on pupil numbers). Larger schools have the highest number of schools in deficit and the lowest number of schools with a surplus of more than 5 per cent. During the four years up to 31 March 2003 almost one in four of all schools has been in deficit. Secondary schools have a more serious deficit problem than primary schools.

Table 3
Analysis of school balances at 31 March 2003 by school size and sector

School size based on pupil numbers	Deficit of -1% or more	Between -1% and 5% *	Surplus between 5% & 8% *	Surplus between 8% & 15%	Surplus above 15%
Less than 100 pupils (2,892 schools)	6%	20%	13%	29%	31%
100 – 199 pupils (4,375 schools)	9%	24%	19%	30%	19%
200 – 499 pupils (9,051 schools)	9%	31%	20%	28%	13%
More than 500 pupils (3,045 schools)	19%	50%	16%	12%	3%
Primary schools (15,457)	8%	27%	19%	29%	18%
Secondary schools (2,974)	20%	49%	15%	12%	4%
Special schools (932)	8%	31%	17%	29%	15%
All schools in sample (19,363 schools)	10%	31%	18%	26%	15%

Source: Audit Commission

Table 4
Schools in deficit between 1999/2000 and 2002/03

	All schools	Primary	Secondary
Schools in deficit during all four years	2%	1%	7%
Schools in deficit for at least one year during the four year period 1999/2000 to 2002/03	24%	20%	43%

Note: Analysis based on sample of 19,363 schools, all open for all 4 years, 1999/2000 – 2002/03.

Source: Audit Commission

What happened to schools finances in 2003/04?

- 59 On the basis of the findings of the study there was no widespread funding crisis faced by schools' in 2003/04. There is strong evidence from the study that overall school balances have risen over the past year. This is in stark contrast to forecasts. At the beginning of 2003/04 all 15 councils in the study reported a significant number of schools using balances to set their budget. All were predicting both a significant overall reduction in the balances and an increase in the number of schools projected to be in deficit at the end of 2003/04.
- 60 In the event only 4 out of the 15 councils in the study appear to have school balances that have fallen significantly. In two council areas balances have reduced overall by 13 per cent; in one they have fallen by 24 per cent. In seven councils balances have remained about the same and in four councils there have been significant increases – in one it is as high as 59 per cent. In one council where a drop of 87 per cent was forecast, the reduction was 24 per cent. In another where it was reported that balances would disappear altogether, the reduction is less than 13 per cent. At the other extreme one council was predicting a 46 per cent reduction, but provisional data now shows an increase of over 17 per cent. If Standards Fund balances were taken into account the figures would be even higher.
- 61 Of the five councils in the study with access to transitional funding in 2004/05 one council's balances remained about the same, two had a reduction in their balances, and two increased their balances by the end of 2003/04. The council in the study with the largest overall reduction in provisional school balances had access to the lowest amount of transitional grant.

Question 2: What are the practical steps councils and schools can take and are taking to plan and manage their finances better under the new arrangements?

Could councils be more effective in assisting in the management and monitoring of schools budgets?

- 62 Government and councils continue to make spending decisions without a solid understanding of schools' individual and collective budget positions. Councils have distanced themselves, and been expected to do so, from monitoring and challenging schools budgets other than to deal with critical incidents. School expenditure represents the largest single element of local government expenditure but attracts the least scrutiny. The budget controversy in 2003 revealed that nowhere in the system is there a secure picture of the state of school finances and the likely impact of any changed funding arrangements on them. It is not possible to predict at school level the effect of funding changes. Reliable information about how schools' actual spending relates to budget is not available until well after the year end.
- 63 Councils are passing on education budget increases to schools and consultation processes are generally good – but after this point engagement with individual schools is often very limited. Councils appear to be unsure about the extent to which they can and should exercise closer scrutiny and challenge in relation to schools' spending.

- 64 Councils are actively involved with schools in relation to their performance and improvement. This is not the case in relation to schools' budgets and financial position. Councils have very limited up-to-date knowledge of the state of schools finances. They have responded to requirements in the past to delegate funding to schools and to support school autonomy. Government restrictions on centrally incurred education expenditure have limited their capacity to fulfil the crucial role of monitoring, challenge, support, and intervention in relation to schools' budgets and financial management. This has been a false economy. The statutory Code of Practice on LEA-School relations has reinforced this distance between council and schools in relation to financial management.
- 65 The newly introduced requirement for consistent financial reporting effectively has delayed the year end close down of individual school accounts until half way through the following financial year. Where councils do have more up-to-date knowledge of spending it has been as a result of being involved in providing a traded financial service. Frequently this will not cover all schools within a council area.
- 66 The difficulties at the beginning of 2003/04 have possibly resulted in a degree of enhanced scrutiny. However, councils in the study were unable to offer a comprehensive picture of spending patterns and mid year positions. No significant use is being made of the returns from the consistent financial reporting arrangement that provided the first returns from schools in 2003. The absence of up-to-date, reliable and comprehensive financial information about a large segment of a council's budget means that councils place great dependence on schools' own reports and forecasts. The effective ringfencing of money allocated to schools diminishes the incentive for councils to feel they should be involved in school budget issues even though the sums involved are substantial. As a result direct involvement with schools by councils is more likely to occur where there is a large budget surplus or where there is a deficit and the school needs to agree a recovery plan.
- 67 During the past four years almost one in four of all schools have been in deficit. It is likely this figure would have been significantly lower if schools had the same monitoring, challenge and support in resource and financial management (where the schools' senior management normally have less expertise) as they receive in the areas of teaching and learning (where senior staff have considerable expertise). Evidence from inspections of the education function of councils is that the link between school improvement support and challenge and the strategic use of resources, budget review and costing of school development plans is not as strong as it should be. The emphasis in school inspections results in limited coverage of resource management and performance, both in respect of revenue and capital funding.

- 68 Governors and headteachers are responsible for very significant budgets. There is an awareness of the need to enhance skills of key staff. Written guidance for schools is generally of good quality, though it often is focused more on processes and procedures than on the quality of resource management. Advice on best value in schools is usually very limited. Training is similarly limited, and education department advisory staff tend to play little part in what there is. This reinforces the division between the financial management and school improvement agenda. In the past school managers and governing bodies have had access to tools and guidance contained in Audit Commission and others' publications and handbooks. Recently, additional web tools have been made available.
- 69 The Audit Commission annual school survey and evidence from inspections have found that council financial support services are generally well regarded by schools. But this service relates predominantly to day-to-day financial management, not strategic financial planning. The range of services and choice on offer varies, but usually reflects schools' demands. Financial training is similarly well regarded by schools. Training content, however, usually covers budget management process and how the fair funding formula allocates money to schools. It is not generally targeted at strategic resource management, how to link the budget to the school development plan, or to managing deficits or surpluses.
- 70 Councils have statutory responsibilities to monitor and challenge resource management and financial decision making. They are also best placed to do so. In practice the role is not undertaken consistently. It is not effectively integrated into the wider monitoring and challenge role carried out by school improvement officers or school advisers. The Audit Commission's *Money Matters* report in 2000 and its joint report with Ofsted in 2003 on Resource Management have both highlighted this deficiency. Councils have been under pressure to reduce central costs and to prioritise spending controlled directly by schools. This has affected their ability to prioritise the financial scrutiny of schools. They have interpreted, and been encouraged to interpret, the requirement to provide support and challenge in inverse proportion to success as a reason to withdraw from aspects of budget monitoring. Many have reached the point where their knowledge of school budget management and resource deployment is not secure. There is uncertainty about councils' responsibility towards the stewardship of resources held and managed by schools.
- 71 Internal audit does now appear to play a broader and more helpful role than in the past. Schools generally appreciate its activities. Most activity now involves a full financial health check, rather than concentrating wholly on probity. The regularity of visits, and use of risk assessment to determine programmes of work, however varies between councils. The extent to which visits cover and provide assurance on wider questions of resource management is variable. Intelligence gained through school audits is not always shared with the school improvement team.

Are School Forums working and contributing to better financial management and targeting of resources?

- 72 As part of the study we reviewed how School Forums were beginning to work. School Forums have been given a significant role in the development of local schools' funding formulae. Overall, they were still at very early stages of development. Many acknowledged that they have much to learn, although the process was seen as useful. School Forums are providing the structure for useful dialogue between key stakeholders and councils although in many instances this is formalising previous practice. However, government prescription on how funding should be allocated is limiting the capacity to engage in medium- and long-term discussion and review. Uncertainty about the length and size of minimum guarantees, for example, provides an inhibition to long-term planning.

Final comment

- 73 School funding is a very complex area. It will continue to attract much debate. The Audit Commission knows that there are no simple solutions to resolve difficulties. But there are changes to the present arrangements that we believe are necessary. Without action, schools' funding arrangements and financial positions will remain an area for which poor intelligence is available to councils and government. Policy decisions relating to schools funding will continue to be based on inadequate data and schools balances will represent an inefficient use of scarce resources. The recommendations in the summary of this report are not designed to reduce school autonomy, as schools with sound financial management will require minimal attention. But the new challenges arising from the integration of children's services, children's trusts and extended schools will make it even more important in the future that there is significantly improved use of intelligence and clearer accountabilities than at present.

4

Consultation

The Audit Commission established an external Advisory Group, which comprised key stakeholders. It met in November 2003, January 2004, March 2004 and June 2004. Representatives from the following bodies took part and we are grateful for their support and challenge:

Association of Local Government (ALG)	Stephen Lord
The Confederation of Education Service Managers (CONFED)	Chris Waterman
Department for Education & Skills (DfES)	Andrew Wye & Stephen Bishop
Local Government Association (LGA)	Jeni Bremner & Graham Lane
National Association of Governors & Managers (NAGM)	Jane Phillips
National Association of Head Teachers (NAHT)	Kathryn James
Office of the Deputy Prime Minister (ODPM)	Robert Davies
Ofsted LEAI Division (OFSTED)	Malcolm Wall
Secondary Heads Association (SHA)	Lindsey Wharmby
Society of Local Authority Chief Executives (SOLACE)	John Schultz

The findings and conclusions of the study are those of the Audit Commission.

Appendix 1

Ministerial statement – measures announced July 2003

- a Minimum guarantee per pupil increase
- b Bring forward deadlines for budget setting process
 - Local Government Settlement notification
 - Passporting deadline
 - Standards Funds notifications
 - Teachers pay award settlement
- c Ensure schools are more involved in funding decisions
- d Not to make any more cuts to the Standards Fund Grant for 2004/05 or 2005/06
- e Continue with the Standards Fund Grant for ‘workforce reform’
- f Consider a two-year teachers pay settlement set at inflation (2.5 per cent)
- g Provide more support to schools on financial planning (three-year budgets)
- h Limit central education budget increases to no more than schools budget increase
- i Provide extra funding for local services including Children Social Services
- j Set out a clear strategy to enable sensible progression on performance pay
- k Each local authority should receive sufficient central government grant to passport in full the increase in FSS into its schools budget

Ministerial statement – measures announced October 2003

- a Minimum guarantee per pupil increase of approximately 4 per cent for 2004/05 and 2005/06
- b Continue budget support grants (London & others allocated in 2003/04)
- c Transitional support and training for Heads. To support schools facing particular difficulties in bringing their budgets into balance
- d Targeted help (£120 million). For about one-third of LEAs who receive smallest increases in 2004/05
- e Universal help (maximum £300,000 or 0.2 per cent of total education resources 2004/05 if higher). LEAs to put forward a compelling argument that transitional funds are needed for schools in the short term to avoid real damage to children’s education. Will consider bringing forward into 2004/05 funding from future years. Schools and LEAs work together to use transitional support to implement a costed, credible plan that protects education standards.

Appendix 2

School funding – Fair Funding (DfES guidance)

The school funding system introduced in 1999 built upon Local Management of Schools (LMS) by increasing the level of financial delegation to schools. Its key aspects are formula funding and the delegation of financial responsibility to schools. Formula funding is designed to bring about an equitable allocation of resources between schools, based on objectively measured needs rather than historical spending patterns. Within each LEA, therefore, schools with the same characteristics and the same number of pupils should receive the same level of financial resources under the LEA's formula. 'Delegation' concerns the proportion of the LEAs total expenditure on schools that is allocated to the schools themselves in budget shares through the LEAs formula, as distinct from being retained and managed centrally by the LEA.

School Funding System

The School Standards and Framework Act 1998 established a new framework of community, voluntary and foundation schools. The system is designed to complement that new framework by establishing a unified system of funding that builds on LMS by allowing schools to develop further their capacity for self-government by increased delegation of responsibility through funding.

The system is based on the following seven principles:

- **Standards** – the system is designed to help both schools and LEAs to pursue the government's number one priority of raising education standards.
- **Self management** – it builds on the experiences of LMS by allowing schools to develop further their capacity for self-government through increased delegation of responsibility and funding.
- **Accountability** – the system makes clear the split between LEA and school responsibilities and the funding that goes with those responsibilities, so that both schools and LEAs can be held accountable for their performance in spending public money.
- **Transparency** – the system is easier to understand and makes decisions on school financing clearer and more comprehensible.
- **Opportunity** – it should be seen as an opportunity for all schools but a threat to none. In particular, small schools are not forced to manage on their own responsibilities with which they cannot cope.
- **Equity** – it ensures fair and equal treatment for all schools.

- **Value for money** – the system is designed to help both schools and LEAs achieve value for money, and to allow all interested parties to assess how well this is being done.

Apart from schemes the regulatory framework for the school funding system is set out in two sets of regulations. The Financing of Maintained Schools Regulations contain rules for the allocation formula and the content of schemes; the LEA Budget, Schools Budget and Individual Schools Budget (England) Regulations define the scope of the LEA Budget and the Schools Budget. The primary legislation is found in sections 45-45A and 47 to 53 of the School Standards and Framework Act 1998 as amended by the Education Act 2002.

Consultation with schools and the School Forum

In operating the system, LEAs are obliged to carry out various consultations. They are obliged to consult the head teachers and governing bodies of individual schools on proposed changes to the allocation formula, and revisions to the scheme for financing schools. They are also now required to consult the local School Forum, not only on these matters but also on a range of issues specified in regulations, which include SEN expenditure and service contracts. They are also encouraged to use the Schools Forum to gain a collective view from schools on more general issues arising from the management of the schools budget, such as the balance of central and school-level spend.

DfES Guidance April 2004

Appendix 3

LEA and School Funding

Education funding is allocated through two separate FSS (Formula Spending Share) blocks, the 'LEA' block (LEA Budget) and the 'Schools' block (Total Schools Budget). LEAs are expected to consult School Forums on the size and appropriateness of centrally retained expenditure within the Schools Budget and cannot increase the retained level of expenditure at a higher rate than the delegated allocations without seeking government dispensation.

LEAs may not delegate expenditure within the LEA block. They can, however, devolve such funding in the form of earmarked allocations.

Schools budget

- Individual Schools Budget (ISB)

LEAs are permitted to retain funding centrally within the Schools Budget for the following:

- SEN support – pupils with and without statements
- promoting good practice/collaboration/integration
- placement of pupils at independent or non-maintained special schools
- inter-authority recoupment
- placement of pupils without SEN at independent schools
- expenditure on primary and special schools meals
- expenditure on the provision of milk
- expenditure on provision for under fives (other than provision made in schools with delegated budgets)
- insurance
- library (primary and special schools only) and museum services
- school admissions
- servicing of schools forums
- contingency reserves relating to schools
- miscellaneous expenditure
- capital expenditure from revenue (CERA)
- matched funding for the Standards Fund or other specific grants

LEA budget

- strategic management statutory/regulatory duties
- premature retirement and redundancy costs
- insurance
- non-devolved grants
- education psychology service/assessments and statementing
- LEA functions in relation to child protection
- parent partnerships
- promoting good practice/collaboration
- school improvement, including education development plan
- asset management
- school place planning
- support for excluded pupils
- behaviour support
- school and college transport
- education welfare service
- music (not standards fund), visual performing arts
- outdoor education
- capital expenditure from revenue (CERA) (LEA central functions)
- youth and community services

Appendix 4

Glossary

Best value – this represents a set of key principles for effective planning and performance management. Following the principles involves regular review of the purposes, processes, costs and outcomes of service delivery.

Fair Funding – the school funding system introduced in 1999 building upon LMS by increasing the level of financial delegation to schools. Its key aspects are formula funding and the delegation of financial responsibility to schools (Appendix 2 gives full details).

Formula Spending Share (FSS) – this represents the share of national spending on education that each LEA is deemed to require. It is the key determinant of the distribution of Revenue Support Grant nationally. Its calculation is based on an assessment of comparative need in each council.

- Education Formula Spending Share (EFSS)
- Schools Formula Spending Share (SFSS)

(Appendix 3 gives specific detail on the School Budget Block and the LEA budget.)

Internal audit – these are auditors employed by the council to advise on a wide range of matters associated with the expenditure of public funds.

School balances – schools are not required to spend all of the money they receive within the same year they receive it. They may have a surplus or deficit to carry forward as a starting balance for the following year. Some of the school balance maybe committed for a specific purpose. (All references to school balances exclude capital and standards fund unless specifically stated in the text.)

- Surplus school balance – schools are not required to spend all the money they receive within the same year they receive it. A surplus is defined as when the total money received during the year plus any balance carried forward from the previous year exceeds the amount they have actually spent. Some of the school balance maybe committed for a specific purpose. (All references to school balances exclude capital and standards fund unless specifically stated in the text.)
- Deficit school balance – A deficit is defined as when the amount actual spent during the year exceeds the total money received during the year plus any balance carried forward from the previous year. (All references to school balances exclude capital and standards fund unless specifically stated in the text.)
- Net school balances – the combined total of surplus and deficit balances.

Passporting – Councils are required to pass on annual education funding increases set by central government to education departments and schools.

Standards Fund – this is one of the main sources of central government specific grant available to supplement council and school spending. A wide range of activities are involved but the overall focus is the improvement of provision for school children.



PFI in Schools – The Early Quality and Costs of Buildings and Services Provided via the Private Finance Initiative

This report looks at current examples of schools that are buying goods under the PFI scheme. It makes comparisons with more traditional procurement methods and looks at the design and build quality of schools so far. The report emphasises the need to learn from the early school schemes, and makes suggestions for future improvements to PFI in schools.

National report, 2003, ISBN 1862404127, £25, stock code LAR2904



Special Educational Needs – A Mainstream Issue

This report looks at how well the education system is serving children with special educational needs (SEN). It raises issues for schools, local authorities and national policymakers.

National report, 2002, ISBN 1862404097, £25, stock code LAR2894



Managing Special Educational Needs – A Self-Review Handbook for Local Education Authorities

This self-evaluation handbook for LEAs covers the key challenges involved in managing SEN, and provides a checklist of actions to help officers and members to reviews their practice.

Handbook, 2002, ISBN 1862404143, £25, stock code LMH2913



Recruitment and Retention – A Public Service Workforce for the 21st Century

This report explores the recruitment and retention problems among public service providers. It highlights the key reasons why potential, current and former public sector workers join or leave a public sector job as well as sharing good practice and learning.

National report, 2002, ISBN 186240392 9, £25, stock code GAR2848



Improving School Buildings – Asset Management Planning in LEAs and Schools

This report draws on evidence from inspections of asset management planning and property services in all LEAs, and shows that extra resources are making a significant impact on the condition of many school buildings. Better information on school buildings and improved consultation with schools are also increasing the ability to plan and use the investments wisely, but there are still substantial variations in the condition of individual schools. The report provides key messages and recommendations for improvement in current public policy and practices for all primary stakeholders.

National report, 2003, ISBN 1862403783, £25, stock code LLI2747

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