2: Monitoring the Financial Health of Providers

Background

2.1 The Learning and Skills Council (LSC) is required, under its financial memorandum with the Department for Innovation, Universities & Skills ('DIUS') to "monitor the financial health of providers and as part of this duty, keep their level of balances under review". In addition to this formal requirement, the LSC assesses colleges' financial health to understand the degree of risk they may represent to the LSC if they do not have the financial resources to continue operating.

2.2 When a college ceases to operate, or there is a significant deterioration in its financial position, the LSC faces the risks of:

- learners suffering when their learning provision is disrupted or terminated
- the LSC being unable to recover any funds owed to it by the college (for example, funds paid on profile in excess of learning provided at the time learning ceases).

2.3 Both risks, which may be present simultaneously, could compromise the LSC's statutory responsibility to ensure proper and reasonable provision of facilities for post-16 learning. To reduce these risks, the LSC gathers assurance that the college has the necessary financial resources to:

- remain able to operate throughout the life of its funding agreements with the LSC
- fully discharge its obligations under those funding agreements with the LSC.

2.4 The two key financial documents used by the LSC to gather this assurance are the college's financial plan and the college's financial statements. The guidance and submission requirements for the financial plan are provided in this Financial Planning Handbook ('the Handbook') while the guidance on the completion of the financial statements is provided in the Accounts Direction Handbook.

Financial Plan

2.5 The financial plan (which should be produced for a minimum of three years, but can be up to ten years) should be an integral part of each college's own strategic and development plans, as it expresses in financial terms the cost of implementing those plans and shows the income and expenditure associated with projected levels of activity. The financial plan is intended to help each college's governing body, and the LSC, to assess the financial effect of a college's strategic and development plans. It is important to include in the financial plan the costs of implementing the college's property strategy for the plan period.

2.6 The financial memorandum between colleges and the LSC requires that colleges approve a budget before the start of the academic year (1 August). Colleges are also required to include this budget as the first year in their financial plans.

What does the LSC do with the Financial Plans?

2.7 As part of their plan submission, colleges are asked to provide a self-assessment of their financial health. The guidance on financial health self-assessment is based upon the principles that:

- the prime responsibility for a college's financial health rests with the college
- self-assessment provides the impetus to improve a college's financial health and is most effective when it is structured, rigorous and continual
- both the college's self-assessment and the LSC's assessment of the college's financial health should focus on the same guidelines, at the forefront of which lies the robustness of the college's finances, the likely risks in the college's environment and the adequacy of the college's contingency plans
- the college's board of governors should confirm the self-assessment.

2.8 When the LSC assesses which financial health group is appropriate for a college, it considers guidelines for each group (which are published annually as part of guidance to the sector), the college's self-assessment and a computed health group, further details on which are set out below. The LSC reviews colleges' financial plans in order to understand the financial health of the sector and to inform financial intervention, where necessary.

Financial Health Assessment

2.9 The LSC has developed a new approach to assessing the financial health of colleges and other providers and this is incorporated in the 2008 college financial returns. The drivers for this revision were twofold:

a. limitations of the current approach including the level of moderation of the autoscore required. In addition, the range of financial circumstances for colleges classed as 'group C' necessitated further analysis to determine where LSC financial intervention should be focused;

b. the introduction of the Framework for Excellence (the Framework) required the development of a four grade financial health assessment to allow financial health to be included in the Framework as one of the Key Performance Areas within the Finance Dimension.

2.10 The new approach has been developed and modelled within the wider development of the Framework. Extensive modelling of the new approach has been carried out based on all college finance record returns for 2005/06 and 2006/07 and all college financial plan returns for the period 2006/07 to 2009/10. The output from workshops and consultation with pilot providers for the Framework (which included some 65 colleges) and wider college audiences has been very much appreciated and has helped to shape the new approach.

2.11 The new approach is introduced with effect from the July 2008 financial plan return. It is recognised that this represents a major change for the FE college sector, and that the traditional financial health assessment (groups A, B, and C) are widely understood by both colleges and their advisers (for example, banks and property consultants). Therefore, the traditional approach is retained alongside the new approach for both the July 2008 financial plan return and for the 2007/08 finance record return. The college self assessment is to be carried out under both approaches but with the primary emphasis on the new approach.

2.12 The new approach results in one of four assessment grades: outstanding, good, satisfactory, or inadequate.

2.13 With effect from 1 August 2008 (based on the LSC review of the July 2008 financial plan returns) a new grade of 'inadequate' will form the basis for issuing a Financial Notice to Improve. Each LSC region has written to colleges in Spring 2008 to inform them about Financial Notices to Improve (a copy of the letter is attached at Annex 1 for reference).

2.14 The finance record returns for 2007/08 (due by 31 December 2008) will provide the basis for colleges' first financial health grades for the purposes of the Framework. The first overall performance ratings under the Framework are to be confirmed during the early months of 2009. Information about the Framework can be found at http://ffe.lsc.gov.uk/.

2.15 One objective in developing the new approach has been that the new automatically calculated health grade (autoscore) should require moderation in a relatively small number of instances. Whilst the Framework development process has sought to develop assessments which are as objective as possible, based on automated calculations, the process of college self-assessment (considered by the corporation and signed off by the principal) is retained. Self-assessment is considered to represent good practice which will support self-regulation in due course.

2.16 The LSC moderation and validation process in relation to financial health assessments is also retained. Regional finance teams will continue to review and confirm colleges' health grades/ groups based on each return.

Grade definitions and scoring

2.17 The grade definitions under the new methodology are summarised below:

Grade	Definition	Indicators
1 Outstanding	A provider that has very robust finances to fulfil its contractual obligations and to respond successfully to opportunities or adverse circumstances.	Normally, a provider with excellent/good indicators for solvency (current ratio), margin (operating surplus/profit), and status (gearing).
2 Good	A provider that has sufficiently robust finances to fulfil its contractual obligations, and to respond successfully to most opportunities or adverse circumstances.	Normally, a provider with at least two good indicators for solvency (current ratio), margin (operating surplus/profit), and status (gearing).
3 Satisfactory	A provider that appears to have sufficient resources to fulfil its contractual obligations, but also appears likely to have limited capacity to respond successfully to opportunities or adverse circumstances.	Normally, a provider with at least two satisfactory indicators for solvency (current ratio), margin (operating surplus/profit), or status (gearing).
4 Inadequate	A provider that is in financial difficulty and very likely to be dependent on the goodwill of others. There is a significant risk of providers in this group not being able to fulfil contractual obligations because of weak financial health.	Normally, a provider with at least two inadequate indicators for solvency (current ratio), margin (operating surplus/profit), or status (gearing).

2.18 Based on the modelling development work, the expectation is that for the majority of colleges the new grade should correlate to the traditional health group which is *confirmed following LSC moderation* (as opposed to the traditional autoscore) as follows:

Traditional health group	New health grade
A	Outstanding or Good
B	Good or Satisfactory
C	Satisfactory or Inadequate

2.19 The table below sets out the initial scoring stage under the new mechanism:

Initial scoring

Score	Adjusted current ratio	Operating surplus	Borrowing as a % of reserves and debt
0	< 0.2	< -4	>/= 95 or negative
10	>/= 0.2	>/= -4	< 95
20	>/= 0.4	>/= -3	< 90
30	>/= 0.6	>/= -2	< 85
40	>/= 0.8	>/= -1	< 80
50	>/= 1.0	>/= 0	< 75
60	>/= 1.2	>/= 1	< 60
70	>/= 1.4	>/= 2	< 45
80	>/= 1.6	>/= 3	< 30
90	>/= 1.8	>/= 4	< 15
100	>/= 2.0	>/= 5	0

2.20 The adjusted current ratio excludes restricted cash from disposal of fixed assets held for future reinvestment AND assets held for resale (i.e. those previously transferred from fixed to current assets).

2.21 The operating surplus figure is the **adjusted** operating surplus as recorded at the bottom of table 1 of the financial plan template. This is calculated as operating surplus after tax less exceptional support and pension finance income plus FRS 17 (staff costs) adjustment.

2.22 The three scores above are then totalled and additional points given for stability as follows:

- 2 ratios >/= 60 – add 50 points
- 3 ratios >/= 60 – add 100 points

2.23 When the final score is calculated, the health group under FFE is as follows:

- 310 – 400 points Grade 1 - Outstanding
- 220 – 300 points Grade 2 - Good
- 120 – 200 points Grade 3 - Satisfactory
- </= 110 Grade 4 - Inadequate

2.24 For the financial plan, each year is now to be assessed separately rather than an aggregate assessment being calculated.

2.25 In the interests of consistency, the autoscore under the new approach will only be moderated in accordance with the criteria set out below.

2.26 Any queries about the new approach to financial health assessment should be addressed to the relevant Regional Provider Financial Management Director in the first instance.

Moderation of autoscore

2.27 In the interests of consistency, the autoscore under the new approach should be moderated only in accordance with the criteria set out below.

Capital Uplift

2.28 For colleges currently undertaking a capital project at their 31st July year end, that is, 31st July lies within the capital project lifecycle which is defined as: date of first claim to financial year in which project ends plus three years, then:

a. where a college is graded outstanding, good, or satisfactory at the time of detailed project approval; and

b. it will return to a grade of at least satisfactory by the third year following project completion; then

c. providing it performs at least as well (in the opinion of the LSC) as forecast in the project proposal during the intervening years, its financial health grade will be maintained on record as being at least 'satisfactory' rather than 'inadequate'; however,

d. if a college performs less well than it forecast then its grade will reflect this.

2.29 Under this approach there will be a clear reference point within the project proposal, minimising any judgment required and providing a clear basis for LSC validation of college financial health grades.

2.30 This has been the major subject in feedback received on the financial health proposals for the Framework for Excellence (the Framework). Concerns focused on the fact that undertaking a capital project usually has an adverse impact on financial health in the short to medium term, together with the possibilities of the overall performance rating under the Framework being affected and adverse local press. The agreed policy set out above avoids colleges which are undertaking a capital project but which are otherwise financially sound, coming into scope for a financial Notice to Improve and/or being unable to achieve an overall performance rating of either 'good' or 'outstanding' under the Framework.

Background

2.31 The LSC has a well-established rigorous business process for evaluating and approving college capital project proposals. The educational, property and financial aspects (including a financial forecast covering five to ten years) are reviewed on a consistent basis across the nine regions, so that at the point of LSC approval there is confidence in the college's management strength and financial capacity to deliver the project. The LSC accepts that it is usual for a college's financial health to deteriorate during the build period, with high levels of short term loans. For this reason, projects are approved based on the forecast financial position at the end of the third financial year following project completion. It would not be reasonable, other things being equal, having carried out the above assessment and given project approval, for the LSC then to label a college as having 'inadequate' financial health for several years running and to issue a Financial Notice to Improve as a consequence.

2.32 The proposed rules of combination to determine a grade for the Finance Dimension as a whole and the overall performance rating for the Framework are such that a college with an 'inadequate' grade for financial health could not achieve an 'outstanding' or 'good' grade overall, regardless of how well they might perform against other indicators. The agreed policy set out above will avoid some colleges being graded overall as no better than 'satisfactory' for a period of several years, and support the credibility of the Framework. It should be noted that the scoring and grading approach for version 1 of the Framework is still being finalised. If there are any changes, these (and any consequences for the approach to capital under the Financial Health Key Performance Area) will be communicated separately.

Moderation criteria

2.33 The following criteria will form the basis for moderation of financial health grades based on colleges' July 2008 financial plan returns and their 2007/08 finance record returns. These criteria are in line with those proposed for version 1 of the Framework for Excellence (the Framework). If there are any changes during the finalisation of the Framework, these will be communicated separately. The expectation is that moderation will only be required in a small proportion of cases. The criteria are as follows:

a. a college or provider may make a case to their Regional Provider Financial Management Director seeking moderation (to one grade higher or one grade lower) on the following bases:

i where a college or provider operates with a revolving credit facility, reducing the reported current ratio; or

ii where a college or provider incurs impairment charges in relation to (or in advance of) a capital project; or iii where a college has incurred professional fees in relation to a capital project proposal which could not be capitalised (the LSC will only accept this where, in the LSC's opinion, there is adequate subsequent confirmation that the project will proceed and the fees will be shown as capitalised in future financial statements).

b. in addition, the LSC will moderate a college's grade on the following bases:

i where a college is in receipt of exceptional financial support in-year, this would normally lead to an 'inadequate' grade for financial health being reported for that year;

ii where a college is operating with LSC consent for solvency-related borrowing in excess of the limits set out in the Financial Memorandum, this would normally lead to an 'inadequate' grade for financial health being reported for that year; and

iii where information other than the latest available audited financial statements, supported by factual evidence, indicates that the financial health is significantly different from the autoscore. 'Significantly' would here be defined as sufficiently different to generate an autoscore at least one grade lower. A grade would not normally be raised until the relevant evidence was confirmed in the subsequent audited financial statements. Examples might include (but would not be limited to):

- a court ruling which has financial consequences;
- the loss of a material contract or area of provision; or
- a contingent liability crystallising.

Submission of Financial Statements

2.34 The LSC is required to collect and retain original copies of colleges' audited financial statements. The financial memorandum between colleges and the LSC requires that colleges submit these to the LSC within five months of the end of the financial year – that is, by 31 December each year.

2.35 Colleges are also required to submit an electronic version of their accounts (called the finance record) in a format consistent with the format used for submitting financial plans. Further guidance on the Finance Record is given in the Accounts Direction Handbook. This is to allow a comparison to be made and forms the basis for an update of the college's financial health assessment.

Annex 1

STANDARD LETTER SENT TO COLLEGES, SPRING 2008

Financial Notices to Improve

This letter highlights the recent introduction of financial Notices to Improve and provides some context in terms of the Learning and Skills Council's (LSC)'s wider approach to financial monitoring and financial intervention.

In response to commitments made in the White Paper *Further Education: Raising Skills, Improving Life Chances* (2006), in January 2007 the LSC published *Identifying and Managing Underperformance.* That publication signalled financial Notices to Improve, and an updated document published on 14 January 2008 provides for their introduction.

In terms of financial underperformance the LSC's approach historically has been to intervene where a college experiences serious financial difficulties (that is, it is in financial failure), sometimes requiring exceptional support funding in order to recover. More recently, the LSC has sought to intervene at an earlier stage, to work with colleges with emerging financial issues to ensure these are addressed, thereby aiming to avoid serious financial difficulties. Colleges with emerging financial issues may still be in reasonably robust overall financial health at the point when the issues are identified, usually through the normal business cycle of college returns and/or through dialogue. As set out in the January 2008 publication, colleges identified as being in financial failure will receive a financial Notice to Improve and the LSC will formally agree Improvement Indicators with colleges which are identified as having emerging financial issues.

The principles underpinning the approach to identifying and managing underperformance for financial health and financial control are as follows:

a. to align with the established LSC financial health and financial control assessment process;
b. once actual or emerging financial issues are identified then the LSC should intervene; and
c. financial intervention should be proportionate to the circumstances.

During the period to 31 July 2008 financial Notices to Improve will be issued to colleges which:

a. are in financial health group C and which are (as opposed to being likely to become) dependent on a third party for funds. This assessment will be based on information already held, and confirmed through the LSC's review of colleges' 2006/07 audited financial statements, or
b. receive a grade 4 or 5 as an outcome of a Financial Management and Governance review carried out by the LSC's Provider Financial Assurance audit teams.

From August 2008 a financial Notice to Improve will be issued if a college receives an 'inadequate' grade for either financial health or financial control under the Framework for

Excellence. Please note that it has been agreed that the impact on financial health of undertaking a well-managed capital project will not, in itself, result in an ‘inadequate’ grade for financial health under the Framework.

Notices to Improve are a vehicle for driving up performance. Financial Notices to Improve have been developed to strengthen and formalise the LSC’s approach to financial monitoring and financial intervention.

The updated guidance on *Identifying and Managing Underperformance* is available on the LSC’s website. If you have any queries in relation to financial Notices to Improve please contact your regional Provider Financial Management Director.

[Letter to be addressed to principals, copied to college finance directors]