2: Monitoring the Financial Health of Providers

Background

2.1 The LSC's successor bodies are required, to monitor the financial health of providers. In addition to this formal requirement, they assess colleges' financial health to understand the degree of risk they may represent to them 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 funding body faces the risks of:

- learners suffering when their learning provision is disrupted or terminated
- being unable to recover any funds owed to them 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 appropriate funding body's statutory responsibility to ensure proper and reasonable provision of facilities for post-16 learning. To reduce these risks, the appropriate funding body gathers assurance that the college has the necessary financial resources to:

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

2.4 The two key financial documents used 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 appropriate funding body, to assess the financial effect of a college's strategic plans.

2.6 Colleges must 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 do we 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 appropriate funding body'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 appropriate funding body assesses which financial health grade is appropriate for a college, it considers guidelines for each grade (which are published annually as part of guidance to the sector), the college's self-assessment and a computed health grade, further details on which are set out below. They review 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's successor bodies' approach to grading the financial health of colleges and other providers is incorporated into the college financial returns. It results in one of four assessment grades: outstanding, good, satisfactory, or inadequate. In the case of the financial plan, a grade will be given for each year of the plan.

2.10 Where a college's financial health is graded as 'inadequate' for the previous year (forecast or actual outturn) or the current year (budget), this will form the basis for issuing a Financial Notice to Improve, in accordance with the guidance published by the LSC, *Identifying and Managing Underperformance*.

2.11 Where a college's financial health is identified as declining year on year, this will normally form the basis for requiring a financial improvement plan or equivalent, except where a college is implementing a major capital project, in accordance with the above gu*idance.*

2.12 *One objective of the approach is* that the automatically calculated health grade (autoscore) should require moderation in a relatively small number of instances. The process of college self-assessment (considered by the corporation and signed off by the principal) is considered to represent good practice, which will support self-regulation in due course.

2.13 The moderation and validation process in relation to financial health assessments requires the appropriate funding body to review and confirm colleges' financial health grades based on each financial return.

Grade definitions and scoring

2.14 The grade definitions under the 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).

2.15 The table below sets out the initial scoring stage under the 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

2.16 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).

2.17 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 but before costs relating to the property strategy (i.e. accelerated depreciation plus property strategy costs net of associated capital grant releases) less exceptional support and pension finance income plus FRS 17 (staff costs) adjustment.

2.18 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

2.19 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 – 210 points Grade 3 - Satisfactory
- </= 110 Grade 4 - Inadequate

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

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

2.22 Any queries about the approach to financial health assessment should be addressed to the relevant funding body in the first instance.

Moderation of autoscore

2.23 The autoscore is moderated only in accordance with the criteria set out below.

Capital Uplift

2.24 For colleges currently undertaking a capital project, with an autoscore of inadequate, 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 its financial health grade will be uplifted to 'satisfactory' rather than an autoscore of 'inadequate' in any year, provided that:

a. the 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;

c. it performs at least as well (in the opinion of the relevant funding body) as forecast in the project proposal during the intervening years; however, if a college performs less well than it forecast then its grade will reflect this.

2.25 This will ensure that colleges which are undertaking a capital project, but which are otherwise financially sound, do not come into scope for a Financial Notice to Improve in respect of their financial health.

Other Moderation Criteria

2.26 Where information other than the latest available audited financial statements or financial plan, 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. Examples might include (but would not be limited to):

- unplanned significant increase in cash requirements;
- 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

2.27 The LSC's successor bodies are required to collect and retain original copies of colleges' audited financial statements. The financial memorandum requires that colleges submit these to the appropriate funding body within five months of the end of the financial year – that is, by 31 December each year.

2.28 Colleges are also required to submit an electronic version of their financial statements in a specific format (the finance record). This is to ensure the data is captured in a consistent format; to allow for comparison and analysis; and to form the basis for an update of the college's financial health assessment. Further guidance on the Finance Record is given in the Accounts Direction Handbook.