

Financial Health Assessment of Non College Providers

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Audience Skills Funding Agency Staff and Providers

Purpose

The Agency assesses a providers' financial health to understand the degree of risk to the Agency in contracting with those organisations and to establish the recommended value of contracts appropriate to the financial resources of those organisations. This document sets out the Agency's approach to the Financial Health Assessment of non-college providers.

Definition

Financial Health is a measure of a provider's financial status in terms of financial performance and ability to meet ongoing financial commitments.

Financial Health is graded, based on the following three elements:

- Current ratio (solvency)
- Profitability (sustainability)
- Gearing calculated using borrowing as a percentage of specific reserves and debt (status)

Data Source

The financial information required to calculate these three elements is taken from the latest available financial statements which every provider has to submit to the Agency under the terms of their contract(s) and in accordance with the Agency's procurement procedures.

Exemptions

The following providers are exempt from Financial Health assessment

- central government departments, executive agencies or non-departmental public bodies;
- local authorities including Local Education Authority (LEA) schools;

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An agency of the Department for Business, Innovation & Skills

- NHS trusts, Universities;
- major national charities and voluntary organisations, for example OXFAM, Red Cross, RNIB, RNLI; and
- established Public Listed Companies and other registered companies for whom Agency funding is incidental to their business i.e. Agency contract values are no more than 5% of annual turnover (see below)

National Apprenticeship Service Managed Large Employers

The Agency directly contracts with employers to fund training which the employers deliver to their own employees. Established Public Listed Companies and other registered companies that the Agency directly contracts with in this way as Large Employers are out of scope and do not require a formal annual financial health assessment provided:

- They are initially assessed by the Agency to be financially stable and
- Agency funding is incidental to their business (i.e. Agency contract values are no more than 5% of annual turnover)

The Agency's Provider Finance Team will access the latest financial statements prior to contracting to confirm that proposed funding is incidental (i.e. within the 5% limit) and identify any concerns around financial stability.

Once status and financial stability has been confirmed no further formal assessment would normally be required other than an annual review (the Agency's Provider Finance team will access the latest financial statements to confirm organisational status and that no change has occurred which could affect the employers "out of scope" status). The Agency's Provider Finance Team will feedback results of reviews to the relevant account managers within the Agency / NAS for action.

The reasons why an employer may come "within scope" are:

- Total Agency funding becomes material, that is exceeds 5% of turnover; and
- Annual financial statements indicate concerns over the financial health of the organisation including, for example, a qualified auditors report and/or doubt over the going concern basis.

Financial Health descriptions

| Grade | Definition | Indicators |
|--------------|--|--|
| 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), sustainability (operating surplus/profit), and status (gearing). |
| 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), sustainability (operating surplus/profit), and status (gearing). |
| 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), sustainability (operating surplus/profit), or status (gearing). |
| Inadequate | A provider that is in financial difficulty and very likely to be dependent on the goodwill and/or the financial support 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), sustainability (operating surplus/profit), or status (gearing). |

Financial health elements

| Element | Definition |
|----------------|--|
| Solvency | Current ratio defined as: $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ |
| Sustainability | Operating position after tax as a percentage of Income defined as: $\frac{\text{Profit after Tax}^*}{\text{Turnover}} \times 100$ <p>* for this purpose depreciation and amortisation is added back to profit after tax</p> |
| Status | Total debt as a percentage of reserves* and debt <p>* reserves are defined for this purpose as shareholders funds less intangible assets Debt is defined as all long term and short term borrowing including bank overdrafts and group loans</p> |

Financial health scoring

For each of the performance indicators a score of zero to 100 points will be awarded, based on performance.

Table 1: Scoring the Financial Health Ratios:

| Score | Current Ratio | Operating Surplus % | Borrowing as a % of Reserves and Debt |
|-------|---------------|---------------------|---------------------------------------|
| 0 | < 0.5 | < 0 | >= 90 or negative |
| 10 | >= 0.5 | >= 0 | < 90 |
| 20 | >= 0.6 | >= 1 | < 80 |
| 30 | >= 0.7 | >= 2 | < 70 |
| 40 | >= 0.8 | >= 3 | < 60 |
| 50 | >= 1.0 | >= 4 | < 50 |
| 60 | >= 1.2 | >= 5 | < 40 |
| 70 | >= 1.4 | >= 6 | < 30 |
| 80 | >= 1.6 | >= 7 | < 20 |
| 90 | >= 1.8 | >= 8 | < 10 |
| 100 | >= 2.0 | >= 9 | = 0 |

Grading the financial health score

An initial grade assessment will be made by comparing the aggregated points score with the assessment criteria shown below:

| | |
|--------------|----------------|
| Outstanding | 240–300 points |
| Good | 180–230 points |
| Satisfactory | 120–170 points |
| Inadequate | <=110 points |

Moderation criteria

In addition the Agency will moderate a college's or provider's grade on the following bases:

- Where a provider scores 0 points for one of the three ratios then it can be graded no better than satisfactory.
- Where the financial statements have been given a qualified or adverse opinion by the auditors;
- Where financial statements are not produced to the Agency then the financial health will be graded as inadequate;
- Where the provider's financial health is affected by the group/parent company financial health and any parent company guarantee. In such cases a grade may be moderated where the financial position of a group/parent company could impact significantly on the financial health of the organisation with whom the Agency is contracting;
- 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' is here defined as sufficiently different to generate an autoscore at least one grade lower. 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;
 - a contingent liability crystallising;
 - recall of debt by the bank;
 - cessation of trading.
- In owner managed companies where company directors receive payment via dividends with only a minimum salary being reflected in the accounts such payments usually represents a more tax efficient substitute for directors' remuneration, which would have reduced the total profit. The adjusted profit will be used to calculate the sustainability ratio;
- Where a company's financial health is calculated as Inadequate solely as a result of a deficit on the pension scheme (as measured under FRS17) which reduces the level of reserves.

Recommended funding limits

A key aspect of the financial health assessment process is the setting of a recommended funding limit (RFL) which is a measure of a provider's financial capacity to deliver. This is not required where the provider is a further education college or exempt or out of scope for a financial health assessment. The funding limit will also vary depending upon whether the provider is new or has existing contracts. There are other constraints that may impact on the capacity of a provider to deliver, for example provider infrastructure, that are monitored by other Agency teams and need to be taken into account when awarding contracts.

The Agency's methodology

The recommended funding limit is calculated as a percentage of the provider's turnover as per their latest annual financial statements. The relevant percentage is determined as follows:

| FH Grade | Existing providers | Prospective providers with financial history | Assessments based on business plans |
|-----------------|---------------------------|---|--|
| Outstanding | 150% | 100% | n/a |
| Good | 125% | 75% | n/a |
| Satisfactory | 115% | 50% | See below |
| Inadequate | 0% | 0% | No contract |

Existing providers within scope will not normally be allocated a recommended funding limit of more than £30m.

Prospective providers who do not hold a contract with the Agency at the time of assessment are considered a greater risk and as such will have a RFL calculated on reduced percentages. A maximum to the calculated RFL is set at £2m.

Prospective providers who do not have a financial history may submit a fully costed business plan for assessment. There is no set format for a business plan but as a minimum it should include:

- a forecast profit & loss account and balance sheet
- a 12 month rolling cash flow forecast
- a narrative supporting the assumptions made in preparing the business plan

Business plans will be assessed on an individual basis on their own merits. Business plans that are considered by the Agency to be viable will be allocated a financial health category of Satisfactory. The RFL will be set at the turnover per the plan up to a maximum of £1m.

There may be occasions where existing or prospective providers with a financial history submit a business plan where otherwise they would be assessed as inadequate financial health or have a calculated RFL lower than the minimum

contract level (currently £500k). In such cases the assessment will be carried out on the same basis as detailed in the paragraph above.

Implications of the RFL within the Agency

Before contracting, the financial health score and RFL are used to inform contract negotiations. The majority of providers are awarded contracts whose aggregate values are within the RFL.

The funding limit is a recommended maximum. Where the Agency proposes to award a contract which takes the aggregate values beyond this limit, this would be subject to a business case being prepared and approved internally within the Skills Funding Agency in accordance with the latest operational guidance and appropriate risk mitigation measures (which may include, for example, enhanced performance management, greater audit scrutiny).

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