Education & Skills Funding Agency

Financial health guidance for organisations contracting with or applying to ESFA

September 2017

Of interest to existing providers and new organisations applying to the ESFA

Contents

Definition

1. This guidance is not to be used for general Further Education colleges, Sixth Form colleges, Academies, or academy trusts. If you are seeking financial guidance for any of these areas, please follow the links below.

- Academies - https://www.gov.uk/guidance/academies-financial-returns
- College financial plans - https://www.gov.uk/government/publications/financial-planning-handbook
- College accounts direction - https://www.gov.uk/government/publications/college-accounts-direction

2. The term organisation is used within this guidance to refer to all entities, and is used as a generic term. Organisations are defined for the purpose of this guidance as Independent Training Providers, Independent Specialist Providers, Charitable and Commercial Providers, Special Post-16 Institutions, Non-Maintained Specialist Schools, Advanced Learner Loans providers, and organisations applying to an Education and Skills Funding Agency (ESFA) register or procurement round.

Purpose

3. This document sets out the ESFA's approach to the financial health assessment of organisations.
4. This is to understand the degree of risk to the ESFA in contracting with them, either directly or indirectly. It also establishes the maximum recommended value of contracts appropriate to the financial resources of organisations that have a direct contract.
5. We use financial health as a measure of an organisation's financial status, in terms of its financial performance and its ability to meet ongoing financial commitments.

Data Source

6. Financial health for organisations is graded, based on the following three elements:
    - Profitability (sustainability)
    - Solvency (current ratio)
    - Gearing (debt ratio)
7. The information required to calculate these three elements is taken from the latest available financial statements. Every organisation must submit this information to us and/or in line with the requirements specified for individual Register and procurement procedures.
8. Organisations applying to any of our Register or procurement rounds must follow the guidance published with the round they are applying to.
9. Financial statements submitted must be full accounts (not abbreviated / abridged), and audited, where appropriate. If only abbreviated accounts are required for Companies House filing, you must still submit your full statutory accounts to us, which must include, as a minimum, the following elements:
    - An end of period Profit and loss account, or equivalent
    - An end of period Balance sheet
    - Commentary and breakdown, including relevant notes to the accounts

    Organisations must supply full accounts, not just an extract or selected pages.

10. If your organisation, due to its legal form, is not required to produce statutory financial statements, you must submit accounts in the format used for producing annual accounts. These must include the same minimum elements noted above.
11. If your organisation is unable to supply statutory financial statements because it has not traded for a sufficient period, you must supply management accounts to date, showing actual activity, along with forecast figures for a remaining period. The combined information must cover a period no less than one year, with the management accounts comprising at least three months of actual trading activity. As a minimum, these must consist of:
    - a profit and loss account covering a 12 month period

- an end of period forecast balance sheet
- a 12 month rolling cash flow statement
- detailed narrative supporting assumptions made for both management accounts and forecast information

12. If an organisation has not been actively trading for a minimum period of three months, then it is not eligible to apply for register or procurement rounds. (Actively trading is determined here as including income and expenditure arising as a result of trade, and does not include the incurrence of set up or start-up costs).
13. Any financial health grade awarded from the submission of management accounts and financial forecasts will only remain valid until the first set of financial statements become available.
14. We will assess management accounts and financial forecasts on an individual basis. We will take into consideration their achievability, potential for delivery against the information submitted and any autoscore recorded.
15. If any of the required information is missing, we will grade financial health as 'Inadequate', due to insufficient information available for assessment.
16. Organisations with a current funding agreement must submit new financial statements each year. They must do this as soon as the statements become available, but no later than nine months after the year-end. Failure to submit financial statements on a timely basis will result in the award of a financial health grade of 'Inadequate' until financial statements are submitted and assessed.
17. We may use external sources of information to inform our decision on your finances, such as, Companies House, Charities Commission, credit reference agencies, along with information from sites that monitor these.
18. Organisations that hold an existing ESFA contract may be subject to further periodic financial reviews.

Parent Companies

19. If your organisation is part of a wider group of companies or is classed as a subsidiary, you must submit full financial statements for the ultimate UK

parent company. You must also submit those of the contracting or applying organisation.

20. If an organisation fails to submit its ultimate UK parent company accounts, this may result in the award of an 'Inadequate' grade.
21. If your ultimate UK parent company does not produce consolidated accounts, you are required to supply the accounts for their non-dormant subsidiaries.
22. If your ultimate parent company is registered outside of the UK, you must supply the full financial statements for your UK parent company.
23. If you do not have a UK parent company, then you are not required to submit overseas parent company accounts.

Exemptions

24. The following organisations are exempt from this financial health assessment process, and do not need to submit annual financial statements to the ESFA:
    - central government departments, executive agencies, or non-departmental public bodies
    - local authorities, including local education authority (LEA) schools
    - free schools
    - NHS trusts, fire authorities and police authorities
    - universities monitored and supported by the Higher Education Funding Council for England (HEFCE)
    - major national charities or voluntary organisations with a consistent annual turnover in excess of £75 million, where total ESFA funding is less than, or expected to be less than, 5% of the organisation's annual incoming resources
25. Further Education (FE) colleges, sixth form colleges (SFC), academies and academy trusts are subject to a separate monitoring regime and are not required to submit accounts for register application purposes.
26. If your organisation is applying to a register or procurement round for the first time, and you consider that it should be exempt from financial health assessment, then you must supply a copy of your most recent accounts along with an exemption form clearly stating your category for exemption.

Exemptions – Large Private Organisations

27. We may also consider established public limited companies or other registered companies exempt if; they have a consistent annual turnover in excess of £75 million, where total current ESFA funding to the organisation constitutes, or is expected to constitute, less than 5% of the organisation's annual turnover.
28. Organisations which are considered to fall under this category must submit their financial statements as part of a register round. Failure to submit financial statements may result in an 'inadequate' grade being awarded.
29. Financial statements for organisations under this category will be reviewed to ensure the organisation is financially stable; and that total ESFA funding is incidental to their business (that it is no more than, or expected to be no more than, 5% of annual turnover).
30. Once we confirm status and financial stability no further formal assessment would normally be required other than an annual review. The ESFA's Provider Risk and Assurance (PRA) division will access or request the latest financial statements. They will confirm organisational status and that no change has occurred which could affect the organisations status.
31. An organisation may be removed from this category if:
    - total ESFA funding becomes material, that is, exceeds 5% of annual turnover; or
    - we become aware of concerns over the financial health of the organisation

Moderation Criteria

We reserve the right to moderate any initial grade. Moderation criteria include, but are not limited to the following.

a. We will not grade higher than 'satisfactory' if an organisation scores 0 points for any one of the three ratios.
b. Where auditors have given the financial statements a qualified or adverse opinion.

c. We will grade financial health as inadequate if Companies House shows your organisation has entered liquidation, insolvency, a Company Voluntary Arrangement, or become dormant.
d. We will grade financial health as inadequate if financial statements are overdue for filing at Companies House or the Charities Commission.
e. We will grade financial health as ‘inadequate’ if organisations do not submit the most recently filed full financial statements to us when they become available.
f. We will grade financial health as inadequate; where we are unable to open the information submitted; the information submitted does not appear complete or contains errors; or where in our view, does not evidence a minimum of three months active trading.
g. If there is a group/parent company whose financial position could significantly impact the financial health of the organisation, we may moderate the grade accordingly.
h. Where information other than the latest available financial statements, supported by factual evidence, indicates that the financial health is significantly different from the autoscore. ‘Significantly’ is 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 or investor
    - loss of key personnel
    - cessation of trading
i. Where an organisation’s financial health is calculated as ‘inadequate’, solely because of a deficit on the pension scheme (as measured under FRS17) which reduces the level of reserves, the grade may be moderated to ‘satisfactory’.
j. If long-term borrowings are high, but are predominantly and demonstrably secured on long-term fixed assets, for example a mortgage on property; if this significantly affects the financial health (by at least one grade), and finances

suggest that sufficient cash is being generated to cover the associated repayments, we may moderate a calculated grade of ‘inadequate’ to ‘satisfactory’. For this moderation criteria to be applied you will need to inform us of the value of such mortgages.

k. Where an organisation’s financial health, in an isolated year, is calculated as ‘inadequate’ solely due to making a distribution of a number of years’ accumulated profits through a dividend, resulting in a zero score for profitability. In such circumstances, we may moderate the financial health score to ‘satisfactory’, if we consider that the underlying business is profitable.

l. We may moderate organisations graded ‘inadequate’ to ‘satisfactory’ upon receipt of a fully completed guarantee, where the use of a guarantee is deemed suitable.

Recommended Funding Limits

32. A key aspect of the financial health assessment process is the setting of a maximum recommended funding limit (RFL). It is a measure of an organisation’s financial capacity to deliver. The funding limit will also vary depending upon whether the organisation is new or has an existing contract with the ESFA. There are other constraints that may impact an organisation’s capacity to deliver, such as its infrastructure. Other ESFA teams monitor and consider these when awarding contracts.
33. The concept of a RFL is not applicable to FE colleges, sixth form colleges, academy trusts or organisations considered exempt for financial health assessments.
34. We calculate the RFL as a percentage of the organisation’s turnover from their latest annual financial statements. The relevant percentage is determined as follows:

Grade	Organisations that hold an existing ESFA contract	Organisations that do not hold an existing ESFA contract but have financial history	Organisations that do not hold an existing ESFA contract and are assessed based on management accounts and forecast
Outstanding	150%	100%	N/A
Good	125%	75%	N/A
Satisfactory	115%	50%	See below
Inadequate	0%	0%	No contract

35. We consider organisations that do not hold a contract with the ESFA at the time of assessment a greater risk. We will calculate the RFL on a reduced percentage; the maximum RFL awarded is £2 million.
36. We will assess management accounts and forecasts individually on their own merits. We will allocate a financial health category of ‘satisfactory’ to management accounts and forecasts we consider viable. We will set the RFL at the turnover in the accounts and forecasts to a maximum of £1 million.
37. If management accounts are specifically requested and reviewed for organisations that hold a current contract with ESFA, these will not result in an amendment of their grade or RFL.
38. Before contracting, the financial health score and RFL may be used to inform contract negotiation.

Annex A – Financial Health descriptions

Grade	Definition	Indicators
Outstanding	An organisation that appears to have robust finances to fulfil its contractual obligations and to respond successfully to opportunities or adverse circumstances	Normally an organisation with Outstanding/Good indicators for profitability, solvency and gearing.
Good	An organisation that appears to have sufficiently robust finances to fulfil its contractual obligations, and to respond successfully to most opportunities or adverse circumstances.	Normally an organisation with at least two Good indicators for profitability, solvency and gearing.
Satisfactory	An organisation 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 an organisation with at least two satisfactory indicators for profitability, solvency and gearing.
Inadequate	An organisation that is in financial difficulty and very likely to be dependent on the goodwill and/or financial support of others. There is a significant risk of organisations in this group not being able to fulfil contractual obligations because of weak financial health.	Normally an organisation with at least two inadequate indicators for profitability, solvency and gearing.

Annex B – Financial Health elements

Element	Definition
Profitability	Operating position after tax as a percentage of income, defined as: $\frac{\text{Profit after Tax}}{\text{Turnover}} \times 100$ For this purpose, depreciation and amortisation are added back to profit after tax and dividends are subtracted.
Solvency	Current ratio defined as: $\frac{\text{Current Assets}}{\text{Current Liabilities}}$
Gearing	Total debt as a percentage of reserves and debt. Reserves are defined for this purpose as shareholders' funds less intangible assets. If this is a negative figure, an automatic score of 0 is given. Debt is defined as all long-term and short-term borrowings, which include, bank overdrafts, finance leases and hire purchase contracts, directors' loans to the company, inter-company and group loans to the company, personal loans to the company, directors' current accounts and amounts owed to the directors'.

Annex C – Financial Health Scoring and Grading

For each of the three elements a score will be awarded as shown below:

Score	Profitability	Solvency	Gearing
0	< 0	< 0.5	>= 90 or negative
10	>= 0	>= 0.5	< 90
20	>= 1	>= 0.6	< 80
30	>= 2	>= 0.7	< 70
40	>= 3	>= 0.8	< 60
50	>= 4	>= 1.0	< 50
60	>= 5	>= 1.2	< 40
70	>= 6	>= 1.4	< 30
80	>= 7	>= 1.6	< 20
90	>= 8	>= 1.8	< 10
100	>= 9	>= 2.0	= 0

We will make an initial grade assessment by comparing the aggregated points score with the assessment criteria shown below. This may then be subject to moderation.

Outstanding	240 to 300 points
Good	180 to 230 points
Satisfactory	120 to 170 points
Inadequate	<= 110 points

This document is also available from our website gov.uk/esfa.

If you have any enquiries regarding this publication or require an alternative format, please contact us info@sfa.bis.gov.uk