Guidance

Financial health guidance for organisations contracting with or applying to ESFA

Updated 15 February 2021

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1. Definition

1 This document sets out the ESFA's approach to the financial health assessment of organisations.

2 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.

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2. Purpose

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3. Data Source

8 Financial health for organisations is graded, based on the following three elements:

- Profitability (sustainability)
- Solvency (current ratio)
- Gearing (debt ratio)

9 The information required to calculate these three elements is taken from the latest audited financial statements. The financial statements should be for a complete period which has contribution to us in accordance with the contract with the Agency or the requirements specified for individual register and procurement procedures. For organisations that hold contract with the ESFA the latest financial statements must be sent to us as soon as they become available.

10 Organisations using any of our register or procurement rounds must follow the guidance published with the round they are applying to regarding minimum submission requirements.

11 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 (in the format required by the Companies Act 2006 and relevant reporting requirements) to us, which must include, as a minimum, the following elements:

- an end of period profit and loss account, or equivalent
- a balance sheet statement
- comments on the auditor's opinion, including notes to the accounts
- a breakdown of amounts contained within creditors' other creditors (other creditors - is determined here as any item recorded within either current or long-term liabilities that is not identifiable in its own right). For Agency assessment purposes, "Other creditors" is not an acceptable accounts classification and it must be clearly explained.

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

12 If your organisation, due to its legal form, is not required to produce statutory accounts, we will accept management accounts, but we will need to see the equivalent of a companies' annual accounts. These must include the same minimum elements noted above.

13 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, covering a period of at least 6 months. Management accounts for a newly combined information must cover a period no more 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 balance sheet
- a 12-month rolling cash flow statement
- detailed narrative supporting assumptions made for both management accounts and forecast information

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. Unlikely trading is defined as organisations with no recent financial transactions (within the last 6 months) and does not include the incurrence of set up or initial costs.

14 Any financial health grade awarded from the submission of management accounts and forecasts will be valid until new financial data with the latest audited accounts become available. If we do not receive full financial statements as soon as they become available, this may result in the financial health grade being moderated to inadequate.

15 We will assess management accounts and financial forecasts on an individual basis. We will use the information provided to assess the organisation's financial health and information submitted and any subsource recorded.

17 If any of the required information is missing, we will grade financial health as 'Inadequate', due to insufficient information available for assessment.

18 Organisations with a current funding agreement must submit financial statements every year. We will use this data 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 financial health grade being moderated to 'Inadequate' until financial statements are submitted and assessed.

19 We reserve the right to use and / or rely upon external sources of information to inform our decision on your finances, such as, Companies House, Dun & Bradstreet, Companies House, credit reference agencies, along with information from sites that monitor fraud.

20 Some organisations may be subject to or given financial monitoring by the ESFA. The guidance between these circumstances can be located in the ESFA Control of Independent Training Providers, operational guidance. Some organisations may be required to submit financial information to the Agency in accordance with requirements published in April 2019. This can include, but not limited to, submission of management accounts, financial forecasts, and cashflows. We may also request earlier submission of financial statements than the statutory requirement.

4. Parent Companies

21 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.

22 If an organisation fails to submit its ultimate UK parent company accounts, this may result in the award of an 'Inadequate' grade.

23 If your ultimate UK parent company does not produce consolidated accounts, you are required to supply the accounts for their non-dormant subsidiaries.

24 If your ultimate parent company is registered outside of the UK, you must supply the full financial statements for your UK parent company.

5. Exemptions

25 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 authorities
- free schools
- NHS trusts, the authorities and public authorities, including Policy and Crime Commissioners
- higher education institutions monitored by the Office for Students
- major national charities or voluntary organisations with a consolidated annual turnover more than £75 million, where total ESFA funding is less than, or expected to be less than, 5% of the organisation's annual income.

26 Organisations which are considered to fall under this category must still submit their financial statements as part of a register round for validation purposes. Failure to submit financial statements may result in an 'Inadequate' grade being awarded.

27 Financial assistance for organisations under this category will be monitored to ensure the organisation remains financially stable, and that total ESFA funding is maintained at a level below 5% (that it is no more than, or expected to be no more than, 5% of annual turnover).

28 We may use external sources of information to inform our decision on your finances. If we become aware of any financial risk to an organisation, we reserve the right to review the exemption status at our discretion.

29 Organisations that are exempt from the financial health assessment process would normally be required either than an annual review. The ESFA's Provider Market Oversight (PMO) team 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.

30 An organisation may be removed from this category if:

- total ESFA funding becomes material, that is, exceeds 5% of annual turnover;
- annual turnover reduces to below £75 million; or
- we become aware of concerns over the financial health of the organisation

6. Moderation criteria

We reserve the right to moderate any initial grade either up or down. We consider such moderation criteria on a case-by-case basis. Moderation criteria may include, but are not limited to, the following:

- We will not grade higher than 'satisfactory' if an organisation scores 0 points for any one of the three ratios.
- Where auditors have given the financial statements a qualified or adverse opinion. This may include a Disclaimer of Opinion or Going Concern declaration.
- We will grade financial health as inadequate if Companies House shows your organisation has entered liquidation, insolvency, a Company Voluntary Arrangement, or is shown as dormant.
- We will grade financial health as 'inadequate' if organisations do not submit additional financial information by us when requested.
- 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.
- We may grade financial health as 'inadequate' if organisations do not submit additional financial information by us when requested.
- We will grade financial health as 'inadequate', where we are unable to open the information submitted. (the information submitted does not appear complete, contains password protection, or is in a format we are unable to open). Companies House, Dun and Bradstreet, Commission website, or where in our view it needs it evidence a minimum of three months active trading.
- If there is a prospective company whose financial position could significantly impact the financial health of the organisation, we may moderate the grade accordingly.
- Where information other than the latest available financial statements, supported by factual evidence, indicates that the financial health is significantly different from the latest ESFA data. We will use the latest information to generate an overall assessment 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 a loss of provision
  - a contingent liability crystallising
  - recall of debt by the owner / investor
  - loss of key personnel
  - cessation of trading
- Where an organisation's financial health is calculated as 'inadequate', solely because of a deficit on the pension scheme which reduces the level of reserve, the grade may be moderated to 'satisfactory'.
- 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 calculation of the gearing ratio, we may moderate the grade to 'satisfactory'. If long-term borrowing generated to cover the associated repayments, we may moderate to a calculated grade of 'inadequate' to 'satisfactory'. For this moderation criteria to be considered the financial statements submitted must clearly detail this fact by the year end.
- Where an organisation's financial health, in an isolated year, is calculated as 'inadequate' or 'satisfactory' solely because of a significant one-off cost, which has caused a temporary decline in profitability, we may moderate the financial health score to 'satisfactory'. If we consider that the underlying business is profitable and removal of identified payments above the current year's profits would improve the grade.
- We may moderate organisations graded 'inadequate' to 'satisfactory' upon receipt of a fully completed guarantee, where the use of a guarantee is deemed suitable.
- We may consider moderation where an organisation can clearly demonstrate that there has been an exceptional loss of income and/or has incurred exceptional expenditure which has caused the financial health assessment to be affected. This moderation will only be considered where financial statements are supported by evidence demonstrating that there will be a return to an improved financial position in the following financial statements.
- Where an organisation has received government loans, e.g. Coronavirus Business Interruption Loan Scheme (CBILS) or Bounce Back Loan (BBL) to support its cash flow or borrowings. We moderate organisations graded inadequate to satisfactory where this government loan is the only reason for the inadequate grade and the business still appears stable. The value and details of the loan must be clearly identifiable within the financial statements.

8. Recommended Funding Limits

31 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 a direct contract holder with the ESFA or is a sub-contractor. It also takes into account impact an organisation's capacity to deliver, such as its infrastructure. Other ESFA teams monitor and consider these when awarding contracts.

32 The concept of a RFL is not applicable to FE colleges, sixth form colleges, academies, academy trusts or organisations considered exempt for financial health assessments.

33 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 are not training providers or providing ESFA contracted full level 3 level financial training	Organisations that are not training providers or providing ESFA contracted full level 3 level financial training	Organisations that are not training providers or ESFA contracted sub-contractors or management accounts and forecast
Outstanding	75%	125%	N/A
Good	125%	75%	N/A
Satisfactory	75%	50%	Sub-lettings
Inadequate	0%	0%	No contract

34 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.

35 We use management accounts and forecasts individually on their merits. We will allocate a financial health category of 'satisfactory' to management accounts and forecasts and we consider viable. We will set the RFL at the lower in the accounts and forecasts to a maximum of £1 million.

36 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.

37 Before contracting, the financial health score and RFL may be used to inform contract negotiation.

9. Annex A: financial health descriptors

Grade	Definition	Indicators
Outstanding	An organisation that appears to have robust finances to fulfill its contractual obligations. It is expected to successfully to opportunities or adverse circumstances.	Technically an organisation would have to achieve the highest indicators for profitability, solvency and gearing.
Good	An organisation that appears to have sufficiently robust finances to fulfill its contractual obligations. It is expected to successfully to cope with opportunities or adverse circumstances.	Technically an organisation would have to achieve a mixture of indicators for profitability, solvency and gearing.
Satisfactory	An organisation that appears to have sufficient resources to fulfill its contractual obligations, but it appears likely to have limited capacity to respond successfully to opportunities or adverse circumstances.	Technically an organisation would have to achieve a mixture of indicators for profitability, solvency and gearing, with at least two satisfactory indicators for profitability, solvency and gearing.
Inadequate	An organisation that is in financial difficulty and are likely to be aware of the goodwill and the financial support of others. Yet it is not clear that this goodwill and financial support will be sufficient to fulfill contractual obligations because of weak financial health.	Technically an organisation would have at least one indicator for profitability, solvency and gearing.

10. Annex B – financial health elements

Element	Definition
Profitability	Operating profit after tax as a percentage of income, defined as: Profit after tax / Turnover x 100 For this purpose, depreciation and amortisation are added back to profit after tax and dividends are deducted.
Solvency	Current ratio defined as: Current Assets / Current Liabilities
Gearing	Total debt as a percentage of reserves and debt: Reserves are defined for this purpose as shareholders' funds (not intangible assets). If this is a negative figure, the gearing ratio is deemed to be 100%. Debt is defined as all long-term and short-term borrowings, which include, bank overdrafts, finance leases and hire purchase contracts, credit cards, 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 connected parties. We may include other creditors within the debt figure if we are unable to identify the purpose of borrowings contained within this figure. A breakdown of other creditors must be supplied alongside the submission of your financial statements.

11. Annex C – financial health scoring and grading

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

Grade	Profitability	Solvency	Gearing
3	>12	>3.5	<= 60 or negative
2.5	>10	>2.5	<80
2	>7	>1.5	<100
1.5	>4	>1.2	<120
1	>2	>1.0	<150
0.5	>0.5	<1.0	>150
0	<= 0	<=1.0	>150
-1	<-1	<1.0	>150
-2	<-2	<1.0	>150
-3	<-3	<1.0	>150
-4	<-4	<1.0	>150
-5	<-5	<1.0	>150

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.

Grade	Points
Outstanding	3 to 15 points
Good	1 to 2.5 points
Satisfactory	0 to -1.5 points
Inadequate	<= -2 points

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