Financial Health Monitoring Procedures for Further Education Institutions

National Assembly for Wales Circular No: **24/2006**
Date of Issue: **1 January 2007**
Replaces Circular: **None**

Guidance Circular

Further Education

Yr Adran Addysg, Dysgu Gydol Oes a Sgiliau
Department for Education, Lifelong Learning and Skills

Llywodraeth Cynulliad Cymru
Welsh Assembly Government

Title of Document:	Financial Health Monitoring Procedures for Further Education Institutions
Audience:	Governing Bodies and Principals of Further Education Institutions in Wales
Overview:	This circular sets out the Welsh Assembly Government's approach to and the requirements for the monitoring of the financial health of Further Education Institutions.
Action required:	No response required
Further information:	Emma Smith, Finance Manager, Welsh Assembly Government, Ty'r Afon, Bedwas Road, Bedwas, Caerphilly, CF83 8WT. 01443 663973
Further copies:	Further copies can be obtained from – Emma Smith, address as above.
Related documents:	Information document 026/06, Financial memorandum between the Welsh Assembly Government, Further Education Institutions and Higher Education Institutions providing further education in Wales

G/211/06-07
ISBN 0 7504 8879 4
November
CMK-22-04-002(23)(316)
Typeset in 12pt

Definitions

‘Adjusted current liabilities’ means creditors less than one year less specific creditors with compensating debtor balances such as VAT

‘Cash in hand’ means the year end cash balance

‘Cash in/outflow from operating activities’ means the cash in/outflow from operating activities as calculated in accordance with FRS 1 (revised) and the SORP

‘Current ratio’ means the total current assets (as calculated in accordance with the SORP) divided by total current liabilities (as calculated in accordance with the SORP) then expressed as a ratio

‘FM (xx)’ means the cross reference to the Financial Memorandum, effective 1st January 2007, (paragraph xx)

‘General reserves’ means the general reserves as calculated in accordance with the SORP

‘Net current liabilities’ means the net current liabilities as calculated in accordance with the SORP

‘One month’s expenditure’ means one twelfth of the annual expenditure of the institution minus depreciation, including interest payable

‘Operating surplus/deficit/result’ means the surplus or deficit on operations after depreciation of tangible fixed assets at valuation and before tax, and before taking account of profit or loss on sale of fixed assets as calculated in accordance with the SORP

‘SORP’ means the Statement of Recommended Practice (SORP): ‘Accounting for further and higher education’ as may be amended from time to time

Introduction

1. This circular sets out the Assembly Government's approach to and the requirements for the monitoring of the financial health of Further Education Institutions (institutions).

Background

2. Under each institution's Instrument and Articles of Government the Governing Body is responsible for the effective use of resources,the solvency of the institution and for safeguarding assets. This responsibility cannot be delegated.

3. The Governing Body of the Institution is also responsible under the institution's Financial Memorandum with the Assembly Government for ensuring that the financial, planning and other management controls established by the institution are sufficient to safeguard funds received from the Assembly Government. The Financial Memorandum also requires the institution to:

a. prepare a financial strategy that underpins the institutional plan (FM 32a); and

b. to set targets in the financial strategy for the generation of cash and operating surpluses sufficient to finance ongoing activity, make funds available for investment and to produce a financial cash reserve excluding long term borrowing to support the future decisions of the institution (FM 32b).

4. The primary responsibility for the financial health of the institution is therefore placed with the Governing Body. The Governing Body can properly discharge its responsibilities only if it receives appropriate information on the institution's financial position. Accordingly, the Financial Memorandum also requires that the Governing Body receive, at least termly, a report that reviews the institution's financial position (FM 32c) containing:

- an Income and Expenditure Account, including commentary on performance to that date against the original budget and a forecast of the outturn for the financial year;
- a Balance Sheet; and
- a 12 month rolling Cash Flow Forecast.

5. The report should comment on the impact on the institution's financial strategy of the results and forecasts presented.

6. The Assembly Government needs to ensure that the uses to which the institution puts funds received are consistent with the purposes for which the funds were given and comply with the conditions attached to them (FM 19 -21). The Assembly Government also needs to ensure the regularity and propriety of expenditure from those funds and the achievement of the best possible value for money in the use of those funds.

7. In order to meet these responsibilities, the Assembly Government will require to be satisfied:

a. that the institution has appropriate arrangements for financial management and accounting (FM 31); and

b. that the uses to which the Assembly Government's payments to institutions are put are consistent with the purposes for which they were given (FM 19-21).

8. The monitoring of the financial health of institutions is one of the processes through which the Assembly Government discharges these responsibilities.

Financial Health Monitoring Procedures

9. The Assembly Government's financial health monitoring procedures are based on an assessment of three financial returns from institutions each year:

- Audited financial statements (and associated finance record), submitted by 31 December each year immediately following the accounting period;
- A five year forecast and financial strategy, submitted by 31 July each year; and
- A mid year return, submitted by 31 March each year.

10. In addition, the Assembly Government may require copies of management accounts, recovery plans and such other information as it may consider necessary to inform its assessment of the financial health of an institution.

11. These returns are used as the basis of financial health monitoring and subsequent categorisation of each institution. The information is also aggregated to inform the Assembly Government of the financial health of the sector.

12. The finance record and audited financial statements are also used to produce an analysis of the financial position of the sector that is published annually in a circular by the Assembly Government.

Financial Health Categories

13. The Assembly Government makes an assessment of each institution's financial health and places them in one of the following four categories. The following section sets out the key indicators that the Assembly Government will consider in making its assessment of the financial health category of an institution. It is essential that the full range of factors that impact on an institution's financial health are taken into account and the relative significance of these factors will vary between

institutions and on an institution's particular circumstance. The achievement or non-achievement of a particular factor therefore will not necessarily give rise to a change in category.

14. The assessment will be based on historical information together with an assessment of the forecast position, taking into account the uncertainties around forecasting that can occur.

Category A: *The institution's financial position and its financial strategy fully support the institutional plan*

15. Category A institution's will normally have:

- A financial strategy that fully supports the institutional plan and identifies targets and actions to deliver the generation of cash and operating surpluses sufficient to finance ongoing activity, make funds available for investment and to produce a financial reserve;
- A year on year operating surplus at a level consistent with the financial strategy;
- A year on year cash inflow from operating activities at a level consistent with the financial strategy;
- A balance of cash in hand plus bank deposits less adjusted current liabilities that is equivalent to one month's expenditure;
- Net current assets;
- A positive balance on general reserves before FRS 17; and
- Operating deficits or net cash outflows from operating activities arise only as part of planned investments or strategic decisions set out in the financial strategy and institutional plan and are fully funded from existing cash reserves.

Category B: *The institution's financial position and its financial strategy currently support the institutional plan but could be strengthened*

16. Category B institution's will normally have:

- A financial strategy that currently supports the institutional plan and identifies targets and actions to deliver the generation of cash and operating surpluses sufficient to finance ongoing activity, make funds available for investment and to produce a financial reserve. The strategy identifies an action plan to address any weaknesses in the current financial position;
- Year on year operating results give a break even position and a plan of how to return to the level of operating surplus required by the financial strategy;

- No net outflow of cash from operating activities, year on year, and a plan of how to return to the level of cash inflow required by the financial strategy;
- A balance of cash in hand plus bank deposits less adjusted current liabilities that is equivalent to one month's expenditure;
- Net current assets;
- A positive balance on general reserves before FRS 17; and
- Operating deficits or cash outflows from operating activities arise only as part of planned investments or strategic decisions set out in the financial strategy and institutional plan and are fully funded from existing cash reserves.

Category C: *The institution's financial position or its financial strategy require improvement to support the institutional plan*

17. Category C institution's will normally have:

- A financial strategy that does not support the institutional plan or fails to identify targets and actions to deliver the generation of cash and operating surpluses sufficient to finance ongoing activity, make funds available for investment and to produce a financial reserve;
- Recurring operating deficits or surpluses that do not meet the targets set out in the financial strategy;
- Recurring cash outflows from operating or cash inflows that do not meet the targets set out in the financial strategy;
- The current or forecast level of cash in hand plus bank deposits less adjusted current liabilities is less than one months expenditure;
- Forecast net current liabilities;
- Forecast negative balances on general reserves before FRS 17; and
- Operating deficits or cash outflows from operating activities occur other than as part of planned investments or strategic decisions set out in the financial strategy and institutional plan or are not fully funded from existing cash reserves.

Category D: *The institution's financial position is weak and does not support its financial strategy or the institutional plan*

18. Category D institution's will normally have:

- A requirement for an advance of grant from the Assembly Government or external loans to enable them to meet liabilities as they fall due;
- Cash in hand and bank deposits is less than one month's expenditure;

- Net current liabilities;
- The forecast level of cash in hand and bank deposits less adjusted current liabilities is less than one month's expenditure in the next two years;
- Net current liabilities are forecast to arise in the next two years;
- A negative balance on general reserves before FRS 17 or forecast negative balance on general reserves in the next two years;
- The operating results and/or the net cash flows from operating activities do not meet the targets set out in the financial strategy or there is no effective plan to address this position;
- The financial strategy does not support the institutional plan and fails to identify targets and actions to deliver the generation of cash and operating surpluses sufficient to finance ongoing activity, make funds available for investment and to produce a financial reserve. There is no effective plan to address this position; and
- Improvements in the financial position of the institution have yet to be confirmed through the audit of the annual financial statements.

Other matters that inform the financial categorisation

19. In addition to the above the Assembly Government will also take into consideration the following matters in arriving at its assessment of the financial health category of an institution:

- The level of borrowing;
- Any off balance sheet finance such as operating lease arrangements;
- Contingent liabilities and financial commitments;
- The condition of the estate including levels of backlog maintenance;
- Trends in the key financial indicators noted above;
- Compliance with the terms of the financial memorandum;
- The impact of FRS 17 on the institution, its balance sheet and income and expenditure account;
- Progress against a financial recovery plan prepared at the request of the Assembly Government or against an action plan to improve the financial position of the institution as set out in the institution's own financial strategy;
- Reports from internal auditors, external auditors, Assembly Government and other audit functions, for example in respect of ESF activities;

- The robustness and appropriateness of the institution's financial strategy; and
- Any policy, action or event that may impact on the financial health of the institution, for example foot and mouth.

Changes in financial health categorisation

20. Changes to the financial health categorisation of institutions in Category C or D to reflect improved financial health will only normally occur following the review of the audited financial statements confirming the improvement in the institution's financial position. In some instances the Assembly Government may delay such a re-categorisation until the receipt of the Mid Year Review to confirm the improvement is being sustained.

21. Other changes to financial health categorisation of institutions will normally occur following the review of the returns set out in paragraph 9. However, the Assembly Government may also revise the financial health categorisation of institution on the receipt of any information that following discussions with the institution, indicates a change is appropriate.

22. Any change in the financial health categorisation of an institution will be formally notified to the Principal of an institution in writing, setting out the reason for the change. This notification will be copied to the Chair of the Governing Body.

Financial Strategy (FM 32)

23. The financial strategy sets out how the institution will finance its institutional plan. The development and monitoring of the institution's financial strategy is therefore critical to the ability of the institution to maintain solvency, generate sufficient funds to ensure the financing of ongoing activity and to make funds available for investment.

24. Annex I sets out the areas that the Assembly Government would expect the financial strategy of each institution to include.

25. The Governing Body must approve the financial strategy each year, and a copy of the financial strategy should be included in the institutional plan. This summary should set out clearly the extent to which the financial strategy and the financial position of the institution supports the institutional plan, and if it does not, the impact on the institutional plan and the action the Governing Body proposes to take to address that situation.

26. The prime responsibility for the financial health of the institution rests with the Governing Body and accordingly the Assembly Government would expect each financial strategy to include a 'self assessment' of the financial health of the institution. This should be undertaken annually alongside the updating of the institutional plan, the financial strategy and the financial forecasts. The institution should use the guidelines set out in paragraphs 13 to 19 above to inform this self-assessment.

27. It is essential that the Governing Body establish an appropriate system to monitor the implementation of the financial strategy. Paragraphs 4 and 5 of this guidance restate the requirement in the Financial Memorandum that the Governing Body must receive, at least each term, a report that reviews the institution's financial position and comments on the impact on the institution's financial strategy of the results and forecasts presented in that report. This formal reporting of progress, alongside the Governing Body's formal review of the financial returns set out in paragraph 9, should provide the Governing Body with an appropriate framework to monitor the implementation of the financial strategy.

Action to improve the financial health of institutions

28. The financial health of an institution is critical to the ability of the institution to maintain solvency, generate sufficient funds to ensure the financing of ongoing activity and to make funds available for investment. It is therefore essential that Governing Bodies and the Assembly Government have a clear understanding of the action necessary to improve the financial health of institutions that are, for whatever reason, unable to meet these financial objectives.

29. Under the Financial Memorandum, the Assembly Government requires institutions that are unable to approve an institutional plan and financial forecasts that deliver the level of cash and operating surplus required by the financial strategy to notify the Assembly Government and prepare a recovery plan (FM 33b). The Assembly Government may also require institutions, where it has assessed as financial health Category C and where a recovery plan is not already in place to prepare such a plan.

30. In these circumstances the Assembly Government will wish to monitor the institution's performance against this recovery plan and so will require the institution to submit each month a copy of the management accounts (including the accompanying narrative report that is submitted to the institution's Governing Body). The Assembly Government will also require the institution to prepare a report each term, to be submitted to the Governing Body, copied to the Assembly Government, commenting on the progress against the recovery plan. The Assembly Government may wish to exercise its powers under the Instrument and Articles of Government to attend the meetings of the Governing Body as an Observer at which these reports are considered.

31. Under the Financial Memorandum the Assembly Government also reserves the right to require an institution to prepare a recovery plan where it has serious concerns about the institution's financial health. This will be a requirement for all institutions in financial health category D.

32. In these circumstances, where a recovery plan is stipulated, the Assembly Government will require the institution to submit both management accounts and a monthly report to the Governing Body commenting on the progress against this recovery plan. In addition to receiving a copy of these reports, in these circumstances the Assembly

Government will normally exercise its powers under the Instrument and Articles of Government to attend the meeting of the Governing Body as an Observer at which this report is considered.

33. Should the Assembly Government consider that there is insufficient progress being made to improve the financial health of the institution it may further exercise its powers under the Instrument and Articles of Government to appoint members to the Governing Body to support the delivery of the recovery plan (FM 16). Prior to taking such a course of action the Assembly Government would meet with the Principal and Chair of the Governing Body to discuss the action required to improve the financial health of the institution.

Recovery plans

34. Paragraphs 29 and 31 above set out the circumstances where the Assembly Government will require an institution to prepare a recovery plan. The scope and content of a recovery plan will depend on the scale of the change in the financial health of an institution that is required to be made. Some circumstances may only require the implementation of a small number of relatively straightforward measures to improve the financial health of an institution. Other circumstances may require a fundamental strategic review of the institution and include a comprehensive assessment of all options to secure and safeguard high quality learning opportunities.

35. Annex II provides further guidance on the contents of a recovery plan. However the core elements of such a plan will include:

- Clear **objectives** of what the recovery plan is seeking to achieve;
- Comprehensive **appraisal of the options** available to the Governing Body to secure and safeguard high quality learning opportunities;
- Detailed **action plan**, including specific tasks with a timetable for implementation and with responsibility for their implementation allocated to a member of the institution's management team;
- Contingency planning, **risk assessment** and sensitivity analysis of the recovery plan; and
- A clear **monitoring and review process** for both management and the Governing Body.

36. In all situations the recovery plan must be approved by the full Governing Body.

Audit arrangements

37. Assembly Government officers will normally visit each Category C and D institution to discuss and review the institution's returns. Accordingly, the Assembly Government will not routinely require an external audit of institution's returns. However, the Assembly Government may require an external review of an institution's returns or the financial position of an institution if it considers this necessary to inform its assessment of an institution's financial health. The Assembly Government will fund such reviews.

Annex I

Guidance on financial strategies

The Assembly Government would expect the financial strategy of each institution to include:

- Clear and explicit links to the institutional plan and how the financial strategy supports the curriculum, human resources, estate and other developments over the period of the institutional plan;
- Clear and explicit targets for the generation of cash and operating surpluses sufficient to finance ongoing activity, make funds available for investment and to produce a financial reserve. These targets must take into account and support the funding requirements derived from the institutional plan;
- The full cost impact and source of funding for major investment decisions or restructuring exercises set out in the institutional plan;
- The institution's policy and funding of its estate and assets to ensure effective maintenance of its asset base;
- The institution's approach to seeking sources of funding other than from the Assembly Government;
- The institution's approach to cash management and investment;
- The institution's approach to and plans for securing value for money, delivering cost improvement programmes including the financial impact of procurement strategies and links to national strategies such as Making the Connections;
- The institution's approach to funding pensions;
- The institution's reserves strategy, both in terms of the minimum financial reserve that the institution considers appropriate and the proposed utilisation of any reserves in excess of that minimum level;
- Actions plans as appropriate to improve the financial position or financial management of the institution;
- Contingency planning, risk assessment and sensitivity analysis of the strategy; and
- A 'self assessment' of the financial health of the institution.

Guidance on recovery plans

The Financial Memorandum and the Financial Health Monitoring procedures set out the circumstances when a recovery plan is required. The scope and content of a recovery plan will depend on the scale of the change in the financial health of an institution that is required to be made.

In some circumstances this may only require the implementation of a small number of relatively straightforward measures to improve the financial health of an institution. In other circumstances this may require a fundamental strategic review of the institution and include a comprehensive assessment of all options to secure and safeguard high quality learning opportunities.

In developing the scope and content of a recovery plan institutions should consider the following:

Objectives of the recovery plan

The objectives of the recovery plan should be clearly established and set out in the recovery plan. These should include not only the key financial health improvements but also the requirement to maintain the quality of provision during the implementation of the recovery plan and the underlying objective to secure and safeguard high quality learning opportunities.

Background/current position

A brief analysis of the current position of the institution and the factors that gave rise to the current financial position and the need for improvements to its financial health are required as a clear understanding of these issues is an important stage in the process of securing change.

Option appraisal

Where an institution is in a weak financial position it will be essential that the recovery plan includes a comprehensive assessment of the options available to the Governing Body to secure and safeguard high quality learning opportunities. These may include the possibility of merger or other strategic collaboration as well as a review of the institution's own structures and method of operation and costs. It may also be necessary to consider the institution's sources of income, relevant local demographics, demand from learners and businesses and the extent to which the institution is, or will be able to, meet those needs.

Curriculum

As the prime objective of the recovery plan is to secure and safeguard high quality learning opportunities it is likely that any recovery plan will require a review of the current curriculum provision, its structure and quality and the impact of any planned changes.

Staffing

As staffing costs typically account for the largest proportion of an institution's budget it will be important to assess the extent to which staff costs are properly and effectively controlled and are at a level to effectively deliver the curriculum. Any proposed changes should be part of the overall recovery plan, support the delivery of high quality learning opportunities and be sustainable.

Support services

In developing the recovery plan it is important that institution's consider the effectiveness of support services. This should include not only the extent to which opportunities for efficiencies have been fully obtained through collaboration, improved procurement practices, or value for money initiatives, but also the role that support services will play in delivering the recovery plan. This may, for instance, include improvements to MIS or financial management systems to provide better cost control or improve decision making.

Estates

It may be appropriate or necessary to revisit estates strategies to inform or support the recovery plan. The options appraisal and curriculum reviews noted above may themselves require or indicate the need for change. These changes could include estate rationalisation to release funds for reinvestment, improved utilisation or changes arising from greater collaborative arrangements.

Financial forecasts

The financial forecasts will need to be updated to show the impact of the recovery plan on the institution's financial position during and at the completion of the recovery plan. The format and narrative requirements for this element of the recovery plan should be the same as those required for the five year financial forecast return.

Risk assessment, sensitivity analysis and contingency plan

As with all significant projects, the recovery plan should include an assessment of the key risks attached to the successful delivery of the recovery plan and a sensitivity analysis where it is identified that a range of potential outcomes may arise, dependent upon matters outside the control of the institution. For high risks and significant sensitivities the recovery plan should identify the contingency plan that the institution would adopt to either mitigate the risk or respond to undesired or less than optimal outcomes.

Action plan

A detailed action plan should be included in the recovery plan setting out specific tasks with both a timetable for implementation and with responsibility for their implementation allocated to a member of the institution's senior management team.

Monitoring arrangements

It is essential to ensure there are clear and effective monitoring arrangements in place to ensure the delivery of the recovery plan. The Financial Memorandum and Financial Health Monitoring procedures require either a monthly or termly report to be made to the Governing Body depending upon the extent of the financial health difficulties the institution is facing. The institution should also establish the monitoring procedures that will be adopted internally by the senior management team.