

**Tertiary Education
Commission**
Te Amorangi Mātauranga Matua



TEI Financial Monitoring Framework Review

Consultation document

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Tertiary Education Institution Financial Monitoring Framework Review

This consultation document seeks your feedback on the Tertiary Education Institution (TEI) Financial Monitoring Framework (FMF), and on proposed changes.

The FMF was introduced in 2010 and is our tool for assessing a TEI's level of financial risk. The FMF was reviewed in 2011, which resulted in a number of changes to the FMF methodology. A full guidance document, which details the full framework and methodology, can be found on our [webpage](#).

The FMF is also a key tool for determining if a TEI is at risk for under the [Risk Assessment Criteria](#), and can assist in determining if an intervention is required. The core purpose and guiding principles of the FMF, and important links are outlined in Appendix 1.

We are reviewing the FMF to ensure it remains fit for purpose

It is important the tools screening for financial risk are fit for purpose and adequately reflect the current operating and policy settings for the TEI sector. The Ministry of Education (MoE) is also undertaking a review of the Risk Assessment Criteria, which are heavily reliant on the FMF for assessing financial risk.

The FMF was last reviewed in 2011 and it is timely that another review be undertaken.

The scope of the review is relatively broad

The review includes:

- › terminology used in the FMF
- › financial measures and thresholds used to identify risk
- › FMF one page summary presentation and layout
- › reporting and feedback processes used by TEC .

The review excluded:

- › data collection methodologies as these are currently under a separate project
- › TEI risk management and interventions framework.

Desired outcomes

We expect that this review will:

- › confirm areas where no changes are required
- › identify any change required to the FMF terminology, measures, or presentation
- › increase sector acceptance of changes (due to collaborative approach)
- › support the MoE review of the Risk Assessment Criteria

You can provide feedback

- › [online survey](#)
- › email, using the feedback form on our [webpage](#), to kirrilee.mahoney@tec.govt.nz.

We are seeking feedback from the sector and other key stakeholders on the information and options outlined in this paper. Space is also provided for additional comments and feedback.

Please provide feedback as soon as possible, and no later than **21 February 2017**.

Impact on risk assessment criteria

A number of the questions or changes proposed below would result in a need to change the risk assessment criteria¹. It is our intention that changes would be limited to updating the risk assessment criteria which refer to the FMF to reflect new terminology.

Feedback on the risk assessment criteria as a whole is sought as part of the Ministry of Education review, which is being run concurrently to this consultation.

Financial monitoring of TEI subsidiary and related entities

Recent changes to the Education Act give the Minister of Tertiary Education a new power to require information about a related entity if reasonable grounds exist to believe the entity poses a risk to a TEI. The Minister must apply the risk assessment criteria in determining whether additional reporting is required. The legislative changes also reinstated parent level reporting. By comparing “parent” and group results, we will be able to see the impact of related entities on overall group performance and identify where a related entity could be putting the core performance of its parent at risk. We will continue to undertake FMF assessments on consolidated group results but will, where necessary, also undertake parent only FMF assessments.

¹ Currently criteria 4 – 8 of the RAC.

Feedback sought

General feedback

Our analysis of the FMF suggests that it is broadly consistent with original intentions and principles. We consider that the current FMF does a good job of identifying areas of potential risk, and allows us to determine where we should focus monitoring activities. There are however, a number of improvements or changes that could be made, in order to clarify and simplify the FMF. We also consider the FMF is the appropriate tool for assessing financial risk under the risk assessment criteria.

Question for consideration

We are interested in your feedback on whether the FMF is:

- › a fit for purpose tool for assessing financial risk
- › an appropriate measure for determining if the risk assessment criteria apply.

Use of viability and sustainability

The FMF currently groups measures into two categories - viability and sustainability, with the intention of taking a short term (viability) and longer term (sustainability) view of potential risk.

Viability focuses on the shorter-term financial performance

This enables judgements to be made about the ability, or otherwise, of the institution to meet its financial obligations as they fall due. The measures included within this dimension look at earnings, liquidity, cash flow and short-term debt servicing. Liquidity can, in some instances, include undrawn borrowing facilities. Details of the undrawn borrowing rules and declaration are outlined in the FMF guidance document.

Sustainability provides a longer-term view

This provides analysis of the financial performance and cost structures of the institution, and whether these are enduring. The measures within this dimension look at the balance sheet structure, return on assets, and the longer-term picture presented by the viability measures. A key revenue driver measure also looks at whether TEIs are achieving the Student Achievement Component funding delivery close to levels as agreed with the TEC.

However, some of the measures used in the FMF could be indicators of both viability and sustainability. While this allows some measures to offset each other, it creates an arbitrary divide between others. In recognition of, this recently developed Industry Training Organisation (ITO) FMF instead groups measures into the categorisations of profitability, liquidity, and industry specific.

Proposed solution

We propose replacing the viability and sustainability classifications with:

- › profitability
 - surplus/deficit after unusual items
 - core earnings
- › liquidity and balance sheet
 - liquidity ratio

- net cashflow from operations
- quick ratio
- ability to service debt
- debt to equity ratio
- debt repayment
- › financial influence measures
 - achievement of SAC domestic funded allocation.

Question for consideration

- › Should we continue to group financial measures into viability and sustainability categories?
- › Alternatively, should these be grouped differently – for example:
 - profitability
 - liquidity and balance sheet
 - financial influence measures.

Use of low, moderate and high risk

The FMF currently results in a historical, future, and overall risk rating of either low, moderate or high risk. This has led to some confusion, as these terms have not been defined in the FMF guidance. The Treasury use the same terms when assessing financial risk, but with a much higher risk threshold which also causes confusion (for example high risk indicates a risk of immediate financial failure).

The ITO FMF has attempted to resolve this confusion by using the terms, low, moderate and increased risk.

There is also some concern that the term high risk does not accurately portray instances where there is an extreme or immediate (i.e. within 6 months) risk of a TEI facing financial failure without intervention or assistance. It is been suggested that a fourth risk category, using either the extreme or immediate risk terminology is required.

Proposed changes

We propose amending the risk categorisations and including clear definitions

- › **Low risk** – the financial position and/or performance of the TEI is very good, and there are minimal or no indicators of risk
- › **Medium risk** – the financial position and/or performance of the TEI is acceptable, but there are some indicators of current or future risk
- › **Increased or heightened risk** – the financial position and/or performance of the TEI is of concern, and there are a number of indicators or current or future risk
- › **Extreme or immediate risk** – the financial position and/or performance of the TEI is poor, and there are indicators of immediate risk or TEI financial failure.

Alternatively, it has been suggested that, rather than rating risk, we should rate financial performance. It is suggested that this would better reflect the link between performance and risk. This would result in performance categories such as:

- › strong performance (low risk)
- › moderate performance (moderate risk)
- › poor performance (high risk)

Questions for consideration

- › Do the proposed definitions give an adequate assessment of potential TEI financial risk?
- › Should a fourth level of risk, using terminology such as extreme or immediate risk, be introduced to indicate those TEI's at significant risk of financial failure?
- › Alternatively, should we move to terminology that rates performance, rather than risk – i.e. strong, moderate, poor.

Individual performance measures and thresholds

We have reviewed the individual performance measures currently utilised in the FMF, and we consider that these, on the whole, work to provide a high level view of potential risk. We also consider that the existing low risk thresholds for each measure continue to be appropriate. In forming this view we have considered both changes to the policy and regulatory landscape and earlier feedback from TEI's.

The exception to this is the inclusion of trust assets in liquidity and debt related calculations. Trust assets typically have restrictions on their use, and cannot be easily utilised to pay other operating costs, or settle debts. Therefore, it may be appropriate to exclude trust assets from liquidity and debt related calculations.

Also, in light of the proposal to remove the viability category, we consider the 3-year average viability measure to no longer be useful. Similarly, the trend and variability in average viability would no longer apply.

We have also considered if there is a need for new and additional measures to capture potential financial risk that may not have been relevant when the FMF was developed and reviewed.

Proposed changes

We propose:

- › excluding trust assets from liquidity and debt related calculations
- › removing the 3-year average viability measure
- › removing trend and variability in average viability measure
- › introducing the measures outlined below. If any of these measures are adopted, we will undertake a short period of additional consultation on the appropriate construct and scoring.

5-year trend in profitability (Profitability)

This would be a historical only measure which considers the 5 years prior audited results. Scoring would be based on the level of volatility in results; with lower scores (indicating higher risk) applying where there is high volatility in results. Lower scores would also apply to periods of sustained deficits. This captures some of the elements currently assessed through the "trend and variability in average viability" measure.

Staff student ratio (Financial influence measure)

Previous sector feedback indicates that TEIs consider the staff student ratio to be an important operating measure, and a good indicator of both efficiency and effectiveness. Difficulties in creating a fair scoring matrix in the past is one reason it was not included. However, NZBT data now provides us with sector and subsector average staff student ratios, which are calculated in a standardised way.

It is possible this would be a historical only measure, and the scores would be based on the level of difference between the TEI ratio and the sector average. It could be measured using either NZBT data, or data included in the financial reporting template.

Capital asset management capability independent assessment (Financial influence measure)

We currently monitor the capital asset management (CAM) capability assessment scores; however, the level of CAM maturity is not reflected as a risk consideration in the FMF. The level of CAM maturity can influence financial performance and risk, as it can lead to unnecessary expenditure or high deferred maintenance. Scoring would be based on the level of maturity identified in the most recent independent assessment, with scores based on the difference between the current and recommended scores.

Questions for consideration

- › Should a single negative score measure relating to investigations, interventions, or departure from funding conditions be introduced?
- › Should the 3-year average viability measure be removed?
- › Should the trend and variability in average viability measure be removed?
- › Should liquidity and debt related measures exclude trust assets?
- › Should a staff student ratio measure be introduced?
- › Should a CAM capability measure be introduced?

Audits, reviews and investigations, Statutory Intervention, or material departure from standard funding conditions

In recent years there has been a significant increase in the number of audits, reviews and investigations. We are finding that the financial impacts and risks that arise are ongoing. At present, this risk is only captured to the extent that TEI include these in financial forecasts.

Similarly, there has been an increase in the number of statutory interventions, and material departures from standing funding conditions. These can mitigate risk, by providing additional oversight or funding, or exemptions from funding recoveries. However, the inclusion of these amounts in financial statements, means FMF assessments are not completed on the core underlying operating result, and can alter FMF risk ratings.

There is a need to capture and reflect the ongoing risk to financial performance that arises after an investigation which results in funding recoveries or where serious funding rule breaches are found. A statutory intervention often reflects financial risk and can also be ongoing.

Finally, a material departure from standard funding conditions can result in a TEI temporarily receiving additional funding, or being exempt from funding recoveries. This can improve profitability and mean the FMF is not assessed using the underlying operational results. It can then appear risks have been removed, rather than temporarily mitigated.

Therefore, in order to capture the ongoing financial risk that can eventuate as a result, we are proposing a single negative score measure, that automatically raises the risk rating by one level (for example from low to moderate, or moderate to high). This measure will be used where the TEI² has had any of the following in the preceding 5-years

- › an audit, review, or investigation that
 - found issues of probity, under-delivery, over claiming or funding, or significant breach of funding rules or
 - resulted in a funding recovery or
 - resulted in the removal or reduction of future funding
- › a statutory intervention
 - under the risk assessment criteria or
 - as the result of a borrowing consent condition or
- › a material departure from standard funding conditions that
 - results in additional funding
 - exempts the TEI from funding recoveries
 - has some other financial benefit.

Questions for consideration

- › Should a single negative score measure relating to investigations, interventions, or departure from funding conditions be introduced?

² This includes TEI subsidiary or related entities which form part of the consolidated group, or have a material impact on the TEI group operating result.

Inclusion of undrawn borrowing in liquidity calculations

The FMF currently allows TEIs with undrawn borrowing to have these amounts included in liquidity calculations, provided certain criteria are met, and the TEI elected it be included. The current criteria for inclusion are:

- › a consent issued by the Secretary for Education under Section 192 (4)(d) exists that allows the TEI to borrow for general operational purposes
- › the borrowing facility has not required a Crown guarantee and is on standard commercial terms appropriate for the tertiary sector
- › the facility is long-term and unable to be readily cancelled by the issuing bank
- › the facility is through a registered trading bank with a significant market share
- › the TEI has an agreed treasury policy that covers liquidity
- › the TEI meets the agreed financial performance criteria³ for the two years prior to, and the year it seeks to have the undrawn borrowing facilities recognised for:
 - good profitability – an operating surplus/deficit ratio before abnormals of 3% or more
 - strong operational cash flows – net cash flow from operations above 111%
 - the TEI has maintained a liquid funds ratio (including undrawn borrowing facilities) of at least 8%.

Typically, borrowing consents issued by the Secretary of Education include restrictions that prohibit TEIs from offering Crown guarantees, borrowing on non-standard terms, or from borrowing from non-registered trading banks. In addition, borrowing consents that include liquidity facilities often allow TEIs to operate outside the financial performance measures required for inclusion in the FMF. This means that most of the criteria for inclusion are either contradictory, or unlikely to not be satisfied. We actively monitor a TEI's performance against borrowing consent terms.

Proposed changes

We propose amending the criteria for inclusion to

- › a consent issued by the Secretary for Education under Section 192 (4)(d) exists that allows the TEI to borrow for general operational purposes
- › the TEI has an agreed treasury policy that covers liquidity
- › the TEI meets the agreed financial performance covenants included in the borrowing consent.

We also propose automatically including the undrawn borrowing in the liquidity calculations without the need for an annual election.

Questions for consideration

- › Should we adopt the suggested criteria for inclusion outlined above?
- › Should undrawn borrowing be automatically included in liquidity calculations provided the TEI meets borrowing consent covenants?

³ The thresholds in relation to each of these elements are aligned to the FMF low risk thresholds.

Change to calculation methodology

One of the core principals of the FMF is that it should be designed to avoid unnecessary complication. It should also be easy to understand, and transparent. Despite these guiding principles, calculating an FMF risk rating currently involves six steps, a number of which operate in the background of the model and are not easy to follow. The current process requires:

- › Step 1: Calculate a percentage or ratio for each measure
- › Step 2: Convert each measure's percentage, for each year, to a score between -2 and +5
- › Step 3: Calculate an overall historical and an overall future score for each category
- › Step 4: Combine the scores in each category to get future and historical scores using a weighted average for each percentage calculated in step 3
- › Step 5: Combine the two historical and two future scores
- › Step 6: Combine the historical and future scores into a single risk rating, weighted depending on the confidence assessment

The removal of viability and sustainability categories and the addition of new performance measures also necessitate changes to the current calculation methodology. In order to maintain the ability for strength in some areas to offset lower performance in others (such as a profitability and liquidity trade off) weighted averages would need to be applied to the three new categorisations.

Proposed changes

We propose to simplify the calculation methodology by moving to a points accumulation method. Historical and future calculations would remain, however the calculation steps would be reduced and simplified.

- › Step 1: Calculate a percentage or ratio for each measure
- › Step 2: Convert each measure's percentage, for each year, to a number of points using a specific points scale for each measure
- › Step 3: Calculate overall historical and overall future points, based on the average points for each measure
- › Step 4: Combine the historical and future scores into a single risk rating, weighted depending on the confidence assessment

We expect that some measures, such the new financial influencing measures, would be historical only. As an example, a points accumulation system could look something like this (please note this is an example only and no indication of proposed points scores for each measure).

Figure 1 – current FMF scoring system

Viability ²	2014 A	2015 B	2016 P	2017 P	FMF Score (3 +) ³	Historical	Future
Operating surplus/deficit	0.3%	2.2%	4.2%	3.9%	3% or more	2.0	3.0
Core earnings	9.0%	10.8%	12.7%	11.5%	9% or more	2.0	4.0
Net cashflow from operations	108.4%	116.6%	114.6%	114.3%	111% or more	2.0	4.0
Liquid funds ratio	12.8%	16.3%	13.6%	24.1%	8% or more	4.0	4.3
Ability to service debt	1.3	6.8	9.1	Operating Deficit	3.0x or more (or no interest costs)	0.5	4.3
Quick ratio	1.9	2.5	2.3	3.7	1.5x or more	3.0	4.3
Overall Average Viability	2.3	4.0	3.8	3.2		2.3	4.0
Sustainability ²	2014 A	2015 B	2016 P	2017 P	FMF Score (3 +) ³	Historical	Future
Debt equity ratio	4.6%	3.0%	3.8%	0.8%	7.5% or less	3.0	3.0
Achievement of EFTS	99.4%	101.7%	N/A	N/A	97% or more	4.0	NA
3-Year average viability	1.4	2.7	3.4	3.8	3 or more	2.7	3.8
3-Year ave return on property, plant and equipment	5.9%	7.3%	8.1%	8.4%	4.5% or more	4.0	4.0
Debt repayment	-199.0%	No net debt	26.6%	No net debt	200% or less	5.0	5.0
Trend and variability in average viability	2.0	3.0	3.0	3.0		3.0	3.0
Overall Average Sustainability	2.1	3.6	3.5	3.8		3.6	3.8

Historical 2013 FMF risk rating:	2.3	Moderate Risk
Future FMF risk rating:	3.8	Low Risk
Overall FMF risk rating:	3.0	Low Risk

Figure 2 – possible points accumulation system

Performance measure	2014 A	2015 B	2016 P	2017 P	Low risk threshold
Operating surplus/deficit	0.3%	2.2%	4.2%	3.9%	3% or more
Core earnings	9.0%	10.8%	12.7%	11.5%	9% or more
Net cashflow from operations	108.4%	116.6%	114.6%	114.3%	111% or more
Liquid funds ratio	12.8%	16.3%	13.6%	24.1%	8% or more
Ability to service debt	1.3	6.8	9.1	Operating Deficit	3.0x or more (or no interest costs)
Quick ratio	1.9	2.5	2.3	3.7	1.5x or more
Debt equity ratio	4.6%	3.0%	3.8%	0.8%	7.5% or less
Achievement of EFTS	99.4%	101.7%	N/A	N/A	97% or more
3-Year ave return on property, plant and equipment	5.9%	7.3%	8.1%	8.4%	4.5% or more
Debt repayment	-199.0%	No net debt	26.6%	No net debt	200% or less

Performance measure	2014 A	2015 B	2016 P	2017 P	Low risk threshold	Historical	Future
Operating surplus/deficit	1.0	2.0	5.0	3.0	3.0	1.5	4.0
Core earnings	3.0	4.0	5.0	4.0	3.0	3.5	4.5
Net cashflow from operations	2.0	4.0	4.0	4.0	3.0	3.0	4.0
Liquid funds ratio	5.0	6.0	5.0	7.0	5.0	5.5	6.0
Ability to service debt	-2.0	5.0	5.0	-2.0	5.0	1.5	1.5
Quick ratio	3.0	4.0	4.0	4.0	3.0	3.5	4.0
Debt equity ratio	3.0	3.0	3.0	5.0	3.0	3.0	4.0
Achievement of EFTS	3.0	3.0			3.0	3.0	
3-Year ave return on property, plant and equipment	3.0	5.0	5.0	5.0	3.0	4.0	5.0
Debt repayment	-2.0	3.0	3.0	3.0	3.0	0.5	3.0
Prior investigation or intervention		-10.0			0.0	-10.0	
Total	19.0	29.0	39.0	33.0		29.0	36.0

Historical 2013 FMF risk rating:	29.0	Moderate
Future FMF risk rating:	36.0	Low
Overall FMF risk rating:	55.0	Moderate

Differential FMF low risk thresholds

Currently, the FMF applies a one size fits all approach to assessing potential risk, regardless of the size or subsector of the TEI. It has been argued that, given the range in total revenue, EFTS volume, and asset base of the TEIs that there should be a tiered approach to the low risk performance thresholds.

This would result in a two (or more) tiered approach that grouped TEI's and applied different low risk thresholds; for example, a 3% surplus threshold for large institutions and a 1.5% surplus for small.

Questions for consideration

We are interested in your feedback on the concept of the tiered risk assessment framework including:

- › Should this be introduced? Why/why not
- › If this were introduced, should TEIs be grouped:
 - by subsector (i.e. University, ITP, Wānanga)
 - by number of EFTS delivered (under 7,000 , over 7,000)
 - by net assets (under \$200m, over \$200m)
 - by total revenue (under \$100m, over \$100m)

FMF communication

Previously, we sent a copy of the annual FMF one page summary report to each TEI, generally late in the year. Since 2014, we have only sent these to TEIs where they have been requested, or where the result of the FMF necessitated a change in the monitoring or reporting requirements. We have received mixed feedback about this approach, with some TEIs preferring to receive these annually.

Questions for consideration

We are interested in your feedback whether the FMF one page report should be sent annually to all TEIs, or issued only where these change.

Appendix 1 – Purpose and principles of the FMF and important links

The purpose of the FMF

The FMF was designed in consultation with the sector and is intended to:

- › assist us in monitoring financial performance
- › ensure we follow a consistent approach to monitoring
- › allow us to meet our obligations under the Education Act 1989
- › support a ‘no surprises’ approach to monitoring and engagement, and
- › help us calculate a financial risk rating.

The FMF is guided by the principle of clarity and transparency

The framework provides clarity and transparency around the financial monitoring assessments we make, by:

- › using readily available information
- › considering both historical and future performance
- › using evidenced-based financial theory relevant to the sector
- › avoiding unnecessary complexity in the design and construction of the framework
- › applying a formulaic approach and a judgement about forecast confidence
- › having stable measures and scoring, and
- › enabling self-assessment by your organisation

Important links

[Tertiary Education Institution Financial Monitoring Framework – Guidance document](#)

[TEI FMF review email feedback form](#)

[TEI FMF review online survey](#)

[Risk Assessment Criteria for Tertiary Education Institutions](#)