

# ITO Financial Matters

## Operational Policy Discussion Paper

February 2010

Name	Reference & Status	Distribution
Financial Matters	OPERATIONAL POLICY DISCUSSION PAPER	ITO Investment and Implementation Design Group  <b>Contact:</b> Industrytrainingprogrammes@tec.govt.nz

## Purpose

1. This paper has been prepared as part of the consultation relating to the operational policy for industry training.
2. The Tertiary Education Commission (TEC) invites feedback from the tertiary education sector on the questions presented in this paper and on any other relevant matters. Please use the separate Feedback Template to submit responses.

## Aims

3. In undertaking this consultation, the TEC will be guided by the following aims:
  - *Minimising transaction and compliance costs:* the operational policy framework should take account of administrative and compliance costs, and where possible seek to reduce these.
  - *Maximising transparency and accountability:* the recipients of Government funding should be accountable for the results they generate, and related information should be available to interested parties.
  - *Minimising any perverse incentives:* the operational policy framework should be designed in such a way as to minimise and mitigate any perverse incentives.
  - *Maximising value for money:* the operational policy framework should ensure a strong focus on results and avoid arrangements that would lead to the funding of activities by government that would otherwise be funded by other parties.
  - *Providing an appropriate degree of dynamism for Industry Training Organisations (ITOs) based on performance:* the operational policy framework should provide suitable incentives for ITOs to manage and improve their own performance.
  - *Providing for consistent treatment of other forms of industry training:* the operational policy framework should take account of other forms of industry training and contribute, where possible, to a common approach.

## Principles

4. The consultation on the operational policy governing industry training will be based on the following principles and considerations:
  - upholding the aims of the consultation process (outlined above);
  - learning from the implementation of the industry training system over the past 17 years;
  - drawing on relevant experience and expertise across the tertiary education sector;
  - exposing proposed changes to scrutiny;

- providing sufficient information on the general approach that the TEC intends to take in relation to the matters discussed; and
- avoiding costly or time-consuming changes unless there are good reasons for believing they will bring significant improvements over time.

## Scope

5. This paper seeks feedback from the sector on the development of operational policy relating to a range of financial matters relevant to ITOs.
6. This paper assesses whether the current guidelines and reporting templates for the reporting of financial information (also known as the 'PM-18') are fit for purpose. In particular, it examines whether the current 'rules' governing the calculation of the rate of industry cash contribution are appropriate.
7. It also explores the possibility of refining the indicators used by the TEC to assess the financial position of ITOs. Additionally, it also discusses the uses to which Government funding may be put and whether additional clarification of these rules may be desirable.
8. This paper does not consider other performance considerations such as the completion of qualifications by trainees as these are the subject of other consultation papers.

## Method

9. This paper:
  - sets out the Government's objectives for tertiary education;
  - provides background to the TEC's interest in the financial matters of ITOs;
  - describes a framework for the development of financial indicators;
  - examines current practice and issues arising from this practice; and
  - identifies possible options for change.

## Government's objectives

10. The Government's objectives for tertiary education include raising the skills and knowledge of the current workforce to increase the productivity of individuals, and to underpin the ability of firms to innovate and adapt to competitive challenges. ITOs have an important role to play by providing, for example, opportunities for employees to complete nationally recognised qualifications, and creating effective pathways towards advanced trade qualifications at level four and above.
11. Cabinet also agreed in May 2009 to re-balance the tertiary education system by shifting away from the current emphasis on central steering and front-end planning and moving towards greater responsiveness to market signals [CAB Min (09) 15/13].

12. Cabinet agreed on the following mechanisms to achieve these shifts:
  - incentives to ensure that tertiary education primarily responds to demand from students and employers;<sup>1</sup>
  - improve quality assurance measures, and back-end accountability; and
  - stronger links between funding and past performance.
13. This paper should also be considered in the context of the recently released Tertiary Education Strategy (TES) which describes the Government's strategic direction for tertiary education over the next five to 10 years. The TES also outlines the Government's priorities in terms of the shifts it expects to see, and intends to do something about, over the next investment plan cycle, starting in 2011.

### **Operational considerations**

14. In exploring the financial matters relevant to ITOs, the following matters are pertinent:
  - while ITOs are private organisations, they fulfil a public role, utilising public funds;
  - ITOs are autonomous, self-managing, organisations, and as such the TEC has no role in the management of these entities, however the TEC has a key role in monitoring ITOs.
  - that accurate financial information should be made available with the least possible administrative and compliance costs for ITOs and the TEC;
  - the current guidelines relating to the reporting of the industry cash contribution do not have regard to the other sources of TEC funding for ITOs (such as Modern Apprenticeships, Embedded Literacy and Numeracy and the Sector Leadership Component);
  - that operational policies dealing with financial matters do not currently take account of the size of ITOs; and
  - a number of rules relating to the use of funding that apply to tertiary education organisations (TEOs) that access the Student Achievement Component (SAC) are not applied to the Industry Training Fund (such as the payment of inducements).

### **Background**

15. The Industry Training Act (1992) prescribes a number of matters that the Minister for Tertiary Education must have regard to before recognising organisations as ITOs. In particular, section 7 of that Act requires the Minister to have regard to

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<sup>1</sup> Cabinet also reaffirmed this commitment in October where it directed that there should be a '...focus on ensuring that the tertiary sector is better aligned to the needs of business.' (STR Min (09) 21/1 refers).

‘...the extent to which the organisation represents and is funded by employers of people engaged in the industry in respect of which the organisation wishes to be recognised...’

16. Additionally, allocation of the Industry Training Fund to ITOs is conditional on an expected level of industry cash contribution. The expected level was set by Cabinet at 30%.
17. The TEC collects information relating to this expectation through the current performance measure 18 which is the  
‘...total cash cost of credit achievement and the total cash cost per credit achieved for the period 1 January to 31 December. The TEC will report the Industry and Government contribution the total cash cost’<sup>2</sup>

## Framework

18. The following reports describe the principles that underpin the funding relationship between public entities (for example the TEC) and third parties (for example ITOs):
  - *Principles to underpin management by public entities of funding to non-government organisations*, Office of the Auditor General (OAG), June 2006
  - *Guidelines for Contracting with Non-Government Organisations for Services Sought by the Crown*, New Zealand Treasury, April 2009
19. The report of the OAG notes that a public entity is accountable for ensuring that public funds devolved to third parties are used lawfully, effectively, efficiently and with integrity. To do this, the public entity should have regard to the following principles:
  - **Lawfulness:** Have activities, resourcing, and accountability requirements been undertaken within the authority granted by Parliament?
  - **Accountability:** Have public entities given full and accurate accounts of their activities? Are governance and management arrangements suitable to address any concerns?
  - **Openness (transparency):** Is the nature of the funding arrangement, and the way in which it was entered into, clear to all parties?
  - **Value for money:** Are resources used effectively and efficiently, without waste, and in a way that optimises the public benefit?
  - **Fairness and Integrity:** Are public entities and NGOs that are involved in funding arrangements together meeting Parliament’s and the public’s

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<sup>2</sup> Performance measure 18 guidelines (see <http://www.tec.govt.nz/Learners--Organisations/Industry-Training-Organisations-ITOs/Reporting/Performance-Measure-18-PM18/>)

expectations of an appropriate standard of behaviour in the public sector?<sup>3</sup>

20. While these principles should be considered holistically, this discussion focuses on the principle relating to value for money. In this context, the definition of value for money from the OAG report as ‘..the best possible outcome for the total cost, rather than the lowest cost...’ is useful<sup>4</sup>. Public entities also need to demonstrate that the funding is having the desired effect and that the money is not going to waste.<sup>5</sup>
21. The avoidance of waste is based on the premise that public resources should be applied for the best possible *public* benefit<sup>6</sup>. One of the ways that this can be achieved is by ensuring that the accountability of the public entity flows through to the contracted party, and is reflected in any contractual arrangements<sup>7</sup>.
22. The Treasury report notes that an important part of the overall contract management system is how to deal with any surplus that remains when the agreed outputs have been delivered.<sup>8</sup> Some examples of possible approaches that can be adopted in relation to a surplus include:
  - The NGO returning any surplus. This is appropriate where the surplus is due to the NGO under-delivering on the quantity or quality of the services.
  - The Government agency and the NGO agreeing to the provision of more of the same services.
  - The Government agency and the NGO agreeing to the delivery of additional related outputs.
  - It may be appropriate for the NGO to retain the surplus as profit. This approach relies on a robust contract management system, and good information on service delivery.
  - Grant money that is not spent for the purposes originally provided should be returned to the Government Agency. It may be appropriate to renegotiate the conditions of a grant to reflect changing circumstances<sup>9</sup>.
23. This discussion does raise pertinent questions about whether and to what extent these principles apply to ITOs. In particular, there may be other considerations that are relevant to ITOs to a greater or lesser extent.

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<sup>3</sup> Principles to underpin management by public entities of funding to non-government organisations, Office of the Auditor General (OAG), June 2006, pp 6-7

<sup>5</sup> Principles to underpin management by public entities of funding to non-government organisations, Office of the Auditor General (OAG), June 2006, p 20

<sup>6</sup> Principles to underpin management by public entities of funding to non-government organisations, Office of the Auditor General (OAG), June 2006, p 17

<sup>7</sup> Guidelines for Contracting with Non-Government Organisations for Services Sought by the Crown, New Zealand Treasury, April 2009, page 15.

<sup>8</sup> Guidelines for Contracting with Non-Government Organisations for Services Sought by the Crown, New Zealand Treasury, April 2009, page 36.

<sup>9</sup> Guidelines for Contracting with Non-Government Organisations for Services Sought by the Crown, New Zealand Treasury, April 2009, page 37

## Corporate arrangements of ITOs

24. The following are some key points that are relevant to this discussion:
- ITOs are not public or Crown-owned entities and the provision of public funding does not change this characteristic;
  - The corporate structures of ITOs limit the uses to which income can be put (notwithstanding the strict limitations on the uses to which public funding can be put);
  - Additionally, most ITOs are registered charities which means that any income, benefit, or advantage derived by the organisation must be used to advance the charitable purposes of the organisation;
  - Some ITOs are business units of larger entities which may raise issues about the uses to which public funding is put; and
  - Most ITOs must provide audited financial statements to retain their corporate and/or charities status, although there are some exceptions.
25. A more detailed discussion of the corporate structures of ITOs is set out in appendix one.

## Implications

26. The discussion above illustrates that the TEC has clear obligations to ensure that ITOs puts the public funds it receives to good use. To do this, it needs to be satisfied that ITOs are using resources effectively and efficiently, without waste, and in a way that optimises the public benefit.
27. This is necessary, whether or not, these objectives coincide with the purposes of the ITO (as mandated by its corporate structure). This reflects the imperatives associated with the appropriate use of public funding, and the funding conditions imposed on the recipients of public funding.
28. As a result, each ITO is required to ensure any funding allocated to them through their plan is used for the sole purpose of implementing that plan.
29. One of the ways that the TEC can be assured of the effectiveness and efficiency of the use of public funding is through the assessments of the financial performance of ITOs. Currently, this assessment is based on the assessment of the performance of ITOs against the information collected as part of performance measure 18.
30. The following section reviews the current arrangements for this performance measure and attempts to assess whether they are fit for purpose.

## Performance measure 18

### *Current practice*

31. As noted above, ITOs are required to report their performance against performance measure 18 (PM-18) which is the

‘...total cash cost of credit achievement and the total cash cost per credit achieved for the period 1 January to 31 December. The TEC will report the Industry and Government contribution to the total cash cost’<sup>10</sup>

32. ITOs are required to submit by 31 March of the following year:
  - the PM18 template for the financial year ending 31 December; and
  - a copy of the ITO’s audited accounts for the financial year ending 31 December
33. ITOs complete the PM18 template (an electronic (Excel) template) using the guidelines published by the TEC. Most ITOs also provide audited financial accounts, however as noted above a number do not prepare audited financial accounts.
34. The PM-18 report collects the total cash cost for the ITO of the activities relating to industry training, ie those required by the ITO to set skill standards and/or developing and/or arranging delivery of industry training. The costs that may be reported through the PM-18 are defined broadly and may include all overheads, salaries and activities relating to industry training.
35. The PM18 collects a subset of the audited financial information of an ITO, as well as some additional financial information noted above that does not flow through the ITO’s accounts.
36. This reflects the primary purpose of the PM-18 which is to enable the calculation of the industry cash contribution to the costs of industry training. This is done through collecting the cash payments<sup>11</sup> made by employers and/or trainees to:
  - the ITO for industry training; and
  - training providers and industry parties.
37. The report enables the TEC to collect information about those cash payments that are not reported through the financial accounts of an ITO because the payments are made by employers and/or trainees directly to training providers.
38. The PM-18 also requires ITOs to account for any payments made to reimburse industry for expenditure in whole or in part.
39. The PM-18 guidelines and the associated template is attached as appendix two.

#### *Possible issues*

40. While the PM-18 guidelines and the associated template provide some direction to ITOs when identifying the correct information to be entered, they are open to some interpretation.
41. This is a particular issue when the ITO receives funding other than through the Industry Training Fund. The current PM-18 guidelines preclude the reporting of Modern Apprenticeships funding. However, a number of ITOs report Modern

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<sup>10</sup> Performance measure 18 guidelines (see <http://www.tec.govt.nz/Learners--Organisations/Industry-Training-Organisations-ITOs/Reporting/Performance-Measure-18-PM18/>)

<sup>11</sup> Payments that are made ‘in kind’ are excluded from this measure because the basis for determining their equivalent dollar value is subjective.

Apprenticeship funding as part of the PM-18. This can have implications for the rate of industry cash contribution reported for ITOs because:

- in contrast to the Industry Training Fund, the funding agreement for Modern Apprenticeships Co-ordination precludes the co-ordinator from charging fees to neither the employer nor the employee (the Modern Apprentice) for the co-ordination services;
  - only some ITOs offer Modern Apprenticeships (either co-ordination or the arranging of training); and
  - the volume of Modern Apprenticeships funding varies considerably amongst participating ITOs.
42. The variable treatment of Modern Apprenticeships funding can have the effect of understating the rate of industry cash contribution. Conversely, it is difficult for ITOs to distinguish between the costs associated with industry training for Modern Apprenticeships and other industry trainees.
43. The current practice of informally exempting some ITOs from the requirement to provide the TEC with audited financial accounts has developed in an ad hoc fashion. Additionally, the current exemptions mean that the TEC is not able to comprehensively and consistently compare the financial performance of all ITOs.
44. This may be appropriate to the level of risk associated with smaller ITOs (ie those that fall within the criteria for differential reporting) however this has not been assessed in a systematic way. Alternatively, it may suggest that a lower level of financial disclosure (to the TEC at least) may be appropriate for larger ITOs.
45. The current method used by ITOs to supply financial information is also labour intensive for the TEC. Additionally, until the implementation of the Industry Training Register the TEC is limited in its ability to support ITOs to find opportunities to benchmark their education and financial performance.

#### *Consultation questions*

46. The discussion above raises a number of questions including:
- What other corporate arrangements do ITOs have and what impact do these have on the financial reporting of ITOs (ie is the discussion in appendix one inaccurate)?
  - Do the current financial reporting requirements take sufficient account of the other sources of income of ITOs?
  - Do the current financial reporting requirements enable the identification of payments to related parties (including those organisations that exercise effective control over ITOs)? and if not, how could the TEC ensure that it is satisfied that any payments made to related parties are reasonable (in the context of the framework discussed above)?
  - Are there any aspects of the PM-18 templates and guidelines that are unclear or misleading? and if so, what changes could be made?
  - Should the requirements relating to the submission of financial information to the TEC be standardised? If not, why not?

- What is the most appropriate way to deal with the funding other than via the Industry Training Funding that ITOs receive? Specifically, how should Modern Apprenticeships funding (either brokerage or STM funding), Sector Leadership Component and Embedded Literacy and Numeracy funding be treated?
- What would be the implications of requiring ITOs to provide their audited financial information in an electronic form?

## Subsidies

### *Current practice*

47. Offering inducements to learners to enrol with a TEO is prohibited under Student Achievement Component (SAC) funding rules. The following three principles underlie the SAC policy:
- a. Tertiary education organisations (TEOs) should not use public funds, whether in the form of tuition subsidies, TEO Component funding, or student loans for fees/course costs, to fund private possession of material items;
  - b. Educational involvement and learning outcomes should be the motivation for learner enrolment in a particular course or with a particular TEO, rather than the prospect of material gain;
  - c. Tertiary education organisations that receive TEC funding must use the funding responsibly.
48. The relevant funding conditions apply whether the sources of the material or financial gain or other personal advantage unrelated to educational provision are public or private.
49. The following are exceptions to this requirement, subject to the TEC's right to review individual schemes for compliance with the policy principles:
- Discounts or scholarships designed to increase access of particular groups of learners identified in the Tertiary Education Strategy; and
  - Scholarships based on merit or financial need.

### *Possible issues*

50. Analysis by the TEC of the business models of ITOs indicates that ITOs employ a number of subsidy models. These include
- a. No or very low subsidies
  - b. Subsidies paid per credit achieved
  - c. Subsidies paid per credit achieved plus subsidies for off-job training
  - d. Individually negotiated subsidies to large employers.
51. As noted above there are some limitations to the ability of ITOs to subsidise employers, trainees and third parties. These include the:
- accountability that ITOs have for public funding;

- legal requirements that the corporate structure of a given ITO imposes on that organisation; and
  - specific funding rules or contractual obligations.
52. Subsidies would appear to be appropriate where they result in the purchasing of specific outputs that can be attributed to education and training. This may occur where an employer has a training division that delivers training to its staff. However, it is possible that the subsidy models described above could take the form of inducements (as defined for SAC funded TEOs).
53. Additionally, such payments may also have the effect of reducing the net industry cash contribution to the costs of industry training. The TEC has received anecdotal evidence to suggest that some ITOs are including payments made to employers and/or trainees in the calculation of the industry cash contribution.

#### *Consultation questions*

54. The subsidy models described above raise a number of questions including:
- what reasons are there for the TEC to continue to permit the payment of subsidies?;
  - are these payments being excluded from the calculation of the rate of industry cash contribution?;
  - would prohibiting the payment of subsidies have an impact on the industry cash contribution of ITOs?;
  - should payments for 'off-job' provision by the training arms of businesses be treated any differently from payments to TEOs for similar services?;
  - would there be perverse impacts associated with prohibiting inducements?;
  - is it appropriate for an ITO or MAC to offer financial incentives to employers to place their trainees/Modern Apprentices with that ITO or MAC?;
  - should employers be paid for the credits achieved by trainees? Why or why not?;
  - what, if any positive effects of incentives could be retained, if possible, by any policy change?

### **Measures of financial performance**

#### *Current practice*

55. As noted above, the TEC is required to take account of a number of considerations when entering into funding agreements with ITOs including that it:
- takes account of the financial sustainability and viability of ITOs<sup>12</sup>;

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<sup>12</sup> The TEC's financial monitoring framework for Tertiary Education Institutions describes viability and sustainability in the following terms:

- ensures that ITOs are funded by employers in the industries that the ITO covers;
  - sets expected financial (or other) contributions by industries to industry training; and
  - ensures that public funding is used effectively and efficiently, and without waste and for its intended purpose (in the case of the industry training fund, to subsidise the costs of industry training).
56. The TEC uses the financial information it collects to undertake a range of analysis to enable it to meet these requirements.
57. As well as determining the rate and change in the industry cash contribution, the TEC uses the financial information it collects from ITOs to determine for ITOs (and collectively) the level, rate and change over time for the following:
- revenue;
  - personnel costs;
  - pre-tax surplus (and deficit);
  - net operating cashflow;
  - working capital;
  - quick assets;
  - equity to total assets;
  - capital expenditure to depreciation;
  - funding per credit achieved; and
  - funding per National Certificate achieved.
58. Analysis of this information is also undertaken that places groups of ITOs into bands based of the level of revenue collected by the organisation. This analysis is undertaken to enable the TEC, when making funding decisions, to have regard to the financial performance of ITOs.

*Possible issues*

59. The current arrangements provide a perspective on the financial status of ITOs but they do not necessarily provide a comprehensive framework. The TEC has not, for example, developed a:
- comprehensive set of financial measures and benchmarks;
  - framework for assessing the risk level of individual ITOs; and
  - monitoring and engagement regime specific to financial considerations.

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*Viability focuses on the shorter term financial performance, to enable judgements to be made about the ability or otherwise of the institution to meet its financial obligations as they fall due.*

*Sustainability provides a longer term view, to provide analysis of the financial performance and cost structures of the institution, and whether these are enduring*

60. It is possible that the current arrangements would not enable the TEC to be assured of the financial viability and sustainability of individual ITOs. This may carry some risk for TEC as the public entity responsible for the effective use of public funding.
61. While such risks are evidently less than those associated with the financial failure of a Crown entity such as an institute of technology or polytechnic, the failure of an ITO could have implications in terms of wasted funding, and the interruption of training for significant industries with large numbers of trainees.

#### *Possible options*

62. To mitigate the risks associated with financial viability and sustainability of TEIs, the TEC has developed a number of financial ratios. These ratios are consistent with generally accepted accounting principles; however some have been tailored to the tertiary sector.
63. The TEC's financial monitoring framework is attached as appendix three. Some specific examples of minimum expectations relating to viability include:
  - operating surplus to revenue of 3%;
  - core earnings to revenue of 9%;
  - net cashflow of 110%;
  - liquid funds ratio of 8%; and
  - quick ratio of 1.5.
64. Additionally, the TEC has identified minimum expectations relating to sustainability including:
  - debt equity ratio of no more than 7.5%;
  - achievement of EFTS between 97% and 103%; and
  - return on net assets employed of at least 1.5%.
65. The TEC also takes account of the trend and variability in the financial viability indicators over time to give an indication of the long-term sustainability of the ITO.

#### *Applicability to ITOs*

66. There may be some merit in applying some or all of the minimum expectations set out above to the TEC's analysis of the financial viability and sustainability of ITOs. However, the TEC's response to financial risk for ITOs would necessarily be different from that it applies to TEIs.
67. A risk-based approach would be appropriate for ITOs both in terms of the level of monitoring and interventions required. As with TEIs, there may be merit in requiring higher-risk ITOs to provide additional financial monitoring information.
68. The financial risk associated with ITOs for the TEC has a number of dimensions. While intuitively such risk is associated with organisations that are not achieving the minimum expectations in terms of financial viability, the TEC also has an interest where there is evidence that public funding is not being used effectively and efficiently, and without waste.
69. An area of particular interest may be the liquid funds ratio which is a measure of the capacity of an organisation to self-fund its cash outgoings. This measure is

important for maintaining the viability of an organisation. However, the accumulation of excessive levels of liquid funds may indicate that public funding is not being used effectively and efficiently.

70. There may, therefore, be merit in developing a performance matrix that takes account of these tensions. This might mean that, for example, the risk associated with the liquid funds ratio might be:
- <3% (less than one week) = high risk
  - 3% to 6% (between one to two weeks) = moderate risk
  - 7% to 12% (between two weeks and one months) = minimal risk
  - 13% to 25% (between one and three months) = moderate risk
  - >26% (or more than three months) = high risk
71. Such an approach would recognise that there is risks associated with having a limited ability to cover its cash outgoing (for the ITO) and with not effectively and efficiently utilising public funding (for the TEC).
72. There may also be merit in defining a minimum quantum of reserves for small ITOs. For example, a minimum level of \$100,000 irrespective of the normal expenses of the ITO may provide a buffer in the event of unexpected changes in the ITO's performance. Alternatively, there may be a case for expecting a lower level of liquid funds than that suggested above. This would reflect the level of funding certainty provided through three-year investment plans.
73. There will also be financial measures that are specific to ITOs. The most significant of these is the volume and rate of industry cash contribution to the costs of industry training. There may be merit in developing a performance matrix that relates to these ITO-specific measures. This would provide additional guidance to ITOs in relation to the expected level of industry cash contribution.
74. There may also be merit, in order to facilitate the benchmarking of the financial and training performance of ITOs, to expand the financial data collected by the TEC. The provision of additional information, combined with the planned self-reporting and monitoring capability of the Industry Training Register may enable ITOs to identify efficiencies<sup>13</sup>.

#### *Consultation questions*

75. The discussion above raises a number of questions including:
- Is it appropriate to apply all or some the TEI financial monitoring framework measures to ITOs? and if not, what other measures would be more appropriate?
  - Are the performance bands identified for TEIs and set out in Appendix three appropriate for ITOs? and if not, what alternative performance bands are appropriate?
  - Is the performance matrix suggested for the liquid funds ration appropriate for ITOs? If not, why not?

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<sup>13</sup> See <http://www.tec.govt.nz/About-us/News/Updates/Industry-Training-Register-presentation/> for more information.

- What level of financial information would be appropriate to collect in order to facilitate benchmarking and to appropriately assess financial risk?

### **Ethical framework**

76. The preceding discussion suggests that there may be merit in developing an ethical framework in line with the principles set out in the discussion relating to the guidance from the Treasury and the OAG. This ethical framework would set out the TEC's expectations for ITOs receiving public funding.
77. This raises questions including whether it would be desirable to develop such a framework? and if not, why not?

### **Consultation Feedback**

78. The TEC invites and welcomes any comments from the tertiary education sector. Individuals as well as organisations are welcome to provide feedback on the direction and decisions outlined in the paper and on how these can be further developed.
79. All feedback relating to this Consultation paper should be responded to using the feedback templates provided on the TEC website. Please only send a response using the feedback templates provided. Send any feedback to [industrytrainingprogrammes@tec.govt.nz](mailto:industrytrainingprogrammes@tec.govt.nz). All feedback should include the subject line "**ITO operational policy – feedback**" and be submitted no later than 5pm, 12 March 2010.

### **Questions for consultation**

80. The areas where consultation feedback is sought are set out in the related feedback template.



## APPENDIX ONE – Corporate arrangements of ITOs

### Corporate arrangements of ITOs

1. It is important to note that ITOs are not public or Crown-owned entities. As a result, they are not, for example, subject to the Public Finance Act or the Crown Entities Act. As the OAG notes, the provision of public funding does not change this characteristic.
2. Each ITO will have specific obligations depending on its corporate structure. To better understand these obligations, we can examine the corporate structures of those organisations that have been recognised as ITOs. Analysis by the TEC indicates that ITOs are:
  - Private limited liability companies (8)
  - Incorporated societies (26)<sup>14</sup>
  - Charitable trusts (2)
  - Business units of industry associations (3, a further three are also incorporated societies).
3. Some of the specific obligations for ITOs with a focus on their financial reporting requirements are discussed below.

#### Most ITOs are incorporated societies

4. The majority of ITOs are incorporated societies. These entities are groups of at least 15 people who have applied for registration as an incorporated society under the Incorporated Societies Act 1908.
5. Once registered the incorporated society becomes a separate legal entity distinct from its members. This means that the members are not personally liable for the society's debts, contracts or other obligations. Likewise, members do not have any personal interest in any property or assets owned by the society.
6. An incorporated society can raise money to help achieve its purpose (as set out in its rules). It is not able to make money (profits) to distribute to its members. For example, a society can raise money to send a sports team to a tournament (if that type of activity is allowed by its rules), but it cannot raise money and give it to its members to use as if it were their own<sup>15</sup>.
7. An incorporated society can employ people, including society members, and pay them for the work they do or it can make payments to members to which they would be entitled if they were not members of the society.
8. Many incorporated societies must file a certified copy of their annual financial statement.

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<sup>14</sup> A number of which are also charitable trusts.

<sup>15</sup> See <http://www.societies.govt.nz/cms/incorporated-societies/learn-about-incorporated-societies/what-can-an-incorporated-society-do/>

### Some ITOs are limited liability companies

9. A limited liability company has a separate legal entity from its shareholders. In most circumstances, the shareholders of a limited liability company are not liable for the business debts of the company<sup>16</sup>.
10. Limited liability companies must comply with a number of requirements including the preparation of annual financial statements. These financial statements must comply with the Financial Reporting Act 1993<sup>17</sup>.
11. Limited liability companies are not limited in terms of the use of profits in the same way as incorporated societies.

### Most ITOs are also registered charities

12. Additionally, most ITOs are registered as charities in accordance with the Charities Act 2005. To be registered as a charity, an organisation must have a “charitable purpose” as defined in Section 5(1) of the *Charities Act 2005* as including

“...every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community.”

13. Registered charities must also provide a public benefit and not be aimed at creating private financial profit. Such entities are eligible for tax exempt status. Tax exempt status means that registered charities do not have to pay income tax and resident withholding tax and donors of gifts to registered charities do not have to pay gift duty<sup>18</sup>.
14. A registered charitable entity must satisfy the Charities Commission of a range of matters including that any income, benefit, or advantage must be used to advance the charitable purposes of the organisation. Such entities must also make annual returns to the Charities Commission which must include annual financial statements.

### Some ITOs are business units of industry associations

15. In a small number of cases, organisations recognised as ITOs are business units of industry associations. While these arrangements do not normally raise particular issues, they do place important obligations on the organisations to ensure that the business arrangements are separate. This is particularly relevant when considering the uses to which public funding is put.
16. From time to time, the TEC has been approached by these organisations seeking permission to use public funding for purposes other than which it has been appropriated. For example, an ITO has sought permission from the TEC to use public funding for marketing activities associated with the industry association.

1. \_\_\_\_\_

<sup>16</sup> See <http://www.companies.govt.nz/cms/how-do-i/learn-what-a-company-is/why-form-a-company>

<sup>17</sup> See <http://www.companies.govt.nz/cms/how-do-i/learn-what-a-company-is/maintaining-keeping-records#finans> for more information on the record-keeping requirements for companies.

<sup>18</sup> See [http://www.charities.govt.nz/guidance/benefits\\_charities.html](http://www.charities.govt.nz/guidance/benefits_charities.html)

17. Such requests raise a number of issues. Firstly, the use of funding for these purposes would not optimise the public benefit of the funding provided by the TEC. Secondly, for ITOs that are registered charities and/or incorporated societies, it is possible that such activities are not consistent with their corporate status. Thirdly and most importantly, there are strict limits on the uses to which funding approved as part of plans may be used (ie solely for the purposes of implementing that plan).
18. It is important to note that ITOs with this corporate structure must make particular effort to ensure that there is appropriate governance and financial separation. ITOs in this situation must make particular effort to ensure that any fees paid to the industry association are appropriately accounted for and meet the expectations noted above.

What difference does size make?

19. Some smaller 'not for profit' entities are exempt from some of the framework of financial reporting and auditing standards developed in accordance with the Financial Reporting Act 1993. This is known as "differential reporting".
20. The Framework for Differential Reporting permits certain entities to adopt less comprehensive disclosure, while remaining Generally Accepted Accounting Principles (GAAP) compliant, through a regime of partial and full exemptions from Financial Reporting Standards. Generally, an entity qualifies for differential reporting if:
  - all of its owners are members of the entity's governing body; or
  - the entity is not large (i.e. does not exceed any two of the following three size thresholds: total revenue of \$5.0 million, total assets of \$2.5 million, 20 employees).<sup>19</sup>
21. A number of ITOs meet both of the conditions relating to revenue and total assets (the TEC does not hold information about the number of employees of ITOs).
22. This means that some ITOs do not, as a matter of course, prepare audited financial audits that are comparable to those of other ITOs.

1. \_\_\_\_\_

<sup>19</sup> See

[http://www.nzica.com/AM/Template.cfm?Section=Financial\\_Reporting\\_Standards\\_files&Template=/CM/ContentDisplay.cfm&ContentID=8965](http://www.nzica.com/AM/Template.cfm?Section=Financial_Reporting_Standards_files&Template=/CM/ContentDisplay.cfm&ContentID=8965)

# Performance Measure 18 Guidelines

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## 1. Introduction

### **Performance Measure 18**

*“The total cash cost of credit achievement and the total cash cost per credit achieved for the period 01 January to 31 December.*

*The Tertiary Education Commission (TEC) will report the Industry and Government contribution to the total cash cost.*

#### 1.1 Objective

The objective of Performance Measure 18 (PM18) is to capture the total cash cost of credit and national qualification achievement; and to identify the relative cash contribution to this achievement by Industry and Government.

Industry Training Organisations (ITO's) will capture and report the total cash cost of achievement and the industry cash contribution. TEC will report the Government contribution.

## 2. Interpretation of Statement

### 2.1 Cash

The use of the word 'cash' in this context shall ***not*** be interpreted as meaning cash accounting. On the contrary, accrual accounting that results in full audited financial accounts, produced in line with generally accepted accounting standards as part of normal business annual reporting, shall be used as a basis for all information required to support PM18.

All provider and industry party costs will be included where an invoice can substantiate them.

The word cash has been used to specifically exclude industry 'in kind' costs, which were previously included in ITF financial reporting. In kind costs are not being included, as they are subjective and expensive to measure and record.

### 2.2 Cost

PM 18 measures the total cash cost of credit and national qualification achievement. In addition, it shows the industry cash contribution towards this achievement. TEC will report the Government's contribution.

Cost includes all costs incurred and recorded through the ITO and costs incurred through training providers and industry parties (whether it is the trainee, employer or other) where evidenced by an invoice.

Some costs do not flow through the ITO's accounts, for example, fees paid directly to off-job training providers by employers or trainees are costs that must be captured.

The costs included are all costs to run the qualification framework system which enable credits and national qualifications to be achieved. As such, there are many activities that must be completed before and after the assessment of a credit. PM18 will capture all costs to 'achieve' the credit not purely the cost of assessing the achievement of credits.

### 2.3 Credit achieved

As defined in the Performance Measurement Guidelines and Definitions document, credit achievement takes place and can be reported as such at the point the ITO accepts the credit achievement report of an assessor registered to assess credit achievement.

### 2.4 National qualifications achieved

National qualification achievement occurs at the point where the ITO is satisfied it, or the trainee or a provider, can demonstrate to NZQA that the trainee has completed the requisite requirements for achieving the national qualification. ITOs should be able to demonstrate an audit trail accordingly (see Performance Measurement Guidelines and Definitions document).

### 3. Key Principles

#### 3.1 Deed of Agreement and ITF Funding Schedule:

The following statements from the Agreement and Funding Schedule provide the framework for the appropriate use of TEC funds:

- ◆ ITOs receive funds from TEC for setting skill standards and/or developing and/or arranging delivery of industry training.
- ◆ ITOs cannot seek or obtain other funds from TEC or any other New Zealand Government source for any purpose for which funding has already been or will be sought or obtained from TEC.

The following key principles underpin the capture of the cash cost of credit and national qualification achievement.

#### 3.2 Clear identification of outputs and outcomes

ITOs should clearly identify and define all their outputs. This will include:

- ◆ Each valid training arrangement that results in credit and national qualification achievement under the Industry Training Fund; and
- ◆ Each trainee enrolled in non-credit related training, i.e. a course of study or a training programme that does not qualify for subsidy under the Industry Training Fund.

The criteria for a valid trainee as per the current Funding Schedule is:

- Linked to an employment contract for employed trainees;
- Intended to lead to the acquisition of at least twenty credits towards a national qualification registered on the National Qualifications Framework<sup>1</sup>.

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<sup>1</sup> This is not a measure of ITO performance; rather it represents a minimum intention.

### 3.3 Basis of cost

The specific activities and associated costs relating to each output or outcome will guide the appropriate allocation of costs.

The cash cost is defined as a cash transaction, i.e. one that has an invoice demonstrating cash expenditure. The cost can be processed by the ITO, industry party or it could be the trainee/employer contribution paid direct to providers towards the cost of off job training, again evidenced by an invoice.

Audited financial statements are to be used to determine the costs of outputs. In all cases, generally accepted accounting practice is to be used as the basis on which financial reports are prepared and costs are included for the period.

### 3.4 Recording industry contributions

ITOs should capture all industry-related payments directly incurred in achieving credits and national qualifications. These costs, whilst not part of the ITO's expenditure, should be recorded and attributed to the relevant training output. This will enable clear reporting of the industry cash contribution.

ITOs are required to make arrangements with their auditors to enable the industry cash contribution (not through the ITO's books) to be shown in the audited accounts as a separate note. Generally, this will satisfy TEC's requirements to verify the industry contribution.

Industry contributions can only be included where they can be evidenced by an invoice.

### 3.5 Cost allocation

Shared costs, such as internal services and personnel costs, and other overheads should be consistently allocated between outputs to ensure that non-credit related training and other activities receive an equitable share of those shared and other overhead costs.

A statement and calculation that is able to withstand scrutiny must support the basis for apportionment of overhead and salary costs. Materiality will be a consideration.

## 4. Costs Included

ITOs receive funds from TEC for setting skill standards and/or developing and/or arranging delivery of industry training.

As a general principle, expenditure relating to this activity can be included except for in-kind contributions and other costs that are specifically excluded (see Costs Excluded section).

### 4.1 ITO expenditure

As the key output of ITOs is credit and national qualification achievement, all the costs of running an ITO including overheads, salaries and activities relating to the ITF, shall be included.

This includes:

- ◆ ITO operating expenditure including direct, indirect, overheads and salaries after suitable cost allocation to non-ITF activities (where appropriate)
- ◆ all costs incurred to enable a trainee to achieve credits and have the credits recorded on their record of learning
- ◆ asset revaluation
- ◆ group apprenticeship schemes where the outputs are consistent with ITF outputs
- ◆ costs to belong to industry associations
- ◆ where ITOs enter contracts with other ITOs to provide services, the ITO supplying the goods/service must net off the income against related costs to show a net cost. This will ensure that the sector costs are reported only once. An example of this type of arrangement is where an ITO offers bureau services or sublease arrangements to another ITO.

### 4.2 Industry cash contribution

PM 18 captures the industry cash contribution towards achievement. As such ITOs should include and/or note the following.

- ◆ Payments made by industry on behalf of the ITO to third parties for goods and/or services must be easily identifiable, specific and its primary purpose must be to achieve credits.
- ◆ It is important to present the industry cash contribution separately from the ITO's expenditure so that the contributing elements of any balance can be explained if necessary.
- ◆ All industry-related payments that relate to the achievement of credits under the Industry Training Fund. For example, fees paid directly to the ITO for the administration of training arrangements.

- ◆ All fees paid directly to training providers by industry (either by employers or trainees) for the following:- assessor training, moderator training, hook-on fees, credit registration fees, student fees and off-job training course fees
- ◆ All other payments to third party suppliers where it can be shown that the primary purpose is to achieve credits. For example, expenditure incurred to develop moderation plans, publication material, unit standards, airfares and accommodation to attend meetings
- ◆ If the ITO reimburses industry for expenditure in whole or in part, the corresponding amount that is reimbursed is to be reported as ITO expenditure and excluded from the reported industry cash contribution.

#### 4.3 GST

- ◆ ITOs should include GST in all the figures reported for PM18 (see Reporting section)
- ◆ To calculate the GST, ITOs will have to make an adjustment for the non-GST related items that have been included in the Statement of Financial Performance e.g. wages, interest, bank fees. These items are to be excluded prior to calculating the GST adjustment.
- ◆ The following is an example of the GST adjustment calculation required.

<b><u>EXAMPLE GST Adjustment Calculation</u></b>		
Total ITF related expenditure from Statement of Financial Performance ( <i>Less all excluded expenditure items</i> )		1,250,000
<u>Less adjustments for non-GST items included in above</u>		
Wages – salaried staff and non GST registered contractors	200,000	
Bank Fees	1,500	
Interest	500	
	Less Total Non GST Items	202,000
	Total of Items Attracting GST	1,048,000
	Multiply by 12.5%	131,000
	( =GST adjustment –refer section 6.3)	

This calculation will need to be repeated for industry party expenditure if it includes non-GST expenditure.

#### 4.4 Accruals

Generally accepted accounting practice and TEC's intention to illustrate the level and cost of training activity in each funding year guide the recording of accruals for PM 18. Accordingly, ITOs record the financial effect of training as it occurs. TEC acknowledges that the timing of the event may or may not coincide with the receipt of an invoice or with the time that cash is paid. In this situation, it would be appropriate for ITOs to record an accrual.

## 5. Costs Excluded

### 5.1 Trainees not subsidised by TEC

Costs relating to trainees that do not comply with current ITF funding policy are to be excluded. For example, trainees without valid training agreements (refer clause 2, ITF Funding Schedule), producing and supplying unit standards or training to people who will not achieve credits in New Zealand.

### 5.2 Non-credit related expenditure

As noted previously, ITOs receive funds from TEC for setting skill standards and/or developing and/or arranging delivery of industry training. As a general principle, therefore, expenditure relating to this activity can be included.

However, some costs do not meet this principle and as such, cannot be attributed directly to credit achievement and must be excluded from expenditure reported.

Some examples are as follows:

- ◆ transfers to reserves
- ◆ school related costs for assessment and awarding of credits/national certificates
- ◆ purchase of assets that is recovered by depreciation, i.e. include depreciation as an expense and exclude the capital purchase
- ◆ costs associated with goods and services for materials that are sold that are not associated with the achievement of credits
- ◆ If the ITO reimburses industry for expenditure in whole or in part, the corresponding amount that is reimbursed is to be reported as ITO expenditure and excluded from the reported industry cash contribution.

Where costs are incurred for activities undertaken by the ITO that are not related to credit achievement, then the costs must be quantified and excluded from PM18.

Additionally, appropriate overhead and salary costs must also be apportioned to these activities and excluded.

### 5.3 Industry in kind

'In kind' contributions or the provision of resources and benefits provided by the industry that are not related to cash transactions, **are excluded** because the basis for determining their equivalent dollar value is subjective.

## 6. Reporting

### 6.1 ITO Reporting Requirements

TEC will identify the Government contribution once ITOs submit the PM 18 report and the total ITF subsidy for the year has been finalised. ITOs must ensure the Government's contribution is not included in any of the figures in the PM18 table.

### 6.2 Reporting frequency

Reporting against PM18 will now occur annually. ITOs are required to submit the report by 31 March in each year.

### 6.3 Reporting Content

A copy of the ITO's audited accounts for the financial year ending 31 December must accompany the PM18 report. **Where ITOs choose not to align their financial year with the calendar year, audited management accounts for the calendar year must be provided.**

Additionally a narrative should be included outlining adjustments and assumptions made which substantiate differences between the figures in the annual accounts and the figures reported for PM18.

ITOs are required to provide a reconciliation of this information.

#### **EXAMPLE Reconciliation Total Cash Cost (Figure 3)**

<b><u>ITO Expenditure</u></b>	
Expenditure as per Annual Audited Accounts or Audited Management Accounts for the year ended 31 December	<b>1,310,000</b>
<b>Less</b> Excluded costs	<b>(60,000)</b>
<b>Sub Total</b>	<b>1,250,000</b>
<b>Plus</b> GST (automatic transfer from GST adjustment calculation sheet)	<b>131,000</b>
<b>Total ITO Expenditure</b>	<b>1,381,000</b>
<b><u>Employer/Trainee Expenditure (not through ITO books) for ITF Activities</u></b>	
Industry payments not included ITO's books	<b>600,000</b>
<b>Plus</b> GST (automatic transfer from GST adjustment calculation sheet)	<b>75,000</b>
<b>Total Employer/Trainee Expenditure</b>	<b>675,000</b>
<b>Total Cash Cost</b>	<b>2,056,000</b>

### EXAMPLE Reconciliation Total Industry Cash Contribution

<b><u>Employer/Trainee Payments to the ITO for ITF Activities</u></b>	<b>100,000</b>
<b>Plus GST (automatic transfer from GST adjustment calculation sheet)</b>	<b>12,500</b>
<b>Sub Total</b>	<b>112,500</b>
<b><u>Employer/Trainee Expenditure (not through ITO books) for ITF Activities</u></b> (Automatic transfer from Total Cash Cost Worksheet)	<b>675,000</b>
<b>Total Industry Cash Contribution</b>	<b>787,500</b>

#### 6.4 Source Documents

As noted, audited financial accounts for the financial year ending 31 December will be used as the primary source of information to support ITO expenditure. This simplifies reporting and provides TEC with rigorous, credible and consistent information.

ITO audited accounts need to include notes to the accounts to support all industry expenditure that are reported to TEC.

The standard record-keeping requirement for retaining financial information is 7 years. ITOs must ensure that they and third parties meet this requirement. This includes copies of all invoices for expenditure reported for PM 18.

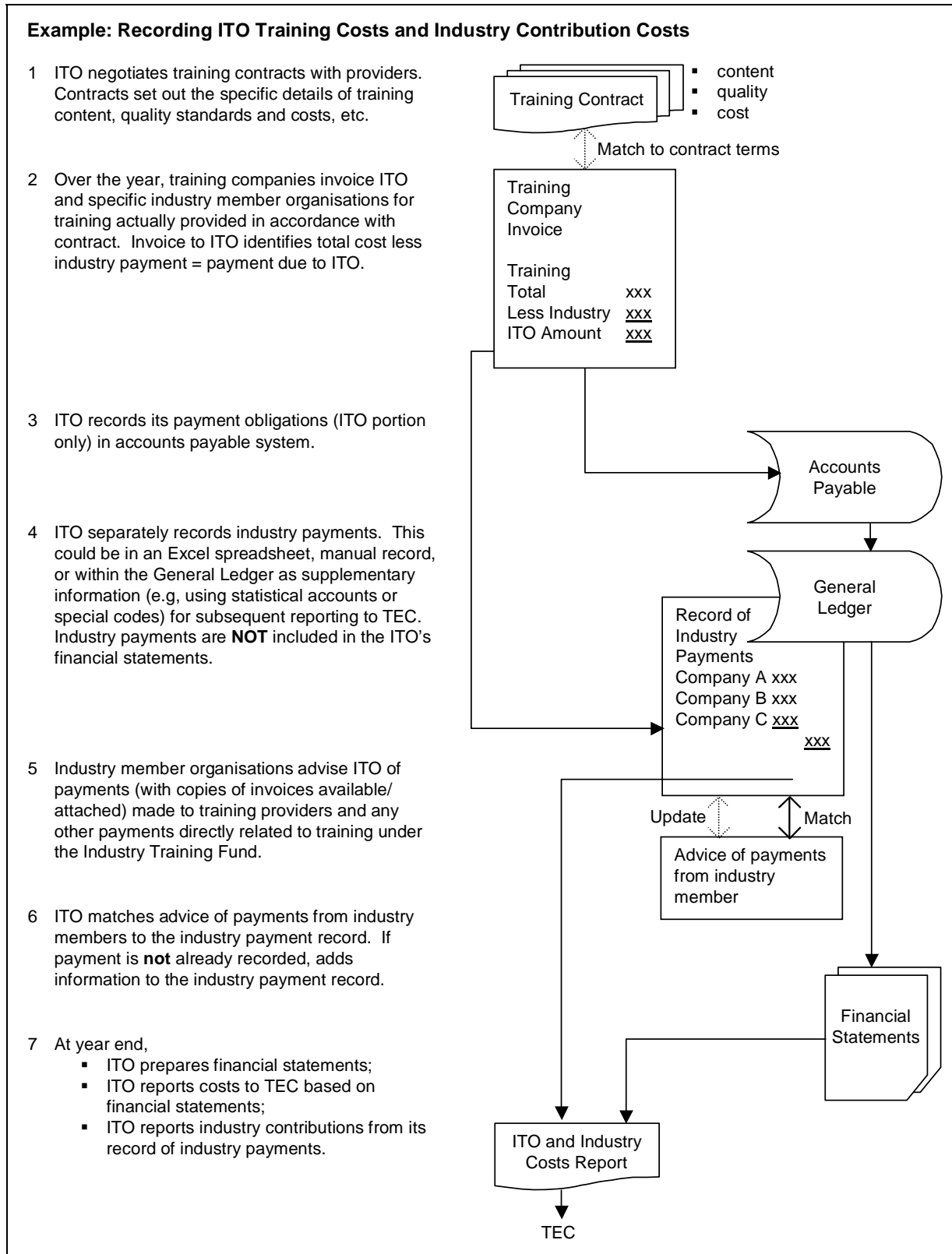
In cases where expenditure has not passed through the ITO's books and has been paid directly by the industry, the ITO must obtain copies of invoices from third parties or, where acceptable by the ITO's auditor, a letter from the industry party that provides a declaration of costs paid. In the latter situation, the industry party would need to retain copies of invoices so that these could be supplied, if requested.

For example, an invoice from an off-job training provider should detail the following:

<b>Provider Invoice EXAMPLE</b>	
Total Course cost	100,000
less industry contribution	25,000
= subtotal (to be paid by ITO)	75,000

Using this example, \$75,000 would be included in the ITO's expenditure and \$25,000 would be included as the industry's contribution.

## 7. Flowchart Example





## **Tertiary Education Institution Financial Monitoring Framework**

### **Purpose**

- 1 The Financial Monitoring Framework (the Framework) sets out the aims and establishes the approach for financial monitoring of tertiary education institutes (TEIs) to be adopted by the Tertiary Education Commission (TEC) from 1 January 2010.

### **Introduction**

- 2 The Framework will allow the TEC to monitor the financial performance of all TEIs in accordance with the Education Act 1989 (s159KBA).
- 3 In addition, monitoring also needs to align to the Government's message of greater responsibility on TEIs for financial sustainability and educational quality and to meet the drivers of low compliance, transparency and a simplified approach. This paper outlines this approach.
- 4 TEI financial performance will be assessed against a suite of measures covering the following dimensions:
  - Viability; and
  - Sustainability.
- 5 As a result of the assessment the TEC will communicate annually to each TEI outlining:
  - the financial performance assessment completed;
  - the assigned risk level (low, moderate or high);
  - the level of monitoring and engagement; and
  - any additional monitoring or reporting required, including the consideration of any interventions.
- 6 The report will include a table of measures and the respective results for each, providing the aggregate score for viability and sustainability (across a current and future view).

## How will performance be measured?

- 7 TEI financial performance will be assessed against a suite of financial measures. The framework is an initial assessment of the financial wellbeing of a TEI. It uses a basket of measures that individually and collectively have an ability to identify the various facets of high level financial performance.
- 8 Assessment of individual TEI financial performance will result in a risk level of either low, moderate or high risk and cover the dimensions of financial viability and sustainability (over a current and future dimension).
- 9 Viability focuses on the shorter term financial performance, to enable judgements to be made about the ability or otherwise of the institution to meet its financial obligations that they fall due.
- 10 Sustainability provides a longer term view, to provide analysis of the financial performance and cost structures of the institution, and whether these are enduring.
- 11 TEIs that are identified as higher risk (ie either a Moderate or High risk assessment) will be assessed at a more detailed level. This will enable identification of the key areas of risk within the institution so the Crown's monitoring and engagement can be appropriately focussed.
- 12 Each area of financial performance will be measured using a set of financial performance measures. Industry-standard calculations of measures have been used where applicable, although some measures have been tailored to the tertiary sector.

## Scoring and calculation of risk rating

- 13 The performance measures to be used are set out in Appendix A. For each measure there has been a set of performance bands developed and a relative score is allocated for each band. Table 1 below provides an example of the performance bands and relative scores for the operating surplus/deficit measure.

Table 1: Score and risk level

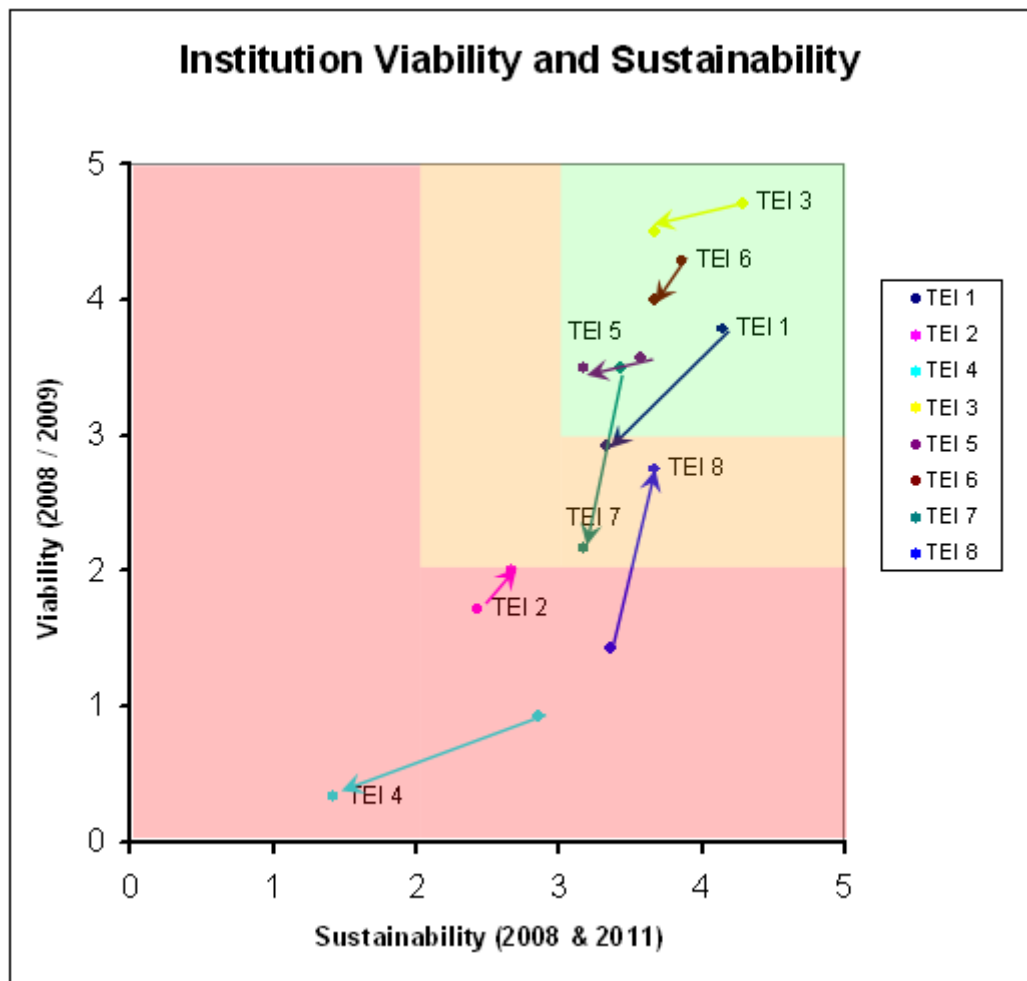
Performance bands for operating surplus/deficit					
< -4%	-4% to 0%	0% to 2%	2% to 4%	4% to 6%	6% +
Score and level of risk					
-2	0.5	2	3	4	5
High risk	Moderate Risk	Moderate risk	Low risk	Low risk	Minimal risk

- 14 The scoring system has been weighted so that poor performance has a greater effect on the score received for each measure. The further a TEI deviates from a given norm the greater the impact on the final score given

for a measure. The performance bands and relative scores for each measure are set out in Appendix A.

- 15 A TEI's results for each measure will be scored depending on which band it falls within. Scores are aggregated, and then averaged, to provide an overall score for both viability and sustainability, which will then be plotted on a graph to identify an overall rating of low, moderate or high risk level.
- 16 TEIs will be scored and plotted twice at each assessment: one based on the previous year's audited results (for example, 2008) and one based on submitted budget or three year forecasts (for example, 2009 for viability and 2011 for sustainability). This will provide a future direction of travel of each institution's financial performance and position. Figure 1 below provides a worked example of how TEIs would be plotted.

Figure 1: Worked example of TEI financial risk rating



- 17 TEIs that feature in the top right are viewed as Low Risk, TEIs in the middle zone as Moderate Risk, and those in the bottom left as High Risk.
- 18 For those TEIs whose current risk ratings and future risk ratings see them sitting in different risk quadrants (for the current and future view) then table three below will be used to determine a TEI's overall risk rating score and monitoring arrangements.

### Implications of risk assessment

- 19 The risk rating a TEI receives will inform the level of monitoring and engagement the TEC will have with that TEI for the year ahead.
- 20 In developing TEI monitoring arrangements a graduated system of monitoring intervention will be used, with low risk TEIs receiving lower monitoring and having less reporting requirements. The TEC has also looked to reduce compliance costs across the board by making more use of TEI internally generated information.
- 21 Table 2 sets out the risk assessments and relative levels of monitoring to be undertaken, as well as an indicative timeline for data and information to be submitted to the TEC.

Table 2: Level of monitoring according to risk classification

Classification	Level of monitoring	Timeline for standard data submission
<u>Low Risk</u>	<ul style="list-style-type: none"> <li>▪ Two standard data collections per year</li> <li>▪ Information used to assess and/or reassess risk classification. TEI will be able to self assess against published TEC financial monitoring measures and benchmarks</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>15 May:</b> final audited accounts from previous year; final council approved budget for current year</li> <li>▪ <b>30 November:</b> reforecast for current year; three year forecast information.</li> </ul>
<u>Moderate Risk</u>	<ul style="list-style-type: none"> <li>▪ Three standard data collections per year</li> <li>▪ More intensive analysis against second stage of assessment to determine key areas of risk</li> <li>▪ Low level interventions considered</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>28 February:</b> provisional accounts from previous year and provisional council approved budget for current year</li> <li>▪ <b>15 May:</b> final audited accounts from previous year; final council approved budget for current year</li> <li>▪ <b>31 October:</b> reforecast for current year; three year forecast information, and a copy of the latest management accounts</li> </ul>
<u>High Risk</u>	<ul style="list-style-type: none"> <li>▪ Three standards data collections per year</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>28 February:</b> provisional accounts</li> </ul>

	<ul style="list-style-type: none"> <li>▪ Collection of specified information such as monthly financial management accounts and council papers</li> <li>▪ More intensive analysis against second stage of assessment to determine key areas of risk</li> <li>▪ Full range of interventions considered</li> </ul>	<p>from previous year and provisional council approved budget for current year</p> <ul style="list-style-type: none"> <li>▪ <b>15 May:</b> final audited accounts from previous year; final council approved budget for current year</li> <li>▪ <b>31 October:</b> reforecast for current year; Three year forecast information</li> <li>▪ Other information required on a case by case basis, including monthly management accounts and/or council papers</li> </ul>
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22 The level of monitoring will be determined by considering both the current risk rating (based on the previous year's results) and the future risk rating (based on forecast results). Table 3 below indicates how the overall level of risk and level of monitoring will be determined.

Table 3: Determination of monitoring levels and overall risk rating

Level of Monitoring				
		Current risk rating		
Level of Risk		Low Risk	Moderate Risk	High Risk
Future risk rating	Low Risk	Low level of risk and monitoring	Moderate level of risk and monitoring	High level of risk and monitoring
	Moderate Risk	Moderate level of risk and monitoring	Moderate level of risk and monitoring	High level of risk and monitoring
	High Risk	Moderate level of risk and monitoring	High level of risk and monitoring	High level of risk and monitoring

23 A TEI's overall risk rating and monitoring arrangements will depend upon the quadrant a TEI is assessed as being in for their current and future assessments. Where a TEI features in a different risk quadrant for their

current and future period assessments, table three above will be used to determine an overall risk assessment score and resultant monitoring arrangements.

- 24 The effectiveness of the monitoring framework is dependant on the input provided by TEI's on their current and future financial performance. Information is based on a TEI's financial statements. In the case of a TEI experiencing a rapid deterioration in its financial position the TEC may move an institution from a low level of monitoring to high level monitoring to enable an appropriate level of engagement.
- 25 Where risk levels are assessed as moderate or high it is recognised that each TEI is unique and the circumstances for greater monitoring and engagement will not be the same. Investment Managers will work more closely with each TEI and undertake further assessment on a case-by-case basis to determine where monitoring needs to be focused. In general the assessment will consider a range of factors covering operational drivers such as staff utilisation, class sizes, contribution margins, funding change impacts, overhead cost structures, space utilisation rates and asset efficiency.
- 26 Any information requirements specified by the Secretary for Education or in other agreements in place for your institution, such as loan agreements, and are monitored by TEC, remain unchanged.

#### **Redevelopment of TEC data collection templates**

- 27 Templates are being redeveloped to minimise compliance, ensure ease of use and allow a high level of transparency. The information compiled will be used for TEC reporting and can also be used by the TEI for self assessment purposes. TEIs will have access to the same measures (and formula) allowing a consistent approach for TEIs in determining their own risk assessment level.
- 28 The revised templates, as well as the timelines for submission, will take into account TEI reporting cycles to council and management, Capital Asset Management (CAM) reporting, as well as TEC reporting required by Ministry of Education, Ministers and Cabinet.
- 29 While TEC will not require half year returns, financial information to enable Treasury to prepare government (fiscal period) accounts, will still be required by the Ministry of Education. The Ministry of Education and TEC are currently finalising these arrangements.
- 30 The Treasury also requires information on sector Capital Asset Management Plans and spending intentions. A separate template has been developed for this purpose. The first return is due in December 2009 and on a yearly basis thereafter. The TEC is looking to set the reporting dates for TEI CAM reporting to coincide with the reporting of TEI annual reporting in May of each year.

**Advice of risk level assessment to TEIs**

- 31 The TEC will communicate in December 2009, and then annually to each TEI, outlining:
- the financial assessment completed;
  - the assigned risk level;
  - the level of monitoring and engagement ; and
  - any additional monitoring or reporting required, including the consideration of any interventions.
- 32 The report will include a table of measures and the respective results for each, providing the aggregate scores for viability and sustainability.
- 33 If subsequent reporting or other events indicate a change in risk level and resulting in a need to revise monitoring and engagement levels, TEC will advise this to the TEI together with the assessment completed.

**Copies and worked example**

- 34 Copies of the framework and a worked example will be posted on the TEIFM web site and is available from: [teifm.info@tec.govt.nz](mailto:teifm.info@tec.govt.nz).

**Appendix 1: TEI Financial Monitoring Framework Measures (final)**

Scores and performance bands per financial measure (indicative)

Measures	Definition/ Calculation	Performance band scores					
		-2 (high risk)	0.5	2	3 (low risk)	4	5 (Minimal)
<b>Viability</b>							
Operating Surplus/Deficit	Operating Surplus/Deficit before abnormals to total income.	< -4%	-4% to 0%	0% to 2%	2 to 4%	4 to 6%	6% +
Core Earnings	EBITDA to total income.	< 3%	3% to 7%	7% to 9%	9% to 11%	11% to 13%	13% +
Net cashflow from operations	Cash inflow (receipts) from operations to Cash outflow (payments) from operations.	< 104%	104% to 108%	108% to 110%	110% to 112%	112% to 114%	114% +
Liquid Funds Ratio	Liquid assets less short term overdrafts to cash outflow (payments) from operations.	< 2%	2% to 5%	5% to 8%	8% to 12%	12% to 15%	15% +
Ability to service debt (Interest coverage ratio)	Earnings before interest paid and abnormals to Interest paid.	< 1.0:1	1.0 to 1.5:1	1.5 to 3:1	3 to 6:1 Or no interest payments and core earnings ratio less than zero	6 to 12:1 Or No interest payments and core earnings ratio 0% - 10%	>12:1 Or No interest payments and core earnings ratio greater than 10%

Measures	Definition/ Calculation	Performance band scores					
		-2 (high risk)	0.5	2	3 (low risk)	4	5 (Minimal)
Quick ratio	Readily liquefiable assets divided by current liabilities likely to result in cash outflows.	0 to 0.5	0.5 to 1.0	1.0 to 1.5	1.5 to 2.0	2.0 to 2.5	2.5 +
<b>Sustainability</b>							
Debt Equity Ratio	Total Debt to Total Debt plus Equity.	25% +	15 to 25%	7.5 to 15%	0 to 7.5%	0%	0% and good debt service ability (10%+ Core Earnings)
Achievement of EFTS	Number of achieved domestic SAC funded EFTS as a percentage of original agreed EFTS at beginning of year.	0 to 85%	85 to 94%	94 to 97%	97 to 98% or 103%+	98 to 99% or 101 to 103%	99 to 101%
Return on net assets employed	Operating Surplus/Deficit before abnormals divided by Net Assets.	< -2%	-2% to 0%	0 to 1.5%	1.5 to 3%	3 to 5%	5% +
Return on fixed assets employed	EBIITDA to end of year fixed assets.	< 0	0 to 2.5%	2.5 to 4.5%	4.5 to 6.5%	6.5 to 8.5%	8.5%+
Debt repayment	Total debt less any surplus liquidity to Surplus/Deficit before abnormals.	Total debt exists and also a deficit before abnormals or >1,000%	500 to 1,000%	200 to 500%	100 to 200%	<100%	No Total debt

Measures	Definition/ Calculation	Performance band scores					
		-2 (high risk)	0.5	2	3 (low risk)	4	5 (Minimal)
Trend and variability in financial viability indicators	Comparison of long term trend in financial viability over a five year period.	Last trend point below 2, high variability in trend points and negative trend in trend points	Last trend point between 2 and 3, high variability in trend points and negative trend in trend points	Either last trend point below 3 and either low variability in trend points or a positive trend in trend points or Last trend point above 3, high variability in trend points and negative trend in trend points	Either last trend point below 3, low variability in trend points and positive trend in trend points or Last trend point above 3 and either low variability in trend points or favourable trend in trend points	Last trend point between 3 and 4, low variability in trend points and favourable trend in trend points	Last trend point of 4 or more, low variability in trend points and favourable trend in trend points

## Defined Terms

### In this notice:

“Cash outflow (payments) from operations” means the amount recorded as cash paid from operations in the cash flow section of the financial statements of an institution.

“Cash inflow (receipts) from operations” means the amount recorded as cash received from operations in the cash flow section of the financial statements of an institution.

“Current liabilities likely to result in cash outflows” means current liabilities that are likely to result in a cash payment rather than a delivery of services. Examples include accounts payable, trade creditors and current debt. Items excluded from the definition include employee entitlements and student fees in advance.

“Domestic SAC funded EFTS” means the number of domestic EFTS at the institution. These students may or may not actually be being funded depending on the total number of students at the institution and their overall position relative to agreed investment plan SAC funded EFTS. The numbers supplied in the TEIFM templates will be used on the expectation that they match the numbers reported in the student achievement component section of the “Single Data Return”.

“EBITDA” means earnings (Operating surplus/deficit) before interest (received or paid), tax, depreciation, amortisation and one-off abnormals within the financial statements of an institution.

“EFTS” means Equivalent Full Time Students.

“End of year fixed assets” means the closing balance of fixed assets from the statement of financial position of the institution.

“Financial statements” means the audited annual accounts, budgeted financial statements, reforecast financial statements or projected statement of financial performance (as the case may be) of an institution. Financial statements cover a period of one year unless stated otherwise.

“Interest expense” is the amount recorded as interest expense in the financial statements of an institution.

“Liquid assets” is cash, securities or other investments which can be readily converted into cash. For the avoidance of doubt receivables are not considered a liquid asset.

“Net Interest paid” means interest expense less any interest received in the financial statements of an institution

“Net Assets” means all assets less all liabilities in the financial statements of an institution. This is also known as the net equity position of the institution.

“Operating Surplus/Deficit before abnormals” is the amount recorded as the net surplus or deficit (as the case may be) in the financial statements of an institution. This is net surplus or deficit is adjusted for any abnormal items. Abnormal item adjustments are deducing any unusual and non-recurring revenues and adding back any unusual and non-recurring costs (in each case as reflected in the relevant statement of financial performance). An item does not qualify as non-recurring simply because it is unplanned or unexpected. An example of non-recurring revenue is a profit on the sale of an asset. Examples, of non-recurring costs include losses on asset disposals or revaluations and major restructuring costs. Reclassification of abnormals may occur if an organisations application of abnormal differs materially from the rest of the sector.

“Overall viability score” means the simple average of the scores for each of the viability indicators for the financial year being assessed. It is possible for this average to be between -2 and 5.

“Overall sustainability score” means the simple average of the scores for each of the sustainability indicators which can be calculated for the financial year being assessed. The achievement of EFTS is not able to be calculated on a future view so the number of indicators entering the average will vary. It is possible for this average to be between -2 and 5.

“Readily liquefiable assets” means assets that are either already cash, will convert to cash readily in the normal course of business or investments of a liquid nature that could easily be converted into cash. Current assets of cash and bank balances, receivables and short term investments will fall within this definition. Readily liquefiable long term investments like government stock are also within the definition. Current assets excluded from the definition include Prepayments, Inventory and other unclassified current assets.

“**Reforecast**”, in respect of an institution, means any financial forecast or similar document which is prepared by or for an institution in relation to a financial year in respect of which there is already a council-approved group budget, and which is either approved by the council of the institution as an amendment to or update of that group budget or regarded by the chief executive or vice chancellor of that institution as forecasting or reflecting, more accurately overall than that group budget, that institution’s likely actual financial performance for that period; and includes any working papers and assumptions upon which that financial forecast is based.

“**Short term Overdrafts**” means overdrafts that are inherently short term in nature. Overdrafts will typically be presented as a current liability within the financial statements of an organisation. Some overdrafts are part of committed cash advance facilities taken out for the purpose of funding long term capital works programmes. If the overdraft is part of a long term (more than two year) funding facility it would be excluded from the above definition.

“**Surplus Liquidity**” means liquidity levels beyond minimum acceptable levels as represented by the liquid funds ratio. A liquid funds ratio score of 3 or more is acceptable for this purpose. This will be achieved if liquid assets less any short term overdrafts are more than 8% of cash outflow (payments) from operations.

“**Trend**” refers to the difference between the average of the first and second data point and the two most recent data points in the series. Where this difference is less than 0.5 it is considered a stable trend. Where this difference is -0.5 or more this is considered a negative trend. Where this difference is +0.5 or greater this is considered a positive trend. Both stable and positive trends are considered a favourable trend.

“**Trend point**” means a point used to evaluate for the trend and variability in financial viability indicators metric. This metric considers the overall viability scores calculated within this framework over the last 5 years. Each trend point represents the overall viability score calculated using the financial statements for that year. The first trend point uses the oldest financial statements information and the last trend point uses the most recent financial statements.

“**Total Debt**” is bank overdrafts, finance leases and term debt whether classified as current or term liabilities within the financial statements of the institution. Should other financing arrangements be utilised with similar characteristics to the above they would also fall within this definition.

“Total Income” is the amount recorded as total revenue or total income in the financial statements of an institution.

“Variability in trend points” means the difference in value between the highest and lowest trend points over the last 5 years for the institution. High variability is considered if the sum of the largest variance above and below a trend line is more than one. This trend line is formed using the average of the first and second trend points and the average of the fourth and fifth trend points.

December 2009