Financial Viability Framework

Legislative basis

The Education Act 1990 ('the Act') prescribes the requirements for registration as a non-government school in NSW. The NSW Education Standards Authority ('NESA') is responsible for the registration of schools under the Act. In fulfilling its functions under the Act, NESA can make rules in relation to its functions, including in relation to the registration requirements for schools. The *Registered and Accredited Individual Non-government Schools* (NSW) *Manual* and the *Registration Systems and Member Non-government Schools* (NSW) *Manual* ('the Manuals') provide information about the requirements for registered and accredited non-government schools under the Act. The Manuals are NESA rules.

Under section 47(a1) of the Education Act, a registered non-government school must be financially viable. The Manuals describe the rules of NESA in this regard.

The Manuals provide that the proprietor of a non-government school is required to maintain evidence to demonstrate the current financial viability of the school. At the time of making an application for initial registration or renewal of registration of the non-government school, this evidence is required to be submitted to NESA. This evidence may be in the form of a certification as prescribed by NESA by a body or person approved by NESA for that purpose. The Financial Viability Framework describes the basis of the certification by the approved bodies or persons.

What is financial viability?

Schools are by their nature, intergenerational, and decisions made in one year may have an impact for many years to come. The effective ongoing operation of non-government schools is underpinned by sound financial management, informed decisions, and incorporating appropriate controls. This requires a proactive approach to preventing, detecting and treating any signs of financial stress which left untreated, would place the school's financial viability at risk.

Financial viability is the ability to generate sufficient income to meet operating payments including salaries, debt commitments and to allow for growth, while maintaining appropriate service and resourcing levels, not just in one year, but on an ongoing basis.

A proper assessment of financial viability should integrate both backward-looking and forward-looking analyses. A comprehensive (backward-looking) financial analysis of a school's audited financial data, using common financial ratios can quantify and highlight key financial issues and can provide confidence that the school's existing financial management is operating satisfactorily.

Any financial analysis must be considered within the context in which the school has operated, and intends to operate in the future. Assessing future financial viability risks requires:

- forward-looking data such as a 3 year forecast incorporating expected enrolment trends for the period of the school's registration period
- evidence that management is aware of the key drivers for making valid and supportable assumptions and has a strategy for managing the risks to achieving organisational objectives.

For a school to make a representation that it will be viable for the duration of a registration period, it should demonstrate that it has a sound understanding of the governance and oversight principles with respect to the school's financial management.

A self-assessment tool comprising 32 questions whereby schools evaluate themselves on key financial governance issues including the existence of strategic objectives, risk management, policies, procedures and other internal controls, is provided at Appendix 1.

This self-assessment tool assists an assessor to form the basis for an opinion on the maturity of the school's strategic financial governance processes, and whether the school may represent a viability risk based on non-financial factors, it may alert the school to possible gaps or deficiencies in their existing procedures which can then be addressed.

There are a number of factors that have implications for a school's financial position and performance.

In arriving at a final risk rating, the assessor may consider:

- the history of the school
- information regarding the management of the school and its governing body, and
- the internal reporting arrangements of the governing body.

The Analysis Process

Past Financial Data

An assessment of the past 3 years of the school's financial statements will provide an initial view on the school's financial performance. This will include a review of the independent auditor's opinion for each of the financial statements. The preliminary outcome of this analysis is a rating of *Low*, *Medium*, or *High* with respect to the risk of the school being financially unviable in the future, based on its past financial performance.

Future Financial Data

An assessment will be conducted of the school's 3 year strategic forecast where it is expected that the school will be able to demonstrate stability and/or growth and will move towards improved key performance indicators as indicated in Appendix 2. (Except in the case of some relatively new schools, it would not be expected that schools plan to operate at a deficit).

The strategic forecast should incorporate operational areas as well as capital budgeting, enrolment and staffing trends, and a debt/loan profile.

Following this assessment, the initial risk rating of the school may be amended to arrive at a final risk rating, as described below.

Risk Ratings

The ratings below are only indicative as predicting a future outcome with certainty is very difficult and subject to many other variables.

LOW – Schools in this group are not considered to present a viability risk in the foreseeable future on the basis of their past financial data and projected future performance.

MEDIUM – Schools in this group have been identified with some key performance indicators that require some additional information to be submitted and assessed before an approved final assessment is made. This information could include answers to specific questions regarding anomalies in the data submitted. If the answers to these questions suggest that the governing body of the school understands the risks and has strategies to mitigate the risks, the risk rating could be moved to LOW.

HIGH – Schools in this group have been identified with a number of key performance indicators across different areas that indicate that the school could be a viability risk. It may well be that the accompanying forecast information provides support for a future (lower) risk rating, however the assessor will require additional information before a final assessment is made. As for circumstances where the risk may be moved from medium to low, if the school proprietor is a registration system or a legal entity that operates a number of schools then an undertaking from the school proprietor to underwrite or indemnify the costs associated with maintaining the viability of the school then the risk may be moved from high to low.

Financial Analysis

Assessment against common financial indicators:

The assessment of financial viability risk and establishing 'going concern' will be undertaken by assessing common indicators of financial performance and position as well as utilising the independent auditor's opinions accompanying the financial statements. The indicators include the following:

a) Liquidity– including current ratio and cash flow assessments

b) Solvency – including debt to assets assessment, debt to net equity assessment

c) Economic Dependency – for example, reliance upon donations, or reliance on a particular cohort of students (e.g. overseas students)

d) Financial Position (in particular Debt & Cash Flow)

e) Education-specific operational KPIs (trade receivables, salary expenditure, PTRs)

f) Audit Management Letter items

Other Information to be assessed:

Additional information that could be requested and used to supplement the common indicators to assist make a determination about financial viability risk may include, but not be limited to:

a) Business (or Master) planning documents current and projected student enrolments, intended capital development etc
b) Information about the aging of debtors and creditors
c) Information about loans and repayments
d) Information pertaining to any legal disputes or contingent liabilities
e) Inter-company dealings (transfers, ownerships, related party transactions, and loans
f) Compliance with all statutory obligations (for example: NESA, DET, ATO (GST, FBT, superannuation), ACNC)
g) Ultimate ownership details, including the land on which the school resides
h) Post reporting activities (includes activities that relate to the period after accounts have been audited that would have a material impact on the school's operations, viability or ownership).

APPENDIX 1: Self- assessment tool

Financial Governance Representation

Representation as to the existence of appropriate internal controls and an understanding of relevant factors involved in decision making.

Economic Reality	Yes	No/NA
1. The governing body is aware of its ability to obtain borrowings, if required, from potential lenders including banks		
2. The governing body sets and maintains a rigorous credit and debt collection policy		
3. For existing bank borrowings and overdrafts, the school's governing body actively monitors its ability to fulfil any covenants or loan terms, and where concerns exist they have been discussed with loan providers		
Market Awareness		
1. The school carries out an analysis and comparison with competitors on a regular basis		
2. The school conducts a survey of parents' satisfaction rating on a regular basis		
3. The school regularly obtains the latest local area demographics		
Early Warning Signs		
1. Actual and anticipated enrolment numbers are reported to the governing body on a regular basis for each academic term		
2. The governing body understands the potential impact of declining enrolments on revenue		
3. The school maintains, and the governing body reviews annually, a strategic risk register with mitigating actions and residual risks		
4. The governing body has ensured that the School has adequate insurance cover to support its activities and the replacement value of its facilities		
5. The governing body understands that poor quality infrastructure can lead to a decline in enrolments		
6. The governing body receives at each meeting a report detailing the aged profile of debtors and compares this with the stated policy		
7. The governing body receives at each meeting a report detailing the aged profile of creditors		
8. The governing body receives at each meeting a report detailing that other compliance matters have been completed		

Information for Decision-Making	Yes	No/NA
1. The governing body has agreed on appropriate financial and non-financial key performance indicators for budgeting and reporting purposes		
2. The governing body has approved a detailed financial budget covering three forward years		
3. The financial budget includes all revenue and expenditure items and is supported by clear assumptions		
4. Included with the financial budget is a cash flow forecast that is analysed on a monthly basis comparing forecast with actual		
5. Included with the financial budget is a capital expenditure budget that covers medium to long term projects		
6. The governing body receives a complete set of financial reports each meeting including balance sheet (debtors, creditors, cash, loans), profit and loss or statement of comprehensive income (revenue [grant funding, tuition fees], expenditure [salaries, teaching resources, rent, interest], cash flow statement		
7. The governing body sets and maintains a policy for the award of bursaries, scholarships, clergy and staff discounts. The overall financial commitment via discounts is set and agreed by the governing body		
8. The governing body receives a report annually on bursaries, scholarships, clergy, financial hardship and staff discounts and compares this to the budget and stated policy		
9. The governing body has a formal policy outlining which tasks have been delegated to the Principal		
10. The governing body is aware of the implications of receiving fees in advance and using them for cashflow		
Appropriate Skills and Strengths		
1. At least one member of the governing body has relevant financial expertise and experience, or, this can be achieved through Committee membership		
2. The leadership team has appropriate experience and expertise and actively demonstrates a thorough understanding of key operational and strategic issues		
3. The leadership team meets on a regular basis to discuss key performance indicators and other concerns		
4. The governing body sets and maintains a policy on fraud		
5. The governing body obtains external professional advice when necessary		
6. Membership of the governing body and Committees is informed by a formal assessment of the skills required and a skills audit of existing governing body members		
Understanding Long Term Planning	Yes	No/NA
1. The governing body has a formal strategic plan that is updated regularly. The governing body monitors performance against the strategic plan on an ongoing basis		
2. The governing body ensures the financial budget incorporates sensitivity analysis and considers alternate scenarios		

APPENDIX 2

Detailed Financial Ratios and Key Performance Indicators used to assess Financial Viability

The following financial ratios together form a framework that will be used to provide insight into the school's financial viability, liquidity and financial stability.

The risk ratings will be incorporated into a weighted scoring matrix to determine an overall risk rating for the school.

The colours used are a guide as to the severity or importance of the measure. Red denotes important measures that carry a higher risk rating, orange measures are important but less than red. Green indicators are informative but are not considered critical.

Trends in financial viability

Ratio	Definition	High	Medium	Low
Enrolment Change (%)	Annual change in enrolments	> -10%	-10% to 0%	> 0%
Net surplus margin ratio # (%)	Net surplus divided by total revenue	< 0%	0% to 4%	5%+
Employee Cost Ratio (%)	Total salaries divided by total revenue	> 80%	75% to 80%	< 75%
Debt Servicing Capacity (x:1)	EBIDA^ compared to total interest and loan repayments	< 1.5	1.5 to 2.5	> 2.5
Income per student ($)	Revenue (excl capital grants) divided by total enrolments	<$11,000	11k to 14k	>$14,000
Student:Teacher ratios	Student FTE/Teacher FTE	P: < 12 S: < 8	P: 13-15 S: 9 - 12	P: > 15 S: > 12
Economic Dependency (%)	Total income derived from overseas students or donations divided by recurrent income	>50%	15% - 50%	< 15%

excluding capital grants

^ EBIDA = Earnings Before Interest, Depreciation and Amortisation

These ratios will be used to assess financial viability and operational trends over the period for which financial statements are obtained and used to determine:

- whether the school has a track record of generating an operational surplus, as measured by the surplus generated in at least two out of the three most recent financial years; and
- whether there is an upward or downward trend in relation to the school's enrolments, tuition revenue, expenses and net surplus. (A decrease in enrolments can place significant financial strain on a school due to limited opportunity to reduce fixed costs)
- whether the school has an overly high salaries level relative to total expenditure
- whether the school can increase income on a per student basis to meet the increasing cost of providing education for each student. Failure to do so places financial strain on the school in the medium to long term
- whether the Student: Teacher ratio is appropriate in terms of the relationship between income and costs whether an overly high proportion of revenue is being derived from overseas students or donations. This may be an indicator that revenue from private sources may not be reliable if economic conditions change.

Trends in liquidity

Ratio	**Definition**	**High**	**Medium**	**Low**
Current ratio (x:1)	Current assets divided by current liabilities	<0.5	0.5 to 1.0	1.0+
Quick ratio (x:1)	Current assets less receivables divided by creditors	<0.5	0.5 to 1.0	1.0+
Cashflow from Operations ($)	Indicates how well the 'engine' of the school operates.	< $0	$0 -	
Cash Surplus as a % of Recurrent Income (%)	Cashflow from operations (excl capital grants) divided by Total Revenue (excl capital grants)	< 0%	0% to 6%	6+%
Current Entitlement Provision as a % of Cashflow from Operations	Current provision divided by Cashflow from Operations (excl Capital Grants)	>50% Or negative	20% to 50%	0% to 20%
Trade Receivables as a % of Tuition Fees	Trade Receivables divided by tuition fees	>25%	5% to 25%	0% to 5%

These ratios provide an indication of liquidity and cash flow.

- the current ratio is a common solvency measure that provides an indication of a school's capacity to meet its debts 'as and when they fall due'. The quick ratio is a more conservative measure than the current ratio. The higher the ratio, the better the school's short-term financial strength

- financially sound schools must ensure they have the ability to generate excess cash for three reasons:

  1) to develop reserves over time that assist them in future capital development, and
  2) to service existing debt, and
  3) to ensure they can develop capacity to tolerate volatility in operating costs without a detrimental impact on educational programs

- schools are obligated to pay annual leave and long service leave entitlements due to both legislation and industrial awards. Due to the nature of schooling, this will often require replacement teachers representing a real expense for schools that at some point, will be expended. Cashflow from operations represents excess funds available for functions such as debt repayment or capital works. If a large portion of the funds may need to be paid to staff requesting leave, this could place the school in financial stress

- apart from Government funds, a school's main source of revenue is tuition fees charged to parents. A key indicator of management's ability to manage this relationship is the balance of those tuition fees remaining at year end – funds that would otherwise be cash in the bank.

Trends in financial position

Ratio	**Definition**	**High**	**Medium**	**Low**
Total borrowings to equity ratio (x:1)	Total debt divided by Retained Earnings	>70%	35 – 70%	< 35%
Reinvestment Ratio (%)	Reinvestment in capital assets to total depreciation charges	< 0.5	0.5 to 0.9	>0.9
Total Equity	Retained Earnings + Reserves	< 0		>0
Debt per Student	Total debt divided by total enrolment	>$15,000	>$10,000	< $10,000
EBIDA^/Interest expense	Net surplus plus borrowing expenses divided by borrowing expenses	< 1.0	1.0 to 2.0	>2.0

^ EBIDA = Earnings Before Interest, Depreciation and Amortisation

These ratios provide an indication of the value of the asset base and the level of gearing underlying the business operations. Issues relating to financial stability that will be considered for high risk schools include:

- whether there is adequate capital;
- the maturity breakdown of the borrowings of the school;
- how non-current assets are valued in the financial statements and whether an independent valuation was used or whether it was the school's valuation;
- whether there are any disclosures in the notes on commitments and contingent liabilities that could impact on the school's future; and
- whether there are any post balance date event disclosures that could affect future operations
- the servicing of borrowings represents fixed costs for schools that usually cannot be altered once in place. The interest cover ratio is often a covenant embedded in loan arrangements and is included to ensure the school retains some headroom and can sustain some variability in other costs such as staffing and teaching resources.

If the entity is part of a larger corporate group, the assessment may be extended to the whole group.

Matters that will be addressed as part of this assessment include:

- whether the entity has any related-party loans which may require repayment by the entity. If it does, copies of the related parties' financials or consolidated financial statements for assessment may be required; and
- where an entity is a subsidiary company, whether it has any parent company guarantees and if so, the nature of the guarantee.

Trends in Future Operations

Ratio	Definition	High	Medium	Low
Projected Enrolment Change (%)	Annual change in enrolments	> -10%	-5% to 0%	> 0%
Net surplus margin ratio (%)	Net surplus divided by total revenue	< 0%	0% to 4%	5+%
Capital Expenditure ($)	Capital expenditure plans look reasonable in comparison to existing asset base and debt servicing capability	No		Yes
Debt Profile	Debt is either reducing or if further borrowings have occurred then the school has a plan to retire debt at some stage.	No		Yes
Debt per Student	Projected borrowings divided by projected enrolments	>$15,000	>$10,000	< $10,000
Projected EBIDA^/Projected borrowing costs	Projected net profit plus borrowing expenses divided by projected borrowing expenses	< 1.0	1.0 to 2.0	>2.0
Debt Servicing Capacity (x:1)	Projected EBIDA^ compared to projected total interest and loan repayments	< 1.5	1.5 to 2.5	> 2.5

^ EBIDA = Earnings Before Interest, Depreciation and Amortisation

These ratios and other assessments will be used to assess potential ongoing financial viability and likely impact on expected outcomes due to decisions pertaining to future capital investment and borrowings over the period for which the registration period covers.