PTE financial viability requirements: Prudential financial standards

The table sets out our prudential financial standards for PTEs. The “recommended level” would indicate in most cases that a PTE has adequate ongoing financial viability. The “minimum requirements” are recommended “hurdle rates” or minimum financial viability indicators that a PTE should meet to be eligible for TEC funding. We will use a PTE’s last annual financial accounts to calculate the ratios. As compliance with the prudential financial standards is an ongoing requirement we will also calculate the ratios from any financial budgets or forecasts provided by a PTE to us.

	Indicator	Recommended level	Minimum requirement	Comment
1	Net tangible assets ratio (shareholders’ equity less intangible assets/Total revenue)	Net tangible assets should be larger than 2% of total revenue and larger than 60% of total tangible assets (less pre-paid fees)	The larger of \$50,000 or 2% of total revenue	Shows the value owners have invested in a PTE to meet initial costs and provide working capital. Equity provides businesses with • an important source of interest free non-repayable finance • partial private funding of infrastructure • support for investment in programmes • the ability to weather any adverse changes in the operating environment and make new investment when opportunities arise. We expect we will deal with established businesses that can operate independent of shareholders. As TEC provided funding may exceed a PTE’s own invested funds a minimum equity requirement ensures providers have some “skin in the game”. It encourages owners to operate commercially and to make long-term investments. Total tangible assets are total assets less intangible assets (e.g. goodwill). We will also give consideration to large amounts of intercompany or

				parent company/entity receivables if these are seen to materially decapitalise an entity. Note • ”pre-paid fees” (student fees received in advance shown as a liability item on a PTE’s Balance Sheet) are deducted from the denominator when calculating this ratio • shareholder loan accounts are treated as debt/borrowing for this calculation. **What the specified level of the particular indicator means** We expect PTEs to operate with sufficient positive equity to provide the necessary backing for operations. We have adopted the Australian Skills Quality Authority’s requirements for a 2% equity to total revenue ratio as a minimum requirement. A 2% equity to total revenue ratio means an organisation can adapt to a small change in costs or revenue without the need for shareholder reinvestment or provider failure. The recommended level is 2%+. Owners should consider their own equity investment needs and adopt an appropriate level of equity investment in their business. Negative net tangible assets tends to indicate that in the event of liquidation or windup an entity would not have sufficient saleable assets to cover its liabilities. In the event of provider failure we do not wish to incur any risks to students and to TEC funding.

				We have set the initial equity requirement an organisation needs to start-up and function in its first year of operation and on an ongoing basis at $50,000. We may waive this requirement in exceptional cases where a PTE receives less than $1 million in TEC funding, can satisfactorily demonstrate ongoing financial viability, and will reach $50,000 in net tangible assets shortly.
2	Liquid assets ratio (Cash plus bank deposits plus readily liquefiable investments less bank overdrafts/Annual cash outflow from operations)	8% to 12%	5%	This measures liquidity and solvency. Liquidity is important in maintaining viability. PTEs need to hold liquid reserves to mitigate risk and uncertainty. A common sector benchmark is to hold one month's cash cover (i.e. 8% of annual cash outflow from operations). A 5% ratio means a PTE's income or expenses can deviate from plan by up to 5% without an adverse impact on solvency. The higher the ratio, the higher the buffer available to meet unexpected changes in the operating environment. A PTE will be able to include in liquid assets the unused portion of committed borrowing facilities with a term to run greater than one year, if it gains TEC written approval. It may also include lending to related entities within a Group, with TEC written approval, where the TEC is satisfied the Group manages the resources of its entities through a central treasury and certain conditions are met i.e. the amount deposited with related parties is repayable on demand, the related entities are financially viable, and the Group has sufficient funds to repay the PTE within 90 days. Where there are restrictions around the PTE's use of particular deposits

				or investments, these are excluded from the definition of liquid assets. Where a PTE does not produce a Statement of Cashflows, the annual cash outflow from operations will be calculated from its stated cash expenses. **What the specified level of the particular indicator means** The appropriate level of liquidity a PTE should hold depends upon such factors as the level of surplus, the variability in earnings year-on year, the strength of the cashflow generating capability, and the level of uncertainty in the operating environment. A target level of 8% to 12% is the benchmark used within the tertiary education sector. A higher level may be more appropriate for PTEs given the changes in TEC funding.
3	Working capital ratio (Current assets/Current liabilities)	100%+	At least 75%. Any working capital deficit should not exceed annual net cash flow from operations	The comparison of a PTE’s current assets and current liabilities indicates its ability to meet its obligations that are due to be paid within a year. Many studies identify this as a key indicator to identify the financial viability of an organisation. A widely accepted benchmark for this ratio is 100%. **What the specified level of the particular indicator means** PTEs with working capital levels below 75% tend to struggle financially and have trouble maintaining solvency. A PTE can meet its obligations as they fall due by selling assets, recovering debts or generating cash from operations. Should a PTE’s current liabilities exceed its current assets, then it relies on cashflow (or

				borrowing) to meet the shortfall. A PTE that cannot meet its obligations and does not have the cashflow generating capability will need to increase equity or other debt to service its obligations.
4	Profitability ratio (Net surplus after tax/Total revenue)	For commercial entities returns of 3% plus are desirable. For charitable trusts and other not-for-profit organisations the aim should be to retain the current level of reserves and attain a neutral budget each year to ensure trust capital is not eroded	Evidence of being able to operate profitably in the long term. Any losses in any one year should not exceed 30% of total shareholders' funds. Any loss should not exceed 8% of total revenue	Profitability is an important measure of a PTE's ability to generate funds for reinvestment and a surplus provides a buffer for unexpected events. Growing providers will normally need to make surpluses to fund necessary resources. A surplus also allows a PTE to accumulate reserves for leaner years, fund capital expenditure, and provide a financial return on the equity invested by stakeholders. To be sustainable a PTE must generate sufficient income to cover its costs of operation over the long term. Large or repeated operating losses are a sign of poor financial performance. A PTE making large and/or recurring losses concerns us as this generally indicates that the PTE is running down its financial resources. We do not expect not-for-profit organisations to generate a surplus each year, but would be concerned if there are recurring losses, as this is not sustainable over the longer term. Many organisations operate with a specified profit/surplus target which is suitable for the industry they operate within. This is good practice. **What the specified level of the particular indicator means** If a PTE makes a loss of greater than 8% it will likely be running down its cash reserves. A loss greater than a third of available equity indicates the organisation will have less than two to three years of operating life

				before it either fails or needs to be recapitalised. This situation would need to be addressed urgently.
5	Net cash flow from operations ratio (Annual cash inflow from operations/Annual cash outflow from operations)	111% plus	100%	Measures the ability of an organisation (taking account of cash generated from all income sources) to service cash expenditure. A good level of net cashflow is important to service debt, build cash reserves and provide for future capital expenditure. PTEs may need to generate higher cashflow ratios to service debt or to expand. Positive net cash flow from operations assists with funding of capital projects or debt repayment. **What the specified level of the particular indicator means** A ratio of less than 100% indicates a PTE spends more on its operations than it generates from operating revenue. It also indicates the organisation is running down its cash reserves. Depending upon the depreciation charge, a ratio greater than 108% generally indicates an entity can accumulate cash resources to replace depreciating assets. A ratio of 111% accords roughly with a 3% surplus. Where a PTE does not produce a Statement of Cash Flows as part of its annual accounts this measure will be calculated from identifiable cash income and expense items in the Statement of Financial Performance.
6	Debt equity ratio (Debt/Debt plus net tangible assets	Total borrowings less than 50% of net tangible assets	Total borrowings should not exceed net	Borrowings include all forms of debt/liabilities but exclude trade creditors, accounts payable, tax payable, provisions or liabilities unlikely to result in cash outflows and student fees paid in advance.

		i.e. a debt ratio of less than 33%.	tangible assets i.e. a debt ratio of more than 50%.	This measure of “leverage” looks at the proportion of the balance sheet funded from debt versus equity. As a PTE’s debt levels rises, the risk of institutional default increases. This is because debt tends to incur interest charges which are a fixed cost. Debt is a legitimate funding source to fund capital works. How much debt an organisation can carry depends upon the earnings it generates, the variability in its earnings year on year, its balance sheet strength (leverage and liquidity), interest rates and general borrowing conditions. The higher the debt levels, the more important it is that capital expenditure is in productive assets (i.e. assets with a positive net present value). Note that shareholder loan accounts are treated as debt for accounting purposes and in the event of windup. Some business owners use shareholder current accounts as an alternative to equity and others rely on the lending to the company to be repaid. When it is unclear from the accounts how a debt is treated and whether funds in current accounts can be extracted on a daily basis, we will treat shareholder current accounts as debt. **What the specified level of the particular indicator means** Larger organisations operate with some level of debt. A high level of debt creates risk. This risk rises as debt approaches 50% of total assets, i.e. the point where debt financing exceeds equity financing. In the tertiary education sector TEIs start to struggle with debt levels over about 20%.