Independent Schools Queensland

choice & diversity

# Defining a Financially Sustainable Independent School in Australia

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*Cover image: Livingstone Christian College*

# Foreword

Significant time, effort, goodwill and money go into the development of an independent school. They are community-instigated, mission-driven institutions. That's why no one ever wants to see one fail.

The impact on and disruption to students, their families, school staff and surrounding schools is significant. It also erodes community and government confidence in the independent sector.

Ongoing monitoring of the financial health of independent schools should be a recurring item on every school Board agenda to ensure any issues are identified early and responded to swiftly.

But how do independent schools define financial sustainability and what suite of indicators do they rely on to confirm their immediate, medium and long-term financial sustainability?

Former Independent Schools Queensland Board Chair John Somerset sought the answers to these questions in his Master of Business (Research) thesis.

While there has been significant international and national research into defining and assessing the financial health of not-for-profit (NFP) institutions broadly, Mr Somerset found there is a knowledge gap when it comes to independent schools.

To fill this void, he asked 17 key independent school stakeholders, including banks, school owners and governments, how they define financial stability and what benchmarks they use to asses it.

Mr Somerset's research found that while financial indicators such as cash flow, cash reserves and debt were critical indicators, non-financial attributes such as student enrolments, education quality, staff, school culture, leadership, governance and strategy were also integral to a school's financial sustainability.

In the wake of the Global Financial Crisis, heightened levels of government scrutiny and accountability and a changing federal funding system, independent schools can ill-afford to ignore the findings of this important research or the insights shared by stakeholders.

I urge all independent school Boards, principals and business managers to read and draw on the practical and considered advice contained in this consolidated version of Mr Somerset's full Masters thesis.

Independent Schools Queensland expresses its thanks to John Somerset for allowing us to publish this significant peice of work in the interests of the independent sector.

DAVID ROBERTSON

EXECUTIVE DIRECTOR
INDEPENDENT SCHOOLS QUEENSLAND

# Abstract


In 2015 there were 1091 independent schools in Australia servicing 587,000 students and their families. Forty four percent of their $9.5 billion recurrent income was provided by government grants, with the remaining fifty six percent provided by parents and other private sources. Capital investment in new buildings and equipment was funded fourteen percent from government grants and eighty six percent from private funds (ISCA, 2016) include debt which is estimated to be $4 billion for the sector (ASBA/Somerset, 2016).

School closures have an adverse effect on social good and undermine consumer confidence in the independent schools' sector. The consequences include disruption to the students' education and loss of public confidence in the sector. Governments (State and Federal) are very sensitive to these failures as they are often a catalyst to expressions of concern about the accountability for government funds expended on the schools, the ongoing funding of non-government schools and paradoxically the pressure put on government schools to absorb both children from schools that fail and children whose parents have lost confidence in the independent system.

Governors of schools have a statutory and/or fiduciary responsibility to ensure the financial viability and sustainability of their schools (Corporations Act 2001, Australian Charities and Not-for-profits Commission Act 2012). There is also a responsibility under the conditions of Commonwealth Government recurrent funding legislation to ensure financial viability and sustainability.

The assessment of financial health for NFPs has evolved beyond the mere assessment of financial ratios. It relies on context, trends, financial and non-financial cause and effect factors (Rottkamp, 2016). There is a gap in the research concerning a comprehensive study of the qualitative and quantitative factors to be considered when assessing financial sustainability of independent schools in Australia.

The qualitative research methodology adopted for this study included the identification of the major stakeholders who are concerned with the financial sustainability of independent schools in Australia and the carrying out face to face semi structured interviews with a sample of 17 stakeholder representatives. The sample frame included representatives from banks, federal and state government, school owners, managers and governors and a parent association.

There were six major findings from this research. First, there was common agreement between the interviewees as to which financial stakeholders were concerned with the financial sustainability of an independent school. Second, it supported the existing research that stakeholders are as interested in the non-financial attributes as they are in the financial attributes of independent schools when making an assessment of the school's financial sustainability. Third, the stakeholders confirmed the importance Financial attributes and in particular of a strong operating surplus (profit) in order to fund facility reinvestment, debt servicing and also replenish cash reserves. Fourth, Leadership and management are important attributes of financial sustainability. Fifth, stakeholders definition of a financially sustainable independent school identified a mixture of non-financial and financial factors. Sixth, although there was a significant level of agreement among the stakeholders concerning the attributes of a financially sustainable independent school, there were some differences between stakeholders as to the relative importance placed on some factors.

I therefore propose that the definition of a financially sustainable school is:

***"A financially sustainable independent school responds to stakeholder needs by using strengths, managing weaknesses, generating adequate operating surpluses to fund debt, reinvestment and cash reserves, identifies changing circumstances and adapts in a timely manner."***

**TABLE 1 – ATTRIBUTES OF A FINANCIALLY SUSTAINABLE SCHOOL**

| Category | More Information |
| --- | --- |
| Ratios and benchmarks | Trends and comparatives<br>Identify and quantify strengths and weaknesses |
| Cash flow | Positive and stable net cash flow from operations<br>Sufficient to fund debt and reinvestment |
| Cash reserves | Adequate buffer in event of financial shock |
| Debt and debt servicing | Function of operating surplus |
| School culture | Positive, honest, Innovative, forward-looking<br>Able to adapt to changed circumstances |
| Enrolments | Sound enrolment trends (past and future) Understand market demographics and needs |
| Service quality | Quality educational offerings and service<br>Deliver on a value proposition |
| Facilities quality and reinvestment | Safe, comfortable, challenging |
| Staff | Quality and engaged staff who are change-ready |
| Board quality and governance | Mix of business, education and other skills<br>Financial literacy<br>Quality policies and procedures |
| Strategy | Adequate strategic planning, dissemination and reporting |
| Management quality | Financial literacy<br>Principal and business manager relationship<br>Ability to adapt to changed circumstances |
| Budgeting, accounting, reporting | Reliable budgeting based on reasonable assumptions<br>Trend analysis of key ratios<br>Disciplined, timely and accurate reporting |
| Stakeholder management | Understand and meet multiple stakeholder needs<br>Reputation management |

*Source: John Somerset (2017) Attributes of a financially sustainable independent schools*

# Chapter 1: Introduction

## 1.1 Introduction to this research

In Australia, until the early 1960's government funding for education was restricted to schools owned and operated by the state governments (Burke, 2002; Canavan, 1999). During the 1960's considerable pressure was placed on both State and Federal governments to also provide funds for schools in the Catholic and Independent school sectors (Canavan, 1999).

As a consequence of this pressure and subsequent actions, governments in Australia now provide funding to schools in the state, catholic and independent sectors. It should be noted that only not-for-profit institutions are able to access Australian government funding (Australian Education Act 2013). State and Federal governments are significant stakeholders in independent schools with the average independent school in Australia receiving 44% of its funding from government grants (ISCA, 2016).

Currently funding for all schools is sourced from a mixture of Federal grants, State grants and private income. Total government recurrent funding (all government sources) received by Government schools was $16,180 per student in 2013-14. (Independent Schools Council of Australia, 2016). The funding for Government schools is ultimately administered by each state/territory government with a very small amount received direct from parents or other private sources. Total government recurrent funding (all government sources) received by Catholic systemic schools was $9,750 per student in 2013-14. Funding for catholic schools is ultimately administered by regional catholic education offices. Federal and state grants are accumulated by the system offices and distributed among their schools in accordance with catholic education office guidelines. The schools also receive fees from parents and other private income. Total government recurrent funding (all government sources) received by Independent schools was $7,940 per student in 2013-14. Funding for independent schools is ultimately administered by an Approved Authority[1]. Usually for independent schools, this is the governing body for the individual school. Independent schools have the highest level of reliance on private income. Because independent schools receive relatively less grant income than government and catholic systemic schools, their fees are relatively higher.

In 2015 the independent schools sector comprised 1,091 schools with enrolments of 586,500[2]. It employed 52,000 teachers and approximately 12,000 support staff. Total turnover for the sector was approximately $10 billion. (ISCA, 2016).

Total debt is estimated to be in excess of $3 billion (ASBA/ Somerset 2016). Given that education is compulsory for all children in Australia until they reach the age of 15 -17, depending on the state it is estimated that if the students currently enrolled in independent schools all transferred to government schools the additional cost (above what is currently provided in funding) to governments would be approximately $4.3 billion a year (ISCA, 2016).

However, while government expenditure on independent schools in Australia is significant it is also contested. There are many who believe that independent schools should not be subsidised by government and that the funds provided to these schools could be better spent in the state school system (Ferrari, J, 2012). On the other hand, there are those who believe that the government should provide equal funding for every Australian child of school age (Greenwell, 2011). In times when electorates expect governments to be accountable, responsible and transparent in the way that they expend public funds, this debate is often ignited during election campaigns and when private schools fail.

In recent times, there have been a small number of independent schools fail financially and were forced to either close or be taken over by other institutions (Mowbray College 2012, Acacia College 2012 plus others).

School closures have an adverse effect on social good and undermine consumer confidence in the independent schools' sector. The consequences include disruption to the students' education and loss of public confidence in the sector.

Governments (State and Federal) are very sensitive to these failures as they are often a catalyst to expressions of concern about the accountability for government funds expended on the schools, the ongoing funding of non-government schools and paradoxically the pressure put on government schools to absorb both children from schools that fail and children whose parents have lost confidence in the independent system.

## 1.2 Requirements for schools to be financially viable

Governors of schools have a statutory and/or fiduciary responsibility to ensure the financial viability and sustainability of their schools. This is supported by Corporations Law

[1] Australian Education Act 2013 section 72, page 74
[2] Includes Non-systemic Catholic schools

(Corporations Act 2001) and the Australian Charities and Not for Profit legislation (Australian Charities and Not-for-profits Commission Act 2012). There is also a responsibility under the conditions of Commonwealth Government recurrent funding legislation to ensure financial viability and sustainability.

Recurrent and capital funding for non-government schools is payable by the Commonwealth to the Approved Authority for independent schools, based on a formula in Division 2 of Australian Education Act 2013. This same act also requires the approved authority to be financially viable in order to receive commonwealth grant income. Further, independent schools are required to be accredited in the State/Territory in which they operate. A requirement for accreditation in each State/Territory includes that the school be financially viable or has sufficient financial capacity.

Table 2 summarises the statutory requirements under Federal and State Acts for independent schools to be financially viable and indicates that all states and territories have legislation and/or regulations that require independent schools to have adequate financial resources and/or to be financially viable. There is inconsistency between states as to how this is administered. Most states have an accreditation board or authority established by the minister of education in that state that is charged with the responsibility of ensuring registered schools are financially viable. In some states/territories (Australian Capital Territory, Western Australia, Northern Territory) that is determined directly by the Chief Executive Officer for the department of education.

In 2008 the Commonwealth Government of Australia introduced the Financial Health Assessment Framework Guidance Notes 2010 – 2012 Interim Arrangements for assessing the financial viability of independent schools with the aim of early intervention to prevent closures . It was proposed that the consequence for failing the financial viability test was for government recurrent funding to be withheld and for schools to work with the government to improve performance. However, if a school incurred the withholding of government funding as a result of failing the financial assessment, this deferral of funding could in itself cause financial difficulties for a school. So, misdiagnosis could cause a viable school to become unviable. Further, the framework was found to be unreliable in identifying financially vulnerable schools, was not well accepted by stakeholders, and was discontinued after the initial trial period. Consequently, to date there is no commonly accepted assessment system or definition of a financially viable/sustainable independent school in Australia.

The purpose of this qualitative study is to define and describe the attributes of a financially sustainable independent school in Australia as generally accepted by the major stakeholders including government regulatory bodies, financiers, owners, parents, professional advisors, school management, peak bodies.

## 1.3 Motivation for this research

The primary motivation for this research stems from the importance of the independent school sector as an education provider in Australia and in particular the consequences for the sector of independent school failures. Subsequent to the failed attempt by the Commonwealth Government to develop a Financial Health Assessment Framework, a small number of independent schools have failed. As already noted, the independent school sector had a turnover of approximately $10 billion in 2015, enrolments of 586,500 students and employs 52,000 teachers and approximately 12,000 support staff (ISCA, 2016). Apart from the considerable disruption to the students' education and loss of public confidence in the sector, school failures potentially put financial pressure on government schools to absorb both children from schools that fail and children whose parents have lost confidence in the independent system. This study is also motivated as a proactive action in preparation for any potential return of some type of financial health assessment framework for independent schools by comprehensively informing the development of any such new framework.

Financial analysis is both an analytical and judgemental process with solutions to financial problems depending on the views

**TABLE 2 – FINANCIAL VIABILITY UNDER FEDERAL AND STATE ACTS**

| Act | Section | Powers | Notes |
|---|---|---|---|
| Federal Australian Education Act 2013 | S 75 (4) Basic Requirements for approval – Financial Viability. | The person (approved authority) is to be financially viable. | Person is the representative body for a non-government school and they represent the interests of the approved authority. This is the body to which funding under section 70 is ultimately paid. |
| Queensland Education (Accreditation of non-state schools) Act 2001 and Regulations 2001 | Section 9 (b) A regulation may prescribe criteria …. financial viability Regulations – Division 2 Financial Viability criteria. | School must have access to adequate financial resources for its viable operation. | The regulations specify the requirement to be financial viability which are assessed by the Non-State Schools Accreditation Board. |
| NSW Education Act 1990 No 8 | Section 47(a1). | The school must be financially viable. | Registration administered through the Board of Studies NSW. Section 3.9.4 Registered and Accredited Individual Non-government Schools (NSW) Manual sets out Financial viability criteria. |
| Victoria Education and Training Reform Amendment (Miscellaneous) Act 2015 | Sections 14 & 15. | Authority may asses the financial capability of registered non-government schools. | Amendment Act empowers the Victorian Registration and Qualifications Authority to monitor and assess the financial capabilities of non-Government schools. |
| Australian Capital Territory Education Act 2004 | Section 91 (g). | Registration condition - the school is financially viable. | ACT Registration Manual Item G sets out evidence used to determine financial viability. |
| South Australia Education and Early Childhood Services (Registration and Standards) (EECSRS) Act 2011 | Part 4 – Administration Subdivision 3 Functions of the board Part 5 Registration of schools Section 44 Board may impose conditions on registration. | School Governance Standard 1 | Education Standards Board of South Australia is responsible for administration of the AACSRS Act.<br><br>Standard 1 includes "ensuring the ongoing financial viability of the school and reporting on the school's financial performance". |
| Western Australia School Education Act 1999 | Section 159 (1) (m). | Minister can determine standards about sufficiency of school finances | Director General of the Department of Education Services decides on the application of standards. Section 5 of the Guide to the registration Standards and Other Requirements for Non-government Schools 2016 lists requirements for the financial leadership and management of school operations and its long-term viability. |
| Northern Territory | Section 61A (f) & (k) Registration requirements. | School must have adequate financial and other resources for its operation and appropriate procedures for its financial management. | The Chief Executive Officer of the Department of Education and Training is responsible for assessing and registering non-government schools. |
| Tasmania Education Act 2016 | Schedule 4 Tasmania Education Regulations | School must have sufficient financial resources. | Standards and guidelines specify what is expected. |

of stakeholders. So qualitative judgements involved in finding answers to financial issues can often count just as heavily as the quantitative results, and no analytical task is complete until these aspects have been carefully spelled out and weighted. (Helfert, 2001).

## 1.4 Research questions

Research to date on defining financial sustainability for independent schools in Australia is largely unexplored. The aim of this research is to collect and analyse in-depth rich descriptions of this complex and illusive definition and discover the generally accepted attributes of a financially sustainable independent school in Australia.

Independent Schools by their very nature involve the co-operation of a diverse group of stakeholders including government regulators and funders (state and federal), parents, students, staff, banks/financiers, and owners (churches or other groups).

Consequently, agreement between stakeholders with respect to financial sustainability is important. This study will therefore investigate the way that stakeholders of independent schools interpret financial sustainability and the attributes that they consider contribute to it. My core research question then is:

***How do major stakeholders define, and what are the commonly agreed attributes, of a financially sustainable independent school in Australia?***

In order to address this question, subsidiary questions are also posed in order to determine the nuances that would be expected from different stakeholder groups, to triangulate the views of stakeholders and also to address the concerns associated with the failed Commonwealth government financial health framework. These are:

1. Who are the important stakeholders?
2. How does financial viability and sustainability differ?
3. Is sustainability a definitive point and what timeframe is relevant?
4. What are the factors, measures, hurdles used in making this judgment?
5. How do you define a financial sustainable independent school?

Obtaining the views of the stakeholders of independent schools will provide a basis for determining a definition of financial sustainability that includes the attributes important to all relevant stakeholders.

## 1.5 Stakeholder theory as a guiding framework

For corporations the traditional view is that the shareholders are the owners of the company to whom the directors have a binding fiduciary duty to put their needs first - generally to increase the value of their investment. However, stakeholder theory argues that there are other parties involved, including governmental bodies, political groups, trade associations, trade unions, communities, financiers, suppliers, employees, and customers. Stakeholder theory posits that a corporation is part of a broader environment with complex and dynamic relationships with its many stakeholders and that the major role of management is to assess the importance of meeting stakeholder demands to achieve the company's strategic objectives. Further, stakeholder importance derives from the power to control critical resources. This perspective can be and is frequently applied in contexts other than the corporate context.

Stakeholder Theory is an umbrella term for a number of theories addressing issues associated with relationships with stakeholders (Deegan, 2009). Stakeholders are defined as groups or individuals able to affect the achievement of an organisation's objectives or affected by the achievement of an organisation's objectives (Freeman and Reed, 1983). They have been further classified as primary: those whose continued participation is necessary for the organisation's survival, and secondary: those who influence or affect, or are influenced or affected by the organisation (Clarkson, 1995).

According to the definitions above (Freeman and Reed, 1983; Clarkson, 1995), independent school stakeholders can be either inside stakeholders; governing bodies, management, members and staff; or outside stakeholders; students, parents, governments, financiers and the general public, who neither own nor work for the organisation but have some interest in it.

Stakeholder theory has both an ethical branch and a managerial branch. While the ethical branch argues that all stakeholders have the right to be treated fairly by an organisation and does not specifically consider the power of stakeholders, the managerial branch of stakeholder theory explicitly considers the various groups or stakeholders that can affect an organisation and their relative power (Deegan, 2009). According to the managerial branch of stakeholder theory, organisations identify those stakeholders whose support and approval is most necessary to achieve the organisation's objectives and manage operations and disclosures so as to privilege those key stakeholders' information preferences regarding financial and social performance (Gray, Owen and Adams, 1996; Bailey, Harte & Sugden, 2000; Buhr, 2002, Deegan, 2009). The managerial branch of stakeholder theory argues that the greater the importance of the stakeholder contribution to the organisation the greater the probability that the stakeholder's expectations will be considered by the organisation. The more critical the stakeholder's resources are to the continued viability and success of the organisation, the greater the expectation that stakeholder demands will be addressed. Gray et al. (1996, p. 45) state:

*"the stakeholders are identified by the organisation of concern, by reference to the extent to which the organisation believes the interplay with each group needs to be managed in order to further the interests of the organisation. (The interests of the organisation need not be restricted to conventional profit-seeking assumptions). The more important the stakeholder to the organisation, the more effort will be exerted in managing the relationship. "*

A successful organisation is considered to be one that satisfies the demands (sometimes conflicting) of the various powerful stakeholder groups (Ullmann, 1985). Since the continuing survival of an independent school depends on the support of a number of stakeholders as identified above it follows from this explication of stakeholder theory that it is an appropriate guiding framework for this research.

## 1.6 Contributions

This research will make both practical and academic contributions.

### Practical Contributions

Regulators are willing and able to issue sanctions against independent schools if they are not financially viable/ sustainable. These sanctions include, deregistration of the school and withholding government funding. Further the failure of unsustainable schools result in adverse publicity and therefore loss of parent confidence in the independent school sector.

Currently there is no commonly accepted definition of a financially sustainable independent school with which to make an informed decision to ensure that an independent school is viable or to provide warning signs that a school is in difficulties.

This research will provide a practical definition developed from the views of stakeholders as to the common attributes of a financially sustainable independent school in Australia.

This information can then be used as a self-regulating mechanism used by independent schools so that they can monitor their sustainability and hopefully prevent the necessity of a government-imposed regulatory system.

Further, given the potential consequences of independent school failure and the potential for a government imposed framework in the future, this research provides an opportunity for the voice of stakeholders in the sector to be heard.

### Academic Contribution

There is nothing more important in any kind of financial/economic analysis than a clear definition of the issue being addressed (Helfert, 2003). Every type of analysis, complex or simple, needs to be preceded by a definition that will naturally lead to a focused choice of measures to be applied (Jung, 2002). Literature identified a gap in the definition of financial sustainability for Australian independent schools which will be filled by this research.

This research however also has consequences beyond the independent school sector. Since all independent schools that receive government funding are NFP organisations, this research will be relevant to the NFP sector more generally. There has in recent times been a focus on the importance of the sustainability of the NFP sector (Weerawardena et al., 2010) and there is growing literature addressing this issue that this research will contribute to.

## 1.7 Thesis outline

This chapter has outlined the aims of this research, the motivations for it, the guiding framework and the contribution of the research. Chapter Two provides a review of the existing literature that has addressed financial viability/sustainability in both the private sector and the not-for-profit sector as well as in the education sector. Chapter Three, excluded from this summary publication, details the research design and methodology. Chapter Four contains the research analysis and findings. Chapter 5 the concluding chapter provides a summing up of the purpose of the research, the key findings of the research, the limitations of the research and identifies the potential for future research.

# Chapter 2: Literature Review

## 2.1 Introduction

The purpose of this research is to define and determine the attributes of a financially sustainable independent school in Australia. There is very little literature relating to schools and financial sustainability. Available literature from 1966 to 2016 includes a common trait of focusing on financial ratios (profitability, relative costs, income, relative debt levels etc.) as a means of assessing financial viability and sustainability, with occasional reference to educational institutions.

The earliest research tried to adapt financial analysis methods used in the commercial for-profit environment to the NFP environment. Although a logical start, the NFP sector has a far more complex social outcome objective rather than a profit and wealth creation objective, and thus the success of this approach was limited.

General NFP literature has demonstrated a progressive increase in sophistication and awareness of the financial and non-financial attributes to consider when assessing financial health of a NFP entity. The literature demonstrates that the assessment of financial health for NFPs has evolved beyond the mere assessment of financial ratios. It now refers to context, trends, financial and non-financial cause and effect factors. There is a gap in the research however concerning a comprehensive study of the qualitative and quantitative factors to be considered when assessing financial sustainability of independent schools in Australia.

## 2.2 Financial output measures to predict failure

Beaver (1966) used a sample of 79 firms in the United States of America that had failed between 1954 to 1964. It also included a control group of non-failed firms. Beaver noted that a firm/organisation is viewed as a reservoir of liquid assets, which is supplied by inflows of cash and drained by outflows of cash. The cash reservoir serves as a cushion or buffer against variations in cash flows. So, the size of the cash reservoir, size of net cash from operations and size of debt are important factors affecting financial health. Beaver argued also that asset size alters the relationship between ratios and failure and that larger firms have a lower probability of failure.

Beaver tested several elements to predict financial failure and found that Cash flow to total debt had the strongest and most consistent ability to predict failure of firms. Net income to total assets, commonly known as return on assets, was the second best and consistent predictor. A common element of both these ratios is net cash flow or net income which is effectively net profit. So, the level of profitability is important because it is profitability that replenishes the cash reservoirs. The data from this study highlighted the role that ratios can play in assisting an analysis of firm financial 'health'.

However, there were some concerns with this study including a lack of accuracy in the accounting data from which the ratios were being calculated, and also the fact that the study looked at various ratios one at a time, as opposed to multiple ratios concurrently. The Beaver (1966) methodology was essentially univariate, focusing on individual ratios as signals of impending financial problems. Ratio analysis presented in this fashion is susceptible to faulty interpretation and is potentially confusing (Altman, 1968).

Altman (1968) extended the use of ratio analysis as predictors of financial failure by involving the use of multivariate analysis to develop "Z scores". This methodology used a combination of ratios concurrently, rather than univariate measures, as a better predictor of financial failure. To arrive at a financial variability profile, it was important to determine the relative contribution of each variable and also the interactions between them. Altman applied statistical methodologies to conclude that the profitability ratios contribute most significantly, but, somewhat surprisingly the Sales/Total assets was the second highest contributor because as sales decline so does the earnings power of the firm. This logically infers that where there is a deteriorating trend in sales, this will have an adverse effect on profitability and therefore cash reserves.

The results of Altman's 1968 study suggested that his bankruptcy prediction model is an accurate forecaster of failure up to two years prior to bankruptcy but accuracy diminishes substantially as the lead time increases.

Altman introduced, but failed to expand, the notion that although models may predict impending failure, it is important that weaknesses identified in an organisation's operations are actioned on by management and changes made in time to avoid failure. This is an important non-financial lead indicator which has been taken up in other studies.

These early studies using ratio analysis as predictors of financial failure informed the processes still being used today by Moody's and other credit rating agencies to develop and publish financial risk ratings for businesses and other bodies. Whilst useful in its time, the Z-score model became out of date and was replaced by a Zeta analysis which was found to be extremely accurate for up to 5 years before failure.

Altman (1984) reviewed the use of the Zeta analysis model as applied by researchers in ten different countries.

He found large differences in average ratios for failed groups and similar differences across non-failed groups. He concluded that the quality and reliability of models constructed in many of those studies was unreliable. This was due to the poor quality of information as well as problems with the researcher's use of the model. If these are not properly addressed, the analysis is largely useless.

Altman (1984) continued his research into business "success factors" and found a growth in non-financial factors that impacted negatively on business success. These included management incompetence (47%), lack of managerial expertise (27%), and unbalanced experience (18%). There was the beginning of a recognition of the deeper-rooted causes and attributes of financial failure unrelated to strictly financially factors.

## 2.3 Suitability for not-for-profit sector?

In the early 1990's studies concerning financial vulnerability in the NFP sector started to emerge. Before this, there was very limited literature on NFP financial vulnerability available in the public domain. Tuckman and Chang (1991) were one of the first to review financial vulnerability of NFPs and their study is now recognised as a seminal study. They identified a number of problems contributing to the lack of research on NFP financial vulnerability including:

- The number of NFP's that were at risk of financial distress was small. They identified that only about 1 percent of all NFPs that reported data to the IRS were at risk of failure. Data that is available on NFP's is likely to be skewed towards large NFPs. To the extent that small NFPs account for a disproportionate share of vulnerable organisations, the available data tends to understate the financial difficulty of the sector.
- Difficulty in quantifying the outputs and missions of NFP's which is required to assess if a NFP reduced is services as a result of financial shock.

This study defined financial vulnerability as "an organization that is likely to cut service offerings when financial shock occurs" (Tuckman & Chang, 1991. p.445).

There was little evidence supporting how the definition of financial vulnerability was derived or the factors that were generally attributable to financially viable and sustainable NFP's. Rather, the focus was again on output measures that were generally present for failed organisations. As with previous studies, the definition was largely implied and the study proceeded to investigate the predictors of financial vulnerability which although valuable, is of limited use without a clear and agreed and quantifiable definition and measurement of financial vulnerability. Also, merely identifying the outcome factors present for failed organisations, does not sufficiently inform us on a more complete suite of factors (financial and non-financial) that are present in financially sustainable organisations.

A major measurement problem of the Tuckman and Chang study was that their definition of financial vulnerability involved an organisation that reduced services. This is problematic because program services are not fully captured by accounting systems and it is difficult to quantify and identify which organisations are experiencing financial shock.

Tuckman and Chang therefore adopted a methodology that does not involve a direct output measure, instead the focus was on options available to NFP's if a financial shock affected them. So, while this is valuable research, it did not contribute significantly to the pool of data on the attributes of a financially viable NFP.

The criteria used to assess NFP financial vulnerability focused on identifying those entities with the least flexibility to sustain financial shock. Tuckman and Chang empirically tested four financial vulnerability criteria on a random sample of 4,730 NFP organisations that filed tax returns in the USA. Those organisations falling into the lowest quintile for all four variables were defined as severely at risk. And those with any one of the four variables in the bottom quintile were defined as at risk. Educational institutions represented 23% of the study sample. The study found that characteristics of an at-risk NFP include, low revenue and equity, higher long-term debt to assets, higher reliance on program revenue and lower revenue to assets (profitability).

Important findings from the study include that the majority of NFPs that report to the IRS have recourse to more than one means of income to offset the effect of an economic downturn. So, diversity in income streams is important to financial viability.

However substantial differences in results existed between different categories of NFP's and only a small percentage (1%) appear to be severely at risk. Another important finding was that organisations with relatively high operating surpluses are more able to sustain a reducing margin and maintain services.

The major problem with this study was the lack of identifiable and quantifiable measurement on outputs of NFP's. They suggested, at a minimum, firstly output data should include clients served, grants made, or other measures of activity. Secondly refinements are needed to the revenue categories to allow precise identification of sources of revenue. Thirdly data needed to be audited. Fourth, more effort is required to gather data on NFP's currently not required to lodge financial data with the IRS. This was one of the first studies to define financial vulnerability for NFPs but it stopped short of identifying why NFPs became vulnerable.

Greenlee and Trussel (2000) extended Tuckman and Chang (1991) to develop a model for predicting financial vulnerability in NFP's. In most previous studies, financially vulnerable organisations included only those that had lodged for bankruptcy. But Greenlee and Trussel wanted to apply the Tuckman and Change criteria to an identified sample or NFPs that reduced services and had incurred financial shock.

To identify organisations experiencing financial shock, Greenlee and Trussel used a method similar to Gilbert, Menon, and Schwarz (1990) which defined financially vulnerable NFP organisations with negative net income over a consecutive three year period as organisations in financial shock.

**FIGURE 1 – TUCKMAN AND CHANG FINANCIAL HEALTH MEASURES**

| *Indicator* | *Formula* |
|---|---|
| Equity ratio (EQUITY) | $\frac{\text{Total equity}}{\text{Total revenues}}$ |
| Revenue concentration ratio (CONCEN) | $\sum\left(\frac{\text{Revenue source}_i}{\text{Total revenues}}\right)^2$ |
| Administrative cost ratio (ADMIN) | $\frac{\text{Administrative expenses}}{\text{Total revenues}}$ |
| Operating margin (MARGIN) | $\frac{\text{Total revenues}-\text{total expense}}{\text{Total revenues}}$ |

Greenlee and Trussel applied the Tuckman and Chang measures against a proxy sample for vulnerability based on organisations with an overall reduction in fund balance (net assets) during a period of three successive years. This methodology is consistent with the theory proposed by the Altman (1968, 1984) studies that identified a deteriorating trend in key ratios as a firm approached financial failure.

The database used for the sample included all charities with more than $10 million in assets that lodged a return with the National Centre for Charitable Statistics in the USA, plus a random sample of approximately 4,000 smaller charities. They divided the sample into charities that were financially vulnerable (reduction in program expenditure and experiencing financial shock) and those that were not. They then calculated the mean result for the four Tuckman and Chang measures, as set out in figure 1 on both groups.

This extension of research was particularly valuable because it applied logistic regression to the four Tuckman and Chang criteria to identify that non-vulnerable (viable) NFPs had higher equity, more revenue sources, relatively higher administration expenses and higher operating margins. So, the regression model identified revenue sources, administration costs and operating margins as the most significant predictors of financial vulnerability.

Noteworthy in all the studies to date is the consistent appearance of operating margins as an important factor contributing to financial health. Referring to the Beaver (1966) study, it is operating margins (operating surpluses or profit) that replenishes the cash reservoir which serves as a buffer for variations in cash flows.

The Greenlee and Trussel model was found to be reasonably accurate in predicting financial vulnerability but it could be improved with further research on alternative definitions of a financially vulnerable organistion. Extending the time period of the study and the population of organisations from which the sample is selected would have given greater rigour to the study.

## 2.4 Ratios and benchmarks to assess schools in the USA

In the 1990's credit rating agencies, government agencies, auditors and consulting firms in America started to apply financial ratios to determine if the financial condition of colleges was adequate to support their missions and long-term debt obligations (Dinkel, 2006). These resources however were focused on universities and larger colleges because at that time they were entering the public debt market to take advantage of low interest rates. Financial ratio analysis was used to help determine if the financial condition of a college was adequate to support its mission and long-term debt obligations.

Although ability to maintain services is core to the NFP mission, Dinkel asserted a logical extension to this definition by including reference to ability to meet long-term debt obligations.

Dinkel noted that generally smaller institutions were not rated by rating agencies and therefore there is no comparative financial information available for analysis purposes. The purpose of his study was to develop comparable financial ratios and benchmarks for schools in the USA, which was the first major study to do so. Dinkel gathered comparable financial data from a sample of 54 Liberal Arts Colleges and Universities that were members of Business Administrators of Christian Colleges in the U.S.

Liberal Arts Colleges have similar characteristics to the Australian independent schools market. They are typically residential, frequently located in relatively small towns or cities with enrollments from 100 to 2000 students. They are typically privately controlled, operated by an independent board of trustees and directly or indirectly related to religious institutions.

Working with the Association of Business Administrators of Christian Colleges in the USA Dinkel calculated a set of measures to assess the financial viability of member colleges. Financial viability was defined as "the financial ability of an institution to continue to achieve its operating objectives and fulfill its mission over the long term" (Dinkel 2006 p 15).

Colleges and universities, specifically at risk institutions, need to be able to respond quickly to financial pressures and change operations to thrive financially. The success of an institution's response largely depends on the ability of the institution to measure performance accurately. Identifying the problem is one step in the process, but noteworthy is the link with the Altman (1968) study that asserts institutions need to also respond and act on that information and correct their course.

Benchmarking is a valuable tool, but it is only one of many practical approaches for assessing how colleges and universities spend their resources. Benchmarking can be a vehicle for promoting substantive, change-orientated action within an institution by providing compelling evidence of the need to change (Birnbaum, 2000; Rush, 1994 as cited in Dinkel).

Dinkel's research suggests that carrying out comprehensive financial ratio analysis and establishing benchmarks for a specific peer group of institutions with similar characteristics is relevant and timely as institutions strive for more accountability to their constituents and governing boards. The credibility of peer comparison studies depends on the ability of a researcher to get comparable data from institutions with similar characteristics.

In a sample of 54 liberal arts colleges, Dinkel tested four key financial ratios: Primary reserve, Net income, Return on assets and Viability, plus a Composite ratio calculated using a table of weights applied to the previous four ratios. Recommendations from this study were extensive, and benchmarking as a strategy was specifically named as a useful tool.

This study was instrumental in applying market accepted financial ratios to educational institutions which had not previously been done. However, a shortcoming of the Dinkel study was the exclusive focus on financial outcome measures in the assessment of sustainability with no recognition of the driving attributes of financial health. A study by Jung (2002) did however broaden the scope to include qualitative factors.

## 2.5 School study in Australia – a qualitative context

A timely study of Australian Independent schools centered on the necessary and sufficient conditions to make a judgment on the financial viability of Non-State schools. Jung relied on the explanatory memorandum of the *Queensland Accreditation of Non-State Schools Act 2001* to define financial viability as "the financial capacity of the provider to deliver and sustain the school's proposed program" (Jung.F, 2002).

Jung defined financial capacity as the "ability to perform", meaning, the financial performance of the school. Hence, consistent with Dinkel, financial viability focused on financial performance ratios for non-government schools.

However, Jung asserted that the ability to sustain a school's educational program and financial viability have far-reaching interdependence. Adequate teaching requires equipment, technology, buildings and other resources which all have direct implications on a school's financial situation. Jung hypothesized that the quality of education may have a direct influence on enrolments. Given that tuition fees are a major source of income, the number of enrolled students is a key determinant of a school's success. Consequently, a school needs to maintain a certain standard of education that is financially affordable to the school.

Jung further proposed that future enrolments and development plans are equally important and for this reason schools must have budget projections and a development plan which reflect the school's basic objectives. It is important that board members and managers make decisions considering the financial consequences for the future.

Jung's literature review identified extensive material on educational standards in schools but virtually none were concerned with the financial management of these institutions.

Jung also explored the question of sustaining the educational program which he defined as to 'endure without failing' and noted that once a school is accredited, it is reviewed externally for compliance with all accreditation criteria every five years. Therefore, he concluded it is reasonable to assume that the timeframe to be considered for sustainability is five years into the future.

He also noted that schools need to consider both external risks, such as falling birth rates and other socio-economic changes, as well as internal risks such as arbitrariness, greed and fraud in financial planning.

As with the Dinkel (2006) study, Jung noted that when assessing financial performance one necessarily needs a standard or benchmark against which performance is compared.

Although the outcomes of this study made a significant contribution to literature and practice, the study was effectively a desktop study based on a small number of interviews with a narrow range of consultants and school business managers. Stakeholders for independent schools include government, parents and bankers as well owners and school board members, who were not interviewed. Also, the interview methodology did not include a transcription and coding process to uncover reliable and comprehensive qualitative data.

## 2.6 Consolidating a wider view of Financial Sustainability

Although the financial health terminology is similar between studies to date, there are multiple terms referring to financial viability including – 'viability', 'vulnerability' and 'sustainability', but none have been adequately defined by the literature, nor has a comprehensive list of attributes of financial sustainability been defined.

Past studies presented a series of ratios and benchmarks, plus in some cases, a scale of achievement required to determine financial health (Jung 2002, Dinkel 2006). However, there is a growing awareness of the need to clarify a definition of financial sustainability and to consider a wider context of the attributes contributing to financial health.

A study concerning the financial sustainability in Australian local governments tried to address the problem of there being no agreed definition (Dollery, 2006). Although this did not have an education sector focus, the NFP sustainability definition is relevant to this literature.

Dollery set out to identify a common definition of a financially sustainable council through a detailed literature review of existing research including a number of government commissioned studies in South Australia, New South Wales and Queensland together with private academic studies. This study was valuable in demonstrating the move in literature towards a better appreciation of a broader context and questioning the applicability of the simple application of comparative financial benchmarks.

Dollery questioned the judgment of financial sustainability exclusively in terms of income, expenses and indebtedness and queried whether the yardstick resides in standards of service

provided and community expectations.

Their assessment provided useful observations including that financial sustainability has a well-understood meaning among Commonwealth and State governments and includes a belief that the local council is able to manage likely developments and unexpected financial shock in future periods.

The 2006 *Queensland Government Size, Shape and Sustainability Guidelines Kit* noted that local councils must assess their current and future sustainability against a number of key indicators, some of which are financial and some qualitative.

In a review of two separate papers published in academic journals, David Murray and Brian Dollery (2005, 2006) investigated the financial sustainability of local government councils and the harsh consequences that resulted from being classified as "at risk". Dollery questioned how financially struggling councils are identified, whether the methodology employed is sufficiently robust and if the monitoring list provides a true indication of financial performance.

They found that the methods employed provide little indication that adequate analysis has occurred and that councils identified as being at risk may in fact not be in a parlous financial state at all. These same outcomes were realized by the Australian Government Schools Financial Health Assessment project discussed later. This led Dollery to ask what the important indicators in assessing financial risk might be.

The study concluded that Key Performance Indicators (KPI's) imperfectly measure the effects of diversity among councils and therefore their predictive capacity for ascertaining potential failure is very low.

This paper also considered a study (Walker & Jones, 2006) that led to the development of an alternative approach to the question of fiscal distress and financial sustainability in Australian local government by defining fiscal distress in the context of not being able to maintain service delivery at pre-existing levels. That is, the councils should have the capacity to deliver the same current level of service provision to their residents.

The contributions of the Dollery (2006) study include that it is not possible to define sustainability with any degree of precision since the concept cannot be given precise meaning and therefore cannot be captured adequately through performance indicators. The immense diversity in councils means that a given set of fixed indicators cannot cope with these subtleties and where indicators are to be used, one size does not fit all. And where indicators are used, empirical evidence is needed to first to determine their predictive ability.

This study demonstrates a consolidation in the academic thought towards maintenance of service delivery rather than maximisation of surpluses when considering the sustainability of not-for-profits. There is a growing realization that financial sustainability in NFPs is more to do with consistency in service delivery over time. This raises the question of what time-period is appropriate to consider.

A study of the New South Wales local government systems expanded this and noted that a focus on efficiency may not necessarily result in financial sustainability (Drew, Dollery, & Kortt, 2016). As Dollery (2006) noted, the lowest performer relative to others may still be sustainable. The 2016 study added that an efficient council may not necessarily be sustainable, which raised new questions for exploration.

Council mergers represent an effective method of enhancing operational efficiency which, together with improved strategic planning, can contribute to financial sustainability. There is an agreement that bigger councils would be more efficient and therefore more sustainable. However, there was no empirical evidence to support these claims.

Policy makers have begun to employ financial ratio analysis to measure municipal sustainability so this study examined whether there was any statistically significant association between efficiency, ratio analysis and sustainability. In the absence of a statistical link scholars need to shift emphasis to identifying the determinants of sustainability. Drew, Drollery and Kortt (2016) gathered financial, demographic, economic and social characteristics for 125 NSW councils and determined a score for each council which measured the relative efficiency with which multiple inputs are converted into multiple outputs. Efficiency was then compared with ten Financial Sustainability Ratios (FSR) using a comprehensive regression analysis methodology. Table 3 summarises the 10 FSRs.

The study found little evidence of multi-collinearity between the efficiency scores and financial sustainability ratios and concluded that there is little relationship between efficiency and sustainability. The researchers suggested other factors contributing to sustainability may include inherited debt, demographics, infrastructure stock, climate and macroeconomic events. Evidence also supported the notion that sustained improvements to municipality efficiency over many years would be required to induce any material enhancement to important FSRs. They therefore concluded that financial statement data alone in its current form is not sufficient for the assessment of local government sustainability.

In summary, there is growing awareness in the NFP sector that sustainability is not about being the most financially efficient, because, indeed, an orgasnisation could be the least financially healthy and still be  healthy enough to be sustainable. Similarly, an organisation could be very efficient, but not deliver on community outcomes and therefore not be sustainable.

## 2.7 Government stakeholder and Australia Independent Schools

In 2008 the Commonwealth Government of Australia introduced the *Financial Health Assessment Framework Guidance Notes 2010 – 2012 Interim Arrangements* as a tool for monitoring the financial viability of Australian schools. The framework was designed to identify financially vulnerable schools to enable measures to be undertaken by the school, in consultation with the Department of Education, to improve the school's financial performance.

The department's key definitions were that a financially vulnerable school is a school that is, or is at high risk of becoming, insolvent and/or unable to operate effectively as a school. A financially viable school is a school that is (and is likely to continue for a substantial period to be) solvent and able to operate effectively as a school (Financial Health Assessment Framework Guidance Notes p. 1).

A major problem with this framework was the focus on short-term financial viability rather than long-term sustainability. Governments are concerned with protecting public monies and therefore ensuring government grants provided to the schools are spent in accordance with grant conditions. The department initially determined a set of thirteen financial ratios to be calculated for every school.

**TABLE 3 – FINANCIAL SUSTAINABILITY RATIOS USED IN LOCAL COUNCILS**

| Ratio | Calculation |
|---|---|
| **Operating** | (Total recurrent Income – Total recurrent expenses) / Total recurrent income |
| **Own source revenue** | Rates utilities charges / Total operating revenue |
| **Current ratio** | Current assets / Current liabilities |
| **Interest cover** | EBIDA / Interest expense |
| **Infrastructure backlog** | Cost to bring assets to satisfactory condition / Total infrastructure assets |
| **Debt service cover** | EBIDA / (Principal + Interest) |
| **Capital expenditure** | Annual capital expenditure / Annual depreciation |
| **Cash expense** | Cash and equivalents / (Total expenses – depreciation-interest)) * 12 |
| **Asset revewal** | Asset reinvestment / Depreciation of building and infrastructure |
| **Asset maintenance** | Asset maintenance / Required asset maintenance |

**TABLE 4 – FINANCIAL HEALTH ASSESSMENT FRAMEWORK INDICATORS**

| Ratio | Calculation |
|---|---|
| **Net asset position** | Total assets - Total liabilities |
| **Current ratio** | Current assets / Current liabilities |
| **Debt to equity** | Total debt / (Total assets - Total liabilities) |
| **Operating margin** | (Total recurrent Income – Total recurrent expenses) / Total recurrent income |
| **Interest cover** | (Total recurrent Income – Total recurrent expenses + Interest expense) / Total Interest expense |
| **Average enrolment changes over time** | (Percentage change in enrolment year 1 + Percentage change in enrolment prior year) / 2 |

The Association of Independent Schools of New South Wales, The Association of Independent Schools of South Australia, Independent Schools Queensland and the Independent Schools Council of Australia analysed the framework and prepared a briefing paper in response (Newcombe, 2009).

This analysis focused on the effectiveness of the benchmarks and ratios in assessing financial viability and found that many of the ratios focused on management of the school rather than financial viability. For example, student/teacher ratio is set by each school council with regard to the strategic direction and financial management policies of the school. Schools have different staffing mixes, but equally, have different income levels with which to fund these differences. Their analysis indicated that 80% of schools that failed the department's student/teacher ratio tests appeared to be financially viable.

The working party determined that nine of the thirteen benchmarks focused, to a great extent, on how schools operate rather than accurately assessing their financial viability. They also noted that major banks focus on three main areas when assessing financial viability - profitability and net operating cash flow, operating surplus relative to debt servicing requirements, and significant movement in student numbers.

As a result of the criticism by the independent schools sector, the thirteen ratios were subsequently amended and reduced to six by the Federal government to those summarised in Table 4.

Due to the unreliability of the tool in identifying financially vulnerable schools and significant negative school community feedback, the Financial Health Assessment Framework has not been applied to assess the financial well-being of schools since its initial trial. It did however play an important role in moving the school sector to an understanding of the importance of an early warning system to protect schools from financial failure. It also highlights the importance of considering a school's individual context.

State and Federal governments are significant stakeholders in Independent Schools because the average independent school in Australia receives 44% of its funding from government grants (ISCA, 2016). Unique to Queensland is the ownership by the State government of eight Grammar schools that are classified as independent schools because they are governed by individual boards of trustees and receive income from a mix of State and Federal grants and private fees.

Because they are state owned entities, they are audited annually by the Queensland Audit Office (QAO, 2016). The annual *Results of Audit: Education Sector Entities* is a document rich in information concerning financial viability and sustainability from the Queensland Government's perspective.

Consistent with the Federal government, the QAO states that the objective for grammar schools is to generate sufficient revenue to meet their financial obligations, but they extend that objective to a sustainability focus by adding *"and to fund asset replacement and new asset acquisitions"*. This is taking the government focus into the medium-term perspective, rather than the traditional government shorter-term view. The QAO defined financial sustainability as "the capacity to meet current and future expenditure as it falls due and to manage future financial risks". (QAO, 2016 page 42)

The QAO use financial ratios to help form their audit opinion. These ratios are summarised in Table 5. Not only do they benchmark individual school's results with other schools, they also consider the trend and the five-year average in individual schools' results.

Further analytics that the QAO carry out include a detailed analysis of staff ratios and employee expenses noting that these costs generally account for between 60% to 70% of total revenue. This is consistent with the findings of Jung 2002.

The QAO recognise that the financial ratios are outcomes as opposed to drivers of sustainability, so they look beyond these measures to form opinions regarding financial sustainability. They consider the influence of the internal and external environment on the ability of the schools to maintain financial health and how the schools shape their businesses and position themselves to remain sustainable. The systems and processes and management's operating philosophy are integral to each

#### TABLE 5 – FINANCIAL RATIOS APPLIED BY QAO 2016

| Ratio | Calculation | Target/Comments |
|---|---|---|
| **Operating result** | (Total recurrent Income – Total recurrent expenses) / Total recurrent income | Includes interest expense. Result greater zero deemed satisfactory |
| **Current ratio** | Current assets / Current liabilities | Greater than 1.0 is acceptable |
| **Net financial liabilities** | (Total liabilities – Current assets) / Revenue | Less than 60% considered reasonable |
| **Debt to revenue** | Total debt / operating revenue | Measures debt affordability. Lower the ratio the better |
| **Capital replacement** | Capital expenditure / Depreciation | Indicates whether capital assets are being replaced as they reach their useful life. Target five-year average of 1.0 |

#### TABLE 6 – RISK MANAGEMENT MATURITY MODEL QAO 2016

| Assessment area | Comments |
|---|---|
| **Leadership** | Senior management's commitment and approach to risk management as a key governance mechanism. Does management drive the integration at both the strategic and operational levels? |
| **People and accountability** | Is risk management incorporated into duty statements and performance agreements? |
| **Process integration** | The depth of integration of risk management in key business processes, practices and systems |
| **Responses** | Exception reports highlight where risks fall outside tolerances. How are these acted upon to resolve and improve processes? |
| **Monitoring** | Monitoring systems including performance indicators that allow management to monitor activities. Benchmarking to external best practice. Ongoing environmental scans to identify trends and external factors |
| **Achieving outcomes and Innovation** | Does the organisation culture support well-managed risk taking that drives innovation and improved services? |

entity's governance framework. The attitude and demonstrated commitment to sound financial control strongly influences the effectiveness of its system of control.

The risk management processes and procedures tested by QAO are summarised in Table 6.

Although government traditionally takes a short-term view of financial health, the QAO procedures clearly take a longer-term sustainability view which includes consideration of financial ratio trends and non-financial factors influencing financial sustainability. They use a different lens through which to view and consider the viability and sustainability of the school, perhaps because they are the owners and therefore have a vested interest in the success of the education enterprise.

Up until 2008, the literature mostly had a quantitative short-term focus on financial viability. But the QAO 2016 approach confirms that stakeholders now include a longer-term sustainability focus when assessing financial health. The timeframe differentiation between short-term viability and long-term sustainability was first addressed comprehensively by Bowman in 2011.

## 2.8 Timeframe considerations

Many of the studies up until 2011 focused on financial ratios calculated for organisations that had failed or had lodged for bankruptcy.

Traditional financial analysis identifies excessive debt, low profitability, low administration costs (because in difficult times there is limited capacity to reduce expenses) and narrow diversity in revenue streams are indicators of financial vulnerability (Tuckman and Chang, 1991). However it has been noted that some organisations survive and grow despite high debt yet other organisations that seemingly have more advantages failed to achieve financial sustainability (Bowman, 2011).

Bowman (2011) proposed a crucial distinction between financial capacity and financial sustainability to improve the predictability of traditional financial health measures. He proposed that financial health should be assessed in two time frames – short term capacity and long-term sustainability. His work added significantly to a better understanding of the role that time plays and as such, will be considered in some detail.

Tuckman and Chang (1991) were primarily concerned about short term reaction to an external shock. Bowman acknowledges short-term resilience as a precondition for long-term success. The contribution that his model adds to the debate is firstly to quantify the concept of financial capacity and secondly, to give capacity a time dimension.

Bowman (2011) asserts the short-term objective is to develop resilience to occasional economic shocks. Resilience requires economic resources to be converted into cash during an economic downturn lasting one or more years. The long-term objective is maintaining or expand services and to do this requires total assets to grow at a rate no less than the long-term inflation rate. The logical rationale for this is that to maintain services a NFP needs to maintain and continually reinvest in its assets, and the cost of doing that increases each year.

Capacity measured the ability to turn assets into cash in order to meet debts as and when due. For capacity, he applied an equity ratio, which measures the extent to which an organisation is funded with debt verses equity together with a version of a working capital ratio which considered the number of months in spending that was held as cash reserves.

For sustainability, he considered operating margin (profitability) and compared that margin to total assets on the basis that return on assets should at least be equal to inflation if the organisation is to be able to sustainably replace assets.

Bowman asserted that sustainability is reached through successive short run periods. So, sustainability is multiple periods of viability.

Bowman (2011) applied four measures against a sample of almost 100 000 NFPs in the USA and used the median values, rather than averages, to determine appropriate benchmarks because medians measure central tendency and are not skewed by extreme cases (outliers).

The standard deviation in results was large, and it was noted that organisations that failed many of these tests were continuing to operate. So, the measures were not effective in consistently predicting financial capacity and sustainability. It also supported the developing view that context for each organisation must be taken into consideration and ratio analysis is not a one-size-fits-all solution to determining financial sustainability.

He proposed that in benchmarking an important issue is how to define "normal" practice. It seemed reasonable to define normal value as lying between the 25th and 75th percentiles. This is a very interesting observation which suggests that there is a very wide range to 'normal' and that NFPs can be financially viable and have very different results in a benchmarking analysis.

One of Bowman's closing comments questioned whether a change in the executive director or board chair is likely to result in an increase or decrease in capacity and sustainability. This supports the importance of qualitative, non-financial factors when assessing financial sustainability.

Although a valuable contribution to literature, the study raised as many questions as it answered and did not provide a list of "normal" benchmarks of attainment for financial ratios nor a list of qualitative factors to take into consideration.

## 2.9 Longitudinal ratio analysis facilitates meaningful dialogue

The concepts of capacity and sustainability have been carried into subsequent literature and are becoming the accepted norm when assessing financial health. So too is the understanding that financial health is mission sensitive – it's not just about the financial metrics but ultimately mission achievement must be the objective of NFP organisations (Ryan & Irvine, 2012).

In this study of Australian NFPs Ryan and Irvine confirm the importance of ratio analysis as a tool for assessing financial health but also highlight the fact that their use for predicting organisational vulnerability has been criticized as being potentially highly misleading. However, they advocate that the calculation of key ratios for internal evaluation can provide valuable information about an organisation's financial health.

Ryan and Irvine (2012) developed a suite of financial ratios to assist boards and managers to understand the financial dynamics of their organisations, and they also provided empirical data about their applications. The intended application is for internal use through trend analysis, as opposed to comparative analysis with other organisations.

The suite of ratios was divided into five categories as summarised in Table 7. The ratios were tested on a relatively small sample of 44 Australian NFP organisations with the sample stratified based on a turnover range.

The outcome of the study was a table of averages calculated for each ratio and stratified between the turnover groups on the 44 data sets. The table was an interesting summary of the sample averages and range of results, but, consistent with Bowman (2011) it did not provide clear indication of a benchmark for best practice due to the significant variation in upper and lower results.

Ryan and Irvine (2012) acknowledged that ratios are an incomplete means of assessing NFP organisational performance, but recommended longitudinal use of financial ratios by boards and management to promote meaningful dialogue to understand and evaluate financial health. This reinforces the growing awareness that it is not so much the ratios themselves, but what governors and management do with that information that affects financial health.

The relatively small sample size, and the wide variation in results prevent the outcomes from being used to set benchmark levels of achievement. If the methodology of the Ryan and Irvine (2012) study incorporated a testing of ratios against identified viable and unviable groups of NFP's, the calculated outcomes would be of greater contribution. It is therefore difficult to rely on the ultimate averages as a guide for predicting financial health.

A major contribution of Ryan and Irvine (2012) is the reinforcement that ratios have a place in the assessment of financial health particularly when the process includes a longitudinal analysis of an organisation's own trends.

## 2.10 Composite financial index verse non-financial factors

At an early stage in the research concerning the applicability of ratio analysis to assess financial health it became evident that the use of a weighted average of multiple ratios or composite ratio provided much higher levels of financial health predictability (Alman 1968, Tuckman and Chang 1991, Greenlee and Trussel 2000, Dinkell 2006).

**TABLE 7 – SUITE OF RATIOS FOR ASSESSING NFP FINANCIAL HEALTH**

| Ratio | Calculation | Indication |
|---|---|---|
| **Efficiency ratios** | | |
| Administration expense | Administration expenses/total expenses | Percentage of expenses outlaid on administration |
| Program expense ratio | Program expenses/total expenses | Percentage of expenses outlaid on programs |
| Fundraising expense ratio | Fundraising expenses/total expenses | Percentage of expenses outlaid on fundraising |
| Cost of fundraising % | Fundraising expense/total revenue | Percentage cost of raising each $ of fundraising revenue |
| **Stability (Revenue concentration)** | | |
| Revenue concentration | Revenue sources/total revenue | Dependence of revenue sources |
| **Capacity (liquidity)** | | |
| Current ratio | Current assets/current liabilities | Ability to meet financial commitments in next financial period |
| Months spending | Working capital/total expenses – depreciation | Months of cash requirements currently available |
| **Gearing** | | |
| Debt to total assets | Total liabilities/total assets | Extent to which assets are funded with debt |
| **Sustainability** | | |
| Surplus margin | (Total revenue – total expenses)/Total revenue | Rate at which organisation builds reserves from revenue |
| Return on assets | (Total revenue – Total expenses)/Total assets | Rate of growth of asset base |

A 2013 study tested a composite financial index (CFI) on 37 Australian universities to assess financial health within the now well-accepted NFP context of Are resources sufficient and flexible enough to support the mission? (Mohanlingam & Nguyen Thi Phuong, 2013).

The CFI ratio was developed using four ratios (primary reserve ratio, viability ratio, return on net assets and net operating revenue) to arrive at the composite score.

The results indicated that 32% of the university sample had very strong financial health, 60% strong and 8% weak. All the larger universities reported strong financial performance which is consistent with the findings from the Dinkel study that larger organisations demonstrate strong financial health.

Mohanlingam, Nguyen, Phuong (2013) also sought to find relationships between financial health and other factors like size, rank, ratio of international students, graduate students, number of graduate and undergraduate programs offered, number of employees, ratios of teachers and general staff and concluded that none of these factors were related to financial performance. This was a controversial finding that runs contrary to Jung 2002 and therefore suggests the results of the Mohanlingam, Nguyen, Phuong 2013 study would not be transferable to the independent schools sector in Australia.

Although the study validates the use of a single holistic index (CFI) to communicate overall financial health, the study by Dollery, (2006) found that performance relative to others is not as important because the lowest performer may still be sustainable. So even the 8% of the sample at the lower end of financial health scale may still be able to sustainably support their mission.

The Mohanlingam, Nguyen, Phuong (2013) study suggests that it is important for Australian universities to consider the effect of non-financial factors such as, quality of teaching and research, ambience, reputation, management style and organisation culture when assessing financial health. This is inconsistent with their findings that the number of employees and the ratio of teacher had no impact on sustainability because surely this affects the quality of teaching and resources.

Contrary to the findings in Mohanlingam, Nguyen, Phuong (2013), but consistent with their suggestions to include non-financial factors, Newcombe (2009) and Jung (2012) highlighted the crucial contribution of enrolments in driving the financial sustainability of an independent school. QAO (2016) also highlighted the ability of management to monitor changes in internal and external environments and adapt accordingly.

The importance of enrolments in driving school income and therefore sustainability, indicates schools should monitor school-age enrolment demographics. This is supported by peak school associations including the ISCA *Submission to the Productivity Commission Inquiry into Introducing Competition and Informed User Choice into Human Services* (2016) indicated from 2015 to 2025 could see an additional 97,924 enrolments in independent schools requiring the equivalent of 187 new schools. Given the importance of enrolments and demographics, the next logical question is what are the factors that influence parents to select an independent school for their child's education. Again, the ISCA Research Report (2017) *Factors Influencing School Choice*, provides rich, qualitative information on this topic and highlights the importance of these non-financial factors to schools.

## 2.11 A new research agenda

The success and failure of NFPs has been researched for over thirty years, however there is still no common understanding on how best to measure NFP success.

The definition of NFP organisational success is complex, however there appears to be common understanding that NFP success is the realization of mission objectives. This was identified as early as Tuckman and Chang (1991). However, mission accomplishment is ambiguous and difficult to measure. Due to the difficulties in measuring NFP success, most studies to date have approached the issue from a different perspective, that is, investigating organisational financial failure.

There is a growing awareness in the literature that it is not all about the money. A reduction in financial resources and perhaps a scaling down of service offerings and operations does not mean that the NFP is failing. Instead the degree of mission accomplishment should be used as an indicator of organisational success or failure.

Some studies have successfully measured this by first identifying organisations that have reduced services over a number of years and then tested a suite of financial indicators against that group (Greenlee & Trussell, 2000). However, small sample sizes and a focus on a few financial outcome measures to the exclusion of possible causes of financial decline, or better still, factors contributing to success, leave a gap in the literature.

This evolving view of NFP sustainability was expertly summarised through the coding and analysis of 147 articles on the topic (Helmig, Ingerfurth, & Pinz, 2014) which proposed some cause-and-effect relationships between non-financial attributes and financial consequences.

They concluded that literature is dominated by research on financial performance and organisational failure. There is little disagreement on the understanding of NFP failure; that is, closure or dissolution of the organisation. However, to take a more positive approach, an understanding NFP success is not as straightforward to define. The factors contributing to financial success of the organisations are yet to be determined.

The Helmig, Ingerfurth & Pinz (2014) study indicated that internal and external factors influence NFP success, and asserted that these factors are sector specific. It follows therefore that the development of a study specific to the independent schools sector in Australia will strengthen external validity and reliability of the findings.

There is a growing awareness in literature that NFP success is a multi-dimensional construct and we should consider the input, transformation, output and environment (internal and external) dimensions.

## 2.12 Cause and effect

The literature is clearly evolving to a common view that financial outcomes are imperative, but equally important are the other factors that ultimately drive those outcomes. So, the attributes of a financially sustainable NFP are likely to be a mixture of both financial outcomes and non-financial drivers.

By 2014 literature was developing with respect to factors contributing to (causing) the financial sustainability of NFP (effect), which is an evolution from where it started with a focus on financial outcomes present in financially successful or failed NFPs.

A qualitative study of NFP organisations in Canada was designed to add to this dimension by advancing and testing the theory that the key organisational attributes of NFP financial sustainability are found across four pillars being sound financial practices, active fund development, strategic planning and, capacity to innovate (Williams, 2014).

Williams (2014) drew on the definition from Bowman, (2011) to define financial sustainability as the mix of revenue and expense management strategies that enable an organisation to pursue its mission and mandate over the long-term. Financial sustainability depends on an organisation's capacity to engage resources to seize opportunities and react to unexpected threats.

Williams (2014) used a mixed method approach including quantitative and qualitative data collection by carrying out in-person interviews with the leaders of five non-profit organisations, preceded by fact-finding quantitative research of accounting, strategic planning and other material shared by each organisation. The interviews were inductive and semi-structured and the researcher appears to have applied a coding methodology to discern conceptual similarities and patterns.

The research revealed great support for the theory that successful NFPs do require sound financial practices, active fund development, strategic planning and thinking and capacity to innovate to be financially sustainable.

While not school specific, William's (2014) research added a richness to the understanding of financial sustainability. In effect, she brought together previously disparate factors into a whole which has significantly enhanced an understanding of this area. Her work probed more deeply into sustainability and as such, is extremely useful.

A weakness in the study is the varied nature of the NFP organisations in the sample as well as the relatively small sample size and the limited scope of stakeholders that were interviewed – only included chief management staff within five NFP organisations. Prior research indicates that financial sustainability depends on context (Jung 2002, Dollery 2006, Bowman 2011) and this can vary significantly between different types of NFP organisations and also different stakeholders. Another weakness of the study was the review of data at a point in time rather than including a longitudinal element of data analysis because trends in data and performance are important.

## 2.13 Increased stakeholder awareness

Public awareness of the need for NFP financial sustainability has increased in recent years following the global financial crisis. Governments in particular want to know organisations have financial stability and that they can continue to meet their missions.

With this increased scrutiny, NFPs have turned to professionals to provide them with resources to help assess, plan, make changes and continue to meet their mission (Rottkamp, 2016).

The Certified Practicing Accountants (CPA) of America believe the ability to identify negative trends and other associated risk factors can help assess financial health so organisations need to continually perform analysis of internal and external risks. This requires the right staff and board governance processes

that assess financial, operational, strategic, legal/regulatory, technological, people/culture, brand and reputational risks. An adequate risk assessment plan will strengthen the organisation's position for long-term sustainability (Rottkamp, 2016).

## 2.14 Summary of literature

Early literature focused on financial output measures of organisations that had failed financially and matured these into measures that could possibly predict financial failure. However research is approaching the question from a negative connotation by reviewing failure as opposed to identifying factors present for successful NFP's. It does help however as one may assume the opposite of those negative factors may be the positive attributes of a financially sustainable NFP.

There does appear to be a common attribute of failed NFP's in that they are more likely to be smaller in size.

Because NFP's are focused on achieving mission rather than maximizing profits, it is difficult to quantify financial success - it is not a competition about who is more financially sustainable than the other. The focus should be on their ability to perform and achieve the mission.

However, it is acknowledged that a school's educational mission and financial viability have far-reaching interdependence. Many non-financial factors need to be considered when assessing the output measure of financial sustainability, including the importance of enrolments and analysis of changes in demographics.

By the mid 2000's literature widely accepted the need to consider financial together with non-financial and qualitative factors that ultimately drive financial sustainability. This was highlighted by the failure of the financial health assessment framework for non-government schools to accurately assess financial vulnerability.

However, ultimately the sustainability of a NFP requires adequate financial capacity, meaning adequate cash reserves to manage economic shocks. It is proposed that sustainability is simply multiple periods of financial capacity.

Therefore, trend analysis of financial, non-financial, internal and external factors is important.

The 2016 CPA's article stresses that the assessment of financial health for NFPs has evolved beyond the mere assessment of a few financial ratios. It relies on context, trends, financial and non-financial cause and effect factors. It is these factors, together with financial ratios, applied to independent schools that will be explored and tested due to the gap in existing research.

*Rockhampton Girls' Grammar School*

# Chapter 4: Analysis & Findings

## 4.1 Introduction

The primary question for this research is "How do major stakeholders define, and what are the commonly agreed attributes, of a financially sustainable independent school in Australia?" Although an informed assessment was made as to who those stakeholders might be, each interviewee was asked for their assessment of who are the major shareholders (subsidiary question 1). Consistent with a snowball sampling technique, this facilitated identification of possible additional stakeholders to be included in the study.

The initial stakeholder groups identified for the study were:

- Banks
- Department of Education – Federal and State (not necessarily all states)
- Owners – Anglican, Christian, Uniting, Catholic independent, Lutheran
- Parents
- School governors and managers
- Others as identified during interview process.

There was common agreement among the interviewed stakeholders that those providing funding to the schools are appropriate stakeholders to be interviewed

*"Well I mean, the report, our report shows that they get 30% of their money from government grants. So I think that's a mixture of state and feds. So to me, both the state and the feds would be 2 of your key stakeholders when you're talking 30% of their revenue coming to them."*

*"Clearly yeah (banks), so anybody who's funding them." "So any lenders, …".*

*"People who provide the finance."*

School systems who ultimately own and govern schools are also directly involved because they have ultimate financial liability if a school falls into financial difficulty

*"but there are others, for example, (unnamed group) schools have a, not a formal financial guarantee, but an effective financial guarantee. … are effectively a system owner, and then you've got a number of other organisations that have, to a greater of lesser extent, some associations with schools."*

Apart from those who provide finance, other stakeholders were identified. Parents are a clear stakeholder

*"Yes, so yeah, so to that extent, parents are, you know, we've had cases in the past where parents or individual governing board members have approached us with concerns about the financial viability of individual schools."*

Government school accreditation authorities that do not necessarily have a funding role were identified as an important stakeholder by audit professionals with the comment

*"There is a non-state school accreditation board…"*

Consistent with stakeholder theory and the notion that some stakeholders will be more powerful than others, interviewees identified that there were several categories of stakeholders who they considered to be more important as they are sufficiently informed and influential in the ultimate financial performance of the school and as such they represent the staff.

*"Yes Board and management. And management to me would include staff as they would have an interest in the school – is it financially viable."*

The influence of school management is supported with the following comment

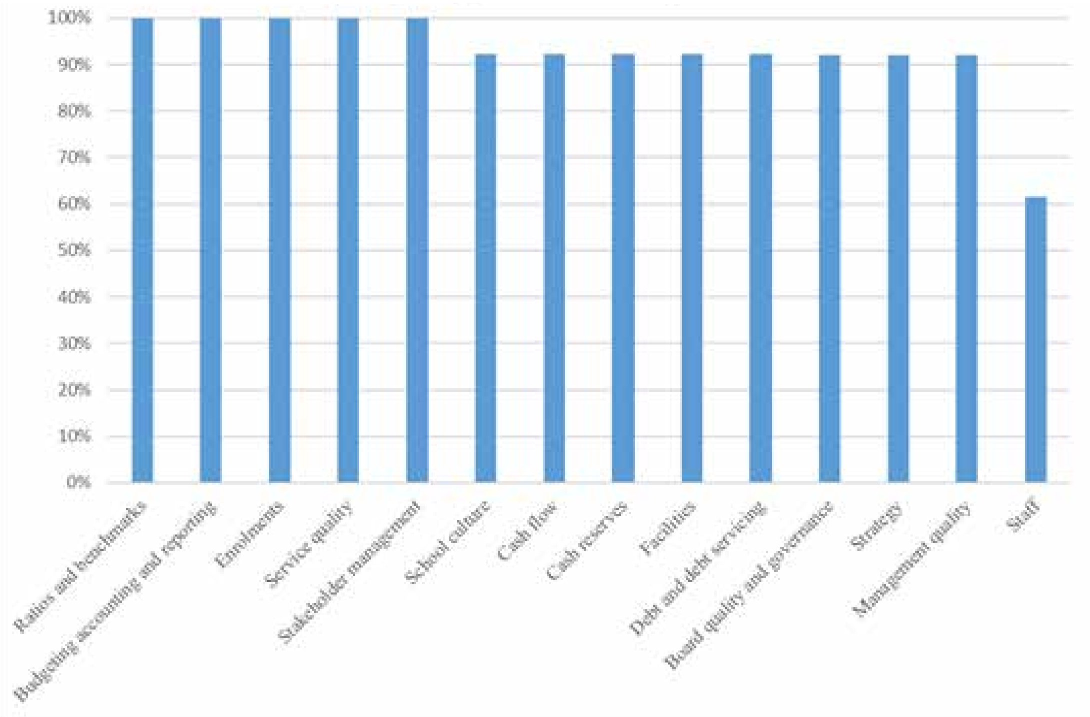
*"…if you have proper financial management in there as well. You know, you have to put in procedures and system in place and you also have to be reviewing, the board reviewing it. So that you have accountable financial management. It's really important that, to become sustainable."*

Similarly, an interviewee identified that there are varying degrees to which stakeholders will be involved in or interested in the financial health of a school. Some stakeholders, for example, the general community, are affected by the financial health of the school but it would be unlikely to identify random participants with sufficiently informed opinions on the matter.

This is confirmed with the following interviewee comment

*"I think the stakeholders are pretty broad. I guess it's just that there are different degrees, potentially, of their, of how interested or what level of stakeholder they play. And it goes from the school, the direct school community, which are the owners of the school, whoever they are, the staff, the teachers, and all other administrative staff, the students, the parents. Then extending from that, the likes of ourselves as the financiers of those, which is government as well, obviously, and then I guess extending that more broadly, the general community through individual tax payers, who through the tax system are funders of schools. And then just the community generally, because it's the outcomes that are achieved through educating students that then drive community and its progress. So it's a bit, maybe it's a bit much to say everyone, but it's very broad, like I said at the start.*

**FIGURE 2 – THEME USE BY PARTICIPANTS - PERCENTAGE OF PARTICIPANTS THAT USED EACH THEME**




*It's just that some people are more directly stakeholders than others."*

Comments by a school owner confirmed the broad spectrum of the stakeholders

*"So, in that regard, I think the owners, whether that's a church, in our situation, lenders, government, staff, parents, and the broader community. And that could include the congregation as well, if it's a church school."*

Although other stakeholders were identified as possibly being affected by the financial sustainability of the school, some stakeholders may not necessarily have an appropriate and sufficiently informed influence on the ongoing financial operations and therefore were not included. For example, although the students would be affected by the financial health of the school and are a major beneficiary of a healthy school, they are not likely to be in a position to make an informed decision on the financial health in a way that contributes to the study. This is supported with interviewee comments including

*"Typically, no. (students can't assess the financial viability/ sustainability of a school)"*

In summary, the participants confirmed that the stakeholder mix originally identified for the study was appropriate. Although some may refer to broader stakeholders such as the community at large, this can be represented by other stakeholders.

Analysis of the interview data identified fourteen themes with respect to stakeholders' understanding of the attributes of a financially sustainable independent school. At a macro level, I first considered how many of the participants used certain themes in describing the attributes of a financially sustainable independent school. Figure 2 indicates that most themes were important to each stakeholder, however the theme concerning staff quality and retention appeared less important.

The themes represented 3 distinct classifications of information that stakeholders considered when assessing the financial sustainability of independent schools. As would be expected **Financial attributes** were important and represented by the ratios and benchmarks, cash flow, cash reserves and debt servicing themes. A second classification of information that was considered by stakeholders was **Non-Financial** information represented by school culture, enrolments, service quality, facilities and staff. And the third major theme was **Leadership and Management** represented by board quality and governance, strategy, management quality, budgeting accounting and reporting, and stakeholder management.

## 4.2 Financial Attributes

As would be expected stakeholders identified a number of financial attributes to be important when considering a definition of financial sustainability. In this category are included ratios and benchmarks, cash flows, cash reserves and debt and debt servicing. A distinction is drawn between the systems and processes that allow reporting of these financial attributes. These systems and processes are considered under the Leadership and Management classification.

### Ratios and benchmarks

Figure 2 indicates that 100% of interview participants mentioned ratios and benchmarks as an important attribute/ theme of financial sustainability. Ratios and benchmarks had the second highest frequency of use by interview participants. This indicates the importance of this theme in defining the attributes of a financially sustainable independent school. Ratios and benchmarks are regarded as an important attribute to most stakeholders, but to a lesser extent to the government and parent stakeholders. Interviewees identified the need to analyse the trends in a school's ratios and financial results when assessing financial health. They also identified specific ratios and benchmarks which they considered more important – net operating margin, staff benchmarks, expense benchmarks and income sources. They also identified that benchmarks may need to be customised.

**Benchmark trends and comparative**

The need to analyse the trends in a school's ratios and benchmarks when assessing financial health was identified by 85% of survey participants.

Benchmarks are a crucial tool in the assessment financial health both now and into the future

*"Yeah, so we use the benchmarking and the trend analysis and the financial modelling as a bit of a litmus test"*

Ratio and benchmarking analysis should be tailored to individual school's circumstances including size of the school, whether it's growing or mature. Ratios such as operating surplus per dollar of income and debt per student remove the effect of school size which allows comparison with other schools together with an individual school's relative performance over time. The movement in a school's own performance over time help stakeholders in their assessment of financial health.

*"So benchmarks are fine but… you've got to tie them to the circumstance of the school – mature schools, new schools, small schools… Trends I think are important… trends you'd be looking for in debt per student, or gross profit/net profit whatever."*

Schools can gain an understanding of how efficiently and effectively they are operating by comparing their ratios with a sample of similar schools. If they are operating in the same market with similar levels of income and one school is operating on a significantly different cost per student, comparative benchmarking helps to identify and quantify operational strengths and weaknesses and develop strategies on where changes could be made to improve financial outcomes. This process also to foster best practice.

*"We look at their fees compared to other schools, we look at their SES score compared to their competitors, and we just look at the business itself and see how they compare. And if they are, if they are substantially one way or the other, what is the reason."*

*"Through our portfolio of schools across the country, we do our own benchmarking analysis. And so having a look at their wages as a percentage of turnover, of ability to collect on debtors, of student teacher ratios. So how efficiently are they operating, and then ultimately we would see those things playing out in terms of positive financial outcomes."*

School boards and management should analyse the trend in enrolments by year group. If the enrolments in the lower year groups of the school are trending down, that indicates that as the current senior years finish and leave, the newer year groups coming through will be lower numbers. If this trend continues it has a multiplier effect on total enrolments in the school and can cause significant decline in total enrolments over a few years.

*"So if enrolments are starting to taper off, particularly at the feeder zones for the school, and all the peers that we give comparison to for that client aren't… it is a very clear signal that something's afoot… you know, that's our biggest warning signal."*

Related to income is an analysis of trends in discounts. If discounts are trending up, this will have an adverse effect on income per student which may not be compensated for by extra enrolments. Discounts should be analysed together with fee collection trends. If discounts are increasing and debtors are also increasing, this indicates parents may either being finding it increasingly hard to pay the fees, or perhaps they are not happy with the service. An increasing trend in discounts and a declining trend in fee collection indicate a possible decline in financial sustainability.

*"The other is the level of discounts and scholarships and stuff, and then the fee collection."*

*"Yeah, it is largely, we identify declining enrolments and ability to collect on their debtors as being, for us, key indicators of financial factors."*

The other side of the equation is school expenditure. If total expenses remain unchanged but enrolments decline, then expenditure per student will increase faster than income per student resulting in a decline in operating surplus. But also, if enrolments are steady or increasing, total expenses may be increasing at a faster rate which would be identified through an analysis of the trend in expenses per student compared with income per student.

*"We'll look at the mix of where they're spending their money, like the sources and applications for funds. Salaries versus admin versus property versus whatever. So there's that mix changing over time. Same as income, are we becoming more or less reliant on government grants, for instance? You know, like, because it's a risk factor."*

Schools should consider the trend in key ratios and financial performance over a five year period. Because over that period of time, schools are likely to have encountered a mix of trading conditions and the stakeholders can gain a sense of the average level of performance, and also how well management adapt to changing trading conditions. This would include five years of history, and five years of budgets.

*"We just used to take 5 year trends, because we reckon over 5 years, we're probably going to see a drought, we're probably going to see one good year, and we're probably going to see 3 average years. And should give you a fairly solid foundation to build a deal"*

Many stakeholders apply different weights to different ratios to arrive at a composite rating.

*"Yeah, (use a weighting of ratios to come up with a weighted score)"*

**Net Operating Margin**

77% of survey participants identified the analysis of profitability and operating surpluses when assessing the school's financial health.

The Net Operating margin is the dollar surplus realised for every dollar of gross recurrent income received, but before the payment of interest expense. By ignoring interest expense the ratio assesses a school's relative profitability ignoring how it was financed. All schools have different levels of debt funding, so by removing the effect of debt funding allows comparisons between all schools, irrespective of size and debt. It also facilitates consistent assessment of relative performance of the school over time. The assessment of the net operating margin and relative operating surplus is a crucial and much used tool for assessing financial health and sustainability.

*"The biggest thing we look at is probably their EBITDA Margin"*

*"Yes, your profit margin. So you look at your trend as well."*

Early literature identified the need for an operating surplus in order to build reserves. So an organisation is like a reservoir of liquid assets with the operating surplus adding to or a deficit reducing that cash reservoir (Beaver, 1966). Interviewees indicated the importance of this.

*"Well we want it to remain in profit or at least not making a loss from the profit and loss perspective from the cash flow perspective and looking at timing of cash flow and do they have the facility and how much they are delving into that facility. If for a period of time they would be using more of that facility which when we looked going forward we try to see improvement."*

*"In terms of ability to generate money, resources that you can call on."*

Interviewees identified the importance of a school having a healthy operating margin. Schools need a margin of safety in their surplus because if the surplus is too low and the school encounters trading difficulties, that lower-than-expected surplus could become insufficient to service the level of debt that the school has acquired. Without cash reserves to call upon during this period of reduced income, a school can fall into financial difficulty. Further, without operating surpluses the ability to invest in facilities is compromised.

*"Yeah, (net operating margin) that's a big viability test for us. Their ability to service debt,"*

*"Sometimes it's been adverse events like fires, cyclones, things a little bit out beyond their control. Because they run at such tight margins and have such low reserves, seems like that can really impact them"*

*"Yes. So operating at a surplus means that obviously you've… you've got a healthy financial model but then that surplus gets reinvested into the school as a not-for-profit is, to be able to them, to maintain or grow. But… which ultimately is, is the… I suppose one of the key success factors of a school."*

If a school has a trend of negative net operating margins this means the school is spending more than it is receiving as recurrent income. This is not sustainable without adequate cash reserves or some other means of financial support. So, if a school has a trend of net operating losses, stakeholders will look to who is supporting the school to decide on financial sustainability.

*"Because you can't have a school on a long term basis making losses. Someone has to be supporting them."*

**Staff benchmarks**

77% of survey participants identified the need to analyse staff ratios when assessing financial health. On average 78% of an independent school's costs are represented by staff wages[5]. It is therefore crucial that a school manages staff numbers in accordance with enrolments. The level of staff compared to student enrolments is measured by student/staff ratios and is a crucial tool for measuring staff efficiency. If enrolments decrease, a school can reduce staff numbers to maintain stable student/staff ratios which will help align costs with the reduced income.

*"Absolutely, it's the nexus between income, student base fees and grants, and the biggest expense item is teachers' salaries, and so if you get that relationship right, a lot"*

*"Trends is pretty powerful for us. I would say the number of indicator, if you like, that we would use as student/teacher."*

[5] ASBA/Somerset Non-Government Schools Financial Performance survey 2015 school-year

If when comparing student/teacher ratios to similar schools the result is significantly lower (fewer students per teacher = relatively more teachers), then this is an important warning sign of possible financial stress and requires further investigation

*"That's it, that's right, but if you get a low fee school that's running 9s in the high school, … it's an indicator… Is it mid-level management's too heavy? Is it we're running to small class sizes?… it's that indicator that it gives you that first call."*

As a consequence, interviewees identified that schools need to consider the mix between permanent and contract staff will help schools to match costs to fluctuations in enrolments and changes in demand for educational offerings. This will require fair negotiated outcomes with staff unions and flexible staff awards.

*"as much flexibility as you possibly can. So there's two interesting aspects of this, and the first part, if the union had it's way, everybody would be permanent, you wouldn't have anybody on a contract… the government itself realised that it needs some flexibility."*

Interviewees also expressed the view that the management of salary expenditure as a percentage of total expenditure is crucial for long-term financial sustainability. So, the long-term costs when appointing staff and ensure appropriate balance between management and direct delivery staff are important.

*"Appointing too many people to positions of added responsibility. Schools generally have more chiefs than Indians. That's a mistake. So I think when you go to make those decisions, you've got to stop and think, "Ok, what are the long term implications for this?" and it's not going to put us in a strong position, and you shouldn't be doing it."*

*"So we say it (wages as % expenditure) shouldn't be greater than 70%. Most of our schools sit around the 63% to 65%.... Yeah (if wages > 70% of total exp), that dramatically impacts on the operating margin."*

Interviewees also thought considering the trend in its wages expenditure to revenue or carrying out a comparative analysis with a sample of similar schools or to the national average wages as a percentage of income of 68% was important[6].

*"And we also looked at employee expenses as a percentage of total revenue. Because employee expenses is the main expense category"*

*"..so what we do now is we have 3 years of trend analysis for the school in question, and we line that up against benchmarking comparison against like schools within our database of clients… wage based ratios"*

**Expense benchmarks**

A smaller but non the less significant number of survey participants (46%) identified the need for schools to understand and compare expense benchmarks. Efficient use of operating resources is important for maintaining financial sustainability. Because wages on average represent 78% of school costs, it is important for schools to monitor wages relative to total expenses and total income because if the percent of expenditure on wages increases beyond benchmark thresholds, it will adversely affect the operating surplus.

*"So we say it (wages as % expenditure) shouldn't be greater than 70%. Most of our schools sit around the 63 to 65."*

*"Yeah (if wages > 70% of total exp), dramatically impacts on the operating margin."*

Expenditure per student ratios are simple to calculate and because they are a relative cost which removes the effect of school size, schools can compare their costs per student with other similar schools to help identify operational strengths and weaknesses. A cost-per-student analysis also facilitate the quantification of trading differences. For example, the average total cost per student for Australian independent schools was $16,600 in 2015. If a school had average cost per student of $20,000, and enrolments of 500 students, this indicates that their operating costs are $1.7 million higher than average ($20,000 - $16,600 * 500). The school can then make informed decisions about where efficiencies may be possible.

*"pretty simple basic one, divide by number of students, divided by total expenditure just to give a bit of a look and a feel for what the sector looks like."*

Using relative cost per student ratios helps the school to know where to look to reduce expenditure if revenue reduces? Literature indicated that not for profits with relatively high costs may be more financially sustainable because if revenue reduces, they have an ability to reduce costs (Tuckman & Chang, 1991). So, schools with relatively high costs may be more sustainable because there are more opportunities to improve efficiency if required

*"And if the revenue goes down, they're ability to cut costs."*

It is important to have a balance between the financial realities of running a school business and the educational objectives that are, in the end, the reason for existence. There is a risk that the financial stakeholders dominate the education stakeholders, or vice versa.

*"So the business manager would squirrel away… for 10 months of the year they'd be reporting to the board, "We're going broke, we're losing money" and then in the last report of the year, would pull out this $300,000 surplus… but what was happening is, the school was, each year, was spending less on resources and materials and teachers' aides and all the things that they needed to make the school work, such that over 5 years, it was almost like a plane slowly going down."*

**Income sources**

A sub-theme which forms part of the ratios and benchmarks theme and used by 46% of survey participants is the importance of income sources. Changes in sources of income create a risk. Existing research suggested income source diversity was an advantage for the financial health of not-for-profits. Revenue concentration ratios were identified early in the literature as being important when assessing financial health (Tuckman & Chang, 1991).

[6] ASBA/Somerset Non-Government Schools Financial Performance survey 2015 school-year

*"We'll look at the mix… Same as income, are we becoming more or less reliant on government grants, for instance? You know, like, because it's a risk factor."*

On average, Independent schools in Australia earn 44% of their income from fees, 54% from government grants and 2% from other sources (ISCA, 2016). Changes in the income mix affects where financial stakeholders focus their attention regarding external risk factors. For example, a larger dependency of government funding exposes a school to changes in government policy regarding funding.

*"some of our schools have gone up on their government grant, while others, means that we're coming more reliant on government grant, therefore any changes in government policy actually have a greater impact…, so we need to be much more engaged in the political funding process to protect our interests."*

Schools must monitor the parent population and their capacity to pay fees. If that capacity reduces, due to economic factors or a change in the socio-economic status of the parent population, the school may drift towards a lower total income per student and therefore should restructure operations to reduce costs.

*"Non-government schools have a capacity to draw private funding and the model is set up to assume that is sort of the case and if that's not the case for a particular school then it probably does question whether it is sustainable."*

Government funding is higher if the parent's capacity to contribute is less. Capacity to contribute is measured on the socio-economic status of the parents whose children attend the school. So, schools must monitor the SES trend of the parent population.

*"A lot of the schools that are unviable are low fees schools and … (grants) are more than 50% of their funding."*

*"we look at their fees compared to other schools, we look at their SES score compared to their competitors,"*

The SES score of a school is a major determinant of funding sources, both level of government funding and ability of parents to pay fees. Schools should understand the mix of income from grants and fees and monitor the per capita trends in that mix, including the changing dependency of international verse domestic fees.

*"Yep, we look at the SES of the school, we look at the, and then we start looking at things on a per capita basis."*

Capacity and willingness of parents to pay school's fees may also be influenced by competitor schools. So, Governors and management should compare their fees and educational offerings with competitors and track the trend in fees and total income per student to ensure a good understanding of the competitive environment. Tracking debtors can also be an indication of a parent's capacity and willingness to pay fees.

*"… if your fees are twice as much as your competitors, well why? And is it sustainable…. So benchmark and trends, but also the underlying items of those. We look at their market, so whether they're a religious based school, what their niche is…"*

Benefactor funding can be a risk for schools if the school is not prepared for the day that benefactor may stop supporting the school. Benefactor support is more susceptible to sudden and major change than a change in government funding or a change in the overall parent population's ability to pay fees. Schools should therefore have a contingency plan in place for the situation where benefactor support is withdrawn.

*"We do see that where we've had schools relying on benefactors who kept the school, like cash-wise there's never been a problem but the school didn't set itself up to be able to cope in the event the benefactors went for whatever reason and in the circumstance we've seen the benefactor is gone. So the school was completely unprepared to deal with this sudden turn the tap off for cash, that's a strategy thing"*

**Customised benchmarks**

46% of survey participants mentioned that benchmarks needed to be different for different schools and analysis needs to take into consideration the individual characteristics of each school. So, there are a number of factors that need to be considered when assessing a school's financial health. Factors that can influence a school's operating metrics include age of the school, income levels, coeducational verses single sex, whether they are part of a faith and school system. There are a multitude of factors and ratios that are taken into consideration to arrive at the ultimate assessment of financial health and sustainability.

*"And then we look at whether they've got 1 or 2 campuses, boys or girls, faith or not, how old they are, and we score them on our financial spreading tool, and so we look at that result over time."*

*"And also just in what stage they are in their lifecycle, you know, a growing school's going to have completely different profile in terms of viability than a mature, stable school, or maybe a mature school that's even declining."*

*"Of financial viability and that is one of the weaknesses with the federal system. You can't apply one size fits all, …. what might be a good benchmark for one school might be a totally wrong benchmark for another."*

New schools are at a disadvantage because they have no track record of performance to allow an analysis of trends in performance. New schools are also likely to have significantly higher levels of debt and therefore will be higher risk.

*"With a new school it is a lot more work in looking at their viability in terms of can they execute on their business plan or their forecast. Whereas with a mature school you've got… obviously you've got a track record and you can look at their trends, and look at their ratios, and see where they are on the continuum of that viability."*

*" Debt per student would be a fine example under the financial health*

*assessment check - as a figure which we know is irrelevant because a new school will have massive debt per student where a mature school will have a whole lot less"*

The relative income of a school determines funds available for investing in the provision of educational services. It is of little benefit comparing the staffing and operating ratios of a high fee school with low fee schools because their modus operando will differ considerably. So, schools should seek to compare their performance with schools with similar income per student.

*"Yes compared with similar schools, the 3 different bands that we look at and this is worked out on income per school - that is how the bands are worked out."*

*"Because every school is a little bit different. Like, don't just say, "Our student teacher ratio should be x" because you might be a low fee school, you know, whatever."*

*"We look at their fees compared to other schools, we look at their SES score compared to their competitors, and we just look at the business itself and see how they compare."*

## Cash Flow

Figure 2 indicates that 92% of interview participants mentioned cash flow as an important attribute/theme of financial sustainability and it the sixth highest frequency of use by interview participants. The cash flow theme ranks slightly higher for insolvency practitioners, banks, governors and peak body. Although the peak body representatives included persons who assess school financial viability for capital funding purposes, so would their interests are similar to banks.

Operating cash flows need to adequately pay for day-to-day operating expenses but also leave an operating surplus to help fund reinvestment in buildings, plant and equipment and to service loans. In the medium to long term a school must have a positive cash flow from operations, because if it is consistently incurring losses, how is that being funded? The losses would need to be funded from external parties or cash reserves.

*"Because you can't have a school on a long term basis making losses. Someone has to be supporting them."*

A stable cash flow is important because it is difficult for schools to sell down assets in the event of a deterioration in trading conditions, unless they have land and buildings that are surplus to requirements and can be liquidated as a mitigating measure. A strong and sustainable cash flow allows schools to manage if trading conditions temporarily deteriorate. If a school has a healthy operating cash flow and surplus it is better able to manage a reduction in that cash flow following unforeseen events. But if cash flow is weak to start with, a reduction in that cash flow may result in financial difficulty

*"You can't really sell the assets but if you've got a sustainable cash flow and you've got a reasonably well-capitalised balance sheet"*

*"So we've just been through the GFC, some schools have fared better than others but strong sustainable cash flow, a 'must have'"*

It is crucial that a school generates an operating surplus to fund the required reinvestment in facilities and operations. This surplus and reinvestment allows the school to grow sustainably. So, financial stakeholders will assess a school's ability to fund required capital improvements from the cash flow remaining after operating expenses and other commitments.

*"So operating at a surplus means that obviously you've… you've got a healthy financial model but then that surplus gets reinvested into the school .. to enable them, to maintain or grow. But... which ultimately is, is the… I suppose one of the key success factors of a school."*

*"so if you made an assessment that a particular asset which is integral to the operations has a limited useful life, your next question is, "Well, where are the funds going to come to replace that?"*

Since poor cash flow is often associated with poor financial viability, operating cash flows should be monitored on a regular, usually monthly, because timing of cash flows can vary significantly from month to month due to government funding timetables and collection of fees from parents. Although the annual cash flow may appear adequate, the school should identify peaks and troughs on monthly rests to ensure they have adequate cash or borrowing facilities.

*"and looking at timing of cash flow and do they have the facility and how much they are delving into that facility"*

*"when we get to that pointy wedge around lack of viability its predominantly cash that we are looking at and the cash flow for the remainder of the year."*

Financial stakeholders review a school's free cash flow after on-going commitments. So, the net cash flow from operations must fund debt principal repayments. After all contracted loan commitments, how much cash flow remains and is it sufficient to fund discretionary items for example capital investment? If the remaining surplus is insufficient to adequately fund asset replacement, this may be a financial sustainability concern.

Financiers may also build in a sensitivity analysis to estimate the effect on cash flows if trading is worse than expected

*"net cash after operations position. Which is after all your ongoing commitments… There's a sensitivity built into that"*

*"it's based on the ability to meet all of your financial commitments, and have a sufficient surplus at the end of that to allow for the school to grow and develop."*

*"so if you made an assessment that a particular asset which is integral to the operations has a limited useful life, your next question is, "Well, where are the funds going to come to replace that? "*

Financial stakeholders take an active interest in the school's management of cash conversion. Schools need to diligently manage fee collection and debtors because large debtor balances adversely affect cash flow from operations. If schools are not collecting fees and approach the stakeholder for extra funds, this will undermine stakeholder confidence in school management.

*"so we look at the cash conversion cycle very heavily"*

*"So (cash conversion) in terms of the, from the invoicing to the client, of receiving money in the year of, or the period of time that we're looking at. "the most obvious example of that is the debtor management. So it's a feature that we look carefully"*

*"assessment on whether the schools current financial difficulty is unexpected, if you have got this long trend of unpaid school fees or other debtors and I guess no evidence that the school sought to address that in a way."*

Another factor impacting on cash from operations and associated with debtor management is an assessment of the level of discounts being offered in the school. The larger the fee discounts the less cash fees there are to collect. Large discounts adversely affect cash flows and need to be responsibly managed by the school

*"The other is the level of discounts and scholarships and stuff, and then the fee collection."*

*"… when we are looking at parents we also look at discounts and scholarships that have been provided to kids so often there is very generous discounts for second and third kids, we also look at how much money has been provided as discounts"*

Schools should ensure they do not get to a point where their current liabilities (debts due in the short term) exceed current assets (cash and other liquid assets that can be used to pay debts). If they do, they may have reached a point of being not sustainable or worse, insolvent. It is a continuum and therefore difficult to identify the point of unsustainability. But there are warning signs that can indicate working capital difficulties including creditor balances growing and statutory debts not being paid. If boards consider they are approaching the point of being financially unsustainable they must act promptly to address the issue, otherwise governors may be held personally liable for debts accruing past the point of deemed insolvency.

*"Yeah, gosh, what is the definitive point? Well when your current liabilities exceed your current assets, …. But I think, I think the definitive point of sustainability is a continuum, … where you come to a line in the sand where you go nothing I can do will be able to retrieve it. … usually you've got warning signs and stuff happening which haven't been addressed"*

*"Can't pay your creditors. I mean, that's a classic. We get schools that have got creditors ringing them every day, saying, "Can you please pay?" Can't make the fortnightly payroll."*

Generally, if a school is having cash flow difficulties, they defer payments that are not so obvious to the general school community for example taxation office and superannuation. The school board should regularly review and ensure that outstanding debts are not accruing with the taxation office or superannuation guarantee obligations, otherwise this is an indicator that they are not financially viable. Also, if the school is paying creditors in round amounts, rather than paying invoices in full, this indicates financial stress.

*"ASIC versus Plymin list in that judgement they provide a list of fourteen indicators of insolvency. … included are you know your current ratio less than one, your overdue state and commonwealth taxes, if they're entering into payment arrangements with particular suppliers or when we do a cash flow analysis if they're paying supplier with round amounts."*

Auditors consider the going concern principal which reviews the school's ability to continue trading as a going concern for at least the next twelve months past the audit date. So, if the auditor is concerned about the school's going concern, they will qualify the audit report accordingly. If a school's liabilities exceed their assets or they receive a qualified audit report, under Section 75 of the *Australian Education Act 2013* and Section 27 of the *Australian Education Regulation 2013* the Federal government authorities will question the school's financial viability and may take action to suspend grant funding.

*"you know there is some requirements under the act. The assets are greater than your liabilities can meet your debts and not a qualified audit opinion"*

When assessing going concern, schools should consider the trend in their past four to five years trading to help inform the budget for the year ahead to ensure they have sufficient cash flow each month to pay debts as and when due. Over five years of historical data, generally schools have experienced some good and not so good times. So, it is a solid base for assessing the reasonableness of budgeted on-going average performance.

*"what we do as part of every audit, we do an assessment of going concern. … "What about next year's budget? What about next year's future cash flow?" So we have to make an assessment of going concern. So, while our report is all around the current year and the past 4 to get a trend, our normal audit has a look at going concern"*

*"We just used to take 5 year trends, because we reckon over 5 years, we're probably going to see a drought, we're probably going to see one good year, and we're probably going to see 3 average years. And should give you a fairly solid foundation to build a deal"*

The point at which the school is definitely unsustainable is when debts are called in by the school's creditors and they are unable to pay these.

*"Well there is a point where you're not sustainable, it's when your debt's been called in or we lose control."*

## Cash Reserves

Figure 2 indicates that 92% of interview participants mentioned cash levels as an important attribute/theme of financial sustainability and it is the eighth highest frequency of use by interview participants. The maintenance of adequate levels of cash reserves is important to most stakeholders.

Cash reserves provide the school with a buffer to call upon in the event of a sudden and unexpected downturn in income or as a school adjusts to a downturn in operating conditions such as a decline in enrolments. Cash reserves can be used as the school trades out of a downturn in operating performance.

*"Sometimes it's been adverse events like fires, cyclones, things a little*

*bit out beyond their control. Because they run at such tight margins and have such low reserves, seems like that can really impact them. Changing demographics and competition,"*

*"there'd need to be some cash reserves because of rainy day stuff or a sudden downturn in income that wasn't anticipated"*

As a rule of thumb, stakeholders considered three months operating costs to be held in cash reserves was appropriate. This is supported by literature which recommends three months spending to be held in cash reserves (Bowman, 2011). Interviews indicate schools should hold between two to three months-worth of expenses in cash reserves - 15% to 25% of annual expenses. Another rule of thumb is to hold 80% of current provisions in cash. This is particularly useful as schools mature because staff are aging and approaching the time when they will start taking long service leave so the school will have to fund payment of these provisions.

*"The old adage for small business is 3 months"*

*"Not generating adequate cash, and insufficient cash reserves. So we like to see our schools, at the end of the year, have a minimum of 15% of their operating expenditure for the final, for the next year, as cash reserves."*

*" … a proxy, which they came up with, which is 80% of current provisions in cash"*

*"But you've actually going to have to have cash here, because you're getting a whole bunch of teachers that are hitting their 50s, you are actually going to have to pay this out"*

Schools with aging buildings will need a replacement program in place. Cash reserves, or the ability to borrow funds, are needed to reinvest in facilities. Schools should increase cash reserves and/or reduce debt when preparing for new capital expenditure projects.

The rule of thumb of a minimum cash reserves of two to three month's expenditure is partly to help fund capital expenditure.

*"as buildings age, yes you do have the money."*

*"… (cash reserves 15% of annual expenditure target) ..if you think about, because that's their, not just meeting their operating expenditure, but it's also helping them to contribute to other investment"*

Where schools are financially supported by a benefactor they need to manage operations and plan for the situation where the benefactor is no longer able to support the school. Benefactor support is therefore also a risk because financial support is discretionary and may stop with little or no warning causing financial distress for the school.

*"We do see that where we've had schools relying on benefactors who kept the school, like cash-wise there's never been a problem but the school didn't set itself up to be able to cope in the event the benefactors went for whatever reason and in the circumstance we've seen the benefactor is gone. So the school was completely unprepared to deal with this sudden turn the tap off for cash"*

## Debt and debt servicing

Figure 2 indicates that 92% of interview participants mentioned the good management of debt levels, borrowing capacity and debt serviceability is an important attribute/theme for financial sustainability. Debt servicing is particularly important to banks, auditors and insolvency practitioners.

Over 80% of independent schools have some amount of debt funding. The average debt per student for an independent school was $7,700 in 2015[7]. Debt is generally accrued to help fund capital expenditure, not to fund recurrent operating expenses. If schools are increasing debt to fund recurrent operations, this is a warning that they are not financially sustainable.

*"If recurrent loans are increasing sharply it's an indicator that this school is no longer sustainable and they are cutting into their future operations"*

If debt is too high and the school has trouble servicing that debt, then that is not financially sustainable for the school.

*"And also I guess I can see a high level of debt, and they cannot pay their debt"*

[7] ASBA/Somerset Non-Government Schools Financial Performance survey 2015 school-year

Borrowing capacity for a school has little to do with the value of the school assets that the bank is lending against because of the special purpose nature of these assets and the difficulty in selling assets in the event of loan default. So, borrowing capacity for schools is therefore based on a combination of asset value in the school's balance sheet and predictable operating cash surpluses that are sufficient to service the loans. So, lending to schools is typically a cashflow-based rather than a loan to asset value based.

*"When schools that have closed down banks have found out that multi millions of dollars' worth of assets on balances sheets aren't worth anything because you can only use it as a school."*

*"obviously your cash flow sustainability, but a balance sheet, if you've got a good balance sheet, it gives you the capacity to borrow."*

*"we call it a net cash after operations position. Which is after all your ongoing commitments…Well, before debt servicing, and before interest, we have a look at what figure does that look like"*

So, the level of debt that a school can borrow is a function of the annual operating surplus it is producing which in turn determines its ability to service that debt. Generally financial stakeholders will consider a school's ability to service debt over a five-year budget period.

*"…and they've got enough behind them to be able to cover their debt with interest cover"*

*"5 years plus, probably, I guess. But in terms of what we would call it, I guess we're looking at, in terms of capacity to repay debt."*

Borrowings will generally include loan covenants that stipulate the minimum enrolments, maximum debt per student and minimum debt servicing ratios. Schools should aim to stay well within these loan covenants, which are designed to avoid schools borrowing more than they can adequately service. The covenants generally allow for some negative movement in a school's trading, such that if the operating surplus is less than budgeted, the borrowing is conservative enough that the school can still service the loan on the reduced income.

*"We do interest cover pay back, leverage against earnings, we do enrolment shifts over time."*

*"We try and get to a point in all our transactions, I want some cushion in the deal"*

*"a ratio like debt per student is relevant to a degree, but we don't look at debt per student above a certain amount"*

Schools can use interest cover (Earnings before Interest, depreciation and amortization / Interest expense) and debt servicing cover (Earnings before Interest, depreciation and amortization / Interest expense + principal repayments) ratios to assess debt servicing. Banks generally set an interest cover covenant of 2 to 3 times.

*"…Normally (we calculate Debt Servicing Cover as EBIDA/Principal and interest) unless we've got, like if a school's got a particular way of presenting their financials that's more effective for them, we'll go with that. But generally it's yeah, EBIDA, yeah."*

*"We do interest cover pay back, leverage against earnings"*

*"I just prefer to have interest cover, because that's what I'm used to…. So that's why generally, you know, 2 times is sort of the ball park "*

The school board must have a culture that recognises the need to respect debt repayment obligations. Financial stakeholders are becoming increasing interested in the governance culture and the board's attitude to debt and debt servicing as well as the school's debt repayment history.

*"Well, governance has become more important than anything… almost all the time you can point some of the responsibility back to management … governance is becoming more prominent for us, … how the school may have managed a borrowing program in the past, if they've had one. What's their attitude to repayment on their loan…"*

## 4.3 Non-financial Attributes

Several non-financial themes were identified by interviewees as contributing to making an assessment about a school's financial sustainability. These included school culture, enrolments, services, facilities and staff.

### School culture

Figure 2 indicates that 92% of interview participants mentioned school culture as an important attribute/theme of financial sustainability and it is the fourth highest frequency of use by interview participants. Culture is particularly important to parents, owners, banks, management and governors.

Interviewees identified the following factors as being important to school culture.

#### Future looking

A sub-theme which forms part of the school culture theme and used by 77% of survey participants is whether the school has a culture that is positive, honest and embraces innovation. Schools must be looking at changes coming in the future and planning accordingly.

*"And that is where I believe some schools become unstuck, in that they're not looking at the future. And they're not sustainable because they haven't made planning decisions."*

An innovative culture helps schools to see problems before viability becomes an issue and may prevent an otherwise slow decline.

*"the place isn't innovative, it doesn't, people aren't willing to try new things, and so everything becomes safe and we did this 10 years ago … in fact the school probably slowly, but surely, degrades."*

*"sustainability's all about management. To be able to see problems before the viability becomes an issue."*

Interviewees noted that it was important that the culture of the schools flows from the top and that as a consequence the nature of the board will tend to influence the nature of management, like attracts like. Consequently, for a school to be future looking it is important that board membership include a healthy mix of innovative thinkers.

*"if you've got a progressive or innovative board, then they should be able to help to drive the change from the top down."*

*"So what we say is, we look at tone from the top. So we look at the board and the key management personnel,"*

The ability to look to the future, was also very much determined by the innovative nature of staff, in particular the principal. The importance of management and staff participating in continual professional development to identify disruption and embrace innovation was noted by interviewees.

*"knowledge of staff - is one thing that I can pick up talking to staff members - are they really aware of what is happening out there in the education world or are they satisfied with their lot– so I've been to two schools in the last 3 weeks who've been very insular. … most good principals would recognise that and do some disruption, so its new ideas, innovation, meeting parent needs, changing of times all that kind of stuff."*

Interviewees also identified the importance of keeping stakeholders, parents in particular, informed about the investment in continuing professional development of staff to give them confidence about the quality of service.

*"It might be that there are signs or information in newsletters that the Principal's going off to PD here or visiting something there. .. That would be a really good indicator that something creative's happening in your school."*

Innovation, vision and strategy is important to parents and can be observed in the progressive improvement of facilities, education programs and pedagogy, newsletters and other interaction with parents including parent teacher interviews. Staff have much interaction with parents and therefore have opportunities to communicate the school vision to parents. Management should therefore ensure a cascading of the school's innovation and strategy to the staff.

"I think you'd see that from the innovation that's going on in the school. You can pick up that there's a culture of continual improvement within a school pretty easily. If everything looks the same as it did 10 years ago it's probably not moving too far. When you go to Parent/ Teacher interviews, when you go to Parent Information Nights, when you read newsletters if there's not a sense of excitement and momentum within the school for the things that it's doing then you'd be wondering what its agenda is. Has it really got a vision? So I'd be looking for a Council again that was transparent. And that there were ways of feeding into a Council that were appropriate."

The technology revolution that we are experiencing, similar to the industrial revolution, is causing large disruption in many industries. Education is not immune to disruption. Schools that are innovative are better able to foresee and manage disruption and be financially sustainable.

*"Yeah, and I think maybe a risk of focusing on financial viability instead of sustainability is around disruption in our industry, and I think longer term, sustainability has that greater capacity for potential disruption in education."*

However, it is not just an innovative culture in the school's education offerings but also in the school's business and back office systems that can contribute to improved financial performance.

*"those schools that have their set way to do it their own way, they perform fine, and they can be sustainable. It's those schools that are open to doing things differently, and doing things better based on the way systems and processes progress, they, as a general rule, I would see them outperforming from a financial position."*

*"how integrated they are with the different service providers in terms of integrated systems between collecting the money, in whichever form it comes in. Be it card, tuckshop, direct debit, whatever. Putting it into their accounting software and then turning it into money in the bank and a set of reports."*

Finally, it was noted that an innovate culture reflects the community and is influenced by the personnel on the board and senior management. It requires management to engage with stakeholders and respond. The school board is generally drawn from the school community, so if the community is not innovative, that will influence the board's behavior and the culture of the school.

*"so the culture of the school I think, and the success of that culture really has to reflect probably your community. If you've got a community of professionals they will expect professionals in the school. If you've got a community of people that are liberal, more relaxed about any of that…"*

### Ability to adapt

Whether the school has a culture that supports a willingness to adapt to changed circumstances was consistently mentioned as an important attribute being identified by 92% of survey participants.

In tough times, schools that are willing to adapt and innovate can maintain financial sustainability. This is the ability to recognise a change in demand or other trading condition and plan innovative and new ways to respond to the changing internal and external environments.

*"my theory is that each school suffers more during difficult times because they are not flexible, not innovative, they are really hard to change practices"*

*"I can also see schools when it's not financially viable, … people aren't willing to try new things, and so everything becomes safe and we did this 10 years ago and it worked, and we don't run the risk of trying something new, of, like, implementing a new program or new*

*way of teaching or technology or whatever it might be, we all just tend to stick to our (?) in fact the school probably slowly, but surely, degrades."*

A change in enrolments generally precipitates a need to change operations. And if enrolments are falling, schools must understand if it is caused by internal or external factors. To do this requires a good working relationship between the education and financial stakeholders within the school. A failure to adjust expenses is often the result of the education stakeholders dominating the financial stakeholders within the school's internal environment.

*"My reflection would be that schools generally gain financial problems don't address the spend issue - because schools are led by educators not bean counters."*

*"sometimes it can be enrolments softening out. Schools get in denial about that,"*

*"So when enrolments are going up, they're putting on extra staff, incurring extra costs, and when enrolments flatten, they don't change their cost structure"*

Governors and management need a willingness and ability to recognise changes in the environment and disruption, however subtle, and start adapting early. It is crucial to be monitoring trends because they will highlight subtle changes by comparing one period to the next.

*"But you know mature schools need just as much management and management insight because you can't afford to not be on top of regulative changes, changes in curriculum, but also in terms of what your market is. … It changes subtly, it is a subtle change to demographic that could impact your business, impact your business and unless you're on top of that in terms of management overview to be able to navigate where your schools going to go, it could impact the sustainability of your school."*

External stakeholders will form an opinion on the board and management's ability to adapt to changed circumstances by how the school responded in the past. So, they use historical behavior to predict future behavior and to assess the board's on-going ability to adapt to changed circumstances.

*"Yeah Board's willingness to innovate and adapt to changed circumstances and also responsive to previous circumstances if we're aware of any. … that's a very strong indicator for us."*

The ability to identify problems, think about solutions, plan and execute corrective action requires governors and managers with innovative personality who can contemplate and challenge the status quo. The "thinkers' and the "starters" must also be supported by the "doers". Management must also have excellent communication skills to gain the respect and following of all school staff and the general school community in order to execute change management within the school.

*"I think it's about the people who are in that role,… Because some people are comfortable in the detail, and just signing off on what's given to them. Some people are very forward looking and much broader. They can listen to, they can read research, read the data, and then think about what that could look like as a possibility, rather than be presented with an option. They can begin to imagine options, and I think that's the type of governance and leadership that is helpful in terms of being able to really consider everything against strategy or the environment that you're working in."*

**School pride**

A sub-theme which forms part of the school culture theme and used by 54% of survey participants is whether the school has a sense of pride, it's values match parent expectations and there is a welcoming environment.

*"it's all probably a bigger thing – it's about the pride in your school which has a link to sustainability."*

Presentation of school facilities affects how students, staff and parents feel. If the school maintains the quality and presentation of facilities this creates a positive environment which transcends to a positive school culture. As parents, students and staff do not generally have access to school finances, facilities are a transparent representation to the wider school community of the financial wellbeing of the school and of school pride.

*"if you're not able to maintain and you, or repair your facilities that it also affect the morale of staff, and even students. I've noticed that here, you know, a long time ago you see graffiti everywhere. But now that we constantly paint and maintain, I think, and the garden looks beautiful, actually the students appreciate it. You hardly see any graffiti anywhere. The student actually appreciate it, and I think it creates this nice environment to study, you know? If your place is drab, your house is drab, you feel different than if your house is nice."*

It was noted that school pride is all encompassing and is made visible through facilities, staff, student's actions and also the professionalism of school governors and management. It is the physical and people environment that creates the positive culture which is important for stakeholder confidence.

*"(how do you assess a school's culture?) Some of it's a gut feeling. Some of it's asking questions. Some of it's looking at the website or Facebook site. Some of it's listening to parents, other parents who are enrolled there. Walking around and observing how the current students behave and how they interact with the school… physical environment is like. So if the bags in the port racks are all over the place and it looks like World War 3 that might tell me something different to if they're all put in in an orderly way. So I'd be looking in classrooms at whether student work is respected. And that would be indicated by how well it's presented in the classroom and whether it's visible in the foyer of the school. So there'd be all sorts of things that I'd be looking at as I walked around a school to give me an indication of the values."*

A positive school culture from the parent's perspective is crucial for enrolments. Is there a sense of pride in the school and the student's work? Staff are a major factor influencing school pride and a positive culture so it is important for schools to have good quality staff who are motivated and engaged with the students and this refers to all staff – teaching and non-teaching. Staff quality is discussed later in this paper.

*"walked around schools and looked at it from the perspective of*

*John Paul College*

*parents. And it's completely unwelcoming. So there are locks on the gate. And "Please Press Here For Reception". And someone barks at you. And there are signs directing you everywhere. And "Keep off the grass" and don't do this and do that. And "Only contact teachers between..." All of this sort of trying to control parents and it's not necessarily the most helpful way to engage. I think one of the most powerful things people can do is to try and look at their reception area. Which is often the first point of call for parents."*

Students have an influence on parents as to which school they attend so current students who love their school will help create a positive environment and stimulate enrolments

*"it must have students that love their school. Because I think students influence where they go to school, and it must have a point of difference in the market,"*

*"they identify with that school having, being the home for them"*

**Low staff resistance to change**

46% of survey participants identified good quality staff who are comfortable with and embrace change, seek continual improvement and stimulate an environment of learning and growth as a contributing factor to financial sustainability. A sub-theme which forms part of the school culture theme is to have staff with a low resistance to change.

*"teachers working alongside each other, peer review of their teaching practice. Which is all new, but it contributes to that environment of learning and growth."*

Cost cutting in schools can create a negative staff and school culture and with this comes a feeling of betrayal and mistrust and a lack of propensity to be forward looking.

*"you can't just automatically increase your revenue, so when it is cutting costs, the major costs in schools are staff, and then once you do that, then people's sense of security goes out the window. And then they don't become forward looking, you know? That's part of the problem, and also I think they feel that they've been betrayed, even though it's circumstances beyond your control,"*

Long term staff will have more resistance to change and make it more difficult for the school to adapt to changed circumstances

*"if you have staff that has been in the employment for a very long time, and that's what they want and that's what they know, and to make them change is very difficult."*

Positive interactions between staff and parents have a significant effect on school culture. Staff need a positive "can do" attitude to foster parent and student confidence and a willingness to remain at the school. Staff should value the parent.

*"the only thing I might notice as a parent is how well I'm treated when I pay my fees. How their business office, in other words how the business office actually interacts with parents and operates with parents. And if the business office doesn't have the capacity to offer me for example different ways of paying. Or they're not open to listening to my particular circumstances then I might have a question mark"*

To foster staff inclusion and lower resistance to change, school management should include staff in the school mission and strategy. Staff then have a better knowledge of where the school is going and what is required of them to achieve that. Staff that are change-ready are better able to assist in the execution of the strategy.

*"you've got people who are change ready. We've tried to keep people here change ready, but it's exhausting for them and for us I think. You've got to have people who are committed to, feel like a mission of the school, that they understand and they buy into why people want to come to the school."*

## Enrolments

Figure 2 indicates that 100% of interview participants mentioned enrolments as an important attribute/theme of financial sustainability and it is the fifth highest frequency of use by interview participants. Enrolments rank highly for most stakeholders but it is particularly important to banks.

**Enrolment trends**

A sub-theme which forms part of the school enrolment theme and used by 100% of survey participants is enrolment trends including the need for schools to have a market focus and consider internal and external factors that may affect enrolments. Also, forecast enrolment trends need to be reasonable.

Enrolment trends was the second most important individual factor, measured by frequency, identified by all stakeholders as contributing to financial sustainability. A stable or growing enrolment gives confidence to financial stakeholders.

*"and their attraction of students, because they need to have an ongoing enrolment base, otherwise again, they, they're not going to be sustainable"*

*"I always look at the enrolment history."*

However, interviewees particularly financiers, board members and management identified that it was important to not only look at overall numbers but also to have a sound understanding of the changing enrolment profile, for example senior classes completing their schooling and new enrolments registered for the coming year and the movement of enrolments through the years, for example year 8 moves to year 9, to assess confidence in the budget period under review.

*"Looking at it not just at a headline number, but across the grades. .. have they got a lot of numbers in the senior years, which are going to be leaving in the next couple of years, and then not getting intake at the bottom end. So that's a leading indicator that in a couple of years' time"*

*"we always try and get enrolments by year level and we try and get that for as many years as we can, and then we look at where they're forecasting to be"*

Interviewees noted that an important predictive indicator of enrolments is the level of enquiries and conversion. Schools should monitor enquiries and conversion to enrolments with significant changes investigated and acted upon accordingly.

*"data is gathered around enquiries, those that convert from enquiries into applications. Those that convert from applications into enrolments. …, but if we, if they notice, say, by June that it's really slowed down, that could be an indicator of change."*

Declining enrolments is often a signal of possible future financial distress especially if the enrolments have been growing and the school had been building, generally on borrowed money, to cater for the growth in enrolments. Enrolments are directly linked to gross income and if enrolments decline then income reduces.

When enrolments taper off or reduce and if the school is not able to adjust its expenses including reducing staff, the operating surplus will reduce and this can affect the school's ability to service loans. A declining enrolment trend may impact on bank loan covenants and cause the financier to seek further explanation. Schools must have a plausible plan as to how they will manage the decline in order to instill confidence in the bank that they can maintain adequate financial health.

*"one of the key covenants that we look to put in place is around minimum enrolments… We've had a lot of occasions where enrolments have dropped below that number, but then it's been a matter of, "Ok, how are you addressing that?"*

*"One thing we look at quite closely are enrolment trends. Because obviously your enrolments are where your income comes from, and how are enrolments growing or declining or stable?"*

*"there could be quite significant changes to the demographics and the numbers of students that will be coming through to be able to sustain their future viability, you know, and particularly if they're relying on growth to be able to fund their investment strategy and their infrastructure."*

*"Look one of the biggest things I see is you've got an enrolment shock, so you've lost fifty kids, fifty kids should equate to two staff, but we don't make people redundant … lack of taking remedial action, … Not looking at, at negative trends. … the enrolment trends, the staff, the EBITDA, their debt, you know, whatever. So you look at those trends and if you're not going to be financially sustainable"*

It was noted that adjustments in staff cannot be done quickly because a school employs staff in the preceding year in anticipation of budgeted enrolments in the following year. It takes time to adjust staffing to match a decline in enrolments. It is probable that in the short term the school will incur a reduction in operating surplus until staff can be adjusted accordingly.

*"In our budgeting, enrolment is the most important thing. If you don't have enrolment, but your staff is the same, you cannot reduce your staff just like that. … And suddenly your margin is lower, and then suddenly you cannot pay your debt when it falls due. So enrolment is so important"*

Clearly a sudden decline in enrolments raises concerns for stakeholders and they are likely to take a closer look at the school's operations, management to determine the underlying cause of that loss. Schools must understand and be able to clearly explain reasons to financial stakeholders

*"we would consider schools where there is a sudden drop in enrolments."*

Apart from the direct financial effects of declining enrolments, interviewees also identified that a declining trend in enrolments may concern parents because they may anticipate a reduction in staff resources and therefore the quality of the educational product being provided. It is important to communicate with parents, who are often time poor, to prevent adverse rumors causing further enrolment declines

*"Dropping numbers would concern me because I would be thinking not only why are they going but also what's that going to do to staffing levels and services and resources that are in the school. … gossip can get out of hand very quickly in a school and be very detrimental to the school. But that's where I think the school has a responsibility as well as the parents to be communicating in all sorts of different ways."*

Interviewees observed the importance of schools monitoring trends in enrolments and understanding why enrolments may be changing and respond accordingly. Schools must identify if it is external environment factors for example natural disasters, economic downturn or internal factors causing the decline. Internal factors are more of a concern to stakeholders because it is most likely associated with management and therefore could get worse unless there is a change in management.

*"if we can get comfortable that there are external factors impacting on enrolments, then we understand that, and would then try and understand how are you adjusting your operations to take into account... if it's internal, then that's a bigger cause for concern, because it could potentially get worse"*

*"So if they're in a metro school with declining enrolments when everyone else is telling us that they're bursting at the seams, it is a very clear signal that something's afoot…our biggest warning signal."*

In particular interviewees highlighted the management of Commonwealth funding as a factor for financial sustainability. If a school had a significant decline in enrolments, they may have been over funded at the beginning of the year and Commonwealth funding in October will be significantly less than budget. This needs to be well managed by schools otherwise it can cause cash flow and financial viability concerns. If there is a significant enrolment reduction and the school has been over funded, a debt may also be owed to the government and the school may have difficulty repaying the funding.

*"So because of that huge impact of enrolment numbers it's probably our largest indicator because if a school doesn't receive an October payment and they were expecting one there's going to be problems and that will then impact on their funding for the following year"*

*"if you've got a reduction then … risk of having a debt at the end of the year because at the end of the day you end up owing us $100,000 at the end of the year"*

Paradoxically, enrolments that grow too fast can also have an adverse effect on financial sustainability because the school needs to fund capital and operating expenditure to service the rapidly growing student population and this is usually done on borrowed funds. It also raises suspicion by financiers as to how sustainable the growth is.

*"you can have too much growth. Because that can put too much stress on facilities and teaching staff."*

*"Yeah because it can bring about.. early investment that wasn't anticipated."*

*"How sustainable is this growth? Is it going to continue or are the extra 20% of students we got last year, is it going to stop"*

**Demographics**

A sub-theme which forms part of the school enrolment theme and used by 69% of survey participants is demographics and monitoring changes in the local economy in specific demographic areas. Demographics of the school catchment have a significant effect on enrolments. Demographic analyses help to support budgeted enrolments and cash flows presented to stakeholders. A supporting demographic analysis will provide confidence to financial stakeholders.

*"things that influence on enrolments, and that can be around demographics"*

*"Yes (justification for numbers such as demographics is important) and it is easy to follow as well so if we look at this number A on the balance sheet is there a basis behind putting that in."*

It was proposed that schools should study the demographics of their catchment area for a period of at least the next 10 years. This will help inform the school on possible enrolment trends and allow the school to make capital investment and resourcing decisions in a timely manner. A demographic analysis should also incorporate an analysis of current and prospective competition from other schools – independent, catholic or State.

*"they need to have an ongoing enrolment base, otherwise again, they, they're not going to be sustainable, and that can be problematic, particularly in, you know, where there's demographic changes in their immediate area. So where, what would be their normal catchment area, the demographics can change over time, you know? 5 to 10 years is a reasonable term*

*"to some extent, competition is probably not the correct term in the schools sector. But what other schools are around, so that if parents have a choice to go to their school or a different one."*

Demographics can change rapidly in an area as a result of changes in local industry in the catchment area. So, it is important for the school to be aware of industry activities and likely changes in the future

*"in some cases that can be areas that provide services to some of those mining industries that are changing at the moment."*

Demographics in a school catchment can be volatile with school-aged children numbers increasing and decreasing as families come and go from the area due to work.

*"volatile communities that people are having to move in and out of because of work."*

Schools in regional areas are more susceptible to changes in demographics and local economic conditions and have less ability to respond to adverse changes.

*"in the capital cities, the schools have such big waiting lists that they can draw on those if there are adverse economic circumstances. Whereas regionally, that's more difficult. So they don't have any ability to react to some of these things."*

By a school understanding the demographics in their current catchment area and how those demographics are likely to change in the foreseeable future, schools can plan for changes to the services offered to capitalize on a niche offering for example sporting programs, boarding, the arts, use of alumni or church affiliation.

*"I've got a school, a long standing mature school, but their demographics around them have changed quite significantly, and they've gone from an area where there were lots of young families moving into the area, to now an area where most of the people have got kids that have now grown up and gone to uni, and empty nesters, and the school hasn't really changed to find a niche for itself and started operating differently to draw people either from the wider catchment, or to change the way they operate."*

## Service Quality

Figure 2 indicates that 100% of interview participants mentioned service quality as an important attribute/theme of financial sustainability and it is the seventh highest frequency of use by interview participants. Service quality ranks slightly higher for parents.

**Education quality**

A sub-theme which forms part of the school service quality theme and used by 85% of survey participants is maintenance of broad and quality educational offerings that are well resourced and reflected in student outcomes.

School registration with state governments requires an assessment of the adequacy of educational services. From government's perspective, if schools aren't providing contracted outcomes for which funding is being provide, then government will question the amount of funding provided. So, to be sustainable, a school must deliver adequate educational outcomes

*"The fact is if outcomes aren't received then the government will then question the amount of funding that is provided."*

The notion of value consistently appeared during the interview process. Independent schools are funded with a combination of parent and government funds. In a market-driven environment parents are looking at the quality of the educational product for the fees being paid.

*"Good educational programme. Because if you don't have a good educational programme you don't have a product to sell. So you're not going to be able to balance the books."*

*"Main reasons I identified would be the value proposition for parents, in terms, recognising that they are paying for a service. The quality of the educational program, the opportunity that it provides for students, and also financial risk management."*

However, it was also identified that while the quality of the educational product being provided to the consumer is important the school must match the product provided with the resources available. Given that sustainability represents multiple periods of viability, a mismatch between service and cost today indicates that in time the school will reach that point where it is not viable because it has depleted cash reserves.

*"they've got to have the facilities, and the quality teaching staff to be able to deliver a quality of education that meets the needs of current and future parents. So it's sufficiently attractive to retain parents, and to attract new parents, new students."*

*"if a school for 5 years might be top performance in whatever but if they are spending more money than to do that than what they're getting in revenue then after 5 years it stops doesn't it or something changes."*

Educational outcomes are a key measure of success for a school and a crucial attribute of the product being provided to the parents and students. But quality facilities and services and the achievement of the strategic plan are contributing to the ultimate educational outcome.

*"so in the school it should drive better facilities, better services, which arguably should drive better educational outcomes because parents can avail themselves to those products and services"*

Highlighting the need for quality educational outcomes, in one instance where a school closure was discussed, it was suggested that a contributing factor was that parents did not perceive they were receiving value for the dollars invested in the educational product offered by the school. This supports the need for good quality educational outcomes in order for a school to be sustainable.

*"the student outcomes have not been where they need to be."*

*"So what they're charging in tuition fees isn't seen by, and this sounds very commercial, but it isn't seen by the market as the same value as what's over here."*

## Facilities

Figure 2 indicates that 92% of interview participants mentioned facility quality and reinvestment as an important attribute/theme of financial sustainability and it is the single most mentioned attribute for the financial sustainability of schools. Facility quality and reinvestment is important to all stakeholders except the Federal Government. That is understandable because the federal government is focused on the current school year particularly the proper use of federal government recurrent funding for the provision of education services in that year.

Schools must maintain their facilities in good order because facilities are a visible attribute of the school to parents and students, who are their customers. Poor facilities can be an indication of weak financial health and cause a decline in enrolments.

*"schools who are hiding their lack of cash flow through using their depreciation are going to get found out eventually aren't they because ultimately their facilities will get to a stage where parents aren't interested."*

*"They weren't reinvesting in the school, and ultimately the school was, the only way I analogised it was the stench of death."*

Good quality facilities will help retain current parents and students and attract new parents and students. Parents are discerning with what they want for their money. Facilities help to demonstrate to parents the value of their investment in independent schooling - it is a visible aspect of the fees. This may also result in parents being less price sensitive regarding fees

*"Yeah, not only services but also in their facilities, their amenities. Parents are a lot more, what's the word? Discerning about what they want, and what they want for their money, particularly in private Schools and they want to, you know they need to... the schools need to be able to demonstrate that they are providing that for their parents."*

*"And also I think, when you've got nice facilities and parents can see where their money go, they're less price sensitive."*

School's need to be strategic in relation to the buildings they invest in. It is important to have sufficient general classrooms but once well established, consider other specialty infrastructure aligned with their strategic plan. For example, if they have a niche in performing arts, then they may need to prioritise appropriate facilities in the building master plan.

*"in time where you need to catch up and say look we've built a lot of classrooms but now let's build the science labs, let's build the performing arts centre, or the multi-purpose courts, because that provides a more rounded facility for the kids."*

*"Just reinvestment in terms of what they're doing, in terms of the conversations that we have with them and against their master plan."*

Good quality facilities are not an outcome in itself, but there is a belief that good facilities help to drive better services and ultimately better educational outcomes.

*"Yeah, so in the school it should drive better facilities, better services, which arguably should drive better educational outcomes"*

Parents are interested in the quality of school facilities. So, schools must continually reinvest in facilities to maintain financial sustainability.

*"but if schools don't invest in their facilities they will not be sustainable so you hear a lot of people say it's not about the buildings well that's not correct."*

It not just about reinvestment in buildings, but also a school must invest in general maintenance and technology. If schools underinvest in maintenance for a period of time it is a physical indication to parents that the school's finances may be weak and also it can be very difficult and costly to catch up.

*"you suddenly realised that the text books were broke, they were old and ratty, the computers were 5 years behind technology, the classrooms weren't painted"*

Maintenance and reinvestment in school facilities, however small, helps to build a positive atmosphere in a school and build the moral for staff and students.

*"do a building program, because they've got the finance to do it, and the whole place lifts in .., it's bizarre, but it does. You know, it can be a, even a small project can be like building a new sandpit in the primary school"*

Particularly when a school has new competition entering their market they must maintain their facility quality and reinvestment to retain and attract new enrolments.

*"particularly when you're in a market where there's new offerings, like new schools developing, with better facilities, it's very hard, I think, to attract new parents, let alone keep your existing ones if they can see what you're offering is deteriorating"*

Schools need physical facilities where parents and children feel safe and comfortable but also facilities that challenge the students.

*"I want a good safe environment. I want a comfortable environment for my children. But I want an environment that's challenging and exciting as well for children."*

Innovative infrastructure can send important intangible messages to stakeholders that the school is keeping abreast of changes in education delivery and therefore providing a top-quality educational product. Without that positive innovative message reassuring parents of their investment in independent schooling, the parent will look further and may question other parts of the school's offerings and value proposition

*"I want to see it even if it's not all classrooms immediately but that there's change going on. I want to see that my fees are growing at a rate which I can understand."*

*"it is very important to maintain and continue to develop new and relevant infrastructure that is, I guess, it looks nice. … But it's also relevant in the context of current way that education is being delivered"*

On a broader aspect, the location of the school itself can have an impact on financial sustainability. It is best if the school is located close to public transport and/or the school has ability to run private bus services to collect students. The school should also have good vehicle access and parking with minimal external traffic concerns.

*"if it's located in the wrong spot again technically it could be financially viable but is it sustainable"*

*"the degree of inconvenience associated with accessing the service ... Because I think .. one of our biggest challenges in terms of ongoing sustainability is actually traffic."*

## Staff

Figure 2 indicates that 62% of interview participants mentioned quality, experienced and engaging staff as an important attribute/theme for financial sustainability. Staffing was particularly important to parents which is understandable. However, it also indicated their relative importance to the State government stakeholder.

Staffing represents 78% of the total cost of operating an independent school, with 58% of that cost represented by teacher salaries[8]. So, the prudent management of staff is important for the financial sustainability of a school. To manage costs, schools need a mix of permanent and casual staff that allows flexibility for fluctuations in enrolments, staff on leave, job sharing and changes in educational offerings. This requires cooperation with unions and the drafting of flexible staff awards.

*"as much flexibility as you possibly can. … if the union had it's way, everybody would be permanent, you wouldn't have anybody on a contract. … the government itself realised that it needs some flexibility"*

*"you've got to have a couple of people who are on shorter term contracts, so we can have shared labour."*

The education service provided by the school is linked to the quality of staff that provide that service. Minimise staff turnover, engage in professional development and ensure staff are aware of developments in the education industry.

*"staff retention, expenditure on PD, engagement outside the school community, knowledge of staff - is one thing that I can pick up talking to staff members - are they really aware of what is happening out there in the education world"*

*"what programs it runs, the nature of the programs, the quality of the staff, the quality of its leadership. Ultimately it is a key driver in everything they'll do."*

Large staff turnover can be an indication to stakeholders that there is something adverse occurring in the school which may cause stakeholders to lose confidence in the school and result in declining enrolments and declining sustainability.

*"if you are seeing turnover in Board or senior staff that's more … it's indicative of something going on there, don't know what it is, but you can see that if there's constant turnover of teaching personal that there's a risk that the parents will actually start losing faith in the school and start pulling their kids out."*

*"staff turnover is another key indicator of potential financial stress"*

Sound financial health allows the school to employ better teachers, which in turn helps the school to be financially sustainable. Schools should avoid the downward spiral where financial health deteriorates, so staff quality and educational service declines and with it enrolments and deteriorating financial health.

*"Absolutely because if you're a financially unhealthy school you're not going to be able to provide the services that the parents would want. You may not be able to employ the best teachers."*

Parents expect that because they are paying school fees there is a good mix of experienced and younger staff and the staff can meet the needs for their children including specialist services that may have been advertised by the school.

*"But I'd certainly want experienced staff. I'd want to know if I had a child with particular learning needs I'd want to know what the school could do to assist them. And what kinds of specialist teachers they had. I guess if I'm paying fees I would hope for more services and better services than I would get in a State School."*

*"Yeah absolutely (staff and governance quality), because if they, if they're not retaining and building on the capacity of their staff, then they're not in a position to deliver a quality education, and therefore, you know, parents will see that results declining, or they'll go into the school and they'll look at the teachers and they'll say, "Well, I'm sure if they, they're going to be able to give my child a good education"*

It is important that staff are properly inducted into the school to understand school culture and can appropriately engage with and sell the school's attributes to the parent community.

*"really think about how you're engaging your parent community. It seems to me that one of the things that we do, not all schools but some schools do relatively poorly is we have an induction programme for teachers which sometimes can last 12 months or longer"*

It is not just the qualifications, experience and training of staff, but the positive attitude, engagement and passion of staff that has an effect on the outcomes and therefore the sustainability of the school.

It is important to engage staff in the school strategy and foster positive cultural capital which positively influences the execution of that strategy.

*"With that whole thing around employee disengagement, and I don't think that schools are shielded from that in any way, and if you look at high performance schools, it's, they've got staff who are passionate about what they're doing, passionate in the outcomes of the student, and maybe to a certain extent, a lot of the work that they're doing is considered voluntary. It's over and above what they're already doing now. And they talk about in workforce planning around strategic roles in organisations that basically tap into what can be considered a point of difference, and at the moment you see that in schools where staff are adopting innovative ways of teaching, of learning and teaching for students."*

## 4.4 Leadership and management

Included in the category of Leadership and Management are the attributes of budgeting accounting and reporting, strategy, management quality, and stakeholder management.

[8] ASBA/Somerset Non-Government Schools Financial Performance survey 2015 school-year

This is consistent with existing literature which, although it tends to focus more on financial ratios as predictors of financial failure/ success, also mentioned that it is important that strengths and weaknesses are actioned on by management and changes made to realise the gravity of the situation in time to avoid failure (Altman,1968). Altman also advocated that causes of financial failure include management incompetence 47%, lack of managerial expertise 27% and unbalanced experience 18% (Altman, 1984). The existing literature however does not expand on the specific management and governance attributes that would be expected to be present, but this been be discussed in the following analysis of interviews.

Further literature noted the importance of how effectively the school monitors and evaluates performance, diagnoses its strengths and weaknesses and takes effective action to secure improvements as an important attribute when evaluating financial sustainability (Jung, 2002). Literature has also questioned whether a change in the chief executive officer or board chair is likely to result in an increase or decrease in capacity and sustainability (Bowman, 2011).

The importance of good governance is recognised by the Queensland Audit Office in their assessment of the Queensland Grammar schools. As part of their auditing procedures they consider the influences of the internal and external environment on the ability of the school to maintain financial health and how the schools shape their businesses and position themselves to remain sustainable. So, the governance framework and procedures are very important when assessing financial health and going concern (QAO,2016).

It is also asserted that good board composition and effectiveness as well as competent leaders are required to adequately deal with internal and external environments including the development of appropriate strategies to buffer from environmental disturbances (Helmig et al., 2014).

From the interviews, five significant sub-themes emerged under the core theme of Leadership and Management. An analysis of these sub-themes follows.

Leadership and management is important to most stakeholders, but particularly important to bankers, government and peak bodies.

## Board Quality and governance

92% of survey participants referred to board quality and professionalism as an important attribute of financially sustainable schools and it is among the highest scoring attributes mentioned by stakeholders. Stakeholders see the financial outcomes of a school as a function of the board and governance systems and in particular the skill and ability of the board members.

*"the financial viability is not enough in its own right, because if you don't have good governance internally within the school and within the governing body, then it can mean nothing. … then they can't then deliver the quality of education …"*

*"If I was to start painting a picture I wouldn't be painting a financial picture, I'd be painting a picture of good governance and a competent board … I wouldn't be couching it around financial indicators …. It'd be around the competence of the people running the school,.."*

The average independent school had debt of approximately $4 million and turnover of approximately $10 million in 2015 . This is a significant business which requires a mixture of business skills at board level. Stakeholders are therefore particularly interested in the business qualities of school board members and the governance systems that are in place to ensure the proper stewardship of resources. A school needs board members with expertise in the areas required to run the school business and who are able to gather the required data to make informed decisions and ask the right questions of management. It is also important all board members feel they have the opportunity to contribute to take advantage of board expertise.

*"we were looking at good governance, good board as one of the key criteria in providing funds…If you have a good board that is very business savvy that understands school finances … that gave the bank a lot of satisfaction.."*

*"so you see boards that have got people that have a deeper insight, make a great contribution. But often it's good checks and balances in the senior management team as well"*

*"You know, where you might have, like, some boards with a very dominant person and the other people are just passengers. Or other boards are more effective where there's open debate and consideration."*

However, interviewees also noted that although a business focus is important it is also important that board members understand school business and be able and willing to balance the competing commercial and educational demands. There must be a balance between the commercial, educational and not-for-profit principles that underlie the school.

*"They've got to, they've got to know schools. Yes business experience is fine, but you've also got to know schools."*

There was recognition that where a board is lacking in particular skills, those skills should be supplemented by external advisors or by coopting people with required skills onto appropriate committees of the board.

*"But the expectation is to be well governed you need to recognise what skills you don't have and have a way to access people or resources that do to buy into it to balance that out to help. "*

However good board composition is only part of the equation. The board must have processes in place that harness the collective skill of the board members with a focus on achieving the strategic objectives of the school. For board members to gain a deep insight into the operations and ask the right questions, they need accurate and timely information flowing from management to the board. Boards will be assisted with the right policies and processes in place to help respond to external and internal factors in a timely manner. Meetings must operate in


an efficient and professional manner including a well-structured agenda and adequate and timely board papers. It is also crucial that the board responds on the information and adapts the school's operations accordingly. A sustainable school is one that can respond to changes in circumstances. There is a difference between receiving and discussing information and then acting upon it.

*"Well I think it's to be proactive. I think I would want to know that my Council knew the right questions to ask of its administration and was getting the right information from its administration. So that it was confident of the financial sustainability."*

*"I think it's around having robust governance, structures, policies and procedures in place. Because then having those in place allows you to react to external factors, internal factors and respond in ways that will maintain the financial health."*

Interviewees identified that this is particularly important when difficult decisions need to be made. For school boards to make decisions in the best interest of the whole school community that sometimes means making difficult decisions now, that are best long-term interests of the school. This also requires good management of conflicts of interest, which is discussed further below. So, it is not about being popular, but about being objective. Again, having the right information helps board members make those difficult decisions, for example a staff restructure to reduce costs in response to a decline in income.

*"I think sometimes also key decision makers make decisions that they think in the short term may be popular, or it's just too easy. It's easier to make that decision and conceive something that is to fight the good fight. But they suffer for it later. I mean, examples would be having an EBA that's just dysfunctional. I've seen that, and they've conceded with good things in the EBA, which you've then got to live with, which clearly can't work."*

The regeneration of the board was also noted as an important factor for financial sustainability. Boards require high quality people with a breadth of experience. But also, it is important to have a board succession plan to re-fresh participants and keep members actively participating and not passive passengers.

Boards should consider a maximum term for board membership to encourage refreshment which helps stimulate a culture of innovation.

*"But certainly we will have more confidence if we do look at a board and they have good quality people with good experience, a good breadth of experience across the board, and then also where there's some turnover in the board as well. … for schools that have small number of board members, who have been, or have been on the board for 20 years, that typically is not going to drive culture of innovation."*

There was recognition that smaller and regional schools may find it harder to recruit board members with the necessary skills because there is a smaller pool of people available to choose from and that schools at different stages of development will need different board skills

*"Well with these small schools they were based on a couple of people who ran out of steam.... small schools and schools in regional areas, they struggle in terms of regenerating the board, getting a breadth of expertise and knowledge on the board as well."*

*"It's interesting but sometimes you can have a board that is good in growing but it is not necessarily the right board when it is falling"*

## Strategy

92% of survey participants referred to the importance of good strategic planning to achieve the school's vision and mission and having the ability to execute the plan as important attributes of a financially sustainable school.

Although independent schools are NFP entities they need to act in a business-like manner and strategize accordingly. Interviewees identified that being financially sustainable includes the ability to understand the market and build an effective strategic plan that has a five to ten year focus.

*"So the must haves are …… I place a lot of value on having a good business plan that stipulates how they're going to get from point A to point B."*

*"Yeah that's right, (achieve their mission) so if they're intending to be in business for a while, then they need to be sustainable over the long term, so they should be looking, you know, 10 years plus in terms of their, you know, in terms of their strategy."*

A well-structured strategic plan highlights the school's strengths and weaknesses, opportunities and threats (S.W.O.T.) which include key internal and external risks. Different boards and individual board members will have different risk tolerances and thresholds. It is healthy to have a mix of thresholds, otherwise if the board was primarily risk averse it may tend to focus on the short term, but if it consisted primarily of high risk takers, that may result in financial distress. The school must have strategies to maintain strengths, overcome weaknesses, capitalise on opportunities and manage threats.

*"if the business plan talks about what the key risks are to their business and how they're going to overcome them then that's a good sign because that shows they've put a bit of thought into that."*

Interviewees recognised that the strategy must be realistic, logical and defendable to convince stakeholders on the quality and achievability of the strategy. Strategy must then be understood and valued by the school community.

Strategy should therefore be supported with underlying research, for example demographic changes to the school catchment, competitive analysis, cost increases. And strategies and action plans must be logically linked.

*"Yeah and I suppose to complement all that, it's to having a game plan that's seen to be, that's seen to have the capacity to have that perpetual succession."*

*"Ok, so my list of things. Strategy vision that is valued in the community. A financial model that supports the strategy, including appropriate staffing, resourcing, and facilities."*

Strategy helps prepare for the unexpected which may or may not have been identified in the S.W.O.T. analysis. These changes in circumstances could be internal (so within control of the school) or external. Having a plan to deal with a risk if it becomes a reality will provide comfort to the stakeholders regarding sustainability.

*"So the school was completely unprepared to deal with this sudden turn the tap off for cash, that's a strategy thing …"*

*"They've got to have long term plans to ensure that, and you now, if they're not reactive to market forces they won't be sustainable."*

With increasing competition in the education market from State schools, an independent school's strategy must incorporate a sustainable competitive advantage together with strategies on how to maintain and develop it. What are the unique elements of the school that encourages enrolments and what is the strategy to keep that occurring?

*"I think more and more Independent schools need to be very conscious about why they are and about their niche and their contributions. Because if they don't have that clarity of purpose, moral purpose as well they're going to find that their selling points are not there for people into the future. "Why would I spend X amount of money a year if I can get a really good product for nothing?"*

The necessity for school boards and management to understand their strategy and make decisions commensurate with that strategy was recognised by interviewees. A school is not able to monitor and make strategic decisions if the board and management don't have that deep understanding.

*"If they had a very clear vision for the school. If the Council and the senior administrators were very clearly able to articulate its vision, their vision for the school. Where it was going. Then that would give me confidence."*

*"That when you are making your decisions on the board around budget planning, financial decisions what are the forward strategies for the school you've got the information you need to make a proper decision."*

Interviewees recognised that newer schools without an operating history will find it harder to convince financial stakeholders of their ability to achieve strategy. However, recruitment of an experienced board and management will help mitigate this disadvantage.

*"With a new school it is a lot more work in looking at their viability in terms of can they execute on their business plan or their forecast. Whereas with a mature school you've got… obviously you've got a track record …"*

*"Highly experienced management, but also a proven track record around sound strategic plans"*

## Management quality

Most survey participants referred to the need for quality management including a competent level of financial literacy and also having good financial processes and systems in place as important factors contributing to the financial sustainability of schools.

School governors are ultimately legally responsible for the school's financial health. However, governors require good operational managers, including the principal, business manager and the senior leadership team, for the sound day to day operation of the school and to execute the strategic objectives.

It is an advantage for a school to have good governors, but good governors with poor management can result in poor financial performance.

*"…schools that we've been monitoring for, you know, up to 3 years, largely because of poor management, you know, poor financial management, by the management of the school, not necessarily by the governing body,.."*

*Interviewees reported that in a practical sense, stakeholders are more likely to questions and blame management for the poor financial performance of a school. The difference between success and failure of a strategy is in the execution of that strategy though sound day to day management. The quality of the principal and their financial literacy skills drives good management and financial sustainability. Stakeholders look for evidence of sound financial systems and good historical performance by management when forming an opinion on the quality of management.*

*"Sustainability is about, good management, so strategic as well as day-to-day financial management."*

*"So good management but also their track record, you know they've got to be able to act."*

*"…and I reckon one of the key ingredients is having a principal who's financially literate"*

Interviewees also noted that if a school gets into financial difficulty, with sound management they can generally trade through. Skills that were viewed as important were the ability to understand and interpret financial results and provide commentary to the board in a manner that will help them make informed decisions.

*"If you got the right management you can trade through it."*

*"…Yeah, and being able to provide a reasonable commentary for when there are variations as well. So understanding what is different. Why are we not following the budget."*

*"Yes I think that the senior management, the CFO, the principal, whatever the arrangement is, obviously they need to be skilled and competent."*

This ability to deeply understand and interpret financial reports and explain them to the governors is influenced by the qualifications and continual professional development of the management team. It is important therefore that the management recruitment process stipulates minimum levels of qualification.

*"Yes I think that the senior management, the CFO, the principal, whatever the arrangement is, obviously they need to be skilled and competent."*

*"The other ones which I guess are really, really well intentioned people, really passionate about the school just don't have the skills, experience and don't access skills experience."*

*"So where typically we had a, what was called a bursar, then became a business manager,... But it's sort of shifting from a person that started in a business office at a school, worked their way up"*

Mutual respect and a good working relationship between principal and business manager is an important contributor to financial health. The principal must understand and respect the financial consequences of their decisions. Equally the business manager must respect that the ultimate objectives of the school are not financial. Because finances are the enabler, a good working relationship between these two key roles will help balance competing educational and financial demands. The principal and business manager should be experts in their respective roles and have some mutual awareness and input into the execution of the other's role.

*"Well, I suppose there's always hopefully a happy balance between the principal and the commercial manager, in our case. Sometimes the commercial manager will say, "Look, fantastic idea, but these are the financial implications of this"*

*"… but it is quite interesting that when you do talk to those business managers or something from those type of schools you have conversations around how they operate and it sounds really slick and well-oiled organisation and it's not just the wealthy school."*

**Willingness to restructure**

77% of survey participants referred to management's willingness to acknowledge changes in the market and school business and to carry out a controlled restructure to maintain or re-establish operating efficiencies in a timely manner.

It is important to build confidence in the school's financial stakeholders, in particular government funding authorities and banks, that the school governors and management have the skill and capacity to adapt to changed circumstances and if the school does not have the required skill to identify a potential financial problem, or is not sure about the extent of a problem, they should engage profession help to assist with early warning, clarifying the nature and extent of issues and suggest strategies.

*"So either act on it or get the right people in to consult and act on it"*

*"But they have to, the first thing is, they have to acknowledge that they've got a problem, and spend the money that they need to spend to get good financial and legal advice. So they know what they've got to do, and then make the decisions that they need to do."*

Having said that, interviewees also commented that the board and management must determine if the changed circumstances are temporary or permanent to avoid taking unnecessarily drastic changes too soon and exacerbate the problem.

*"You might look at it and say, "We just see it as an aberration" you know? That is not, then we'd be taking action immediately. So it's those early warning signs I think that you need to respond to."*

*" if you cut too hard in that initial phase, you actually reinforce the problem, and you actually, what we, it's like a doomed spiral the school gets in, because they've got financial difficulty, they cut their programs, but because they've cut the programs, more kids withdraw, which makes the problem worse, and it just suddenly goes, bang, bang, bang, bang, and so…"*

However, if after due investigation and advice it is confirmed that the school does have a problem which requires action to adjust operations, it is important that the school board and management acknowledge their responsibility to take appropriate action.

*"I used to liken it to my previous place, a train is coming down the track, you can see it coming down the track, get off the track, you know? Just amazes me sometimes, people either don't see it or just imagine it's going to disappear at the last second, and then they find themselves with a major problem."*

Interviewees were of the view that when there is a change in circumstances the school should be open and transparent with stakeholders about the situation and have a clear plan to respond to the change in circumstances. This will engender stakeholder confidence.

*"….we're not inclined, … to go heavy handed on a school that looks in trouble if they come to us and say they're a bit shaky but their doing AB and C to try and rectify it … and they give us confidence that this has thrown us off but this is the plan …"*

Stakeholders will also consider the school's historical record with respect to managing change. Have they previously proven that they are prepared to make changes when necessary. This promotes stakeholder confidence in the school's ability to deal with changing situations.

*"Yeah Board's willingness to innovate and adapt to changed circumstances, and also responsive to previous circumstances if we're aware of any. …and how they've managed that as well, that's a very strong indicator for us."*

If the changed circumstances are sudden, unexpected and out of the school's control, stakeholders are usually willing to support the school particularly if the school has not brought the problem upon themselves through poor management.

*"something hits you out of left field that really puts you in financial stress. That has happened and our programme supported those schools to keep themselves afloat while they adjust to whatever the changed circumstance was."*

*"..assessment on whether the schools current financial difficulty is unexpected, if you have got this long trend of unpaid school fees or other debtors and I guess no evidence that the school sought to address that in a way."*

### Board and Management relations

A less frequently identified factor, but still used by 46% of survey participants, is to have a healthy relationship between the board and management.

*"…and the decision makers (principal and board), and sometimes the two don't mix."*

We have previously discussed the importance of a positive and innovative culture in the school community and the flow on effect this has to all stakeholders. Stakeholders need to feel confident in the school's ability to deliver. Parents want confidence that the school will deliver an excellent education for their children and financial stakeholders want confidence in the school's ability to prudently use the funding they provide. Much of that confidence is made visible through the actions of the people in the school. The culture of the school tends to flow from the top down. So, if there is perceived unrest at the top – board and management, that can flow through the school all the way to the parents. Stability in governance and management personnel will help foster a positive relationship.

*"Even at that stability if you are seeing turnover in Board or senior staff that's more … it's indicative of something going on there… there's a risk that the parents will actually start losing faith in the school and start pulling their kids out. … we have seen in certain schools that have come up on our radar for various things that quite often there is a churn of top people and you do think that's had an impact on the educational outcomes but it sort of cascades."*

If governors and management are settled, that also settles the school staff. They feel the school is being well governed and managed which fosters job security and good culture.

*"Yeah, (culture of governors, management and staff) to me it is important that they all work together towards, everybody wants to have financial health…. So that if you know that the school is financially healthy, you know that you have job security."*

School boards must manage conflict of interests to ensure decisions are made without bias and in the best interests of the whole school community. That can sometimes be compromised for schools because often board members include parents of the school. Schools must minimize this conflict by the appointment of independent board members, and minimise parent representation on the board.

*"Sometimes there's a little bit of a lack of independence though, like, they're always an old lawyer and all girl so there can be sometimes, and often they've got children at the school as well, so they can often be very sort of short term focused."*

## Budgeting, accounting and reporting

Figure 2 indicates that 100% of interview participants mentioned budgeting accounting and reporting as an important attribute/theme of financial sustainability and it had the third highest frequency of use by interview participants. Budgeting accounting and reporting theme is less important to peak bodies, state government and parents. But it is particularly important to insolvency practitioners, auditors, owners and the Federal government.

### Reliable budgeting

A sub-theme which forms part of the budgeting accounting and reporting theme and used by 85% of survey participants is reliable budgeting. Interviewees identified that there must also be a logical and clear link between the strategic plan and the budget. So, for example, if there is a strategy to invest extra educational resources in certain areas, how is that reflected in the budgets?

*"So, in my opinion, that's driven very much by a robust strategic plan and strategic financial plan. So, linking both the strategy with how it's going to be achieved."*

The preparer of the budget must have a sound understanding of the school and its operations to build reliable budgets. Further it must be based on reasonable assumptions and as best as possible based on history, known facts and strategy

*"I'd say the big difference there is precise budgeting versus inaccurate budgeting, and understanding your business model enough to be able to do that."*

*"but you've got to have very robust assumptions on that as well…. based on history or based on known facts."*

Interviewees identified that the time horizon for budget preparation can vary. For newer or higher risk schools where there are expected changes in the school's risk profile, a shorter budget timeframe may be more suitable

*"So we, at the moment, work with a 10 year plan. But in some, for some of our schools, we are looking 2 to 3 years. Particularly where there's been changes in risk profile, and changes in the data that they're using. But we also, in the case of a new school, we would very much concentrate on initially the first 5 years, and then stretch out from there."*

Budgets are less reliable for new schools because of limited or no historical performance upon which to base estimates. Users of budgets will consider past performance to help assess the reasonableness of future performance. So, without historical performance, this sense checking is not possible so reliability of the budget is reduced.

*"With a new school it is a lot more work in looking at their viability in terms of can they execute on their business plan or their forecast."*

However, the usefulness of an extended budget period of say 10 years is questionable other than providing `confidence to financial stakeholders as to the competence of school management. They do not expect that budget to be overly reliable for that period, but it sends a positive signal to stakeholders that management have good governance and planning processes in place.

*"…you probably wouldn't put too much weight on a 10 year budget, just because how much can change in that time, and even government funding models, they're not assured for that long. …. But the fact that they are budgeting and planning that far ahead provides confidence in terms of their governance strategies."*

In terms of budgets being based on reliable information enrolments were seen as key. Enrolments are the major driving factor behind budgeted income and expenses. Enrolments determine total income, staffing and other resources required to service the demand. It is important to accurately predict enrolments using history as well as demographic data about the school's catchment. Governors and management must understand the change in demographics and how that may impact on future enrolments. A study of enrolment patterns by year group will help to identify future enrolment changes, for example if larger cohorts are completing their time at the school and these are being replaced by smaller cohorts, enrolments may trend down.

*"So in terms of enrolments, and there may be changes in their enrolment patterns, the demographics, other schools in the area."*

*"if you've got, like, a low cohort in year 9, and a massive cohort in year 12, well you know, you're not really, you should be looking at the 2 year and 3 year projection, not to last year's results. Because those kids are finished in 6 months."*

Per student income flows to an independent school are quite predictable and crucial in the budgeting process. Assumptions regarding large increases in per student income streams indicate an unreliable budget. Trend analysis of income per student is therefore a useful tool in assessing reasonableness of budgets

*"It's very clear what the Commonwealth's annual contribution to the school is for a given year, … and they know exactly what they are going to get from the state, history suggests what their private fund raising capacity is from parents and other sources"*

*"Yes the trend is important. .. we tend to take the enrolment number then what they are getting in for a student fee and do a check that what they're saying they're are going to get in their revenue side is actually reflective of what they've got in their enrolment side."*

It was also noted that budgets and projections are used by stakeholders to assess the point at which schools become non-viable so it is crucial that the school knows what measures and thresholds the stakeholders will use to assess financial viability and sustainability and build those tests into the budget tool. The school can then plan how to resolve any financial concerns and prepare a response to the expected questions from the financial stakeholder.

*"we will ask for cash flow statements basically till the end of the year and that pretty much would give us an indicator of when they'll stop being able to meet payroll. In essence and that's when we would say they are no longer viable"*

*"…, if we could, say for example, say 12 months out, you know, 12 to 18 months out, this school is at risk, is at high risk of failing financially, then that would help us."*

It is important to build confidence in the stakeholders that school management have the necessary skills to build reliable budgets. Management can demonstrate this by having a well-qualified and experienced business manager who has a detailed understanding of the budget, and being well prepared for questions, including the timely provision of supporting information. Without that confidence, stakeholders are not able to make well-informed decisions.

*"at the end of the day what is your budget based on … we ask for additional financial information also ask for management*

*Rivderside Adventist College*

*information … it's surprising how many schools come back and say "hold on, we need to prepare this" and we are like well…"*

*"… That when you are making your decisions on the board around budget planning, financial decisions what are the forward strategies for the school you've got the information you need to make a proper decision."*

**Budget to actual comparisons**

A sub-theme which forms part of the and budgeting accounting and reporting theme and used by 46% of survey participants is the importance for schools to compare actual to budget performance on a regular basis and act accordingly.

*"performing schools would be looking at where they set their plan, and how they're performing against that plan."*

*"good reporting back against those budgets. How, are we actually tracking?"*

If the school has a good history of achieving budgets, this provides confidence to stakeholders of the school's ability to meet current budgets.

*"Yeah, so certainly we do look at what was the budget they gave us 2 years ago, how did they attune to that budget, what was the budget they gave us last year, how did they achieve to their budget. … having that past history of over achievement, we can take some confidence in that."*

Financial stakeholders expect schools to be able to provide monthly actual to budget comparisons in a timely manner.

*"we always ask for up to date financial information… give us your cash flow and your budget position actual verses budget work it out monthly and it's surprising how many schools have difficulty doing it."*

Budget to actual monitoring and providing clear and appropriate commentary on variations helps inform governors and management to plan mitigating action.

*"…and being able to provide a reasonable commentary for when there are variations as well. So understanding what is different. Why are we not following the budget"*

*"(comes back to budgeting and reporting) And responding accordingly"*

**Accurate and timely accounting**

A sub-theme which forms part of the budgeting and accounting and reporting theme and used by 69% of survey participants is the need for accurate and timely accounting.

## Generally, schools that are financially problematic have poor financial records.

If governors and management cannot rely on the financial information, problems may not be identified in a timely manner and misinformed decisions made in response.

*"..to the extent that you can rely on their financials. I mean, the ones, the schools that we've looked at, or the schools that have been more problematic, actually haven't had good financial records."*

It is important for information to not only be accurate, but also timely. Although audited financial statements are trustworthy they are generally received six months after year end, so that means eighteen months of trading has taken place before that accurate information is received on the trading year just completed.

*"But you know, you don't want to be sitting there waiting for the next 15 months to see the audited accounts to come in. You'd rather have an opinion now."*

*"if it were possible to be able to identify a range of early warning signs, ... So you're not going to be able to do anything unless you've got good quality, access to good quality financial information."*

Financial information must be presented on a regular basis usually at least on a quarterly basis, but preferably monthly. Governors and management should set a policy specifying a reporting timeline for the year.

*"It's very surprising sometimes where we ask for additional financial information … how many schools come back and say "hold on, we need to prepare this"*

*"and then it is monitoring its financial position on a regular basis, and we'd sort of tend to look at that on a, certainly a no less than quarterly, but probably a monthly basis."*

It is important to have evidence to satisfy financial stakeholders that school management is well prepared and has adequate accounting and reporting procedures in place. This will build stakeholder confidence in the school's ability to competently manage the finances.

*"., and you have sustainable if you have proper financial management in there as well. You know, you have to put in procedures and system in place and you also have to be reviewing, the board reviewing it. So that you have an accountable financial management. It's really important that, to become sustainable. Because if you're not disciplined, that can easily derail your financial viability."*

Governors should compare the final audited accounts against the final management accounts for the year, as well as the auditor's adjustments to identify the extent of changes. If there are material differences, then governors should question the accuracy of management accounts presented throughout the year and the competency of those preparing the accounts.

*"If they give us a version of accounts, their first version of accounts, we compare that to the final version that I sign. We make a comparison of how many errors we've found, what changes, and timeliness."*

Smaller schools are more likely, but not always, to have less sophisticated and inadequate accounting and reporting systems and are likely to be to be less financially sustainable.

*"it's typically the smaller schools … that, who we see struggle to provide us information, and largely they're the ones that we would*

*have more concern about as being less financially sustainable as those performing schools."*

**Reporting**

A sub-theme which forms part of the and budgeting accounting and reporting theme and used by 54% of survey participants is for schools to have effective and disciplined reporting processes. Although closely associated with the accounting sub-theme, this theme focuses more on the reporting process and formats.

Governors and management should be aware of the factors that affect their sustainability and ensure reporting is tailored to monitor performance against critical factors. Good reporting and disciplined monitoring procedures help to instill confidence in the school governors and other stakeholders about management accountability.

*"When you look at, you know, the governance, and the ability of a board or senior management team to monitor a school, and what they're getting to monitor it, they're as aware as we are of their sustainability issues."*

*" You know, you have to put in procedures and system in place and you also have to be reviewing, the board reviewing it. So that you have an accountable financial management. It's really important that, to become sustainable. Because if you're not disciplined, that can easily derail your financial viability."*

Reporting should include comparisons with board policies and performance thresholds together with other schools to better inform board and management decisions

*"The boards often don't know. They don't have a reference to, like, what are we comparing to?"*

Governors must set appropriate key performance indictor thresholds that provide guidance to management concerning expected performance. This process simplifies the on-going reporting.

*"key performance indicators, you know, we, some schools don't, they don't want to look at what all the expense line items in the budget. They basically say to the principal, keep the KPIs right, and we don't care about the rest. Because the KPIs we've set will mean that the school is long term sustainable."*

Once the board has settled on reporting formats and KPIs, the information must be calculated and reported in a consistent manner. This allows for trend analysis.

*"and the other thing I said there was just the consistency of reporting to improve the quality of the benchmarks in the trend analysis."*

Again, monitoring by the school board and senior management must happen at least quarterly and preferably monthly to assists financial sustainability

*"and then it is monitoring its financial position on a regular basis, and we'd sort of tend to look at that on a, certainly a no less than quarterly, but probably a monthly basis."*

## Stakeholder management

Figure 2 indicates that 100% of interview participants mentioned the good management of stakeholders as an important attribute/theme for financial sustainability. There are a number of sub-themes forming part of stakeholder management including school reputation, student welfare and positive parent awareness. I will consider these together in this part of the analysis. Stakeholder management is particularly important to parents.

The government will have somewhat of a short-term financial viability, rather than the long-term financial sustainability focus. Schools must ensure all government recurrent funding is spent in the year received and not held over for future reinvestment. The reinvestment funds therefore come from parent fees. Therefore, governments will be particularly interested in ensuring public money is spent on the provision of education in the year provided and, if a school needed to close, did the students receive the required service and were funds appropriately applied and are there adequate cash balances for an orderly closure of the school?

*"… the needs of government (in terms of this area) is slightly different to all those other groups … it's more about political protection about the use of government taxpayer funds"*

The parents and students however want to ensure that the school is meeting their needs over the term of their education, which could be thirteen years. If the school can't, they will take their business elsewhere. Parents, and therefore school governors and management, are focused on the product/service and the educational outcomes to assess long-term sustainability.

*"I think sustainability is a bit of a different concept. Sustainability is about a school meeting its market needs, so again a school could be very financially viable but if it is not providing what its community wants it may not be sustainable"*

*"If you're charging 25 grand a year, and not meeting your mission, and you've got piles of money at the bank, they'd be saying, "Yeah, financially you're ok, but you're not really"*

*"educating a student from day one to end of school is 13 years so stability is very important and clearly to exist you have to be financially viable"*

It is important also that schools focus on meeting the changing needs of future parents as well as the needs of current parents.

*"they've got to have the facilities, and the quality teaching staff to be able to deliver a quality of education that meets the needs of current and future parents."*

Schools must have mechanisms in place that gather the needs and wants of the various stakeholders and respond accordingly. Schools need to be careful not to just communicate to stakeholders, but to appropriately engage with stakeholders in a two-way environment.

*"if you look at newsletters they're all one way. They're all about what the school's doing and not necessarily listening in return."*

This is particularly important with parents who are the ultimate customer/partner.

It is important to explain what the school is providing and how that is being funded so that parents can make a connection between the fees they are paying and the value proposition they are receiving.

*"I think fees are critically important. And I think that as a parent I am concerned that fees would seem to be rising each year faster than CPI. And I don't understand as a parent why that is because to me CPI is the pressure that's on me so why is schooling exponentially growing in its fees? I think the schools need to provide parents with good information about how fees are set and why"*

Some schools meet with parents and staff to explain the school's current position and their plans for the future. Transparent communication with stakeholders can pay good dividends for a school.

*"parents and families...meeting where they might put a whole lot of issues that the Council are starting to look at to the parents to get their views. They would talk about school fees. They'd talk about programmes"*

*"I've been to a few (stakeholder meetings) .. and they're really good .,.. they just nip things in the butt because suddenly you've got an informed parent group. Instead of an uninformed who still make it up because they want the information. So you may as well make it up from, you may as well have the facts to start with."*

Reputation management is also a crucial part of stakeholder management. If schools are perceived in a positive way by stakeholders, this can support the financial sustainability of the school. Stakeholders are looking to gain confidence in the school's ability to respond to their needs.

*"if I see my Principal driving a very, very expensive car I'm going to wonder is that the best use of my school fees. And so I want to know that the most important thing is the educational programme of the school."*

So, it is important to manage the reputation because a poor reputation in the market can adversely affects enrolments and the financial stakeholder's perceptions concerning sustainability.

*"it might be that their reputation is so ruined that parents are never going to enrol back in that school again, or it could be that the business is just not viable financially"*

Perceptions and reputations can be real or rumoured, so clear and open communication with stakeholders with the facts can help foster positive stakeholder relations and sustainability.

*"… that could just be a rumour that … and we have actually in the past had .. a rumour that a school was going to close and suddenly they had one third of their kids disappear"*

For schools that are part of a school system, the reputation of that system and individual schools in that system, can have a flow on effect to all those system schools.

*"Systems are as strong as their weakest members in a way. The risk to reputation of brand in a system is much greater than it is with an individual school"*

Aligning multiple stakeholders including parents, financiers, staff and students with the mission of the school, and balancing the competing needs of those stakeholders, will greatly assist the achievement of the school mission, and if strategy is correct, the ultimate sustainability of the school.

*"You've got to have people who are committed to, feel like a mission of the school, that they understand and they buy into why people want to come to the school. It should be the same for both staff and for students and parents, really. They want to operate in a school that's focused on the welfare of students for example. That's different to operating in a school where you're just interested in getting results, and you're operating a sausage factory. It's a different thing. I'm not saying they're mutually exclusive, but where the main emphasis is, and if you've got the people who are aligned with that, then it pretty well runs itself"*

## 4.5 Stakeholder definitions of financial sustainability

The final question asked at the conclusion of each interview was for the interviewee to define a financially sustainable independent school in their own words. This question was intended to highlight the factors at the forefront of the interviewee's mind when they consider the assessment of an independent school's financial sustainability.

All but one interviewee mentioned the importance of strategic planning and a focus on the school's ability to achieve its mission as a necessary attribute of a financially sustainable independent school. So, consistent with the evolution of literature (Rottkamp 2016), the non-financial drivers are as important and the financial outcomes when in the assessment process.

*"So really it comes back a financially sustainable independent school is one that can continue to provide its education mission in a sustainable way"*

*"strategy vision that is valued in the community"*

Every interviewee mentioned, in some form, the importance of ratios and benchmarks including comparative and trend analysis to assess financial and operational performance.

It is important that schools are living within their means and are operating at a cost that is consistent with similar schools. The comparative and trend analysis helps identify and quantify operational strengths and weaknesses which facilitates data-driven, well-informed decisions. Schools can then develop strategies to maintain strengths and address weaknesses.

*"I think, sometimes in independent schooling we run into trouble. Because we can get too far away from what's normal"*

*"operate within acceptable margins"*

*"one that gears its resources, and therefore its expenses up to meet fairly demand"*

*"Decision making that's data driven rather than gut feel"*

The outcome of good management and alignment of expenses to income is the production of an adequate operating surplus. The school must be sufficiently "profitable" to sustain all financial commitments but also to fund growth and development.

*"And when we say sustainable it has got to be at a profitable outcome"*

Ninety percent of the interviewees mentioned that it is important for schools to not over borrow and that they have adequate operating surpluses to service debt. The adequacy of the operating surplus facilitates debt serviceability.

*"obviously it can meet its debts as and when they fall due"*

The operating surplus should also facilitate the maintenance of adequate cash reserves and working capital after meeting all financial commitments. Ninety percent of interviewees mentioned the importance of adequate cash reserves. But these cash reserves should be measured after meeting all other commitments including reinvestment in facilities and other initiatives that grow the school.

*"So working capital, sustainable growth, poor record keeping, so you have to have good record keeping, reasonable debt, reasonable profitability"*

*"not just a master plan for buildings, but a master plan for their school"*

*"it's based on the ability to meet all of your financial commitments, and have a sufficient surplus at the end of that to allow for the school to grow and develop"*

*"make sure that you've got sufficient working capital for a sustained period of time"*

If we go back a step before measuring the financial outcomes, if the school is not maintaining or growing enrolments, income and operating surplus may decline. So, it is crucial that schools understand their market, the needs of stakeholders and ensure the education services offered meet those needs in order to maintain and/or grow enrolments.

*"A school that offers education to a community at a price that would cover all costs with a long term view"*

*"they know their target market, they're adaptive to change"*

*"and have the market for that (the right product) as well"*

*"So one there'd be demand for and enrolment numbers would be adequate because that's the top line revenue that's important"*

However, even if enrolments are not growing, or maybe even declining, the ability to embrace innovation and the school's willingness and ability to adapt to changed circumstances, has a significant impact on its sustainability. So, schools can still be sustainable in a declining market.

*"you've got to be at the forefront of innovation, whether it be delivery of your service or your product to your kids"*

*"A learning community, which invests in ongoing learning and innovation, and the capacity to respond to changing market conditions and possible disruption"*

So, consistent with the evolution of literature and with what has been discovered throughout the preceding analysis of attributes and factors, financial sustainability is dependent on a mixture of non-financial and financial factors. Usually it is the non-financial attributes that underwrite the ultimate financial outcomes.

*"So that financially sustainable is about more than just finances, it's about, you know, that whole encompassing thing of management, your market, your strategic plan"*

## 4.6 Sustainability time frame

I devoted part of the interviews to discussing what timeframe stakeholders considered as reasonable when trying to assess a school's financial sustainability. Is financial sustainability a point in time assessment or should we consider the relative sustainability of the school on a range or scale? There was a general consensus among the stakeholders that financial sustainability is on a continuum. It is difficult to identify a point in time where a school will not be sustainable, apart from the point where their liabilities exceed their assets and they are unable to pay their creditors on time.

*"Yeah, gosh, what is the definitive point? Well when your current liabilities exceed your current assets"*

The concern with the previous government initiated financial health assessment framework was that that the assessment was too definite and abrupt and did not consider all the factors that are necessary to adequately diagnose financial health.

*" it has to be a continuum and that was part of the problem with the financial health assessment, it's so sudden"*

Generally sustainability should be measured on a continuum with many warning signs in a lead up to the point where a school is insolvent. The warnings include declining enrolments and financial performance and management not acting to adapt to those changed circumstance.

*".. it's usually on a continuum because usually you've got warning signs and stuff happening which haven't been addressed. So you come into a point in time where you say the financial sustainability is probably no longer there."*

Sustainability is the achievement of multiple periods of viability. So, if a school is temporarily unviable, it is important for management to make changes to bring the school back to viability. If they do that, then they may remain sustainable.

*"a lot of it is financial obviously, but it's also management, you know is the school a viable proposition right now? Sustainability is the continuum of viability."*

Because sustainability is on a continuum, it is important to have the correct indicators to assess sustainability, because the wrong assessment can precipitate the cessation or restriction of government funding and result in the financial failure of the school.

*"the approach is as we have information to give us concern about the viability, sustainability of the school we move to that varied payment schedule."*

In terms of a time frame over which sustainability might be considered there were different perceptions from stakeholders. Government stakeholders are more concerned with the school's short term ability to properly use government grants and to not fall into financial difficulty before year end. So, they focus on short term of within 12 months.

*"as a department our primary concern is ensuring that schools a) meet the commitment for the year and that they trade out the entire year"*

Similarly, the school auditor has an obligation to inform the reader of financial statements about the school's going-concern which looks at the period 12 months past the audit date. So, their assessment also is also relatively short term.

*"Well the audit itself is actually only the 12 months, the current 12 months, and then we also assess the next 12 months with the going concern"*

Other stakeholders identified much longer time frames for up to 13 years.

*"educating a student from day one to end of school is 13 years so stability is very important and clearly to exist you have to be financially viable"*

*"it is a straight 20 year contingent liability so if we provided a building worth $1m their contingent liability decreases over that 20 years life period"*

*"I guess we're looking at, in terms of capacity to repay debt"*

So there can be a disconnect between some stakeholders views on the required period for financial health and the needs of other stakeholders

*"So there is a bit of disconnect there because governments will always look at a point in time, they don't work on timeframes"*

Historical trend analysis is also important to stakeholders as it provides know facts about the school's performance. Analysis of the five-year trend in financial performance is sufficient time to gain confidence in the average maintainable performance of the school. The Net Operating Margin is particularly important as it helps to establish maintainable operating surplus.

*"Absolutely. If the ratio's been negative for the last 5 years, I would make a comment in my report"*

*"Yeah we are looking at the 5 year average"*

*"Yeah, (we look at their EBIDA over time) so what we do now is we have 3 years of trend analysis for the school in question, and we line that up against benchmarking comparison against like schools"*

The general consensus from the majority of stakeholders is a five to ten-year view of financial health is necessary when assessing financial sustainability. But that can vary depending on perceived risk.

*"So we, at the moment, work with a 10 year plan. But in some, for some of our schools, we are looking 2 to 3 years. Particularly where there's been changes in risk profile"*

The analysis indicates that stakeholders would look at up to five years of historical information to provide a base of known facts about performance, and five years of budgeted financial information, beyond that the material is too unreliable.

## 4.7 Summary of attributes

The major stakeholders that have an appropriate and sufficiently informed influence on the financial sustainability of an independent school include banks, Federal and State departments of education, owners, parents, school governors and school managers. Students are a major stakeholder have a less informed influence.

The attributes of financial sustainability are summarised in three classifications and a number of sub-classifications. The content of each are briefly summarised as follows;

**Classification 1: Financial Attributes**

Ratios and benchmarks

All participants stated the use of comparative and trend analysis of ratios as important when assessing financial sustainability - in particular, net operating margin, staffing, expense and income.

Comparative benchmarks should be tailored to individual circumstances and be used to identify and quantify strengths and weaknesses.

Analysis of enrolment trends by year group is important.

Use trends in fee discounts and debtors to identify parental financial stress or dissatisfaction.

A five-year trend best identifies a school's average pattern of performance. This applies to past and future (budgeted) ratios.

If profit and net operating margin is too low that will inhibit financial viability and sustainability, in particular, the ability to service debt and replace assets.

78% of school expenditure is salaries and therefore schools must manage staff numbers in accordance with enrolments.

Low student/teacher ratios relative to similar schools' indicates possible financial stress.

If enrolments reduce, to maintain relative expenditure per student, staff numbers should reduce. This requires flexible employment contracts.

Schools must respond to an increasing trend in expenditure per student.

As a rule of thumb, wages as percentage income should be less than 70%.

Schools must balance the financial realities with educational objectives to ensure an appropriate balance between financial and educational stakeholders when making management decisions.

Schools must monitor and manage income sources and socio-economic status of the parent population. If parent capacity to pay reduces, the school should consider a restructure to reduce costs.

School management must understand the mix of fee and grant income as well as reliance on international full fee-paying students.

Schools must monitor competitor schools and fees.

The discretionary nature of benefactor income increases the risk of a sudden drop in income.

New schools will generally have higher debt per student and no trading record so are therefore are higher risk.

Cash Flow

Operating cash flow must pay for day to day expenditure and leave an adequate surplus to fund debt repayment and asset replacement which allows schools to grow sustainably.

Schools with healthy operating surpluses are better able to manage reductions in trading performance.

Management and governors should be aware of seasonal peaks and troughs in cash flows and monitor actual to budget performance monthly.

Good debtor and discount management will have a positive effect on cash flow.

School boards must ensure debts are being paid in full and on time, especially statutory obligations, otherwise this is an indication of poor financial viability.

Schools should receive an affirmative going-concern assessment from their auditors, otherwise cash flows may be insufficient.

Use a five-year trend in cash flows to help predict future cash flows.

Cash Reserves

Cash reserves provide a buffer to call upon in the event of a downturn in income. As a guide, schools should maintain cash reserves equivalent to three months of expenditure.

Schools with and aging staff profile and/or aging buildings may need more cash reserves because cash outflows are more immanent.

Ensure current assets exceed current liabilities, otherwise there is a risk the school may be insolvent and unable to pay debts as and when due.

Discretionary support of benefactors is a risk to be managed.

Debt and Debt Servicing

Good management of borrowing capacity and debt serviceability is important for financial sustainability.

Because of the specialist nature of school assets, borrowing capacity is based on predictable operating cash surpluses sufficient to service loans. Debt levels are a function of operating surpluses.

Stakeholders should consider a school's ability to service debt from operating surpluses over a period of five years.

Loan covenants generally include minimum enrolments, maximum debt per student and debt servicing ratios. Schools should stay well within covenants.

Average debt per student is $7.600 in 2015.

Use interest cover and debt servicing cover ratios to assess debt serviceability. Banks general required a minimum interest cover ratio of 2 to 3 times.

Debt should not be incurred to fund operating expenses.

School board and management culture must respect debt repayment obligations.

### Classification 2: Non-financial Attributes

School culture

Schools should have a culture that is positive, honest and embraces innovation.

For a school to be forward looking requires innovative board members and principal and staff with a healthy mix of innovative thinkers. This can be fostered through continual professional development.

Innovation should be visible to parents through progressive improvement in facilities, pedagogy, newsletters and other parent interactions.

Schools should ensure a cascading of the school's innovation and strategy to staff so they are equipped to engage with parents.

Innovations is not restricted to educational offerings and should extend to office and other systems.

School culture must include a willingness to adapt to changed circumstances.

Schools should monitor trends in enrolments, finances and key ratios to identify changing circumstances.

A change in enrolments generally precipitates and need to change operations which requires a good working relationship between education and financial stakeholders within the school. Schools must manage cost cutting carefully because it may have an adverse effect on culture.

Maintaining facilities in good order creates a positive welcoming environment and a sense of school pride – school values match parent expectations.

School pride is made visible through facilities, professionalism of staff, governors and student actions.

Positive culture and students who love their school will have a positive influence on enrolments.

Schools need staff with low resistance to change to enable it to adapt to changed circumstances. This may be harder with long-term staff.

Enrolments

Schools must have a market focus and consider internal and external factors that may affect enrolments.

Enrolment analysis must include a sound understanding of the changing enrolment profile by year group.

Monitoring enquiries and conversion is an important predictor of enrolments.

Declining enrolments is often a predictor of pending financial stress and therefore requires a plan to manage the change including adjustment of expenses in a timely manner.

Declining enrolments may have an adverse effect on parent confidence which must be managed accordingly.

A significant decline in enrolments may result in repayment of government funding.

Paradoxically, enrolments that grow too fast may cause financial stress due to the need for capital facilities.

Schools should base their plans and budgets on a 10-year demographic analysis of the enrolment catchment, including proposed new schools.

Boards must be aware of changes in local industry (for example mining) because this can have a significant and rapid impact on demographics and therefore enrolments.

Service quality

Schools must maintain broad and quality educational offerings that are well resourced and reflected in student outcomes.

Management and governors must be aware of, and deliver on, the value proposition in response to fees paid by parents.

School must reconcile offerings to fees and not commit a level of service that exceeds their ability to fund these in a sustainable way. Live within their means.

Facilities

Good quality facilities are a visible attribute of parental fees, positively impact on education delivery and outcomes, and will help retain and attract new enrolments.

Schools must align facility investment to school strategy.

Facility investment includes scheduled maintenance which helps to build a positive atmosphere and positive moral of staff and students.

Parents and children need to feel safe, comfortable and challenged by facilities. Innovative infrastructure can send important intangible messages to stakeholders and help to build positive school culture.

Schools are best if located in an area easily accessible by private and public transport.

Staff

Staff represent, on average, 78% of total school recurrent expenditure. So, prudent management of staff is important for financial sustainability.

Quality staff are linked to quality educational services. Adequate professional development for staff will help to maintain quality and innovation.

Minimise staff turnover otherwise this can be an indication to stakeholders of something adverse in the school culture.

Sound financial health enables employment of quality staff.

It is important for staff to be properly inducted into the school, including the school strategy, so they can understand the school culture and appropriately engage with parents and other stakeholders.

**Classification 3: Leadership and management**

## Board quality and governance

Financial outcomes are a function of board quality and governance systems to ensure proper stewardship of a school's physical and human resources.

Board members should include a mix of business and education qualifications, and other skills, be able to gather the right data, ask the right questions of management and make informed decisions.

School boards must be willing and able to balance competing commercial and educational demands.

Where skills are lacking, boards should supplement with external advisors.

Accurate and timely information must flow from management to the board to enable accurate, informed decisions that respond to changed circumstances in a timely manner.

Good quality policies and procedures will help the board to respond to internal and external factors in a timely manner.

Policies should include conflict of interest to ensure decisions are always made in the best interests of the school.

Good boards understand the required mix of skills, have a succession plan and a maximum term for board members.

Schools in smaller and regional communities may find it harder to recruit board members with the necessary skills.

## Strategy

Schools must act in a business-like manner, understand their market and build an effective strategy that has a five to ten-year horizon.

Strategy must include an analysis of financial and non-financial strengths and weaknesses plus internal and external opportunities and threats.

Strategy must be supported by underlying research including demographics, competitive and cost analysis.

Board and management must understand their sustainable competitive advantage and unique elements that attract enrolments to their school.

Performance against strategy must be monitored by board and management.

New schools without a trading history should recruit experienced board and management to help mitigate this disadvantage.

## Management quality

School management require a competent level of financial literacy skills and good financial processes and systems which is influenced by the qualifications of senior management and adequate professional development.

The principal requires sound financial literacy skills to drive good management and financial sustainability.

Good management will help a school to trade out of financial difficulties.

Mutual respect and a good working relationship between the principal and business manager is an important contributor to financial health.

It is an advantage for a school to have good governors, but good governors with poor management can result in poor financial performance.

Management must be willing to acknowledge changes in the market and school business and carry out a controlled restructure, when required, including engaging professional help to re-establish operating efficiencies in a timely manner.

A history of management's ability to adapt to changed circumstances promotes stakeholder confidence.

Because good culture is important, and that generally flows from the top down, it is important to have positive and effective board and management relations.

### Budgeting, accounting and reporting

There must be a logical and clear link between the school strategy and budget.

Budget must be prepared by someone with appropriate business qualifications and sound knowledge of the school and be based on history, known facts and strategy.

Demographics and enrolment are a major driver of income and expenditure. Therefore, governors must understand changes in demographics and the likely effect on future enrolments.

A trend analysis of key income and expenditure ratios helps assess budget reasonableness.

Budgets are less reliable and therefore higher risk, for newer school's due to lack of trading history.

Management must provide monthly actual to budget comparisons in a timely manner including appropriate commentary on variations to help governors and management plan mitigating action where required.

Schools with poor financial records and accounting procedures are generally financially problematic. So, it is important that financial information is timely and accurate.

A comparison of the annual management accounts with the audited accounts will help assess the likely accuracy of monthly management reporting.

School should have agreed reporting policies and timelines.

Smaller schools may have less sophisticated and inadequate reporting systems.

Governors should set policies and key performance indicator thresholds and receive regular reports (quarterly or monthly) against progressive achievement during the year as well as trends over multiple periods or years.

### Stakeholder management

Government stakeholders are particularly interested in the application of government recurrent funding on the provision of education in the year received by the school. Schools therefore must ensure government recurrent funding is not carried forward to be spent on property, buildings or any matter not directly attributable to the provision of education.

Governors and management must understand and meet the needs of parents and students through clear, transparent and open communication. To do this, schools must engage with, not just communicate to, parents and students.

Poor reputation can have an adverse effect on enrolments and therefore sustainability. Reputation management can be more difficult for schools that are part of a school system because the system reputation can be transferred to individual schools.

Aligning multiple stakeholders including parents, students, financiers and staff with the mission and strategy of the school can help to balance competing demands.

### Stakeholder definition of financial sustainability

Stakeholders were asked to succinctly state in their words how they would define a financially sustainable independent school. All mentioned ratios and benchmarks including comparative and trend analysis as an important tool.

Crucial attributes include a focus on mission, understanding their market and stakeholder needs, and therefore maintaining enrolments, income and operating surpluses adequate to sustain all financial commitments plus adequate cash reserves.

If enrolments decline, schools that embrace innovation and have a willingness to adapt to changed circumstances are more likely to be financially sustainable.

Financial sustainability is a continuum and can be viewed as multiple periods of viability. Viability is more likely assessed over a twelve-month period. Sustainability is best assessed over a five to ten-year period.


*St Hilda's School*

# Chapter 5: Conclusions

This chapter identifies the purpose of the research and the major findings of it. It also discusses the implications of the findings before detailing limitations of the study and offering avenues for further research.

## 5.1 Purpose of the research

In 2015 there were 1091 independent schools in Australia representing at least twenty different affiliations plus non-affiliated schools, servicing 587,000 students and their families. Forty four percent (44%) of their recurrent funding was provided by government, with the remaining fifty six percent (56%) provided by parents and other private sources. Capital investment in new buildings and equipment was funded fourteen percent (14%) from government grants and eighty six percent (86%) from private funds (ISCA, 2016). Total school debt is estimated to be in excess of $3 billion. (ASBA/Somerset, 2016).

In 2011 the Australian Government introduced a financial health assessment framework for non-government schools that used ratios and benchmarks to assess financial viability. The government was concerned with the protection of public money. Failure of the tests indicated financial vulnerability and resulted in suspension of government funding until a plan was agreed to meet the benchmarks and prove financial viability. The system was found to be unreliable in identifying financial vulnerability and was suspended.

In recent times, there have been a small number of independent schools fail financially and were forced to either close or be taken over by other institutions (Mowbray College 2012, Acacia College 2012 plus others). Apart from the considerable disruption to the students' education and loss of public confidence in the sector, school failures potentially put financial pressure on government schools to absorb both children from schools that fail and children whose parents have lost confidence in the independent system. Governments (State and Federal) are very sensitive to these failures as they are often a catalyst to expressions of concern about the accountability for government funds expended on the schools, the ongoing funding of non-government schools and paradoxically the pressure put on government schools to absorb both children from schools that fail and children whose parents have lost confidence in the independent system.

The purpose of this qualitative study is to define and describe the attributes of a financially sustainable independent school in Australia as generally accepted by the following major stakeholders – government regulatory bodies, financiers, owners, parents, professional advisors, school management and sector peak bodies. This study is also motivated as a proactive solution in preparation for any potential return of some type of financial health assessment framework for independent schools by comprehensively informing the development of any such new framework.

Literature concerning the assessment of NFP financial viability has evolved to indicate that KPIs alone imperfectly measure the effects of diversity and therefore their predictive capacity for ascertaining potential financial failure was low (Dollery 2006).

Literature now supports the assessment of financial health for NFPs being based on context, trends, financial and non-financial factors (Rottkamp, 2016). Research specific to the financial and non-financial attributes of financially sustainable independent schools is lacking, so this qualitative study directly accessed prominent stakeholders to uncover these factors together with a proposed common definition.

## 5.2 Summary of findings

There were six major findings from this research. First, there was common agreement between the interviewees as to which financial stakeholders were concerned with the financial sustainability of an independent school. This confirmed the stakeholder groups selected for inclusion in this study were accurate. There was common agreement that although students were a major stakeholder, they were more a beneficiary than a financial stakeholder who could have, or indeed would want to have, an informed opinion on the school's financial sustainability. The parents on the other hand were an interested party as they seek to protect their financial contribution and also their children's education.

Second, it supported the existing research that stakeholders are as interested in the non-financial attributes as they are in the financial attributes of independent schools when making an assessment of the school's financial sustainability. All stakeholders indicated that schools need to understand their product, have a market focus and monitor the trend in enrolments because this ultimately drives income from fees and grants and therefore significantly influences the operating surplus and financial sustainability. Closely associated with this is the influence that educational service quality plays in the retention of enrolments, which in turn appears associated with staff quality. Although this has a link to financial outcomes, the next most sited attributes, used by ninety two percent (92%) of the interviewees, included a school culture that supports adaptation to changing circumstances, having quality facilities, and also a high quality and professional board with an appropriate mix of skills.

A much-discussed attribute was the school's ability to adapt to changed circumstances. This attribute had the second highest frequency of use and discussions often turned to the fact that it's the school's ability to reduce costs and adjust trading in response to reduction in enrolments that makes the major difference between sustainable and not sustainable operations. So, even in a declining enrolment environment, schools can be sustainable if the culture supports adaptation. The use of ratio and benchmarks including an analysis of trends in performance was also sighted by 92% of interviewees as a crucial attribute. But interestingly the discussions quickly turned to the ability of school governors and management to understand and use this information to make data-driven and well informed decisions. Again, this is dependent on a qualitative assessment of governor and management skills and practices.

Third, and quite predictably, the stakeholders confirmed the importance Financial attributes and in particular of a strong operating surplus (profit) in order to fund facility reinvestment, debt servicing and also replenish cash reserves. The earliest research indicated that organisations are a reservoir of liquid assets, which is supplied by inflows of cash and drained by outflows of cash. The cash reservoir serves as a cushion or buffer against variations in cash flows. So, the size of the cash reservoir, size of net cash from operations (profit) and size of debt are important factors affecting financial health (Beaver 1966). This was supported by the stakeholders of independent schools who confirmed the importance of positive cash from operations, reinvestment in facilities, ability to service debt and maintaining adequate cash reserves and working capital in order to cushion variations in trading.

Fourth, Leadership and management are important attributes of financial sustainability. The importance of reliable budgeting, accurate accounting and good reporting systems was identified. This indicates that a school can have a competent board and management and a culture that is willing and able to adapt to changed circumstances, but if the information upon which those decisions are to be made is coming to governors and management too late and/or it is unreliable, then it is not possible to make well-informed decisions.

Fifth, the final question asked of stakeholders at the conclusion of each interview was to state, succinctly in their words, how they would define a financially sustainable independent school. The outcome was consistent with the detailed analysis of themes and sub-themes and included financial, non-financial, strategic, market, human and cultural attributes. It was well summarise in the following quote

*"So that financially sustainable is about more than just finances, it's about, you know, that whole encompassing thing of management, your market, your strategic plan"*

Sixth, as evidenced throughout the analyses, although there was a significant level of agreement among the stakeholders concerning the attributes of a financially sustainable independent school, there were some differences between stakeholders as to the relative importance placed on some factors. Banks placed a relatively higher importance on governance, facilities, cashflow, cash balances and benchmarks. Auditors and insolvency practitioners placed a higher importance on benchmarks, budgeting and accounting and cash flow. Parents placed a higher importance on stakeholder management and services. While governments placed a relatively higher importance on governance.

## 5.3 Contribution to research

Research to date on the financial sustainability of NFP's acknowledges that it difficult to define financial success. As opposed to for-profit organisations where success can be measured on the quantum of profits and return on investment and equity, that is not the focus in NFP's. Research of NFP's agrees that it is the ability of a NFP to maintain its services and sustain its mission that determines its success. It is not appropriate to say one NFP is more successful than another because the lowest performer relative to others may still be sustainable, Dollery (2006).

My research has confirmed that financial sustainability of independent schools is related to mission achievement and sustainability which is somewhere on a continuum. However, it

did extend that definition to confirm that the point at which an independent school cannot pay its debts as and when due is a definitive point for lack of financial sustainability.

By developing a definition and identifying a comprehensive list of attributes associated with a financially sustainable independent school, this facilitates the use of these attributes by schools as warning signs to assess relative financial sustainability. It is beyond the scope of this study to attribute a weighting to these attributes, but this has set a solid foundation for such a study. The identification of these attributes has made a significant contribution to the research topic and specifically for independent schools in Australia.

## 5.4 Implications of the research

Chinese general Sun-Tzu provided the following to his warriors "If you know your enemy and you know yourself and you need not fear the result of a hundred battles. If you know yourself but not your enemy, for every victory gained you will suffer a defeat. If you know neither the enemy nor yourself, you will succumb in every battle."(Clavell, 1983).

Taking this analogy to the independent school's sector, a school must understand and prioritize the needs of stakeholders, identify and quantify strengths and weaknesses to set and execute a strategy for sustainability.

This study confirmed who the important financial stakeholders are for an independent school and then went on to identify a comprehensive list of attributes that they look for when making a determination about financial sustainability. There was a significant level of agreement among the stakeholders concerning the attributes, however, as expected, there was some variation about relative importance of attributes.

An independent school can be viewed as a reservoir of liquid assets (Beaver, 1966). To be sustainable, the school must maintain or expand its services, and to do this requires reinvestment. The reservoir is used to fund reinvestment, and/or the servicing of debt that was generally incurred for reinvestment in the first instance. The school also needs to have resilience to occasional economic shocks, and this resilience requires the ability to call on the remaining reservoir during an economic downturn (Bowman, 2011).

So, the rate at which funds flow into the reservoir from operating surpluses must exceed the rate at which funds flow out. The reservoir should grow by at least the rate of inflation, because for each year that passes, the cost of reinvestment increases by inflation (Bowman 2011).

There was common agreement among the stakeholders that financial attributes were important when assessing the sustainability of an independent school. These financial attributes included analysing income, expenditure, staffing and profitability ratios and comparing trends in a school's results as well as comparative performance against similar schools. This process helps to identify the school's strengths and weaknesses. How competently a school performs, affects operating cash inflow, the drain of cash to fund debt and reinvestment, and the resulting cash reserves. Financial attributes essentially measure the ability of a school to fill, the rate at which it uses, and the residual cash added to, the cash reservoir.

Consistent with the latest literature, the stakeholders also identified a number of non-financial attributes that they consider when assessing sustainability. These included a school culture that was innovative, future looking and willing to adapt to changes in the internal and external environments. They also identified the importance of enrolments, quality service, staff and facilities.

Finally, the stakeholders agreed on the importance of good quality leadership and management to enable mission sustainability. Factors considered included good governance, strategy, management, accounting, reporting and balancing the competing needs of various stakeholders.

A significant outcome of the study is the identification of a comprehensive list of financial sustainability attributes which provides a soundly researched base for further study. It is beyond the scope of this study to determine the relative importance of the attributes in determining the sustainability of independent schools.


Considering the suite of identified attributes, and attempting to condense them into a single, succinct definition of a financially sustainable independent school, I propose the following definition

***"A financially sustainable independent school responds to stakeholder needs by using strengths, managing weaknesses, generating adequate operating surpluses to fund debt, reinvestment and cash reserves, identifies changing circumstances and adapts in a timely manner."***

The consensus is that school sustainability is best assessed over a period of 10 years including five years of history and five years of budgeted data. But sustainability is somewhere on a continuum, it is difficult to identify when a school becomes unsustainable other than the point where they are not able to pay debts as and when due. But there are many warning signs, which if identified and actioned upon in a timely manner, should prevent financial failure.

It is not so much how financially sustainable a school is, because the least financially healthy may still be sustainable. But sustainability does turn on a school's ability and willingness to adapt to changing circumstances.

### Limitations of the research

This research has provided a qualitative understanding of the attributes of a financially sustainable independent school as generally accepted by the major financial stakeholders. However, in any research there will inevitably be limitations.

Semi-structured interviews are led by the responses of interviewees, and so may represent a biased perspective of individuals, decisions and events. The recorded interviews were transcribed and interpreted by the researcher so there are limitations with respect to the researcher's interpretation of results and also researcher bias.

## 5.5 Future research possibilities

The findings of this study provide a rich foundation for further research in the independent school sector. An extension of this study could be a quantitative survey of the attributes identified by this qualitative study using a database of over 1,000 independent school business managers, financiers, owners and other key industry stakeholders. An empirical study of that nature would help determine the predictive ability of the identified attributes in the assessment of the financial sustainability of an independent school.

Since independent schools are NFP organisations, this research also provides a foundation for further research in the NFP sector more generally.

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# Appendices

# Appendix A: Interview Field Report Form

## Interview – Field Reporting Form

**Research Question:** ***How do major stakeholders define, and what are the commonly agreed attributes, of a financially sustainable independent school in Australia?***

| | Information | Comments |
|---|---|---|
| Details of Interviewee<br>• Name<br>• Organisation<br>• Position<br>• Stakeholder group<br>• Gender<br>• Qualifications | | |
| Date | | |
| Location | | |

**Permission to record and use data form:**

The domestic student research team commitment: We commit to ensuring that any comments you make in this session will be reported anonymously and that your privacy will be protected at all times in the process.

| Participant name | Signature: I agree that it's OK to record this session & to use the data | Your nationality | Age category. (18-25, 26-35, 36-49, 50+) | Your email (to receive a copy of the study result) |
|---|---|---|---|---|
| 1. | | | | |
| 2. | | | | |
| 3. | | | | |

Permission granted to record and recorder turned on?

**Question 1 Who are the stakeholders concerned with financial wellbeing of Independent schools?**

| Participant | Question responses | Non-Verbal observations (physical, voice tone, facial expressions etc) |
|---|---|---|
| Name<br>Gender ___________<br>Age group _________<br>Stakeholder_________ | | |
| Name<br>Gender ___________<br>Age group _________<br>Stakeholder_________ | | |

| | |
|---|---|
| **Question 2** | **Is financial health of a school an end in itself, a means to an end, or both?** |
| **Question 3** | **Why is financial health important to the school, you and your organisation?** |
| **Question 4** | **Do you see a difference in financial viability and sustainability or is there another term that is important to you and explain your reasoning?** |
| **Question 5** | **Is timeframe of financial health important – eg short-term verse long-term and explain your reasoning?** |
| **Question 6** | **What factors, measures, hurdles are currently used in making this judgement? Financial, operational, cultural, infrastructure, benchmarks and trends, enrolments (increase, decrease, rapid growth)** |
| **Question 7** | **What factors indicate that a school is NOT financially sustainable?** |
| **Question 8** | **What do you notice about accounting, budgeting, reporting practices in sustainable and failing schools?** |
| **Question 9** | **Is financial sustainability a definitive point or somewhere on a continuum? If on a continuum, at what point would you consider it unsustainable?** |
| **Question 10** | **What are the “must haves” and “nice to have” qualities/factors?** |
| **Question 11** | **Impact of culture of governors, management and staff – willingness to adapt Can this be sensed?** |
| **Question 12** | **How do you define a financially sustainable independent school in Australia?** |
| **Question 13** | **Other matters?** |

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