An Engagement Framework for Managing the Crown's Ownership Interests in the New Zealand Tertiary Education Sector

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Abstract

Monitoring and managing the effective stewardship of the Crown's ownership interests in the New Zealand Tertiary Education Sector is being achieved through integrating a suite of recognized performance assessment methodologies into an operational system that will enable more timely and effective intervention to either protect or enhance the Crown's ownership interest. The core analytics and tasks comprise financial stress testing, the Baldridge assessment approach and capability benchmarking, integrated into an overall risk management system using many of the elements of Robert Simons "Levers of Control". The Framework has a singular performance measurement focus, a reduction in the number of institutions requiring statutory Crown management, with a target of zero.

Keywords: engagement framework, crown residual ownership risk, intervention

Introduction

The Crown has a significant ownership interest in the Tertiary Education sector in New Zealand. This is expressed primarily through assessing the ownership risk surrounding the ongoing financial viability and sustainability of the Tertiary Education Institutions (TEIs) and the overall education system. The higher the ownership risk, the higher is the likelihood of the Crown being required to inject capital and intervene in the governance of the effected institutions. Measuring, monitoring and proactively seeking to have managed, through influence and advice, those factors shaping ownership risk is a critical task of the Tertiary Advisory and Monitoring Unit (TAMU) which resides within the tertiary sector funding agency, the Tertiary Education Commission (TEC).

This paper is written with the objective of communicating with practitioners in the field in the expectation the authors can benefit from the leanings of fellow travelers. Accordingly the paper:

- outlines the engagement framework to identify and performance manage the Crown's ownership interests in the New Zealand Tertiary Education Sector;
- presents some preliminary analysis arising from the framework deployment;
- discusses insights gained from the deployment of the framework to date: and
- offers some thoughts on the future development of the framework.

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* Chief Business Adviser, ** General Manager. The opinions expressed in this paper are those of the authors in their personal capacity as professionals with a strong interest in performance management and do not necessarily reflect those of the TEC.

Framing the Challenges

In designing the Engagement Framework, the authors deemed it critical to describe the attributes of the desired future state, a state that would enable institutions to readily adapt to changes in their environment as so enhance the likelihood of business sustainability. This section draws heavily on the work of the Beyond Budgeting Round Table (BBRT) and the insights contained in its published work by Hope (2006).

In doing this, the framework to be designed is embedded in a change management context. As is evident from Table 1 below, the future state represents a significant paradigm shift and one which will continue to challenge both public policy makers as well as those charged with policy delivery.

Aspect	**Current**	**Future**
Emphasis	Risk – minimising the Crown's residual liabilities	Optimisation- maximising the Crown's strategic outcomes
Time Frame	Short/medium term	Medium/long term (especially given capital asset management considerations)
Success	Viability	Sustainable value creation
Managerial emphasis on TEIs	Control	Self Governance
Performance Management	KPIs, support control	Balanced Scorecards, support organisational learning & continuous planning
Risk Propensity	Low	Higher, with stronger emphasis on identification and mitigation
Culture	Low Trust, Rules based	High Trust, Self Governance
Engagement	At some distance	Partnering
Analytical focus	Historically orientated	Strategic and Agenda setting
Resource allocation	Budgets central to process, fixed resourcing	Rolling forecast central to process, dynamic resourcing
Adaptability (of ITPs)	Slow	Shifts quickly to market & policy changes
Sector behaviours	Compliant, observing the rules	Committed and aligned to outcomes
Benchmarking	Target setting	Catalyst for continuous improvement/organisational learning
Strategy	Is a destination	Is a direction

Table 1: Emergent Change

Integrating the above aspects into an appropriate framework demands an unrelenting approach to systems disciplines. In particular, systems thinking, systems design and systems implementation, all the while trying to anticipate what might be the unintended consequence (negative feed backs) of poorly designed interventions.

Framework Design

The framework described here comprises of a guiding set of principles/legislative requirements, an enabling set of processes and analytical tools, underpinned by clarity and alignment of roles and responsibilities.

Context

As shown in Table 2 below, the context is provided by the relevant sections of the New Zealand Education Act 1989, Government policy objectives for the sector and TEI's own strategic and business plans.

Legislation	Policy	Operational
Sections 170 & 171 – Council Appointments	Tertiary Education Strategy	TEI Strategic plans
Sections 180 Functions of Councils	Statement of Tertiary Education Priorities	TEI Business plans
Sections 195 - Crown Interventions	Investment Guidance – Distinctive contribution framework and decision making criteria	TEI Budgets and financial forecasts
Sections 159 F(b)(ii) & 159 KBA – Monitoring	Investment plan approval letters, including KPIs	TEI Capital Asset Management plans
Sections 159YC Information provision		TEI Audited Financial reports

Table 2: Factors shaping the Framework design

Analytical Tools (lenses)

<u>Financial</u>

The financial analysis undertaken covers those ratios financial analysts routinely use in assessing the financial viability of an organization, such as those described by Magoon (2008). These include the level of surplus, net cash flow from operations, free cash flow, working capital and liquidity position/cash reserves. The analysis concentrates on short-term (1-3 years) financial viability which is based on solvency and cash flow. Long term sustainability is largely based on measures of balance sheet strength. (A worked example is provided in a later section of the paper).

Organisational Capability (including capability maturity assessment)

The working hypothesis is that the financial outcomes are a product of the business enablers, and by assessing the strengths and weaknesses of the key enablers, an assessment can be made of future financial performance and risk.

The Baldridge (2002) model is the central assessment tool. It has been adapted for educational purposes under the banner, “Education Criteria for Performance Excellence”. The level of analysis does not approach the level of detail required to enter a national quality award. Rather, the intent is to recognise the key components of the business model, and assess key attributes on a 1-5 scoring system, based on the evidence of the attributes that define the continuum from poor to best practice. The Australian Universities benchmarking manual, compiled by McKinnon et al (2000), is a valuable servant, providing a compendium of capability assessment metrics with descriptions of differing states of capability, ranging from poor to best practice.

The authors are of the opinion that well run organizations have a strong finance function, this being reflected in the fiscal disciplines and quality of decision making generally. In assessing the capability maturity of the finance function, the rating system across five key finance processes, as presented by Walther et al (1996), has proved to be a useful starting point. This is especially so for the planning and performance management processes.

Governance

A set of assessment questions have been framed covering the standard aspects of good governance as covered in most references on the subject, such as Matheson (2006). As a first approximation, the assessment involves Board’s responding to a series of yes/no questions. If the response is affirmative, it must be evidenced to the satisfaction of the person undertaking the assessment. The alternative to this approach is the use of open ended questions of the type, “tell us about how you went about doing such and such a task?” The response to these types of questions gives a good indication of the processes employed, and knowing the attributes that characterise best, good and poor performance; it is possible to make a rating along this continuum.

The quality of governance is critical to ensuring the Crown’s interests in the sound stewardship of its assets are achieved. In thinking about the issues and looking for alignment across the organisation, the authors have found Hope’s (2004) representation, as shown below, to be useful in establishing clarity of roles and thinking about how good performance might be evidenced in those roles. This approach differs from the more traditional Board-Management split of roles, and in the opinion of the authors offers more insights and direction for evaluating organisational performance, especially around aspects of organisational alignment.

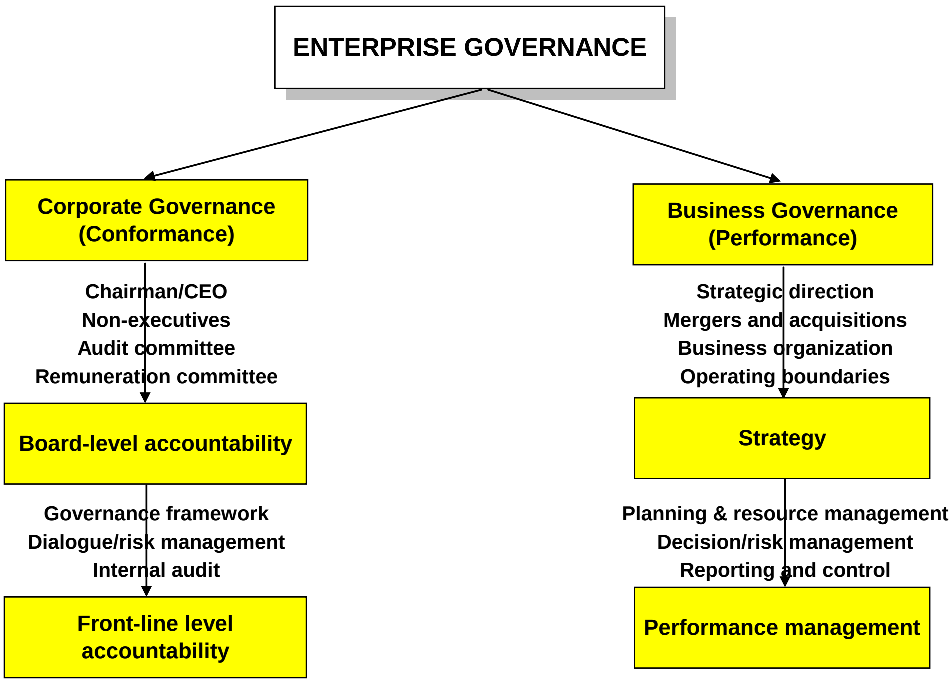

Figure 1: Enterprise Governance

<u>Crown Residual Ownership Risk (Levers of Control)</u>

In assessing and managing the risk facing the Crown, officials are faced with the situation of balancing the policy intent of trust and devolved decision making within the sector against the need to ensure ownership risk is identified and managed within constraints acceptable to the Crown. This is a classic agency issue, as described by Milgrom and Roberts (1992), involving information asymmetries between the principal (in this case the Crown) and the agent (individual TEI's). Robert Simons' (1995) "Levers of Control" provides a useful tool in framing this part of the analysis. This approach has received more recent support from Hope (2004) in light of the disciplines imposed by Sarbanes-Oxley requirements. Belief and Boundary controls are critical to devolved accountability. Interactive controls describe the constant dialogue between senior executives and frontline teams, while diagnostic controls focus on critical performance indicators.

Residual ownership risk is the cost to the Crown of returning a financially distressed organisation to a state of financial viability in the short run, (e.g. can pay the wages for the next 12 months), and sustainability in the longer term. As described in more detail later in this paper, there are three components to residual ownership risk. These are that risk which is external to the organisation and beyond its control in the short term at least, that what it can influence but not directly control, and that which is in its the direct control.

Tools as an Analytical System

Figure 2 below shows the relationship between the various analytical tools and the high level processes which are described in more detail later in the paper. The unit of analysis is the institution/organisation, and as such a systems approach is required to guide thinking and ultimately the analysis of performance.

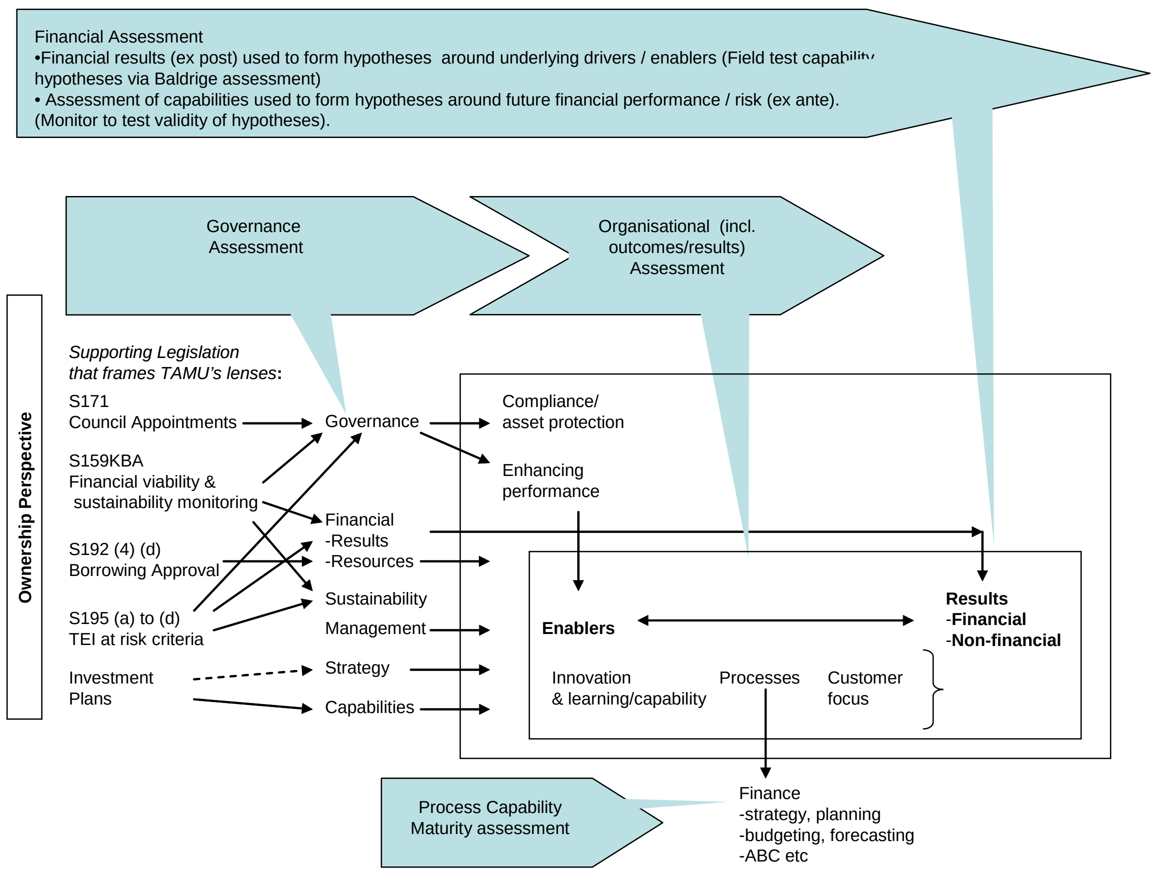

Figure 2: The Analytical Framework

The organisational assessment as portrayed in Figure 2, with the linkages between outcomes and enablers, reflects Kaplan and Norton's (1996) balanced scorecard. In understanding the organisational forces that produce the metrics that ultimately populate the balanced scorecard; the authors have chosen to use a Baldrige/European Foundation for Quality Management (EFQM) Model. The model is a practical tool, which as the EFQM notes on its website, can be used in a number of different ways:

- as a tool for self assessment
- as a way to benchmark with other organisations
- as a guide to identify areas for improvement
- as a basis for a common vocabulary and a way of thinking
- as a structure for the organisation's management system

In the engagement process with TEIs, all these aspects will be relevant at some point in time. Throughout this paper the authors will make frequent reference to these aspects, as enhancing sector capability is pivotal to enhancing the ownership interest. Figure 3 below illustrates the Baldrige (2002) model used.

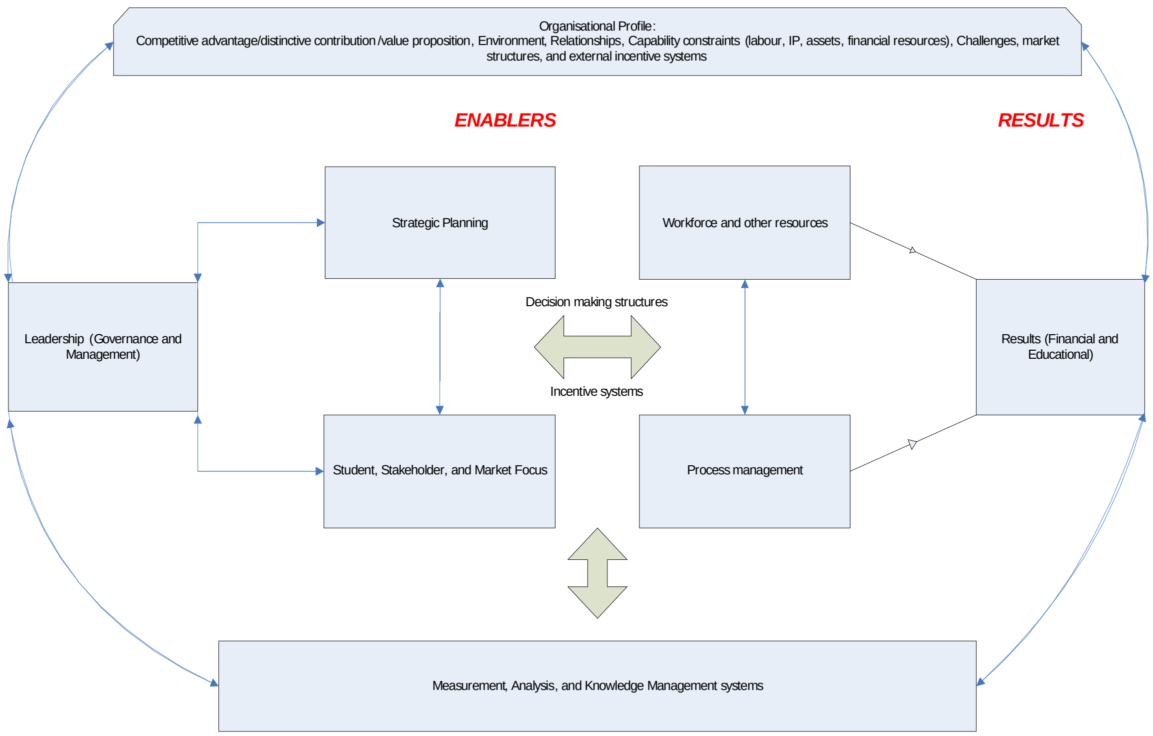

Figure 3: Baldrige Model

The Process

The integration of the assessment tools into the overall engagement process is shown in Figure 4 below.

With the overall framework there are four discrete sets of analysis. These are the:

- Financial Assessment Review (FAR)
- Organisational Assessment Report (OAR)
- Crown's Residual Ownership Risk calibration (RoR)
- Work out Plan (WoP)

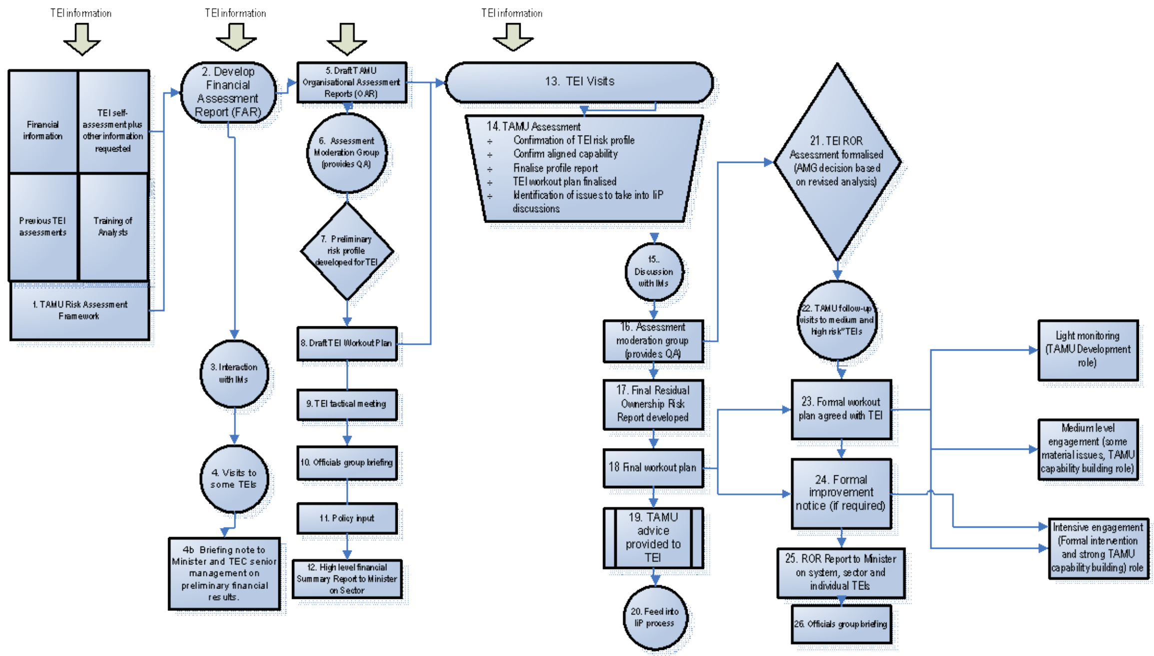

Figure 4: The TEI Engagement Framework

The framework starts with desk based analysis of financial and non-financial information. This establishes an evidence based assessment of performance and allows the advisors to frame a set of hypotheses around the enablers of that performance, i.e. cause and effect. These hypotheses are peer reviewed, and then validated or reframed during a series of site visits and discussions with the institutions concerned. This hypothesis driven approach mirrors that of McKinsey Consulting, as described by Rasiel and Friga (2001). Armed with this analysis, the advisers, through consultation gain agreement with the institution on the issues impacting on the Crown's ownership interests and how they should be resolved.

The FAR subjects actual, budgeted and forecasted statements of financial performance and position to the standard forms of financial ratio analysis, such as that described by Magoon (2008). Budgets are subject to stress testing of critical performance variables. This is in part a component of Simons "Diagnostic Control Systems". The financial patterns emerging from stress testing the budget and outer year financial forecasts provide insights around the risks to the critical success factors underpinning business plans. These insights shape the agenda for the initial engagement with the TEIs. The focus of this dialogue is around the ramifications of the sensitivity analysis, and what risk contingencies are in place to manage the range of possible outcomes. This conversation provides the bridge to the Organisational Assessment Report and Simons' "Interactive Control Systems". The quality of this dialogue is driven by the quality of the financial analysis and the insights derived from it.

The OAR involves both an evaluation of Council/Board governance effectiveness and the management team. The engagement with councils is predominantly through the finance and risk and audit subcommittees. During the process an assessment of the risks to be avoided (Simons's "Boundary Systems) is made and whether information flowing from the business on critical performance variables and strategic uncertainties is sufficient to give Council the required levels of transparency.
The Crown's Residual Ownership Risk is derived from the OAR. Three categories of risk are considered. These are:

External/exogenous to the TEI. The TEI bears the financial consequences but in the short term at least, has no control over this element of risk   For example a change in the Official Cash Rate by the Reserve Bank of New Zealand impacts of both the cost of borrowing and revenue from financial reserves invested in fixed term deposits.

Influencible by the TEI. The TEI bears the financial consequences and can influence the outcome by making clear to the Crown the impact on their financial bottom line. This aspect of risk usually relates to policy settings and the TEI can, through the quality of its financial analysis, make policy makers aware of the unintended consequences of current policies and there seek to have them refined.

Controllable by the TEI. This is the risk that the management team in the TEI can control and is accountable to their Council and ultimately the Minister for doing so. Much of the emphasis of the engagement is on this aspect.

Collectively these three components make up the residual ownership risk. Under this construct a TEI may have high ownership risk even if it is well managed as the other two components can swamp this aspect.

The workout plan reflects agreement with the TEI on the overall risk assessment for the TEI, and on the basis of that what actions are required to mitigate/minimise the risks. This then becomes the work plan for the engagement with the sector over the next twelve months, at which stage the exercise is repeated.

Roles and Responsibilities

To ensure clarity and alignment of roles and responsibilities, the RASCI (responsibility, accountability, support, consult, inform) tool used in project management has been effectively adopted. This approach ensures effective handovers at key points in the process, especially around the information flows required to support the framework.

From Value Protection to Value Creation

Once financial viability is established, the emphasis shifts to longer term business model sustainability and the evaluation of options to grow the business. To date, as discussed in an earlier section of this paper, the focus of TAMU's engagement efforts has been on institutions that are financially distressed. At the other end of the engagement continuum are those institutions that are in the process of creating value. Looking after the Crown's ownership interests in these situations is equally challenging with the focus being on value optimization within acceptable risk constraints.

A Current Work Example

In order to target its efforts on those institutions currently with the greatest financial stress, the financial statements of the 31 institutions that make up the New Zealand Tertiary Sector were subjected to the Financial Analysis Review (FAR) component of the framework. The financial performance metrics were graded on a one to five scoring system and overall composite scores of financial viability and short-term sustainability (based on balance sheet strength) were constructed. The results of this analysis are shown in Chart 1 below.

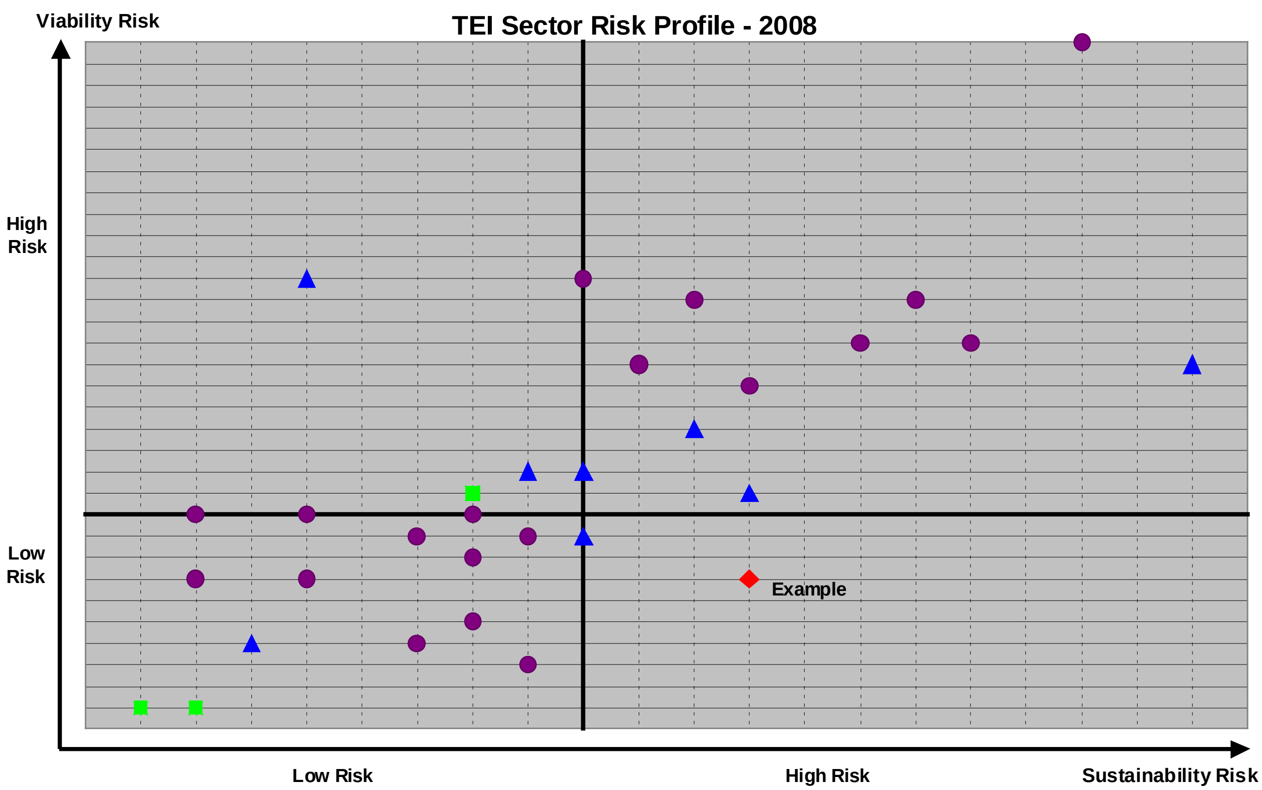

Chart 1: TEI Sector Financial Sector Risk Profile (2008)

In Chart 1 at the bottom right quadrant is a plot for an "Example TEI". TEIs which are in the bottom right quadrant are performing well in the current period financially, but have long term sustainability issues. This Example TEI is a made up observation to illustrate the scoring system. For illustrative purposes we have chosen an example of an institution which is performing well overall from a financial perspective – due to a one off spike in profits - but whose long term sustainability is in question due to a declining trend in enrolments and poor balance sheet strength.

As an illustrative example this TEI scores:

Financial Viability Factors

Indicator	Score	Explanation
Surplus	5	indicating a strong 2008 performance
Working Capital	3	indicating average working capital levels
Cashflows	5	indicating strong cashflow from operations due to the extraordinary surplus
Liquid Assets	2	indicating poor retained cash reserves, possibly improved by the recent windfall
Debt levels	4	indicating minimal debt levels
Average returns	3	indicating adequate returns over a three year period
Trend in earnings	2	indicating erratic earnings
Total Viability score	24	this would put this TEI in the low viability risk quadrant

Sustainability Factors

Indicator	Score	Explanation
Working Capital	3	indicating average performance and balance sheet strength
Liquid Assets	2	indicating weaker cash reserves and hence liquidity
Debt levels	4	indicating minimal leverage
Fixed Assets per EFTS	2	indicating poor capitalisation
EFTS trend score	2	indicating poor trend and outlook for EFTS numbers
Shareholder funds trend	2	indicating variability or negative trend in capitalisation levels over time
Sustainability score =	15	this would place the TEI in the moderate sustainability risk quadrant

Table 3: Financial Risk Scoring Method

TEIs with high risks to short-term viability and ongoing sustainability of operations (top right quadrant) have high levels of risk indicators for both operational viability and sustainability. These TEIs pose a high level of ownership risk to the Crown. Many are under some form of Crown Intervention or intense monitoring.

On the basis of this analysis, those institutions in the upper right hand quadrant are deemed to be the most exposed and will be subject to the next stage of the Engagement Framework described above, namely the Organisational Assessment Review. On the basis of this organisational assessment and the consequential assessment of the Crown's ownership risk, a series of workout plans will be developed with the relevant institutions.

Insights

Wearing the hats of performance management practitioners and not Crown advisers, the authors make the following observations on experiences to date:

- There are ample tools and techniques available to do what we need to do. Ultimately success is through system design and management of the performance management system itself. In this sense the capability of those undertaking the activity is as equally important as those whose capability is being assessed.

- For the people doing the work, emotional quotient (EQ) is as important as IQ. We will be putting our people through Heresy and Blanchard (2008) type situational leadership training as well lifting skill levels in questioning and observing non-verbal behaviour. In moving through the Engagement Framework, the hard skills of the analyst at the financial analysis stage are replaced by the soft skills of the change agent at the Work out Plan (WoP) stage.

- There is no substitute for field analysis in assessing culture, rapport between Council and senior management, alignment amongst senior management team, leadership etc.

- Poor documented understanding of value and cost drivers. Accordingly there are dangers in the rote application of balanced scorecards without clarity around the causal linkages between the value proposition and the enablers of that value. This point is stressed by Ittner et al (2003) in an article on coming up short on nonfinancial performance measurement. Understanding the dynamics is critical. The real world is non-linear, stochastic with positive and negative feedbacks. Without that perspective, there is what the authors have termed the "tyranny of KPIs". Every indicator is deemed to be a key one. This strengthens the case made by Parmenter (2007) for the need to define critical success factors in the first instance and let the determination of what is key flow from that. The authors' assertion is that if the organisation is understood as a system and the interdependencies and dynamics understood, only a small number of indicators /performance measures will be required. The stress testing of budgets in the FAR is the first stage to identify those critical factors impacting on ownership risk.

- There is no silver bullet approach to organisational turnaround. A systems approach to the analysis is required in the first instance. In seeking to lift performance, a systems approach is similarly required. The importance of working on the system and not in it is a point worth well remembering. (In the design of the Engagement Framework the design objective is to keep the processes as simple as possible, have alignment through RASCI and allow the information to flow so the system as a whole operates effectively).

- Benchmarking will not be successful unless supported by a strong CFO Office. The authors' support the benchmarking proposition of "looking in before looking out". This statement means that unless there are strong internal management process that track performance period on period, bringing in external information is unlikely to succeed as the internal disciplines are not there. The Office of the CFO has a critical role in setting these internal reporting disciplines, starting in the management reporting area. Beyond that, the importance of what Nevis et al (1995) defined as the facilitating factors for organisational learning (read continuous improvement) remain valid, with the climate of openness, involved leadership and a systems perspective being factors worthy of continued focus. Furthermore, benchmarks, or performance metrics in general, if not aligned with incentive systems and decision rights, will be ineffective, see Brickley et al (1997).

- Our observations to date validate many of Kotter's (1995) views of why organisation changes fail, with some of them being correlated with weaknesses around Nevis et al "facilitating factors".

Further Development

In concluding, some thoughts are given on what other models may enrich the ongoing development of this framework. In particular Stafford Beer's Viable Systems Model (VSM), as described by Espejo and Harnden (1989) would seem to align well with Simons' "Levers of Control" and provide a deeper understanding of organizational risk and performance.

Two papers presented at this conference in 2006 will likely figure large in developing the authors thinking in this area. One is by Hoverstadt et al (2006) on the application of systems concepts to performance monitoring and measurement, using the VSM. The other is by Parsons (2006) which is on measuring to learn while measuring to learn. With its focus on organisational learning, these thoughts would seem to align with VSM through learning feedbacks and adjustment to a steady state following the system being subject to an external shock.

The other dimension that will be further developed is performance managing across horizons and the appropriate choice of metrics for each horizon This is critical as soon as investment enters the equation and performance management needing to consider the taking of options against future uncertainties. In this space the work of Baghai et al (1999) will continue to influence the authors' thinking.

Summary

This paper has described the design and early stages of implementation of an engagement system that proactively seeks to have managed, through influence and advice, those factors shaping the Crown's ownership interests in the New Zealand Tertiary Education Sector. The framework is designed around a core of accepted performance management theory and practice. From a practitioner's perspective, it is ultimately about putting theory into practice. Hence the importance of executing on the core processes that make the engagement framework a continuous monitoring and risk management system. The challenge is to manage the system and keep the component processes as simple as possible.

The success of this approach will be evident if there is a reduction in the future number of statutory sector interventions, this being the ultimate performance metric for the engagement framework. From a performance management perspective, the theoretical underpinning of the system will increasingly reflect Simons' "Levers of Control" coupled with greater use of Beer's Viable Systems Model as the organizational diagnostic, along with a sharper focus on performance managing across horizons to reflect the growing adoption of Capital Asset Management Strategy (CAMS) processes across the sector.

These opportunities present exciting challenges and reflect the way theory informs practice, and how practice tests theory. The authors expect that in two years time they can report back on taking the Engagement Framework to another level of design and performance.

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