This guidance note is particularly for governors on the audit or finance committee, but will be of interest to all governors.

- What is the governing body’s appetite for risk and how is it assessed and monitored? What part does risk assessment play in board decision making?
- How do governors ensure that the financial health of the college is good?

Introduction

The governing body of a college has a statutory responsibility for the effective and efficient use of resources, the solvency of the institution and the safeguarding of the College assets. This will normally be discharged by governors ensuring that there is a robust process for financial planning and reporting, accompanied by a risk management plan. For most colleges, their main income is from the Education Funding Agency and the Skills Funding Agency, both of which require formal financial agreements to be signed to ensure that public money is properly accounted for. These agreements set out how the funds may be used and the way in which accounts are to be submitted. The two agencies also collect and publish financial data as part of a national benchmarking scheme which gives a picture of the financial health of the sector. The financial health of colleges is also judged using the standard Ofsted criteria of Outstanding to Inadequate, based on a number of financial key performance indicators.

Using Key Performance Indicators

Key performance indicators are a useful way for governors to monitor the financial health of the College and to see whether or not it is providing value for money. In measuring financial performance, three key indicators are used and need to be understood by governors:

- **Solvency or adjusted current ratio.** This is a measure of a college’s ability to meet its financial liabilities in the short-term. It therefore relates to current assets such as cash and other assets that can be relatively quickly turned into cash, such as stocks, debtors and creditors due for payment within one year, including overdrafts, trade creditors (goods or services provided on short credit terms, e.g. 28 days’ or 30 days’ credit) and taxes owed to HMRC. The FE College sector average is approximately 1.5:1.

- **Performance.** This is a measure of a college's ability to generate a surplus of income over expenditure. The operating position is a measure of an organisation's profitability and is measured through assessing the operating surplus (or deficit) as a percentage of income. This ratio excludes surpluses or deficits relating to asset disposals, taxation and reserve movements. The SFA uses an adjusted income and
expenditure figure to arrive at a performance ratio for comparison purposes. The FE sector average is circa 2.2%.

• **Gearing.** This is a measure of the college’s level of debt, usually measured as borrowings expressed as a percentage of income. It is a good measure of how high the level of borrowings is relative to the size of the organisation. The sector average is circa 20%.

Other useful indicators include pay costs as a percentage of income, dependency on EFA and/or SFA income, cash generation and administration costs.

**Financial Planning**

A key element in the financial planning cycle is the approval of the annual college budget. The budget should agree with the corresponding year in the three-year financial plan and the financial plan needs to be delivered to the funding body by 31 July. Whilst the finance committee may review the budget and make recommendations for its approval, it is the responsibility of every governor to satisfy themselves that the budget can be approved in order adequately to discharge their statutory responsibility for ensuring the solvency of the college. This can only be done at a full governing body.

It is therefore imperative that governors obtain sufficient evidence and assurances to be able reasonably to ensure that the budget is based on sound assumptions, prior to giving approval. The budget also needs to be consistent with any other strategic plans, as there will inevitably be a cost attached to many of the organisation’s plans. In order to approve the budget, governors should obtain certain assurances and / or a written report setting out the key assumptions contained therein.

Some suggestions for useful consistency checks could include:

- Key further education grant income budgets should be based on the relevant funding body contracts.
- Student recruitment targets should be supported by detailed curriculum plans to ensure that they are deliverable and that the assumed level of student demand exists.
- Sufficient teaching resource should be contained within the budget to deliver the curriculum plan. Pay budgets should be consistent with the college’s human resource strategy, new legislation and planned workforce levels.
- Adequate levels of inflation (especially fuel costs, which have seen exceptionally high levels of inflation in recent years), cost of living and incremental pay awards, changes to employers’ national insurance rates and employer’s pension contributions should have been factored into the budget.
- The cost impacts of new strategic plans should have been separately identified and included.
In addition to applying logical consistency checks, governors should also consider the credibility of the information being presented. The accuracy of previous budgeting would be a good guide to how reliable the information being presented may be and this can be checked through comparing previous years’ accounts against the original budget.

The financial plan produced should show the current year’s forecast, the following year’s budget and budget for a minimum of a further two years, though this could be for up to ten years in total. The financial plan is intended to help the governing body, and the appropriate funding body, to assess the financial effect of a college’s strategic plans.

**Financial health grading**

The methodology for grading financial health uses grade definitions and indicators as follows:

- **Grade 1. Outstanding** - A provider that has very robust finances to fulfil its contractual obligations and to respond successfully to opportunities or adverse circumstances. Normally, a provider with excellent / good indicators for solvency (current ratio), performance (cash-based operating surplus/(deficit) to income ratio), and gearing (borrowing to net assets ratio).

- **Grade 2. Good** - A provider that has sufficiently robust finances to fulfill its contractual obligations, and to respond successfully to most opportunities or adverse circumstances. Normally, a provider with at least two good indicators for solvency, performance and gearing.

- **Grade 3. Requires Improvement** - A provider that appears to have sufficient resources to fulfil its contractual obligations, but also appears likely to have limited capacity to respond successfully to opportunities or adverse circumstances. Normally, a provider with at least two Grade 3 indicators for solvency, performance and gearing.

- **Grade 4. Inadequate** - A provider that is in financial difficulty and very likely to be dependent on the goodwill of others. There is a significant risk of providers in this group not being able to fulfil contractual obligations because of weak financial health. Normally, a provider with at least two inadequate indicators for solvency, performance and gearing.

Where a college is deemed to be financially inadequate it will be served with a financial notice to improve from the funding body and be required to produce a financial improvement and recovery plan.

**Setting and monitoring financial targets**

The use of KPIs is an important element of the financial management of the organisation but the KPIs are relatively uninformative without some form of comparator. Using a combination of funding body financial health measures, FE and skills sector benchmarks and the organisation’s own historical performance, it should be possible to set challenging but achievable strategic financial targets. Financial targets can be set over a variety of periods, e.g. monthly or annual, or they can be indefinite.
As with all targets, financial targets need to be specific, measurable, achievable, relevant and time-bound (SMART targets). An example would be to set a target operating surplus for the year 2013/14 of 2%. In this case, operating surplus is a specific term that can be calculated, it would be achievable if it matched the surplus reached the previous year, relevant because the operating surplus is a key measure of the organisation’s cost effectiveness and time bound because a specific date has been set by which it must be achieved.

Good practice for the provision of financial reporting includes the production of monthly management accounts, which could easily be expanded to include data on other areas of an organisation's business that impact on its finances, such as student recruitment targets. As a minimum, governors should expect to be presented with the following information, ideally on a monthly basis, within 2-3 weeks of the end of the reporting month. These deadlines should be set and agreed at the beginning of the academic year:

- A financial commentary
- Income and expenditure account
- Balance sheet
- Cash flow forecast
- Capital expenditure
- Debtors' report
- Creditors report

Agreed KPIs should also be reported on a monthly basis and can be readily provided in dashboard format.

**Audit and financial assurance**

It could be argued that there is a potential conflict of interests between the management’s responsibility for the organisation's ultimate success or failure and those same individuals often being the governors’ single source of information. The use of auditors is therefore an essential method of obtaining professional and independent financial assurances.

It is a requirement of the financial memorandum that governors establish an audit committee with the remit of receiving reports from both internal and external auditors. These will provide assurances on the adequacy of internal controls, the effectiveness of governance and whether or not strategic objectives are being met and on the truth and fairness of the annual financial report.

Funding agencies will require their own financial assurance arrangements to ensure that public money is properly accounted for and used for the purposes intended. The procedure for reporting on this is laid down in the Joint Audit Code of Practice.

**Risk management**

The financial plan should be based upon suitably robust plans and levels of activity. However, given the level of uncertainty in the current economic climate and other challenges facing the FE sector, it is prudent to have in place robust risk assessment processes and contingency plans. The governors and senior managers should consider what it would do in the event of
certain key financial assumptions proving adversely inaccurate, including such key financial areas as funding body income and staff costs. This will take the form of a sensitivity analysis which will indicate what the college would do in a worst case scenario and the effect this would have on the key performance indicators of solvency, performance and gearing. If this process suggests a serious financial worsening of performance, a new financial plan may be required.

**Risk management plan and appetite for risk**

The funding bodies have previously requested that risk management plans be submitted to accompany the financial plans, but this is no longer a requirement. Organisations are still expected to keep this document updated on an on-going basis and there is published guidance which sets out the requirements for risk management planning to allow organisations to comply with the Turnbull Report on the Combined Code of Corporate Governance.

The concept of risk appetite is a starting point for governors to set their risk management strategy. Governors will need to define and agree their own risk appetite as a Corporation. Each governing body will vary and risk appetite can be seen on a spectrum. Those with a high risk appetite may be happy to set high risk strategies and undertake high risk, innovative and ground-breaking activities. Those with a more measured approach will have a lower risk threshold, adopt safer strategies and be less willing to undertake higher risk activities. Where a governing body sets its risk appetite will depend on a number of factors including recent activity, an inspection outcome, the nature of governing body members, the steer from senior college leaders and often the financial position of the college.

It is useful to assess both the likelihood and the probable impact of each risk in turn to establish its overall level of importance to the organisation, and it aids accountability if the responsibility for each risk is assigned to an individual (or their post) within the college. These risks are drawn together and form the college Risk Register which should be monitored at each meeting of the Audit Committee and be a driver for the whole internal audit process, with areas of high risk providing the focus for the annual internal audit strategy. The Risk Register needs to be a working document, embedded and used by all levels of management within the college. It should be regularly reviewed and updated as circumstances require.

Risks are usually measured using a scoring system. For example, a score out of ten could be assigned to the level of impact for each risk and a score out of ten could be used to measure the likelihood of the risk occurring. These could then be multiplied together to arrive at a risk percentage. The higher the result, the more robust the contingency planning needs to be. Risk management plans should cover the following types of risks: Strategic; compliance; operational; financial; reputational. Examples of typical risks in a college risk management plan would include: poor student recruitment, retention and achievement; inability to adequately recruit and retain key staff; weak financial solvency and financial health; unsatisfactory buildings / learning environment; ineffective MIS function; poor Ofsted inspection/audit result; negative publicity.

With the new freedoms under JACOP governing bodies can move away from internal audit but will need to establish a robust framework for Board Assurance which will make them confident that all risks are being adequately managed and mitigated.
Disaster recovery plan

Governors are expected to have in place contingency plans that would be required in the event of a major disaster affecting day-to-day operations. In addition to the usual risks of fire, flood or other ‘acts of God’, colleges should consider the effects of events such as failure of information technology services, corruption or loss of essential data, sudden loss of key staff or default of major suppliers. Colleges are recommended to establish a formal process to define and allocate responsibilities for action to be taken in the event of any major disaster occurrence. As a minimum, this process should identify a key manager who will take on the role of business continuity management. The person in this position would take control of the implementation plan and identify such support as necessary. The main initial aspects of this role would be to: implement immediate emergency reaction; notify and mobilise support services; control central coordination; assess actual and potential damage; communicate clear instructions and guidance; and restore essential functions.

Action for Governors:

A good practice self-assessment checklist to cover the area of financial planning and risk management could have the following headings:

- Senior management supports and promotes risk management.
- The college culture supports well thought-through risk-taking and innovation in line with the agreed risk appetite of the governing body.
- Risk management policies and the benefits of effective risk management are clearly communicated to all staff.
- Risk management and the Risk Register as a working document is embedded in management processes and at all levels down through the college.
- Management of risks is closely linked to the achievement of objectives.
- Risks associated with other organisations are assessed and managed.

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