May 2003/**20**

Core funding/operations

**Consultation**

Comments should be sent to HEFCE by Thursday 31 July 2003

The model financial memorandum, between HEFCE and the institutions we fund, sets out the terms and conditions for payment of HEFCE grants. This document seeks comments on our proposals to revise and update the memorandum. Following consultation, we plan to issue a final version in September, to take effect from 1 October 2003.

# Proposed revisions to HEFCE model financial memorandum

# Proposed revisions to HEFCE model financial memorandum

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| To | Heads of HEFCE-funded higher education institutions<br>Heads of HEFCE-funded further education colleges<br>Heads of universities in Northern Ireland |
| Of interest to those responsible for | Finance, audit, planning |
| Reference | 2003/**20** |
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## Executive summary

Purpose

1. The model financial memorandum, between HEFCE and the institutions we fund, sets out the terms and conditions for payment of HEFCE grants. This document seeks comments on our proposals to revise and update the memorandum.

Key points

2. The current financial memorandum has been in place since 1 August 2000. In general it is effective, but there are some areas that require clarification or updating. These areas are highlighted in the report, and the proposed revised version of the memorandum is attached as Annex A.

3. Following consultation, we propose to issue a final version of the financial memorandum in September, to take effect from 1 October 2003.

Action required

4. Comments on the proposals, and any other relevant issues, are welcome. They should be e-mailed to fmreview@hefce.ac.uk **by 31 July 2003**.

## Background

5. The model financial memorandum between HEFCE and the institutions we fund sets out the terms and conditions for payment of HEFCE grants. The current version has been in place since 1 August 2000. The DfES and HEFCE consider it good practice to review financial memoranda every three years. We are therefore consulting on a revised version, to take effect from 1 October 2003.

6. In general, the financial memorandum is working effectively. However, some areas need clarification or updating, and in others we wish to emphasise new policies and requirements.

7. These areas are summarised below. A complete revised version of the model financial memorandum is attached at Annex A. Paragraph references in the text are to that version.

## Proposed changes to the financial memorandum

Short-term borrowing

8. Currently, institutions must obtain written consent from HEFCE if their short-term borrowing (that is, negative net cash) exceeds £2 million or 5 per cent of total income – whichever is lower – for more than seven consecutive days.

9. The limit of £2 million is not appropriate for all universities and colleges. It imposes a disproportionate restriction on larger institutions, since it represents a very small percentage of their turnover. Conversely, an absolute limit may inadvertently give smaller institutions a greater scope to borrow than is intended, since £2 million may be a significant proportion of total income. A percentage limit would be more meaningful. It is suggested that 5 per cent remains an appropriate level and that, in terms of materiality, this change would not lead to increased risk. (Paragraph 66.)

*10.* Institutions need to satisfy themselves that any requirement for short-term borrowing fits with their financial strategy. To this end, we believe some amendments to the wording of the financial memorandum would be useful to reinforce the need for institutions to maintain comprehensive systems of internal control and governance. (Paragraph 65.)

11. The current level of seven days' consecutive borrowing has proved in practice to be too short. We propose to change this to 35 consecutive days. This would fit with our requirements, since we would only need to know if an institution's borrowing is more than one monthly payment cycle. (Paragraph 66.)

12. Requests for HEFCE consent to short-term borrowing should be signed by the institution's director of finance as well as by the head of institution. (Appendix 2, paragraph 11, condition 3.)

Long-term borrowing

13. Long-term borrowing presents different types of risk, so we need to maintain the different reporting requirements.

14. Consent for long-term borrowing is not necessarily project specific. Rather our concern is with the overall profile of affordability and risk that any request for borrowing presents. We therefore propose some amendments to the type of information required when assessing such requests. (Appendix 2, paragraph 9, condition 1.)

15. The current method of calculating an institution's annualised servicing costs is seen as the most appropriate, and we do not propose to change this. (Paragraph 63.)

16. At present an institution's combined expenditure on its total number of operating leases is classed as off balance sheet funding. In this review we do not propose to change the way we capture information on these costs. We have access to the information already, through financial returns from institutions. If that information suggested that there might be a current or future problem with an institution's off balance sheet funding, then we would discuss this with the institution. However, we will revisit this issue if the Accounting Standards Board changes its requirements on accounting for leases.

17. The requirement for higher education institutions (HEIs) to account for small changes in the servicing costs of separate individual leases is removed, as it imposed disproportionate restrictions on smaller institutions. It will be replaced by a requirement looking at the total cost of an institution's leases. (Paragraph 64.)

Audit, assurance, risk and control

18. We have added a paragraph on risk management, reflecting the Council's Accounts Direction to institutions, and outlining the key principles of effective risk management. (Paragraph 35.)

19. The terms 'risk management' and 'internal control' replace 'insurance' and 'internal financial control'. (Paragraph 35.)

20. We believe that a checklist for external auditors on what assurance we are seeking in terms of compliance would be useful, but we think it would be more appropriate to publish it in the HEFCE Audit Code of Practice.

Connected institutions

21. We have clarified the definitions of 'connected institutions' and 'legally distinct entities'. We propose to issue separate additional guidance on the controls and requirements necessary when funding connected institutions. (Paragraphs 2 and 37.)

Costing and pricing

22. Further to our work with the sector on transparency in costing and pricing of activities, we propose to add an explicit requirement for HEIs to identify and recover the full economic costs of their activities, and for transparent costing and pricing methods to be fully integrated into an institution’s decision-making processes. (Paragraphs 68 and 69.)

Widening participation as a condition of grant

23. Increasing importance is being placed upon widening participation to higher education in both the White Paper, ‘The future of higher education’, and in the Council’s 2003-08 strategic plan (HEFCE 2003/12). We therefore propose that formula funding for widening access and improving retention is made conditional upon HEIs submitting acceptable strategies and action plans. This proposal received general support in a recent consultation with the sector (see HEFCE 2003/14). (Paragraph 41.)

Subscription to the quality enhancement academy as a condition of grant

24. A review of arrangements for enhancing learning and teaching in higher education was carried out in 2002 by the Teaching Quality Enhancement Committee (TQEC), led by Sir Ron Cooke. The review recommended the setting up of a new body – the quality enhancement academy. We propose that institutions should subscribe to the academy as a general condition of grant. This proposal reinforces the importance of the issues raised in the review and our strategic focus on quality enhancement, and treats subscription to the academy in the same way as subscriptions to the Quality Assurance Agency or the Higher Education Statistics Agency. This proposal depends on a satisfactory conclusion of the consultation on the TQEC report, and on work to establish the new academy. (Paragraph 32.)

HEFCE’s role in relation to mergers

25. The revised financial memorandum contains a new section outlining the responsibilities of the institution to actively involve the Council at the early stages of any proposed merger. This will enable us to address any concerns about the academic and financial viability of the merged institution, and to be satisfied that the interests of students are not being jeopardised. (Paragraph 80.)

Data Protection Act

26. We propose to add a new requirement to the section on providing information. This relates to the data that we (or other bodies acting on our behalf) may require, for example to inform the First Destination Survey. The revised financial memorandum ensures that institutions are aware of and are complying with their duties under the Data Protection Act 1998. (Paragraph 30.)

Race Relations Amendment Act and equal opportunities

27. A new paragraph is proposed, drawing institutions' attention to the requirements of the Race Relations Amendment Act (RRAA) and other equal opportunities legislation. We would normally expect institutions to comply with all their statutory duties, and would not highlight specific Acts. However, under the RRAA we have certain monitoring duties (as described in HEFCE Circular Letter 22/2002). We therefore feel it is appropriate to include in the financial memorandum a note on institutions' general duties in relation to equal opportunities. (Paragraph 31.)

Financial sanctions in the case of audit failure

28. We propose to add a new requirement in the section on allocation and payment of funds. In the past we have stated that we would withdraw funding from an institution that failed an audit re-inspection by the Quality Assurance Agency. This is now included as an explicit reserve power in the revised financial memorandum. (Paragraph 47.)

Other issues

29. A number of changes have been suggested which are not issues of substance, but have been made to improve presentation or clarity.

**Responses**

30. Institutions are invited to comment on the proposed changes outlined in this document, and any other issues they wish to raise. In order to collate and analyse responses it would be helpful if comments were made using the template provided at Annex B.

31. Please send the response as an e-mail attachment to fmreview@hefce.ac.uk, by **31 July 2003**. For further information, contact Richard Harris at HEFCE, tel 0117 931 7347, e-mail r.harris@hefce.ac.uk.