January 2008/01

Core funding/operations

Consultation

Responses should be made by e-mail by Thursday 28 February 2008

This is a consultation on changes to the Financial Memorandum between HEFCE and institutions. It incorporates consultation on revisions to the Accountability and Audit Code of Practice (HEFCE 2004/27). Amended versions are to take effect from 1 August 2008.

January 2008/**01**

Revisions to Financial Memorandum

Consultation on changes to the funding agreement between HEFCE and institutions

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

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To	Heads of HEFCE-funded higher education institutions Heads of HEFCE-funded further education colleges Heads of universities in Northern Ireland
Of interest to those responsible for	Audit, Finance, Senior management, Governance
Reference	2008/**01**
Publication date	January 2008
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Executive summary

Purpose

1. This is a consultation on changes to the Financial Memorandum (FM) between HEFCE and institutions. It incorporates consultation on revisions to the Accountability and Audit Code of Practice (Code). Amended versions are to take effect from 1 August 2008.

Key points

2. The Financial Memorandum sets out the conditions attached to HEFCE funding which must be complied with by institutions. The Accountability and Audit Code of Practice sets out our audit and accountability requirements.

3. The FM and Code are both due for review. The suggested changes will result in these two documents being brought up to date, and better aligned to a higher education (HE) sector in which institutions are autonomous and demonstrably sustainable. We continue to encourage effective accountability on the part of institutions, and these revised documents will serve to better achieve this no matter how the mix of public-private funding evolves in coming years.

Financial memorandum

4. The document that is under consultation constitutes Part 1 of the FM. We are not proposing any changes to Part 2, the annual schedule of funds and conditions relating to each institution.

5. We propose to adopt a new principles-based approach to the FM which is less prescriptive and more attuned to better regulation.

6. We have clarified that HEFCE’s principal interests are that we meet our responsibilities to Parliament, ensuring primarily that our funds are used for the purposes intended, and that institutions remain sustainable. We have also updated our institutional support strategy.

Accountability and Audit Code of Practice

7. The principal proposed changes to the existing Code (HEFCE 2004/27) are described at Annex B. The only new proposed mandatory requirement is that we are seeking assurance about the management and quality assurance of data submitted to the Higher Education Statistics Agency (HESA) and HEFCE.

Action required

8. Responses to HEFCE are invited by e-mail, using the response form at Annex I, by **Thursday 28 February 2008**. All annexes are available on the HEFCE web-site (www.hefce.ac.uk) under Publications/2008 Publications.

Consultation process

9. This draft document contains HEFCE's proposed new Financial Memorandum (FM) to take effect from 1 August 2008. It replaces the 'model financial memorandum' issued in 2006 (HEFCE 2006/24). This consultation also extends to a new audit code to replace 'Accountability and Audit: HEFCE Code of Practice' issued in 2004 (HEFCE 2004/27), which is at Annex B.

10. This document is in two parts: the main text of the proposed FM is published here in hard copy. The annexes, including the proposed new version of the Code, are on the HEFCE web-site (www.hefce.ac.uk) with this document under Publications.

11. We are now seeking views on the new FM and Code. Responses should be made by e-mail, using the form at Annex I. This form can be downloaded from the HEFCE web-site (www.hefce.ac.uk) with this document under Publications. Please e-mail the completed form as an attachment to FMCodeconsultation@hefce.ac.uk by Thursday 28 February 2008. All responses received by the deadline will be taken into account but it will not be possible to discuss individual responses.

12. Following sector consultation, we will issue the final version of the FM, to be effective from 1 August 2008.

Summary of proposed changes to Financial Memorandum between HEFCE and institutions

The principal proposed changes to the current version of the Financial Memorandum (FM) published in 2006 (HEFCE 2006/24) are as follows:

- We propose to publish in print the Financial Memorandum as the core document in a suite of HEFCE and other documents that cover the HE accountability framework. The rest of this suite of documents, including the audit code, is to be published on the HEFCE web-site along with links to key sources of good practice and guidance.
- We are not proposing any changes to Part 2 of the FM, the annual schedule of funds and conditions relating to each institution.
- No new mandatory requirements are proposed.
- The wording of the FM is more principles-based and less prescriptive than before, in line with our commitment to better regulation.
- We have clarified that HEFCE's principal interests are that we meet our responsibilities to Parliament, ensuring primarily that our funds are used for the purposes intended, and that institutions remain sustainable.
- We have updated our institutional support strategy (now renamed institutional engagement and support strategy) and included it as an annex to the FM (see Annex D).
- We have restructured parts of the FM as follows:
  - paragraphs 36-48 of the old FM on the payment and allocation of funds are replaced by Annex C in the draft new edition
  - paragraphs 68-73 on financial commitments are replaced by a new Annex F.
- We have removed a substantial amount of detail in the old FM (HEFCE 2006/24) that is now covered by paragraph 25 in the new draft FM which lists the governing body's main responsibilities including coverage of:
  - compliance (paragraph 8 in HEFCE 2006/24)
  - responsibilities of the institution (old paragraphs 16-19)
  - financial management (old paragraphs 20-24)
  - value for money (old paragraph 25)
  - provision of information (old paragraphs 26-30)
  - risk management (old paragraph 13)
  - audit (old paragraphs 81-86).

Draft Financial Memorandum between HEFCE and institutions

In this memorandum the definitions listed at Annex H apply.

Purpose of this document

13. This Financial Memorandum sets out the formal relationship between the Higher Education Funding Council for England (HEFCE) and the governing bodies of the institutions it funds. It reflects our responsibility to provide annual assurances to Parliament that:

- our funds are being used for the purposes for which they were given, and
- internal control, corporate governance and risk management in the sector are effective and that value for money is being achieved.

14. The memorandum is in two parts. Part 1 (this document) sets out the terms and conditions which apply in common to all institutions funded by HEFCE. Part 2 (issued each year) gives conditions specific to the institution, a schedule of funds available in the academic year, and the educational provision the institution has agreed to make in return for those funds. References to the memorandum embrace both Part 1 and Part 2.

15. Institutions are bound by the requirements of their charter and statutes (where appropriate) and by rules relating to their charitable status. This document does not supersede those requirements; rather it provides evidence that institutions are complying with them.

16. This memorandum takes effect from 1 August 2008, as does the Accountability and Audit Code of Practice (Annex B).

Our responsibilities to institutions

17. We will work with institutions and the higher education sector to the high standards of openness, integrity and consistency expected of public sector bodies. We recognise that institutions are autonomous bodies and will act reasonably. We will not ask for information that we already have, and as far as possible we will rely on data and information that institutions have produced to meet their own needs. We will try to make regulation efficient and ensure that its benefits outweigh the costs to institutions, ourselves and other parties.

18. Our aim is to be open and transparent with institutions and other stakeholders. We recognise that this may sometimes conflict with the desire to protect commercial confidentiality. In complying with the Freedom of Information Act and similar legislation we will try to make it clear to institutions what information we regard as confidential, and we will judge each case on its merits.

19. Our grants to institutions are to fund activities defined by the Further and Higher Education Act 1992. For higher education institutions these are:

- providing education and undertaking research
- providing facilities and undertaking activities that the institution's governing body thinks are necessary or desirable for providing education or doing research.

For further education colleges, we fund the provision of 'prescribed' courses of higher education.

20. Our funding is subject to certain conditions, as set out in the 1992 Act. The Act allows us to add certain conditions to our funding. We will consult the sector on any changes to those conditions.

21. These conditions of funding do not apply to any funds that institutions receive from other sources, although the principles will be reflected in conditions of grant associated with other public sector income to institutions. We want to encourage them to develop other sources of income that are consistent with their overall mission and objectives.

22. We will review an institution's annual accountability returns to us and give to the designated officer and governing body a confidential risk assessment. When we assess an institution to be 'at higher risk', we will engage with it in line with our institutional engagement and support strategy (see Annex D). One of the annual accountability returns to be submitted is the annual assurance return (see Annex E).

Institutions' responsibilities to HEFCE

23. HEFCE is the major public sector funder of higher education institutions as a whole and has lead public accountability for them. As a result, institutions need to provide certain information about their viability and the way they operate. HEFCE is also being appointed as the principal regulator of the sector under the Charities Act, though this should not involve a significant additional burden on institutions.

24. Institutions are accountable to all their stakeholders, not just HEFCE, and this will be easier if they operate in an open and transparent way. An institution will need to plan and deliver its activities effectively, in line with its mission and objectives, and meet its various legal requirements, particularly those to ensure fair and equal treatment of its staff and students.

25. The governing body of an institution is collectively responsible for overseeing its activities, determining its future direction and fostering an environment in which its mission is achieved. Acting in accordance with the institution's own statutes and constitution (where appropriate), the governing body should ensure that the institution:

- has a robust and comprehensive system of risk management, internal control and corporate governance
- has regular and adequate information to monitor performance and track the use of public funds
- plans and manages its activities to remain sustainable and financially viable
- informs us of any material adverse change in its circumstances
- uses public funds for proper purposes and strives to achieve good value for money from public funds
- complies with the mandatory requirements relating to audit set out in our audit code and our annual accounts direction
- sends us
  - the annual accountability returns which constitute the 'single conversation' (see paragraph 28)
  - other information we may request to understand the institution's risk status
  - any data requested by HESA
- has effective arrangements for the management and quality assurance of data submitted to HESA, HEFCE and other public bodies
- considers our assessment of its risk status and takes action to manage or mitigate the risks we identify.

26. The governing body will appoint the head of institution as the 'designated officer', who will advise it (and HEFCE, if necessary) if the institution fails to comply with this memorandum. The designated officer and/or chair of the governing body may be required to appear before the Public Accounts Committee alongside the Chief Executive of HEFCE, as our Accounting Officer, on matters relating to grants to the institution.

27. Institutions shall subscribe to HESA and QAA, and ensure that their use of JANET and SuperJANET networks conform to acceptable practice and current legislation.

28. We expect institutions to consider how their actions affect our policy objectives for the sector, as set out in our strategic plan. When they plan a major change in strategy or academic provision, or consider merging with another body, they should discuss this with us at an early stage.

29. Institutions may only use Council funds for activities eligible for funding under the 1992 Act, and this condition applies where the HEI passes on part of its HEFCE grant to another legally distinct entity – a 'connected institution' – for the provision of facilities or learning and teaching or for research to be undertaken. In such cases, as set down in Section 27 of the 1998 Act, the institution must obtain the Council's consent before passing HEFCE funds to the connected institution.

Financial management and sustainability

30. Institutions should have a financial strategy that reflects their overall strategic plan, sets appropriate targets and performance indicators, and shows how resources are to be used. To remain sustainable and financially viable they should also assess, take and manage risks in a balanced way that does not overly constrain freedom of action in the future.

31. Institutions must:

- stay solvent
- not incur deficits, unless these are covered by discretionary reserves. Any deficits not covered by these reserves must be recovered within three years or within a period agreed with us. For this purpose, any pension scheme deficits included on an institution's balance sheet following implementation of FRS17 should be excluded from the calculation of reserves. However, institutions should still work towards improving any pension scheme deficits.

32. We normally expect an institution to increase its reserves broadly in line with income. A series of deficits, even if covered by discretionary reserves, might be a cause of concern, as would low levels of liquidity or increased borrowing. In such cases we would expect to discuss financial performance and strategy with the institution.

33. We expect an institution to consider the consequences of new financial commitments and ensure they are consistent with its strategic plan and financial strategy and represent good value for money.

34. An institution must get written consent from us before it agrees to any new financial commitments as follows:

a. Long-term commitments – where the annualised servicing cost of its total financial commitments would increase to above 4 per cent of total income.

b. Short-term financial commitments – where negative net cash exceeds 5 per cent of total income for more than 35 consecutive days.

Annex F sets out the information we need to assess both types of request, and the methods of calculating the annualised servicing cost and negative net cash.

35. The thresholds mentioned above are not limits and should not constrain an institution from increasing its financial commitments where this is appropriate. An institution should determine the level of borrowing that is both affordable and consistent with its financial strategy. We ask the institution to demonstrate this in the case presented to us, show that the proposal represents good value, and confirm the approval of its governing body. In responding to requests for consent we aim to be helpful and pragmatic, taking into account the circumstances of each proposal.

36. As part of ensuring its long-term viability, an institution should know the full cost of its activities and use this information in making decisions. If it does not seek to recover the full cost, this should be the result of a clear policy set by the governing body and included in the financial strategy, and should not put the institution in financial difficulty. We expect our funds not to subsidise non-public activities.

Estate management and exchequer interests

37. Institutions should manage their estate in line with an estates strategy. The strategy should be written with reference to guidance available to the sector, including that from HEFCE. Institutions should review their current and expected use of land and buildings, and consider rationalising and disposing of assets no longer needed. Former voluntary colleges and other institutions holding land and buildings not covered by exempt charitable status shall also take into account the requirements of the Charity Commissioners.

38. For exchequer interests, the institution, having entered into an agreement with HEFCE effective on 1 August 2006, shall follow the conditions set at Annex G. If an institution has not signed such an agreement, it is bound by the terms and conditions set out in the earlier model Financial Memorandum (HEFCE 2003/54).

Accountability and risk assessment

39. We expect institutions to have governance and management processes that can easily demonstrate to their public sector funders (including HEFCE) proper control over, and accountability for, the use of public funds. The better these processes are, the easier it will be for institutions to show that they are making proper use of public money.

40. As far as possible the accountability process between HEFCE and institutions will be concentrated into an exchange of documents and dialogue during a specific period each year – this is known as the single conversation. We will confirm the specific content of this exchange each year and consult the sector on any major changes to the process. Our aim is to minimise our demands on institutions and as far as possible to rely on data and information that they have produced to meet their own needs.

41. Institutions should send us their accountability information on the specified dates in December of each year. We will review this and give each institution a confidential, formal assessment of its risk status. For those we consider to be 'not at higher risk' – in our experience to date, the vast majority – there will be no need for further information or discussion of accountability until the next year's return. Sometimes we will ask for more information to clarify uncertainties.

42. When we assess an institution as 'at higher risk' we must respond appropriately, to protect the public interest. Our institutional engagement and support strategy (see Annex D) describes the range of ways in which we might respond and help institutions resolve difficulties and manage risks. We will always discuss our concerns with the institution, and take its views and actions into account, before we formally make an 'at higher risk' assessment. We will also try to reach agreement on what needs to be done. When we consider the institution to be no longer at higher risk, we will write to its governing body to confirm this.

43. Beyond the exchange of accountability information each year, we welcome the opportunity for regular and informal discussions with an institution about its plans and developments. We believe this will help us to work together and reduce the risk of misunderstanding.

Revisions to the memorandum

44. We will revise this document only after consulting the sector or its representative bodies.

Consultation questions on the Financial Memorandum

Question 1: Our new approach to the FM and accountability documentation is for it to be principles-based and integrated. Have we achieved this?

Question 2: Do you accept that HEFCE's principal interests are that our funds are used for the purposes intended and that the institution remains sustainable? (Paragraph 13 refers.)

Question 3: Do you agree that it is appropriate for HEFCE to engage in a dialogue with an institution in the event of a continuing financial deficit, low levels of liquidity or increased borrowing? (Paragraphs 42 and Annex D refer.)

Question 4: Is our requirement to be advised of 'material adverse changes' clear? (Paragraph 25 and Annex A, paragraph 16 refer.)

Question 5: Do you agree that the revised annual assurance return from the Designated Officer (Annex E) provides appropriate assurances about compliance with the FM and accountability?

Question 6: The institutional engagement and support strategy (Annex D) updates the support strategy agreed in 2005. Is the new version clear and helpful?

45. Consultation questions on the Accountability and Audit Code of Practice are at the end of Annex B.

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