July 2010/19

Core funding/operations

Report

Effective 1 August 2010

The Financial Memorandum, between HEFCE and the institutions we fund, sets out the terms and conditions for payment of HEFCE grants. The memorandum should be read in conjunction with Part 2, the schedule, which gives conditions specific to the institution, the funds available to the institution, and the educational provision the institution has agreed in return for those funds. This document supersedes HEFCE 2008/19 issued in August 2008.

July 2010/19

Model Financial Memorandum between HEFCE and institutions

Terms and conditions for payment of HEFCE grants to higher education institutions

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Free

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Foreword to the 2010 edition of the Model Financial Memorandum

HEFCE is a non-departmental public body. This means that while our remit is set by the Secretary of State for Business, Innovation and Skills, we are not part of any government department. This enables us to act as a broker between universities, colleges and the Government ensuring the appropriate institutional freedom for teaching and research. The Government decides on the total public funding for higher education, and we distribute this funding fairly and transparently, according to agreed criteria.

Under the Further and Higher Education Act 1992, which established HEFCE, the Secretary of State is not entitled to frame his conditions of grant to us by reference to specific institutions, or to particular courses of study or programmes of research, or to the criteria for the selection and appointment of academic staff or for the admission of students. This is designed to safeguard both institutional and academic autonomy, which are widely regarded as key factors in the success of English higher education. We strongly endorse these principles.

However, HEFCE does have a clear regulatory duty to ensure that universities in receipt of public funds provide value for money and are responsible in their use of these funds. We also ensure that the funding we distribute accurately reflects what is delivered. In addition, we now act as the principal regulator for those universities and colleges that are exempt charities, advising the Charity Commission where appropriate. We aim to reduce the accountability burden on institutions by enabling other public bodies, wherever possible, to rely on our systems of oversight and assurance.

HEFCE is also legally responsible for making sure that the quality of learning and teaching is assessed in each university and college across England. We also assess the quality of research, enabling us to fund research selectively by supporting excellence wherever it is found.

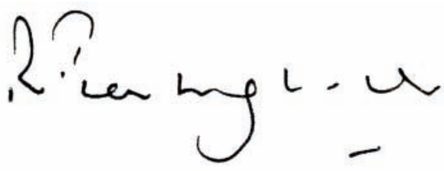
As accounting officer, the chief executive of HEFCE has a personal responsibility to safeguard public funds and achieve value for money as set out in HM Treasury guidance, 'Managing Public Money'. This includes responsibility for the public funds allocated by the Council to higher and further education institutions and other bodies for education, research and associated purposes.

Higher education in England is made up of a diverse range of institutions of varying size and complexity. To give expression to the principle of autonomy, every institution is headed by a governing body which is unambiguously and collectively responsible for overseeing the institution's activities, determining its future direction, and fostering an environment in which the institutional mission is achieved and the potential of all students is realised. The governing body ensures compliance with the statutes, ordinances and provisions regulating the institution and its framework of governance. HEFCE funding is provided explicitly to the governing body as the institution's ultimate authority.

The chair is responsible for the leadership of the governing body and the executive head of institution (usually the vice-chancellor or principal) is responsible for the leadership of academic affairs and management of the institution. The employment status of the head of institution, including his or her appointment (or dismissal), is governed by employment law and is the responsibility of the governing body.

This approach draws on the expertise and diligence of governors and a relationship of trust between HEFCE and institutions which serves higher education well.

The principle of institutional autonomy and the system of regulation on which it depends relies on clear lines of accountability for the proper stewardship of public funds and on being able to demonstrate to Parliament and the public that, in the exceptional circumstance when something goes wrong, there is a clear mechanism to put it right. The purpose of the Financial Memorandum is to provide this clarity and assurance by defining the formal relationship between HEFCE, governing bodies and heads of institutions.



Alan Langlands

Chief Executive
Higher Education Funding Council for England
July 2010

Model Financial Memorandum between HEFCE and institutions

Terms and conditions for payment of HEFCE grants to higher education institutions

Purpose of this document

1. This Model Financial Memorandum sets out the formal relationship between HEFCE and the governing bodies and accountable officers of the higher education institutions (HEIs) 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
- risk management, control and governance in the sector are effective
- value for money is being achieved.

2. The Financial 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 as the 'grant letter') gives conditions specific to each 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.

3. Institutions are bound by the requirements of their charter and statutes (or equivalent) and by rules relating to their charitable status. This document does not supersede those requirements but is intended to complement and reinforce them.

4. This memorandum, including the Audit Code of Practice (Annex B), takes effect from 1 August 2010. The content of the memorandum which deals with financial management and sustainability (paragraphs 28-33 and Annex F) will be subject to review in consultation with the higher education (HE) sector, commencing in 2010-11, to ensure that our requirements reflect the changing economic circumstances for institutions and anticipated developments in financial reporting requirements.

Our responsibilities to institutions

5. HEFCE is the major public sector funder of HEIs as a whole and has lead public accountability for them. As such 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, and acknowledge that institutions accept that they are accountable for the public funds they receive. 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.

6. We aim for two-way openness and transparency 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 where objections to publication arise we will judge each case on its merits.

7. Our grants to institutions are to fund activities defined by the Further and Higher Education Act 1992 ('the 1992 Act'). For HEIs 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.

8. Our funding is subject to certain conditions, as set out in the 1992 Act. The Act allows us to add conditions to our funding, including special conditions for particular HEIs. We will consult the sector on any material changes to general conditions. 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 institutions to develop other sources of

income that are consistent with their overall mission and objectives.

9. We will review an institution's annual accountability returns to us, and give to the accountable officer and governing body a confidential risk assessment. We will not make our risk assessments public until three years have elapsed. This period, based on advice from the Information Commissioner, gives an institution that is designated 'at higher risk' time to address its problems. We will make our risk assessments available within this three-year period, on an exceptional and confidential basis, to:

- other public funders to enable those bodies to make their own assessments of risk, and
- to the National Audit Office who may exceptionally need to discuss those assessments at the Public Accounts Committee or disclose them in a published report.

We must do this to minimise the risk to public funds distributed by those bodies.

10. We may exceptionally make public a risk assessment at any stage if we have strong grounds for believing that it is in the general public interest to do so. We will only share or publish our risk assessments after having notified the accountable officer and governing body of the institution concerned. 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).

11. We define an institution as at higher risk when in our judgement, on the basis of all available evidence, it:

- faces threats to the sustainability of its operations either now or in the medium term
- has serious problems relating to value for money, propriety or regularity (that is, whether funds are used for the purpose intended), or
- has materially ineffective risk management, control or governance.

More detail on how HEFCE assesses institutional risk is given at Annex D, Table 2.

Institutions' responsibilities to HEFCE

12. Institutions need to provide HEFCE with certain information about their viability and the way they operate, because we have responsibility and lead public accountability for HEIs. Our information requirements are set out in this Financial Memorandum and in annual guidance on financial statements and accountability returns. Institutions also have an obligation to supply information to enable us to fulfil our new role as principal regulator of HEIs as charities under the Charities Act. The information required for this is summarised at Annex H, and it largely draws on existing returns that institutions make to HEFCE.

13. Institutions are accountable to all their stakeholders, not just HEFCE, and this responsibility is easier if they operate in an open and transparent way. An institution needs to plan and deliver its activities effectively, in line with its mission and objectives, and to meet its various legal requirements.

Governing bodies

14. Governing bodies of HEIs and their members have a set of legal responsibilities and other duties. These are outlined in Annex I. These responsibilities are summarised in this document to reinforce for governors what their role requires. Annex I also clarifies what issues HEFCE can and cannot become involved in. It is important for institutional autonomy that the scope of HEFCE's role is understood, and that HEFCE is not expected to enforce legal or mandatory responsibilities that are not within its remit.

15. Taken together, the responsibilities of members of a governing body and of the governing body as a whole are considerable, and must be met. Its members are trustees of charitable bodies, and have the responsibilities and potential liabilities that go with trustee status. Members who act prudently, lawfully and in accordance with the governing instrument should not find themselves liable for their actions. However, HEFCE will be obliged in exceptional cases to use its powers and consider all relevant options to ensure that governing body

members discharge their duties under this memorandum and as trustees. In addition, in relation to trustee responsibilities, the Charity Commission has the power to take proceedings against trustees who have acted imprudently. Trustees need to be particularly careful to ensure that the charity has the means to meet its obligations when the institution is entering into substantial contracts or borrowings.

16. HEFCE will in exceptional cases consider designating an institution as 'at higher risk' if it has firm grounds for believing that a governing body is not discharging its duties under this Financial Memorandum and is unable or unwilling to commit to improvement. HEFCE would expect to arrive at such a judgement on the basis of an assessment of the institution's governance. Our assessment would include a dialogue with the governing body about our concerns and conclusions. In such a case, and after the governing body's views had been considered, HEFCE may make its risk assessment public, in line with paragraph 10. This would be on the basis that when a publicly funded body is subject to ineffective governance it is of public interest. HEFCE may also place conditions of grant on an institution that fails to address the risks of ineffective governance where this puts public funding at risk.

17. Members of governing bodies and accountable officers should comply with the principles set out by the Committee on Standards in Public Life, and their conduct should always be in the public interest. They are accountable for their decisions and actions, and must submit themselves to whatever scrutiny is appropriate to their office. They should also be as open as possible about all the decisions and actions that they take. HEFCE will write to the new chair of each governing body, on appointment, drawing attention to their own and their governing bodies' responsibilities under the Financial Memorandum. A model for this letter is at Annex K.

18. The governing body of an institution is collectively responsible and has ultimate non-delegable responsibility for overseeing the institution's activities, determining its future direction and fostering an environment in which its mission is achieved. In accordance with the institution's own statutes and constitution, there should be effective arrangements for providing assurance to the governing body that the institution:

- has a robust and comprehensive system of risk management, control and corporate governance
- has regular, reliable, timely 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 change in its circumstances which – in the judgement of the accountable officer and in agreement with the governing body – is a material adverse change, as well as any significant developments that could impact on the mutual interests of the institution and HEFCE
- 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 of Practice and our annual accounts direction
- sends us:
  - the annual accountability returns
  - other information we may reasonably request to understand the institution's risk status
  - any data requested on our behalf by the Higher Education Statistics Agency (HESA)
  - information needed to enable us to act as principal charity regulator for the HEI
- has effective arrangements for the management and quality assurance of data submitted to HESA, HEFCE and other funding bodies (we reserve the right to use our own estimates of data where we have reason to believe institutional data are not fit for purpose). Responsibility for the quality of data used for internal decision making and external reporting, which must be fit for purpose, rests

with the institution itself. Data submitted for funding purposes must comply with directions published by HEFCE; if in doubt institutions should ask their HEFCE regional consultant to provide an authoritative, written ruling

- has an effective framework – overseen by its senate, academic board or equivalent – to manage the quality of learning and teaching and to maintain academic standards
- considers our assessment of its risk status, engages with us during the risk assessment process, and takes action to manage or mitigate the risks we agree upon.

Head of institution and accountable officer

19. Each governing body will appoint a head of institution. It will delegate to that person responsibility for the executive management of the institution and its policies.

20. Under this Financial Memorandum, the governing body is responsible for the use of funds. To assist and enable it to discharge this responsibility and to provide clear accountability, the governing body will designate a senior officer, normally the head of the institution, as the 'accountable officer': that is, the officer who reports to HEFCE on behalf of the institution. On being notified by, or on behalf of, the governing body of a new accountable officer, HEFCE will write to that individual explaining what the responsibilities of an accountable officer involve. A model for this letter is shown at Annex J.

21. The accountable officer is personally responsible to the governing body for ensuring compliance with the terms of this Financial Memorandum and for providing HEFCE with clear assurances to this effect.

22. The head of institution is first and foremost responsible for leadership of the academic affairs and executive management of the institution. The appointment (or dismissal) of the head of institution is governed by employment law, and this is clearly the responsibility of the governing body. HEFCE has no role, rights or responsibilities in relation to the appointment (or dismissal) of the head of institution and has no wish to change this position. We presume that in a case where a head of institution does not discharge his/her duties or acts improperly the governing body will take appropriate action.

23. The head of institution as the accountable officer is also required to report to HEFCE on behalf of the institution in relation to the requirements set out in paragraph 18. In exceptional circumstances HEFCE may take the view that the accountable officer is failing to meet these responsibilities. Faced with this position HEFCE would be obliged to respond and in a fair, reasonable and proportionate way.

24. If, in the judgement of the HEFCE chief executive, there is evidence of serious failure in relation to the oversight and management of public funds, he will raise this as appropriate with the accountable officer concerned and/or the chair of the governing body; provide the relevant evidence; and seek and consider a response. Experience suggests that most difficulties can be resolved through this process.

25. *In extremis*, and after all due process has been exhausted, the HEFCE chief executive may conclude that the accountable officer is unable to meet his/her responsibilities under this memorandum. HEFCE may then ask the governing body to appoint someone else to report to HEFCE on behalf of the institution. In taking this action HEFCE will not seek to influence the employment relationship between the governing body and the head of institution. The governing body is clearly entitled to maintain the head of institution in post. However the governing body would then have to designate another senior officer as the accountable officer, and adjust the roles and responsibilities of the head of institution accordingly.

26. The institution's accountable officer and/or chair of the governing body may be required to appear before the Public Accounts Committee alongside the chief executive of HEFCE in his role as accounting officer, on matters relating to grants to the institution.

27. In the event of a prolonged absence from work or a sudden departure by the accountable officer, the clerk to the institution's governing body must ensure that HEFCE is made aware immediately of the identity of the interim accountable officer.

Financial management and sustainability

28. 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. 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.

29. We normally expect that an institution will make a surplus in line with its financial strategy for sustainability, and thus that its discretionary reserves will grow over time. A series of deficits, even if covered by discretionary reserves, might cause us concern, as could low levels of liquidity or increased borrowing. In such cases we would expect to discuss financial performance and strategy with the institution.

30. Institutions must apply the following principles when entering into any financial commitments:

a. The risks and affordability of any new on- and off-balance sheet financial commitments must be properly considered.

b. Any commitments must be consistent with the institution's strategic plan, financial strategy and treasury management policy.

c. The source of any repayment of a financial commitment must be identified and agreed at the point of entering that commitment.

d. Financial commitments for the procurement of a particular capital asset should not be entered into if they involve any proportion of those commitments remaining to be met after the expected useful life of the asset has expired.

e. Planned financial commitments must represent value for money.

31. HEFCE is concerned to ensure that any financial commitments entered into by an institution are affordable and do not leave challenges to its sustainability that will have to be faced in the long term. 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 explains the methods of calculating the annualised servicing cost and negative net cash. When we designate an institution as 'at higher risk' we may vary these two thresholds.

32. The two thresholds are not limits, and should not deter an institution from increasing its financial commitments where 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 any 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.

33. 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 do not expect our funds to subsidise non-public activities (see paragraph 36).

Other requirements on institutions

34. We expect institutions to consider how their actions affect our policy objectives for the HE 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.

35. Institutions shall subscribe to HESA and the Quality Assurance Agency for Higher Education (QAA), and ensure that their use of JANET and SuperJANET networks conform to acceptable practice and current legislation.

36. Institutions can only use Council funds for activities eligible for funding under the 1992 Act and other relevant legislation. 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 Teaching and Higher Education Act 1998, the institution must obtain our consent before passing HEFCE funds to the connected institution. Consent is also required where the institution passes on part of its grant (via a franchise or indirect funding agreement) to an entity that is neither an HEI nor FEC supported from public funds.

37. Institutions should manage their estate in a sustainable way, in line with an estates strategy and the requirements of HEFCE's Capital Investment Framework. Institutions should review their current and expected use of land and buildings, and consider rationalising and disposing of assets that are no longer needed. Institutions are also required to have carbon management plans in accordance with guidance in HEFCE 2010/02, and performance against these plans will be a factor in determining future capital allocations.

38. For exchequer interests, the institution, having entered into an agreement with HEFCE effective from 1 August 2006, shall follow the conditions set at Annex G.

39. Until April 2011, institutions are subject to the public sector duties listed within the Race Relations (Amendment) Act 2000, the Disability Discrimination Act 2005 and the Equality Act 2006. These laws impose positive duties on all public bodies – including HEIs and HEFCE – to promote race, disability and gender equality in everything that they do. HEFCE also has a statutory duty to monitor the HE sector for any adverse and differential impact on race, disability and gender equality arising from its policies and actions, but it does not have an enforcement role. In April 2011, the integrated public sector Equality Duty will be implemented, which will place additional duties on all public sector bodies to pay 'due regard' to the needs of all protected groups. These include: age, disability, gender reassignment, marriage and civil partnership, pregnancy, race, religion or belief, sex or sexual orientation.

Accountability and risk assessment

40. We expect institutions to have governance and management processes in place that can readily 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.

41. 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 following the end of the financial year. 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.

42. Institutions should send us their accountability information on the dates in December that we specify each year. We will review this and give each institution a confidential, formal assessment of its risk status – see Table 2 of Annex D. For those we consider to be 'not at higher risk' – our experience to date suggests that this is the vast majority – there will be no need for further information or discussion of accountability until the following year's return, save in the case of an unanticipated change in circumstances. Sometimes we will ask for more information to clarify uncertainties.

43. When we assess an institution as being 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 to help institutions resolve difficulties and manage risks. We will always discuss our concerns with the institution's accountable officer, and take his/her views and actions into account, before we formally make an 'at higher risk' designation. 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.

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

Revisions to the Financial Memorandum

45. We will make material revisions to this document only after consulting the higher education sector or its representative bodies, as appropriate.

Annex A

Mandatory requirements of the Financial Memorandum and Audit Code of Practice

1. The following are mandatory requirements of the Financial Memorandum and the Audit Code of Practice ('the Code'). We will assess compliance with these.

2. The governing body must ensure that the institution meets its responsibilities as set out in the Financial Memorandum. The governing body and accountable officer must comply with:

- the general conditions of grant set out in this Financial Memorandum
- any special conditions of grant. Save in a case where urgent action is required to safeguard public funds, special conditions of grant will only be imposed after HEFCE has consulted the institution about the conditions.

3. The institution must obtain written consent for financial commitments, as specified in Annex F.

4. The governing body of each higher education institution (HEI) must take reasonable steps to ensure that there are sound arrangements for risk management, control and governance, and for economy, efficiency and effectiveness (value for money), within the HEI.

5. The governing body and accountable officer must ensure that data submitted to HEFCE comply with relevant published directions.

6. Each HEI must have an effective audit committee which produces an annual report for the governing body and the accountable officer. The audit committee annual report must relate to the financial year and include any significant issues up to the date of preparing the report which affect the opinion. The audit committee annual report must include the audit committee's conclusions on the adequacy and effectiveness of:

- the HEI's risk management, control and governance arrangements
- arrangements for promoting economy, efficiency and effectiveness
- the arrangements for the management and quality assurance of data submitted to the Higher Education Statistics Agency, HEFCE and other funding bodies.

7. Members of the audit committee must not have executive authority. Members should not also be members of a finance committee, unless the institution's governing body has made a clear decision to allow one audit committee member to sit on both (no more than one member may sit on both and he or she should not be the chair).

8. The audit committee of each HEI, advised where appropriate by its internal audit service, must satisfy itself that appropriate arrangements are in place to promote economy, efficiency and effectiveness.

9. Each HEI must have an effective internal audit function, which reports regularly to the audit committee and at least annually to the governing body and the accountable officer. The internal audit annual report must relate to the financial year, and include any significant issues up to the date of preparing the report which affect the auditor's opinion. The work of the internal audit service must cover the whole of the risk management, control and governance arrangements of the HEI.

10. The head of the internal audit service must have direct access to the HEI's accountable officer, the chair of the audit committee and, if necessary, the chair of the governing body. Internal as well as external auditors must also have unrestricted access to information – including all records, assets, personnel and premises – and be authorised to obtain whatever information and explanations the head of the internal audit service or the external auditor considers necessary.

11. Internal and external audit services must not be provided by the same firm or provider.

12. Fees paid to external auditors for other services must be disclosed separately in a note in the financial statements.

13. Subject to legislative constraints, the HEFCE assurance service must have unrestricted access to information – including all records, assets, personnel and premises – and can require anyone to

give any explanation which it considers necessary to fulfil its responsibilities. This includes access to any work of the internal and external auditors, or correspondence between internal and external auditors. When it needs access to external audit work, the HEFCE assurance service will exchange letters (where necessary) with both parties to deal with confidentiality and the terms under which access is given.

14. HEIs must not agree to any restriction in external auditors' liability in respect of the external audit of their annual financial statements, except as specified at Annex B, paragraph 79.

15. The following information must be provided, according to a timetable which will be notified each year:

- a signed and approved set of financial statements to include the auditor's opinion
- a copy of the audit committee's annual report
- a copy of the internal auditor's annual report
- the completed annual assurance return (Annex E)
- a copy of the external auditor's management letter and the management response.

16. The HEI's accountable officer must report any material adverse change without delay – such as a significant and immediate threat to the HEI's financial position, significant fraud or major accounting breakdown – to all of the following:

- the chair of the HEI's audit committee
- the chair of the HEI's governing body
- the HEI's head of internal audit
- the external auditor
- the HEFCE chief executive.

17. The governing body must inform HEFCE's assurance service without delay of the removal or resignation of the external or internal auditors.

Annex B

Audit Code of Practice

Purpose

1. The Audit Code of Practice ('the Code') sets out our requirements for higher education institutions' (HEIs') accountability and audit arrangements and the broad framework in which they should operate. It forms part of the Financial Memorandum, and compliance with the mandatory elements of the Code is therefore a condition of grant.

2. HEFCE's chief executive is its accounting officer. The chief executive is responsible for ensuring the proper and efficient use of public funds by HEFCE, by HEIs and by others who receive HEFCE funds, and for ensuring that Treasury guidance is observed. The financial memorandum between the Department for Business, Innovation and Skills (BIS) and HEFCE requires the issue of an Audit Code of Practice for institutions. This is that Code.

Overview

3. The Code states how effective accountability and audit coverage should be achieved. It sets out our minimum requirements for the reporting of risk management, control and governance arrangements, for internal and external audit arrangements, and the broad framework in which they should operate.

4. The Code applies to the relationship between HEFCE and HEIs – and in principle to their related companies and other bodies which, indirectly, receive HEFCE funding. These include, for instance, entities associated with HEIs such as subsidiary companies and charitable funds. These subsidiary entities are not required to observe the Code in detail, but should pay appropriate regard to it. We also fund a small number of connected institutions through HEIs, which are also subject, indirectly, to the Code. The colleges of the Universities of Oxford and Cambridge are not funded directly by us but are subject to an agreed audit protocol.

5. We also fund and have relationships with a number of related bodies. These are independent bodies established to assist HEFCE and the higher education (HE) sector to deliver HE strategy. Each related body is required as a condition of its funding with HEFCE to conform to the Code as far as is appropriate and practical.

6. We assess institutions' performance against the Code in two ways. Firstly, every report and return required under the Code, from each institution, is scrutinised on an annual basis by the HEFCE assurance service (HEFCEAS). Where institutions fail to report as required, this is classed as non-compliance with conditions of grant. Secondly, each institution is subject to audit visits from HEFCE's own auditors, and the nature of our audit evolves over time and is tailored to the circumstances of each institution. Our audit normally leads to a report which is publicly available and which has been agreed by the accountable officer on behalf of the HEI and its governing body.

7. The Code is primarily for use by internal and external auditors, HEIs' senior management, members of the governing body and audit committees.

Corporate governance

8. The corporate governance arrangements of an HEI are the means by which strategy is set and monitored, the executive is held to account, risks are managed, stewardship and trustee responsibilities are discharged, and sustainability is ensured. A more complete description of corporate governance in an HEI can be found in the guide by the Committee of University Chairs (CUC) – 'Guide for members of higher education governing bodies in the UK' (HEFCE 2009/14). The CUC Guide includes a Governance Code of Practice, against which CUC and HEFCE commend institutions to evaluate themselves. The principle should be that institutions 'comply or explain' and the outcome of each periodic evaluation should be published, ideally in the Corporate Governance Statement or Statement of Internal Control in the published financial statements.

Higher education audit framework

9. In accordance with the Financial Memorandum, HEIs must have effective risk management, control and governance arrangements. Other funding bodies also have an interest in these control arrangements, including Parliament, BIS, the Skills Funding

Agency, the Student Loan Company (SLC), Research Councils UK, the Department for Employment and Learning (DEL) in Northern Ireland, and the Training and Development Agency for Schools (TDA).

10. Each of these bodies makes appropriate arrangements to safeguard its interest. Each has its own auditors, but in practice there are only two groups engaged in regular audit investigation of an institution's systems and records – an institution's internal and external auditors. This is the same level of activity that is common in the private sector. Of the interested parties, BIS, HEFCE, DEL, TDA and the Research Councils seek to avoid duplication by relying on the work of the other bodies' assurance arrangements whenever possible.

Parliament

11. Parliament's interest is to see that public funds are properly applied and accounted for and used economically, efficiently and effectively by recipients. The Comptroller and Auditor General (CAG), head of the National Audit Office, is the external auditor of HEFCE. The CAG has the right to inspect the accounts of any HEI that receives HEFCE grant, and the right to carry out value-for-money (VFM) investigations. The National Audit Office is selective in its use of inspection rights: much of its audit work is undertaken at HEFCE, and VFM investigations normally involve only a sample of institutions at any one time.

Department for Business, Innovation and Skills

12. Public funds for HE are primarily channelled through BIS. The BIS permanent secretary, as principal accounting officer, is responsible and accountable to Parliament. The HEFCE chief executive must be satisfied that proper arrangements are being made to safeguard public funds. This is achieved through the financial memorandum between BIS and HEFCE, which requires HEFCE to have an audit service and appropriate accounting systems. The work of HEFCE auditors and institutional assurance staff is examined by the BIS audit service, which may observe them at work in HEIs but does not audit HEIs itself.

HEFCE

13. HEFCE operates an internal audit function and a separate team that is responsible for monitoring institutions. This team (the HEFCEAS) operates our regulatory framework, undertakes audit work in institutions and assesses institutional risk. In common with the arrangements in HEIs, there is an audit committee to assist the HEFCE chief executive and Board in discharging their accountability and audit responsibilities, both in respect of HEFCE and of HEIs and other entities.

14. In the event of any material adverse change in an institution's circumstances – such as a significant and immediate threat to the HEI's financial position, significant fraud or major accounting breakdown – the accountable officer must inform, without delay, all of the following:

- the chair of the HEI's audit committee
- the chair of the HEI's governing body
- the HEI's head of internal audit
- the external auditor
- the HEFCE chief executive.

15. On receiving any such notification, the chief executive will discuss what response to make with the HEI's governing body or accountable officer, including any action to be taken. If a matter requiring report is discovered by external or internal auditors in the normal course of their work and the accountable officer refuses to make a report, the auditors must report directly to all of the following:

- the chair of the HEI's audit committee
- the chair of the HEI's governing body
- the HEFCE chief executive.

This is to ensure that the HEI has taken appropriate action.

16. Below, we provide an indicative list of what should be reported to HEFCE. The accountable officer, in agreement with the governing body, or in urgent cases the chair, may judge that there are other circumstances that warrant notification:

- any financial loss or reduction in income or working capital which is significant enough in the accountable officer's judgement to materially impact on the financial outturn or the cash position

- any new decision to invest or expend funds which in the accountable officer's judgement will have a material impact on the forecast position as reported to HEFCE in the most recent annual accountability exercise
- any new or changed risks which – in the accountable officer's judgement – are significant enough to affect the institution's future sustainability
- any theft, fraud, loss of charity assets or other irregularity where the sums of money involved are, or potentially are:
  - in excess of £25,000 (this figure aligns with reporting requirements for charities and we will keep it under review and notify changes through our annual accounts direction); or
  - where the particulars of the fraud, theft, loss of charity assets or other irregularity may reveal a systemic weakness of concern beyond the institution, or are novel, unusual or complex; or
  - where there is likely to be public interest because of the nature of the fraud, theft, loss of charity assets or other irregularity, or the people involved.

17. There may be cases of fraud, theft, loss of charity assets or other impropriety or irregularity, that fall outside this definition. In these cases or any others, HEIs can seek advice or clarification from the HEFCEAS. In view of the public interest, HEIs should normally notify the police of suspected or actual fraud. Where the police are not notified, management should advise the institution's audit committee of the reason.

Audit and risk assessment of HEIs by the HEFCE assurance service

Role and scope

18. The HEFCEAS operates our regulatory framework, undertakes audit work in institutions and assesses institutional risk. It is responsible for evaluating the risk management, control and governance arrangements of HEIs and other entities funded by HEFCE, and for giving assurance on those arrangements to HEFCE's chief executive. It will also provide information and advice to the HEFCE audit committee to enable it to fulfil its role in advising the HEFCE Board and chief executive.

19. All the activities of HEIs are within the remit of HEFCEAS. HEFCEAS works in accordance with the standards for internal audit in the Government Internal Audit Standards issued by the Treasury, and guidance from relevant professional auditing and accountancy bodies. It will consider whether risk management, control and governance arrangements are adequate to manage risk and to secure propriety, efficiency, economy and effectiveness in all areas. It will seek to confirm that management has taken the necessary steps to achieve these objectives.

20. Subject to legislative constraints, HEFCE has access to all records, information and assets of HEIs and other entities, and can require any officer, including members of the governing body, to give any explanation which we consider necessary to fulfil our responsibilities.

21. HEFCE will liaise, whenever appropriate, with the National Audit Office, the HEI's internal and external auditors (collectively and individually), BIS, TDA, the Scottish Funding Council, the Higher Education Funding Council for Wales, DEL and any other appropriate HEFCE officer or relevant organisation. HEFCE will also liaise with sector bodies as it seeks to promote good governance, management and auditing. Liaison is pursued both for effectiveness and to avoid duplication of effort.

Reporting

22. HEFCEAS will report on HEIs' compliance with our mandatory requirements and conditions of grant to HEFCE's chief executive and audit committee.

23. HEFCEAS will, when appropriate, draw the attention of the HEFCE chief executive and audit committee to material adverse changes including significant frauds and any major accounting breakdowns.

24. HEFCEAS will submit an annual report on institutional risk to HEFCE's chief executive and audit committee. This will:

- include the HEFCEAS assessment of the adequacy and effectiveness of the risk management, control and governance arrangements within HEIs and other entities funded by HEFCE
- provide an opinion on the sector's achievement of propriety, regularity and value for money in its use of public funds
- summarise the risk position of the sector
- report on coverage achieved
- provide audit performance measures.

Ongoing risk assessment

25. We expect HEIs to notify us of significant changes and issues as they arise, not simply material adverse changes. This will help us to maintain the currency of our risk assessments. For example, changes of auditors, of key personnel (such as the finance director, or university secretary/registrar) or key systems changes (such as the implementation of a new finance information system) are potentially significant in our risk assessment.

HEFCE audit work in institutions

26. HEFCEAS undertakes reviews at institutions with the objective of determining whether the institution's reports and returns, including those specified in the Code, can be relied on. Where this is so, and an institution continues to perform well and sustain itself, HEFCEAS will only need to undertake its review once in every five-year cycle. The format of the review is explained in detail in HEFCE Circular letter 25/2006.

Data assurance

27. HEIs are required to supply us with data to inform our allocations of funding generally and in response to specific initiatives. To avoid duplication we will wherever possible use data that are already supplied through HESA or HESES.

28. Within HEFCE, our institutional teams monitor the reasonableness of data, and our analysts undertake verification, validation and reconciliation work. We also undertake limited, periodic data audits in each institution.

Audit committees in HEIs

Scope

29. The governing body of an HEI must ensure that it is fulfilling its responsibilities for adequate and effective risk management, control and governance, and for the economy, efficiency and effectiveness (or VFM) of the HEI's activities. To assist in this, each HEI has appointed an audit committee.

Operation

30. The way an audit committee in an HEI should operate and be constituted is set down in guidance from the CUC, published in 2008 (HEFCE 2008/06).

31. HEFCE's position is that governing bodies and audit committees should conduct themselves in line with the CUC's principles and practices, and that where they believe they differ in any material respects then this should be explained and made public. Overall we aim to be content to rely on the accountability provided by an audit committee following CUC practice and by a governing body able to exercise accountability on behalf of external investors. We therefore support the principle of an external majority on an HEI governing body – in other words, a majority of members who are external and independent, and are not staff or students of the university.

32. Audit committee members should not be members of an institution's finance committee or its equivalent because this would create a potential conflict of interest when the audit committee is considering decisions involving the finance committee. If an HEI's governing body determines that cross-representation involving one member is essential, this should be the subject of an explicit, recorded resolution – but it should not be an option for the chair of either committee.

Reporting

33. The audit committee must produce an annual report for the governing body and the accountable officer. The audit committee annual report must cover the financial year and include any significant issues up to the date of preparation of the report. The audit committee annual report should normally be submitted to the governing body before the members' responsibility statement in the annual financial statements is signed. The internal auditors' annual report and the audit committee report must be submitted to HEFCE according to the timetable to be published annually in a circular letter. This informs our institutional risk assessment.

34. The audit committee annual report must include the committee's conclusions on the adequacy and effectiveness of the HEI's arrangements for the following:

- risk management, control and governance
- economy, efficiency and effectiveness (value for money)
- management and quality assurance of data submitted to HESA and to HEFCE and other funding bodies. This latter assurance is to ensure adequate governance oversight of the systems used to generate funding data by the HEI, since poor data may represent a significant financial risk for HEIs that audit committees need to consider.

35. The audit committee opinions should be based on the information presented to the committee. The data management assurance does not require audit committees to verify data: that is the responsibility of management. The audit committee's interest should be in the management and quality assurance of data.

36. The audit committee annual report should also record the work of the committee, and consider the following:

- the external auditors' management letter
- the internal auditors' annual report
- value for money work
- any HEFCEAS reports or other relevant evaluations.

Internal and external auditors in HE: general principles

Duties

37. Internal and external auditors should adhere to their professional standards. This includes taking care to avoid personal and professional conflicts of interest, being clear about their reliance on each other's work and acting with due care. The same firm may not provide both external and internal audit services to a HEI.

Internal audit arrangements in HEIs

38. Each HEI is required by its Financial Memorandum with HEFCE to have an internal audit function. Internal audit should follow a risk-based approach.

39. Each institution will manage its own risks, and in turn each institution's internal auditor will undertake a programme of risk-based work. It is for the institution to make judgements on this work: HEFCE cannot impose particular areas for review on any institution's internal auditors save in the exceptional individual cases set out in our support strategy (see Annex D). However, on the basis of experience from several serious cases over many years, HEFCE believes strongly that internal financial control should factor in internal audit risk assessment every year. This may or may not lead to specific audit reviews in a given year, but the governing body and accountable officer should be content that – based on audit risk assessment, direct audit work or other forms of review such as control risk self-assessment (CRSA) – assurance about financial control is always available. From time to time, we may draw other areas of risk to the attention of institutions with a recommendation that these be factored into internal audit planning.

40. HEFCE guidance on internal audit practice in HEIs endorses the approach set out in the Code of Ethics and International Standards (January 2009)[1] of the Institute of Internal Auditors (IIA).

41. Within the HE sector, the prime responsibility of the internal audit service is to provide the governing body, the accountable officer and the other managers of the HEI with assurance on the adequacy and effectiveness of risk management, control and governance arrangements. Responsibility for these arrangements remains fully with management, who should recognise that internal audit can only provide 'reasonable assurance' and cannot provide any guarantee against material errors, loss or fraud. Internal audit also plays a valuable role in helping management to improve risk management, control and governance, thereby reducing the effects of any material adverse risks faced by the HEI.

Operation

42. An HEI must ensure that it has effective risk management, control and governance arrangements. These help to ensure that:

a. The HEI's objectives are achieved as far as possible and associated risks are managed.

b. The economic, efficient and effective use of resources is promoted.

c. There is adherence to management's policies, directives and established procedures, and compliance with any relevant laws or regulations including charities legislation.

d. The HEI's assets and interests are safeguarded – particularly from losses arising from fraud, irregularity or corruption.

e. As far as reasonably practicable, the integrity and reliability of accounting records, data and other information is maintained. This includes data supplied to HESA, HEFCE and other funding bodies.

43. Accordingly, the internal audit service must consider the whole of the HEI's risk management, control and governance arrangements, including all its operations, resources, staff, services and responsibilities for other bodies.

44. Internal auditors may carry out additional work at the request of management, including consultancy and investigations, provided such work does not compromise the objectivity of the audit service or the achievement of the audit plan. Accordingly, each HEI's audit committee should satisfy itself that the objectivity of the internal audit service has not been affected by the extent and nature of other work carried out. Internal audit services should not have any management responsibilities other than for internal audit.

45. Internal audit should be seen to have sufficient status, respect and support within the HEI. To be effective, the head of internal audit – or equivalent where the service is provided on a contract basis – must have direct access to the HEI's accountable officer, to the governing body (normally through the chair of the audit committee) and, if necessary, to the chair of the governing body. Whether provided internally or externally, day-to-day line management and overall reporting arrangements for the internal audit service should be such as to preserve its objectivity by avoiding concentration of responsibility and reporting with any one senior person within the HEI. Internal auditors must also have unrestricted access to all records, assets, personnel and premises, and be authorised to obtain whatever information and explanations are considered necessary by the head of the internal audit service.

Reporting

46. The reporting requirements for any internal audit service are discussed in standards published by the IIA. It is a requirement of the Code that the internal audit service produce an annual report of its activities. The internal audit annual report must relate to the financial year and include any significant issues, up to the date of preparing the report, which affect the opinion. This should be addressed to the governing body and the

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[1] Available at www.theiia.org under Standards & Practices/Code of Ethics.

accountable officer, and should be considered by the audit committee. The audit committee may forward the report to the governing body with its own report. The report must be submitted to HEFCE after it has been considered by the HEI's audit committee.

47. The internal audit annual report should include the internal auditor's opinion on the adequacy and effectiveness of the HEI's arrangements for:

- risk management, control and governance
- economy, efficiency and effectiveness.

48. This opinion should be placed into its proper context: that is, the work undertaken has been based on the agreed audit strategy and on the areas reviewed in the year, as well as incorporating knowledge of areas audited in previous years (including from a previous auditor). Internal audit performance measures should be provided, including stating coverage achieved against the original audit plan. It should also draw attention to any significant audit recommendations which the internal audit service considers have not received adequate management attention.

Provision of service

49. There are a variety of ways to acquire an internal audit service, and we do not favour one approach above the others. Each HEI, advised by its audit committee, should establish which is the most suitable and cost-effective way of obtaining internal audit services. However, every five years at least, it should consider market testing internal audit services where those services are provided by outside contractors, since this provides a powerful incentive to maintain quality and cost-effectiveness. Where internal audit is an in-house service, there should be periodic consideration of whether this continues to be the appropriate type of provision for the institution.

50. In all cases the audit committee should monitor internal audit effectiveness. In addition, where the internal audit service is provided in-house, the audit committee chair should be consulted on the annual performance appraisal of the head of internal audit. This appraisal process is the responsibility of management.

Removal or resignation of auditors

51. Subject to normal staffing arrangements (for 'in-house' internal auditors) and any contractual arrangements in place, only the governing body (or the audit committee where delegated authority exists) may pass a resolution to remove the internal auditors before the end of their term of office if serious shortcomings are identified.

52. Where internal auditors cease to hold office for any reason, they should provide the governing body with either a statement of any circumstances connected with their removal which they consider should be brought to the governing body's attention, or a statement that there are no such circumstances. The internal auditors may also request an extraordinary general meeting of the governing body to consider the statement. Any such statements should also be sent to the HEFCEAS by the HEI – or, if it fails to do so, by the outgoing internal auditors.

53. The governing body must inform HEFCE without delay of the removal or resignation of the internal auditors and of the reasons.

Restriction of auditors' liability

54. Where the internal audit service is provided through a contractual arrangement with an external provider, the provider may ask the HEI to agree to a restriction in the internal auditors' liability arising from any default by the auditors. Normally such liability should be without limit. However, HEIs may negotiate a restriction in liability so long as the decision is made on an informed basis and the liability remains at such a level as to provide reasonable recourse to the HEI. The governing body, through the audit committee, should be specifically notified of any request for a liability restriction.

Fraud and corruption

55. Internal auditors should assess the adequacy of the arrangements to prevent and detect irregularities, fraud and corruption. However, the primary responsibility for preventing and detecting corruption, fraud and irregularities rests with management, who should institute adequate systems of internal control, including clear objectives, segregation of duties and proper authorisation procedures.

56. The work of the internal audit service, in reviewing the adequacy and effectiveness of the internal control system, should help management to prevent and detect fraud. The internal audit service should ensure that it has the right to review, appraise and report on the extent to which assets and interests are safeguarded from fraud. When internal auditors suspect fraud, or are carrying out a fraud investigation, it is important to safeguard evidence. They should assess the extent of complicity to minimise the risk of information being provided to those involved, and the risk of misleading information being obtained from them.

57. The HEI should ensure that the internal auditor is informed, as soon as possible, of all attempted, suspected or actual fraud or irregularity. The internal auditor should consider any implications in relation to the internal control system, and make recommendations to management, as appropriate, to strengthen the systems and controls.

External audit arrangements in HEIs

Introduction

58. Institutions in the sector are expected to follow the Statement of Recommended Practice (SORP) on Accounting in Further & Higher Education published by Universities UK, and the accounts direction published as a circular letter every year by HEFCE. The 2007 SORP introduced a requirement for an operating and financial review, and institutions are encouraged to use this as an opportunity to demonstrate their effectiveness, accountability and performance.

59. The primary role of external auditors is to report on the financial statements of HEIs and to carry out whatever examination of the statements, and their underlying records and control systems, is necessary to reach their opinion on the statements. Their report should also state whether, in all material respects, recurrent and specific grants from HEFCE (and other bodies and restricted funds where appropriate) have been properly applied for the purposes provided, and in accordance with the institution's Financial Memorandum with HEFCE; in other words, that the conditions of grant have been met.

60. We accept that HEFCE is not the direct client of the external auditor and that the auditor does not have a duty of care to us. However, we require that external audit engagements in the sector meet the requirements of the Code, and that this is reflected in the external audit engagement letter.

Qualification of auditors

61. The qualifications required for external auditors of higher education corporations are set out in paragraph 18(5) of Schedule 7 of the Education Reform Act of 1988. For other HEIs, the requirements are the same as under the Companies Acts. Auditors should be registered with one of the appropriate professional bodies, and conform to that body's standards.

Selection criteria and procedures

62. The governing body is responsible for appointing external auditors, although it will usually delegate the detail of the process to the audit committee. Before receiving proposals, the HEI should determine selection criteria, procedures and the frequency of external testing.

63. The duties of HEIs and external auditors should be clearly presented in the agreed terms of reference.

Additional services

64. HEIs may ask external auditors to provide services beyond the scope of the audit of financial statements, including special investigation work, taxation compliance and advice, consultancy and VFM reviews. Generally, it is a matter for HEIs and auditors to agree precise requirements, although the audit committee must be informed of all significant facts and matters that have a bearing on the auditors' objectivity and independence related to the provision of non-audit services, including the safeguards put in place. Any additional work must not impair the independence of the audit function, and so should normally be the responsibility of different staff within the firm of auditors.

65. The audit committee has a key role to play where the auditors supply a substantial amount of non-audit services. The committee must keep the nature and extent of such services under review,

seeking to balance independence and objectivity with the HEI's needs.

66. In order to help judge the relationship between the HEI and its external auditors, the HEI must disclose separately, by way of a note to its financial statements, the fees paid to its external auditors for other services. Each HEI's audit committee must review both the level of fees incurred and the future planned work, and satisfy itself that the extent and nature of other work does not affect the objectivity of the external audit.

Letter of representation

67. In order to undertake their work, external auditors seek from those charged with governance a letter of representation providing details of any material changes that need to be brought to the auditors' attention to enable them to complete their work in an effective manner. In addition to the requirements of International Standards on Auditing (UK & Ireland), HEFCE recommends that auditors satisfy themselves that management has provided all necessary evidence to confirm any possible significant adjustments to past or future HEFCE funding.

Management letter

68. External auditors should issue a report to those charged with governance – normally referred to as a management letter – which highlights accounting issues and control deficiencies arising from the audit. The HEI's management should provide written responses to any recommendations made or issues raised. The Code is not prescriptive about the format or title of a management letter, but it should enable the HEFCEAS to see what observations have been made about the internal control system and how management has responded.

69. External auditors should also indicate in the management letter whether, or to what extent, they are content to rely on the work of the internal auditors in support of external audit work. These statements will be based on work which should already have been carried out for the purpose of external audit. They provide information which is useful to the audit committee and to HEFCE in determining institutional risk assessments.

70. The letter, with management responses, must be made available to the HEI's audit committee in time to inform the committee's annual report. HEIs must send a copy of the final management letter (incorporating management responses) to the HEFCEAS according to the timetable published annually in a circular letter. External auditors should attend audit committee and/or finance committee meetings at which the audited financial statements are discussed, and attend governing body and other meetings when appropriate.

Audit report

71. The external auditors shall report whether in all material respects:

a. The financial statements give a true and fair view of the state of the HEI's affairs, and of its income and expenditure, recognised gains and losses, and statement of cash flow for the year. They should take into account relevant statutory and other mandatory disclosure and accounting requirements, and HEFCE requirements.

b. The financial statements have been properly prepared in accordance with the Statement of Recommended Practice (SORP) on Accounting in Further & Higher Education, and sections 495 and 496 of the Companies Act 2006 (where the HEI is incorporated under the Companies Act), and/or other legislative or regulatory requirements.

c. Funds from whatever source administered by the institution for specific purposes have been properly applied to those purposes and, if relevant, managed in accordance with relevant legislation.

d. Funds provided by HEFCE have been applied in accordance with the Financial Memorandum and any other terms and conditions attached to them. In particular, auditors should have regard to the specific requirements of the Financial Memorandum, such as compliance with the short-term and long-term borrowing conditions.

72. HEFCE publishes as a circular letter an annual accounts direction, and institutions and their

external auditors are required to conform to it. The accounts direction summarises and updates HEFCE's financial reporting requirements.

73. External auditors have a duty to consider the Statement of Internal Control with the annual financial statements and to comment by exception if the statement is inconsistent with their knowledge of the HEI. It is for each HEI to decide whether it wishes its external auditors to do more than this required minimum. Each HEI needs to ensure that processes are in place – including work by internal auditors, external auditors and management – to provide assurance on the effectiveness of the arrangements underpinning the Statement of Internal Control. External auditors may report privately to the governing body (through the audit committee) on the results of their work on the Statement of Internal Control, or may make reference to this work in the financial statements, either in their audit opinion report or through a separate report.

Reappointment of auditors

74. HEIs should reappoint external auditors formally each year. The audit committee should assess the external auditors' work each year to ensure that it is of a sufficiently high standard and represents value for money. The committee should then make a recommendation to the governing body regarding the reappointment of the external auditors. Performance measures could be used as part of the assessment. Provided that the external auditors' performance is satisfactory, it will not be necessary to repeat the full selection process each year. However, full market testing should be undertaken at least every seven years. One partner in the firm is normally responsible for the institution's audit; he or she should not hold this position for more than seven consecutive years.

Removal or resignation of auditors

75. The governing body may pass a resolution to remove the external auditors before the end of their term of office if serious shortcomings are identified.

76. External auditors who have resigned or been removed from office for whatever reason should be entitled to attend, and make representations to, the general meeting of the governing body at which their term of office would have expired, or at which it is proposed to fill the vacancy caused by the resignation or removal. They are entitled to receive notices of, or other communications relating to, that meeting and to be heard on any part of the business which concerns them as former auditors of the HEI.

77. As with internal auditors the governing body is responsible for advising HEFCE where external auditors cease to hold office, and the reasons for this.

78. In deciding whether or not to accept the appointment, anyone proposing to take up the office of external auditor should obtain the HEI's permission to communicate with the outgoing auditors. Outgoing auditors should also obtain permission from the HEI to discuss their affairs freely with the proposed auditors, and should disclose all information required by the proposed auditors that is relevant to the appointment. These provisions are analogous to those in the Code of Ethics of the Institute of Chartered Accountants in England and Wales.

Restriction of auditors' liability

79. HEIs must not agree to any restriction in external auditors' liability in respect of the external audit of their annual financial statements, unless a liability limitation agreement has been entered into under the terms of the Limited Liability Partnerships Act 2000 and the Companies Act 2006 or, in the case of HEIs that are not incorporated under the Companies Act 2006, as if the relevant provisions of that Act applied to HEIs.

80. For other types of work performed by the external auditors, the provider may ask the HEI to agree to a restriction in the auditors' liability arising from any default by the auditors. Normally, such liability should be without limit. However, HEIs may negotiate a restriction in liability if the decision is made on an informed basis and the liability remains at such a level as to provide reasonable recourse to the HEI. The governing body, through the audit committee, should be notified of any liability restriction agreed.

HEFCE access to auditors

81. HEFCE may wish to meet with an HEI's external auditors, particularly in connection with a visit to the HEI. The HEI should not limit access in any way. Formal discussion should normally be arranged through the HEI's accountable officer or representative. HEFCE will exchange letters where necessary with both parties to deal with confidentiality and the terms under which access is given.

Annex C
Allocating and paying funds

1. Each year we determine how much money to allocate to each institution. In doing so we may distinguish between recurrent and capital funds, and between formula capital and project capital.

2. Higher education institutions (HEIs) should use this money only for the proper purposes, as defined in the Further and Higher Education Act 1992 or other relevant legislation.

3. The above condition applies if an HEI passes on money to another body or organisation to provide education, research or related activities. The HEI remains responsible for controlling such activities. There should be a written agreement with the other body covering financial accountability and quality assurance. However, this is not necessary if the other body is an HEI or HEFCE agrees to the arrangement.

4. Sometimes we pay funds to an HEI or further education college (FEC) as the lead institution for a consortium of universities and colleges. In such cases, there should be a consortium agreement setting out how the money is passed on to the consortium members. Guiding principles for agreements are published in HEFCE 00/54.

5. An institution must use specific or capital funding for those purposes only. If it uses them for other purposes, it must let us know as soon as it becomes aware of the fact.

6. We will tell institutions their allocation of formula funds as soon as we can in advance of the academic year to which they relate: normally by 31 March. We will normally pay such funds in monthly instalments. The profile of payments will take into account the expected needs of the sector as a whole and the receipt of tuition fees from students and the Student Loans Company.

7. We will pay formula funding for widening access and improving retention only where institutions have sent us widening participation strategies and action plans that we find acceptable.

8. We will consider requests from individual institutions to alter the profile of payments, provided that such payments are not in advance of the institution's need to spend the money.

9. Our capital grants are administered through our Capital Investment Framework. Institutions that meet the framework requirements will have discretion over the use of capital funds in line with their estates strategies. We will continue to require other institutions to send us details of capital programmes and projects to which we may contribute costs, in line with criteria we set. We will set out conditions for such grants and agree a payment profile with the institution. All institutions are expected to work towards satisfying the requirements of the Capital Investment Framework.

10. We will require an institution to repay part or all of a grant payment if it does not comply with the conditions we attach to the grant or if it is over-funded. This might arise from our audit and reconciliation work. We may reduce or withdraw funding from an HEI or FEC under the terms of our unsatisfactory quality policy (HEFCE 2009/31). In cases where we require repayment we may charge interest, at 2 per cent above the Bank of England base rate, for the period before it repays the funding to us.

11. If we overpay grant as a result of using estimated data, we will recover the amount overpaid, plus interest, as set out in the previous paragraph.

Annex D

Institutional engagement and support strategy

Introduction

1. This strategy sets out how we will engage with and support higher education institutions (HEIs) and our related bodies (RBs) on matters relating to performance, accountability and risk assessment. It also describes what will happen when, as a result of our assessment, we find there to be significant risks either to the organisation itself or to HEFCE's functions or interests. Our risk assessment methodology is summarised in Table 2. The strategy applies to our work as both funder and principal regulator.

2. The principles underlying our institutional engagement and support strategy are that we will:

- protect the interests of the public and the taxpayer
- respect the independence of HEIs and the formal status of each related body: the operation of our engagement and support strategy underwrites the independence of institutions when they are not at higher risk
- maintain an open dialogue on matters of mutual interest
- seek to intervene only when necessary but we will do so vigorously, using the full extent of our powers, when we judge that an institution's management and governors are not effectively addressing risks to public funds and the interests of students
- be open with the HEI or RB in our risk assessment and requirements and, if warranted on public interest grounds, disclose our risk assessments publicly
- ensure our involvement is proportionate to the risks
- end our enhanced involvement as soon as possible.

3. In broad terms there are three levels at which HEFCE may engage with institutions:

- normal contact
- focused dialogue (in cases where we are supporting an institution's change or development or where we perceive there to be medium-term risks which, if not addressed, will put the institution at higher risk)
- support strategy (for institutions at higher risk or institutions which will be at higher risk if decisive action is not taken).

Normal contact

4. As part of our routine engagement with institutions and RBs we will want to understand their mission, strategy and operational plans. This will help us to make appropriate responses to the needs of the institution and the HE sector, and to gain assurance about matters that affect the delivery of our own objectives. There will often be a formal visit by the HEFCE regional team to the institution in each year, and in the context of a more frequent exchange of information and views. It is also part of our normal contact to discuss an institution's accountability returns and give feedback, as part of the annual accountability returns exercise.

Focused dialogue

5. There are occasions when it is to the advantage of both HEFCE and institutions to explore issues in more detail. For example, an institution may wish to secure our support for particular plans, and we will want to understand how best to provide help to meet its development needs and fit with our wider objectives for the sector. Likewise, we may wish to discuss with an institution whether there are opportunities to improve its performance or work collaboratively with others. There will also be cases where an institution's risks are increasing because of developments in its market position, its performance or its internal control arrangements; HEFCE will seek to engage at such times to try and ensure that the risks are appropriately addressed.

Support strategy

6. We have a risk assessment system covering all institutions and RBs. This draws on the information we routinely collect through the annual accountability returns exercise and on other information such as research and teaching quality assessments. Sometimes we will ask for more information to clarify our understanding. There are currently two risk categories: 'not at higher risk'

(the vast majority of HEIs at any time) and 'at higher risk' (for a small number of institutions).

7. Through these annual returns or our regular contact with an institution or RB, there may be issues that require further discussion. All institutions face business and operating risks. The issue is therefore about managing risk; putting in place systems to identify, mitigate and report on risk. In many cases, as a result of further discussions, we will conclude quickly that there is no cause for concern.

8. When we have major concerns we need to intervene to protect the public interest. We will firstly discuss these issues with senior management, specifically the accountable officer (of an HEI) or chief executive (of an RB). We will seek a common understanding of the issues, clarify what actions have already been taken or are planned, and if necessary then agree an appropriate support strategy. Table 1 sets out the range of possible actions, though sometimes we will agree a different approach with an HEI or RB.

9. The HEFCE associate director responsible for dealings with the HEI or RB will lead our support activity, but a relevant senior manager – the HEFCE regional consultant, relationship manager (in the case of an RB) or assurance consultant – will manage the day-to-day engagement. In exceptional cases, our chief executive will become involved. All cases will be overseen by our audit committee and reported to the HEFCE Board.

10. If an institution or RB fails to address its problems to our satisfaction, it might be in the public interest for us to disclose our risk assessment (see paragraph 10 of the main text). We expect this to be a rare occurrence, because in our experience institutions generally do take appropriate action.

Table 1 **HEFCE support strategy for HEIs and related bodies 'at higher risk'**

Possible HEFCE actions
Overall
We may require institutions to make changes as conditions of grant if we feel that risks to our funding and the interests of students and the public are not being addressed. We will only do so after due consideration and consultation, and only on the basis of appropriate advice. Thus it will always be our intention to make only reasonable demands of institutions. If institutions do not comply with conditions of grant we will take steps to enforce compliance or withhold funds. In addition to the actions below we will consider any other action that we believe is necessary to support institutions at risk and protect the interests of the public and the taxpayer.
At governor and senior manager level we:
• Will engage with senior management, including the accountable officer. • Will assess the accountable officer's compliance with the Financial Memorandum, including the requirement to have effective management and quality assurance arrangements over data supplied to the Higher Education Statistics Agency, HEFCE and other funding bodies. • Will inform the governing body of our change in risk assessment and seek commitments to improvement. We will notify other public funders, as appropriate, of any 'at higher risk' assessment, and exceptionally we will make such an assessment public at any time where we consider it to be the public interest to do so. • Will engage directly with the chair of the board and/or chair of the audit committee. • Will engage with the whole governing body and, if necessary, take steps to ensure improvements are made to governance arrangements.

- May require observer status at governing body or audit committee meetings to enable us to assess whether our specific concerns are being addressed. This could be for individual meetings or over a period of time. Our observer will always be a senior HEFCE officer.
- May request the appointment of interim managers.

Regarding information and audit we may:

- Require or commission additional information, reports and data relating to the risks.
- Require that information and reports be audited.
- Request changes to internal or external audit arrangements.
- Undertake or commission audit investigations.

Regarding planning and strategy we may:

- Require or commission a recovery or action plan.
- Discuss possible changes to strategic plans and market positioning.
- Explore collaborative opportunities with other institutions.

Regarding funding we may:

- Re-profile grant to assist an institution that has a cash flow difficulty.
- Consider the use or withdrawal of special funding.
- Attach special conditions to grant.
- Reduce or withdraw funding.
- Use our own estimates of data where we are not satisfied that information from the institution can be relied on.

As risks decline we will:

- Inform the institution (and others who may have been notified of our risk assessment) about changes in our risk assessment.
- Remove special conditions of grant and other requirements.

Table 2 **HEFCE institutional risk system**

Introduction
HEFCE's management of risk obliges it to assess the risk to public funds or the activities provided from those funds posed by institutions. We maintain an assessment of each HEI, which focuses on the three areas of risk identified in paragraph 11 of the Financial Memorandum: • institutional sustainability • value for money, propriety or regularity • risk management, control or governance.

Sources of information
We have a number of mechanisms and sources for enabling us to assess risk, including: a. The annual accountability process in which institutions submit a range of information and returns relating to financial performance and forecasts, student numbers, the use of funds and risk management, control and governance. b. Our own institutional audit processes, including data audits and cyclical assurance visits, which are designed to complement institutions' accountability returns. c. The continuing dialogue that we have with each institution about their changing priorities and strategies and their reporting of adverse developments. d. Information from other sources including public bodies that might potentially impact on our concerns with sustainability, among other issues. For example, we have memoranda of understanding with other funders of HEIs that commit us, on a confidential basis, to share information which could have a bearing on each others' assessments of the risk to funds. e. Indicators that we do not monitor systematically for the purpose of institutional risk but which, at times and in specific institutional cases, could have a bearing on our risk assessments. For example, quality assurance judgements, any implications under our policy for addressing unsatisfactory quality (HEFCE 2009/31), or National Student Survey outcomes. f. Information directly supplied by institutions, for example concerning material adverse changes to their circumstances. g. Information disclosed to us through public interest disclosures but only when substantiated by us in dialogue with the institutions concerned. h. Other sources of publicly available data.

Our risk assessment

Our assessment of the risk to financial **sustainability** is based on historical (two years) and forecast (four years) of financial information supported by a narrative commentary. A number of indicators are employed as set out below. We perform this assessment once a year for every HEI and as many times as necessary during the year for institutions 'at higher risk' and those in danger of becoming at higher risk. We have internal benchmarks for each of these indicators which help us to flag concern. We also try to look beyond the snapshot position which the indicators represent to an institution's trends and how its performance compares with the sector and its peers. We feed back key parts of our financial assessment to each institution in our annual risk letter. The current indicators are:

- historical cost surplus as percentage of total income
- cash flow from operations as a percentage of total income
- liquidity expressed in days
- affordability of borrowing (as indicated by the level of annual servicing costs of borrowings, in line with our consent procedure for financial commitments)
- discretionary reserves as percentage of total income
- staff costs as percentage of total costs.

We develop and supplement these indicators over time and in response to individual cases.

Our assessment of risk relating to the **use of public funds** is concerned with all public funds being used for the purposes intended by Parliament (regularity), fraud and impropriety being prevented or dealt with effectively, and value for money (economy, efficiency and effectiveness) being pursued in the application of those funds. We do not audit these matters directly ourselves but derive information for our risk assessment from these sources:

a. The annual submission by HEIs of the reports of the governing body, audit committee, accountable officer and internal and external auditor.

b. Information and evidence from institutions themselves and other organisations and sources that confirms any misuse of funds on a material scale. From time to time we may receive information through these routes relating to any aspects of an institution's operations or provision that could cause us to reconsider our risk assessment. We would make such a judgement on a case-by-case basis in dialogue with the institution concerned.

Our assessment of institutional **risk management, control and governance** is concerned with ensuring that public funds are being administered by well-run corporations. In addition to information on finances and the use of funds, our own data and assurance audits enable us to corroborate institutional assurances. Overall, the regular sources of information for this risk assessment include:

- the annual accountability returns including the governance and accountable officers' assurances
- the outputs of the institution's internal and external auditors
- information from other public bodies
- HEFCE's own audit work.

Risk notification

The work undertaken by HEFCE, augmented by information from other sources, enables us to make a single annual risk assessment, normally in March. For the majority of institutions this results in a letter from the HEFCE chief executive advising that in HEFCE's judgement the institution is not at higher risk. We ask that all our risk letters be communicated to the governing body.

In some cases, the HEFCE assessment letter notifying that an institution is not at higher risk will be qualified by comments alerting the institution to concerns we have that need to be addressed and which, in some cases, if not addressed, may lead to a worsening of the institution's risk status. The comments can include a range of issues including financial performance, strategic challenges and technical matters of accountability. Some of these matters are more serious than others. We will endeavour in such cases to explain the issues fully and we expect that our concerns will be considered and dealt with by the institution.

Institutions at higher risk

In a small number of cases, HEFCE's judgement will be that an institution is at higher risk. This assessment is most likely to be made for financial reasons. Whatever the reason for the judgement, the process of making and communicating the judgement is very thorough and follows the following stages:

a. The initial assessment will be made by a member of the HEFCE assurance service. This team is made up of experienced, qualified accountants, working to an established methodology that is subject to managerial quality control and periodic internal audit. The assessment will be made in consultation with the relevant HEFCE associate director who will maintain contact with the head of institution at this early stage.

b. The initial assessment will be developed in conjunction with other colleagues including those who have lead responsibility for institutional relations – HEFCE associate directors and regional consultants. A dialogue will take place with the institution about our intention and the reasons behind it. The institution will have opportunities to supply new information that could materially affect our judgement and we will reconsider our assessment in such a case.

c. The assessment will normally be finalised at a meeting of HEFCE's institutional risk review group, an internal forum that interrogates and scrutinises institutional risk work and ensures the application of consistent standards and judgements. This group, chaired by HEFCE's deputy chief executive, makes recommendations on risk status to the chief executive.

d. The chief executive will then make the risk judgement, possibly after seeking further information and advice.

e. Any changes of risk status are reported to HEFCE's audit committee and Board. At this stage a draft risk letter will be shared with the head of institution and the chair of the governing body. Every effort will be made to ensure that the text, the circumstances discussed in the letter, and the action plan for improvement are agreed by the institution, including its governing body.

f. At the final stage the letter will be sent by the HEFCE chief executive to the head of institution and the chair, along with our request that it be shared with the institution's board.

g. From this point onward, until the risk status improves, the institutional relationship will be managed by the relevant HEFCE associate director under the terms of our support strategy.

h. HEFCE will not make public the names of institutions that we consider to be at higher risk until three years have elapsed since that designation. This period is based on advice from the Information Commissioner. HEFCE will depart from this practice and will make public the identity of an institution at risk in exceptional cases, following a dialogue with that institution in line with the obligations on us under the Freedom of Information Act. This is likely to be when the institution's position as a going concern in the short term is under threat.

Annex E
Model annual assurance return from institutions

This return is to be submitted as part of the annual accountability returns exercise, the timetable for which will be specified annually in a circular letter. The purpose of the return is to confirm that the institution has met its obligations to HEFCE under the Financial Memorandum. The return also confirms that the institution is complying with its duties as a charity and thus it enables HEFCE to fulfil its responsibility as principal regulator.

The return is in two parts.

- part 1 should be signed by the accountable officer of all HEIs
- part 2 is not required from HEIs that are either not a charity or are registered with and make an annual return directly to the Charity Commission. For all other HEIs, part 2 should be signed by the accountable officer, unless he or she is not a trustee, in which case it should be signed by an appropriately authorised trustee. This means that the return should normally have been approved by the governing body.

Institution ……………………………………………………………………

Year ended ……………………………………………………………………

Part 1	
Can you confirm that in this period the institution has met its responsibilities to HEFCE (conditions of grant) as set out in the Financial Memorandum?	
Have there been any changes of senior officer in the period that have not been notified to HEFCE, including the chairs of the governing body and audit committee and the heads of finance and internal audit?	
Have there been any material adverse changes that should have been notified during the period that now need to be brought to our attention in line with paragraph 18 and Annex B, paragraphs 14-17, of the Financial Memorandum? If so, please provide details.	

This is to confirm that the data and annual accountability returns submitted to HEFCE conform to the requirements of the Financial Memorandum and published guidance. The data have been subject to effective oversight and management review. Quality assurance has been provided to the audit committee, which in turn has been able to provide assurance to the governing body and myself as accountable officer.

Signed ……………………………………………….... Print name …………………………….....…........................

Date ………………………………………………

Part 2

I confirm that, in all material respects, the institution has conducted its affairs during the year in accordance with its status as a charity.

Apart from material adverse changes (see Part 1), the institution has either:

- reported any serious incidents (as defined in Annex B, paragraphs 14-17 and Annex H, paragraphs 8-11); or
- now attaches a report of serious incidents not previously reported.

Signed as a trustee on behalf of all of the trustees:

Signed ……………………………………………….... Print name …………………………….....…........................

Date ………………………………………………

Annex F
Consent for financial commitments

Introduction

1. 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 (ASC) 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.

c. At higher risk – where institutions are designated by us as at higher risk we may vary the thresholds set out above.

Definitions

Total income

2. Total income is as reported in the latest audited financial statements, or the estimated amount for the current year if that is lower.

Short-term commitments

3. 'Negative net cash' is determined on a cash book basis and as defined by FRS 1 (revised 1996): 'Cash Flow Statements'.

Long-term commitments

4. The requirements of paragraph 31 of the Financial Memorandum only apply when an institution intends to do one of the following:

- take out additional financial commitments, including repayable grants from us
- refinance existing financial commitments, including fixing the interest rate.

5. There is no need to seek our consent where the ASC increases above the 4 per cent threshold, or any other threshold approved by the Council, solely as a result of either an increase in the interest rate on variable rate borrowings or a reduction in total income. Similarly, consent is not required if refinancing existing commitments results in a lower ASC.

6. In all cases, the ASC calculation should reflect the economic substance, which may differ from the legal form.

7. Long-term financial commitments mean amounts which are due for payment after more than 12 months, in accordance with Generally Accepted Accounting Principles. These include:

- all borrowing, whether self-financing or not
- finance leases, subject to the exclusion below
- inherited debt and leases which are not fully reimbursed by us
- Private Finance Initiative (PFI) arrangements which are accounted for as loans or finance leases in accordance with the requirements of SSAP 21 or FRS 5

and exclude:

- lease payments where the combined ASC of such leases does not exceed 0.5 per cent of total income.

8. The ASC of the financial commitments consists of total expected net cash payments (capital and interest) over the period of the loan, divided by the loan period in years. This includes lump sums at the end of the term.

9. Where the financing involves a lease-and-leaseback of existing assets (that is, the institution receives rental income linked to rental expenditure), the ASC should be calculated on the net cash outflow.

10. For new loans, the interest rate to be used in the calculation is the one in force at the start of the loan, whether this is fixed (for all or part of the loan period) or variable. For existing loans, the interest rate to be used is the one currently in force.

11. The loan period is as defined at the time when the commitments are agreed. It starts when the first part of the loan is drawn down and ends when the final liability is repaid. If there is an option to extend at a later date any part of the commitments to a longer term, the ASC will still be measured on the original term.

12. Where the loan period is to be shortened or extended, the ASC calculation should be reworked using the revised term and rates of interest in force at that time. If this increases the ASC above the 4 per cent threshold, the institution must get (revised) written consent from the Council.

Our response

13. The Council will try to give a response to a request for consent within 15 working days of the receipt of all relevant information. Where the proposed ASC for long-term financial commitments is above 7 per cent, approval must come from the HEFCE Board. This will extend the period required to deal with the request, and institutions should discuss this with us when they are planning to seek consent. We accept, however, that very occasionally an institution may need to get a faster response, in which case it should discuss this with us at an early stage in developing its plans.

14. In responding to requests for consent we aim to be helpful and pragmatic, applying the general principles outlined here to the circumstances of each proposal. If an institution is unsure how to calculate the ASC or whether consent is required, it should discuss this with us.

Information required

15. We set out in Table 3 the information we require to consider a request for consent. This addresses the issues we would expect the institution's own governing body to seek assurance on before approving additional financial commitments. The main focus is on affordability and risk, not necessarily on the individual project.

Table 3 **Information required by HEFCE to consider a request for consent for new financial commitment(s)**

Long-term financial commitments
1. There should be a reasonable case for the new investment. Information required: a. Brief description of the new investment. b. An explanation of how it broadly fits with the institution's mission and strategic priorities. c. Confirmation that the institution has followed HEFCE guidance on appraising investment decisions.
2. The new financial commitment or refinancing arrangement should be consistent with the institution's financial strategy and represent good value for money. Information required: a. An explanation of why additional finance or refinancing is necessary and how this fits with the financial strategy. b. The forms of finance considered and the selection process and criteria. c. The net present value for each financing option and a brief explanation of why the chosen method was selected.
3. Details of the new financial commitments. Information required: a. Details of the chosen option, including: name of lender, sum borrowed, loan period and basis of repayment. b. Terms and conditions of the financing (for example, a copy of the offer letter) and an evaluation of the risks and uncertainties.
4. The new investment and financial commitments must be affordable. Information required: An update of the latest financial forecasts, to include the impact of the new investment and financial commitments, and demonstration that they are affordable. This update must include any other material changes in the institution's financial prospects, including guarantees to third parties.

5. The institution's governing body has made an informed decision about the new investment and financial commitments.

Information required:

a. Details of when the governing body approved the new investment and financial commitments, and a minute of the decision reached.

b. A summary of the information the governing body received in reaching its decision.

6. Details of the new threshold.

Information required:

a. Details of continuing financial commitments (including the lender, loan term and ASC) and of the new financial commitment.

b. A calculation of the new threshold required.

Short-term financial commitments

1. Short-term financing should be an appropriate solution.

Information required:

a. Brief description of why increased short-term finance is necessary, and how this fits with the financial strategy.

b. Cash flow forecasts which show the need for the increased borrowing.

c. The forms of finance considered and the selection process and criteria.

d. Brief explanation of why short-term finance was selected.

2. Details of the new financial commitments.

Information required:

a. Details of the arrangement, including: name of lender, sum borrowed, loan period and basis of repayment.

b. Terms and conditions of the arrangement (for example, a copy of the offer letter) and an evaluation of the risks and uncertainties.

3. The institution's governing body has made an informed decision about the short-term financing arrangements.

Information required:

a. Details of when the governing body approved the arrangements and a minute of the decision reached.

b. A summary of the information the governing body received in reaching its decision.

4. Details of the new threshold.

Information required:

The revised threshold (in £) and the period for which this is required.

HEFCE guidance that may be helpful

16. The following documents may be helpful, and are all available on the HEFCE web-site www.hefce.ac.uk under Publications:

- 'Financial strategy in higher education institutions' (HEFCE 2002/34)
- 'Investment decision making: a guide to good practice' (HEFCE 2003/17)
- 'Practical guide to PFI for higher education institutions' (HEFCE 2004/11)
- 'Borrowing in the higher education sector: 2004 update' (HEFCE 2004/44)
- 'Guide for Members of Higher Education Governing Bodies in the UK' (HEFCE 2009/14).

Annex G

Exchequer interests

Introduction

1. This annex reflects the revised system for exchequer interests, which will provide better accountability for public funding while reducing the existing administrative burden on institutions and enabling them to manage their estates more flexibly (see HEFCE Circular letter 12/2006).

Requirements

2. Each institution, having entered into an agreement with HEFCE effective on 1 August 2006 to enable the retrospective elements of a new system of accounting for exchequer interests to be enacted, shall follow the conditions set out below.

3. The exchequer interest identified and agreed with HEFCE in that agreement will form the opening balance of a simple exchequer interest register maintained by HEFCE. The register will be adjusted immediately for the addition of capital grants received in the year, and annually for both of the following:

- indexation of the opening balance and all grants received in subsequent years
- writing down grants over the prescribed period.

4. The indexation rate used will be the GDP deflator published annually by the Treasury. This will take account of changes in value and ensure that the value of the exchequer interest is not eroded through inflation.

5. All capital grants made by HEFCE after 1 August 2006 that create an exchequer interest will be entered onto the register, regardless of how they are treated for accounting purposes.

6. The opening exchequer interest balance as at 1 August 2006 will be written down over a 10-year period on a straight-line basis. All further capital grants will be written down annually over 15 years from the year of the grant in question on a straight-line basis, to recognise their consumption through the provision of education over that period.

7. The closing balance of the register as at 31 July 2007 and annually thereafter will provide a single reportable sum for the exchequer interest, and will be confirmed annually with the institution by HEFCE.

8. As repayment of exchequer interest only occurs in exceptional circumstances (see below), it does not need to be disclosed as a contingent liability in the institution's annual accounts.

Circumstances in which the exchequer interest becomes repayable

9. If either of the following remote events occur, they will trigger immediate liability for the institution to repay HEFCE the full amount of the exchequer interest (as shown in the exchequer interest register at that date). The institution will recognise HEFCE as an unsecured creditor until such repayment is made. If a liability to make repayment arises, HEFCE may agree to accept repayment of some other sum, or to delay repayment, at its absolute discretion, and such agreement may be on terms and conditions as HEFCE thinks fit.

10. The first trigger event will be if the institution becomes insolvent, including going into liquidation or administration, or if it dissolves or transfers its undertaking to some other body (for example, by the exercise of the Secretary of State's powers under the Education Reform Act 1988), or if it experiences any analogous event.

11. The second trigger event is if there is a significant reduction in the level of HEFCE-funded activity by the institution, using the following indicators:

- the absolute level of HEFCE income
- the absolute level of total income
- the percentage of total income represented by HEFCE income.

12. A base level for each of these indicators will be set as at 31 July 2006 by reference to the institution's 2005-06 financial statements. The trigger event will only occur if two or more of the three indicators reduce to at least 50 per cent from the base level.

13. This second trigger has been designed to ensure that HEIs are not discouraged from generating other sources of income, providing they continue to

offer the same level of HEFCE-funded education. HEIs may activate the trigger if, for example, they cease to educate publicly funded students, significantly downsize or go into liquidation, but are unlikely to do so if activities continue as normal or they expand. We will not use our exchequer interest rules to penalise institutions that are successful in diversifying their income.

14. The agreed base level for each indicator will be reviewed every five years by HEFCE and may be reset if appropriate to reflect the changing nature of the provision of education and more general changes within public sector funding.

15. If two or more of the trigger indicators reduce to at least 30 per cent from the base level, this will lead to discussions between HEFCE and the institution about the impact of further downsizing, including consideration of whether to reset the base indicators.

16. If the triggers are activated, HEFCE has the right, but not the obligation, to request repayment. It has discretion to waive the requirement for repayment.

Annex H

Information requirements for HEIs that are exempt charities

1. This annex sets out our main requirements relating to annual and longer-term cyclical monitoring of HEIs as exempt charities. These are new requirements that arise from our becoming the principal regular of HEIs as charities from 1 June 2010.

2. In addition to the requirements set out here, from time to time we may need to ask for other information to enable us to deal with particular issues about HEIs as charities. Our power to collect any information necessary for our role as principal regulator is set out in Section 79A Further and Higher Education Act 1992 (introduced by The Charities Act 2006 (Principal Regulators of Exempt Charities) Regulations 2010 (statutory instrument 2010 No. 501)).

3. This annex does not apply to the HEIs that are registered charities, who provide information directly to the Charity Commission ('the Commission'). Nor does it apply to the one HEFCE-funded HEI that is not a charity because it is part of a local authority.

4. The information requirements of HEIs as exempt charities (see paragraphs 5 to 12 below) are similar to those of the Commission for registered charities. The Commission publishes some of the information it collects on its own web-site; instead we require each HEI to publish information on its own site. We may subsequently provide more detail about some items in the HEFCE Accounts Direction to HEIs, which is updated by an annual circular letter. An e-mail list, charityreg-hefce, is available for anyone to join who wants to keep up to date on issues related to HEFCE's charity regulation role; it can be viewed or subscribed to at www.jiscmail.ac.uk/cgi-bin/webadmin?A0=charityreg-hefce.

Information to be made readily available on HEIs' web-sites

5. HEIs that are exempt charities must develop a page on their web-site by 31 January 2011 to provide a gateway to the following information:

a. The legal name and correspondence address of the HEI. The preferred name(s) used by the HEI should also be shown.

b. The main constitutional document of the HEI (such as its Royal Charter, Memorandum and Articles, or Trust deed). This should be the document that was in force in 2009-10, including any changes made during that year. A record of changes that occurred thereafter will be required.

c. The names of the trustees on 31 January each year, together with a list of all other charities (if any) of which each trustee is then also a trustee. The first such list will be the names of the trustees on 31 January 2011.

d. The full audited consolidated financial statements for 2009-10, and each year thereafter until five years of financial statements are available. From 2014-15 it will be sufficient to maintain links to the most recent five years of financial statements.

6. The 'gateway' web page should be easy to locate on the HEI's web-site and should be updated with the previous year's information no later than six months after the end of the previous academic year. (The first such page should therefore be available by 31 January 2011.) HEIs must provide HEFCE with the web address (URL) of the gateway page so that third parties can access it via our own web-site, and to send us an update of it if the URL changes.

Information to be included in audited financial statements

7. The following information must be included in the HEI's audited financial statements and related reports from 2009-10:

a. The charitable status of the HEI.

b. The trustees who served at any time during the financial year and until the date the financial statements were formally approved.

c. A statement that the charity has had regard to the Commission's guidance on public benefit.

d. A report on how the HEI has delivered its charitable purposes for the public benefit

e. Information about payments to or on behalf of trustees, including expenses; payments to trustees for serving as trustees (and waivers of such payments); and related party transactions involving trustees.

f. From 2010-11: the names of linked charities of the HEI.

We are not specifying where in the financial statements this information should be presented, but it is likely that:

- a and b will form part of the corporate governance statement
- c and d will either form part of the operating and financial review or be presented as a separate section
- e and f will be included in appropriate notes to the financial statements.

Reporting serious incidents

8. A serious incident is one which has resulted in, or could result in, a significant loss of funds or a significant risk to a charity's property, work, beneficiaries or reputation. More guidance as to what might constitute a serious incident for a HEI is available on the charity regulation section of the HEFCE web-site (www.hefce.ac.uk/charityreg). HEIs must report serious incidents to HEFCE at the time when they are identified. Incidents to be reported under the new requirements are any that HEIs become aware of on or after 1 June 2010. We have also included in HEFCE's annual assurance return (see Annex E) a specific declaration that serious incidents have been appropriately reported to us. This declaration will be made on behalf of all trustees. It would be appropriate therefore for the governors to be informed about incidents reported to HEFCE; however, we do not stipulate how this should be done.

9. Paragraphs 14-17 of Annex B set out our reporting requirements in respect of the loss of an HEI's assets through fraud, theft or other cause. We will consider an incident reported under the terms of paragraphs 14-17 both as funder and as principal regulator.

10. In addition, and as principal regulator in the first instance, we expect HEIs to report the following serious incidents:

- donations of more than £25,000 from unknown donors or where the source cannot be verified
- abuse or mistreatment of a charitable beneficiary involved in activities of the HEI
- disqualification of a trustee
- known or alleged links (other than for bona fide academic reason) with proscribed organisations or terrorism; this applies to trustees, staff, students or anyone else associated with the HEI.

Further guidance on how to interpret this reporting requirement is available on the HEFCE web-site at www.hefce.ac.uk/charityreg.

11. A report of a serious incident should be sent to HEFCE's head of assurance. Our primary concern is to satisfy ourselves that the HEI has responded to the incident in an appropriate way, designed to protect the HEI as a charity. In order for us to do this, HEIs should provide as much information as possible to help us to decide if their response has been appropriate and what, if any, further action is appropriate. In particular we would expect the report to indicate:

- whether the incident has happened or is suspected
- when it occurred and who was involved
- the impact of the incident on the HEI, any beneficiary involved, or both
- what inquiries have been made and/or actions taken, including any reports to other regulators or the police
- what policies and procedures were in place that apply to the incident, whether they were followed and, if not, why
- whether the trustees have determined that policies and procedures need to be introduced or revised – and if so, how and by when.

We would welcome a provisional report if it is likely that internal investigations may be time-consuming.

12. In extreme cases, a serious incident report may lead us to invite the Commission to consider opening a formal Inquiry under S8 of the Charities Act 1993.

13. We appreciate that information provided under the terms of paragraphs 10 and 11 may be of a sensitive nature, and we undertake to treat it with care. We ask for the information to fulfil our statutory obligations as principal regulator, and such obligations may require us to consult the Commission to ensure that we deal with an issue in a manner consistent with the regulation of charities generally. As public authorities, both HEFCE and the Commission are subject to the Freedom of Information Act. We will only disclose information to someone outside HEFCE or the Commission in circumstances where we are legally obliged to do so. Further guidance about the way HEFCE applies the Freedom of Information Act and the Data Protection Act 1998 is available on our web-site.

Annex I

Summary of responsibilities of members of governing bodies

1. HEFCE is the lead public funder of higher education institutions (HEIs) and also acts in the interests of fee-paying students. HEFCE requires the institutions that it funds to have high standards of corporate governance. This annex describes the main legislative and other requirements placed on governing bodies. HEFCE is not empowered to enforce every requirement specified here, but will take breaches that come to its attention into consideration in its risk assessments.

Financial Memorandum

2. HEFCE requires institutions to comply with the Financial Memorandum (FM). Governing bodies must ensure that the mandatory requirements of the FM are complied with, and that full and appropriate consideration is given to all elements of the FM and the Audit Code of Practice (Annex B). HEFCE will enforce this requirement using the powers available to it through the FM and the Further and Higher Education Act, 1992. HEFCE also requires governing bodies to ensure that the conditions of grant imposed by other public funding bodies are complied with.

Legislative obligations

3. HEFCE **requires** institutions to meet the legislative requirements imposed upon them as corporate bodies, in particular the laws relating to:

- higher education institutions, notably the Further and Higher Education Act, 1992
- employment
- health and safety
- diversity and equality of opportunity.

HEFCE is **not empowered to enforce** these laws directly but will take breaches that come to its attention into consideration in its risk assessments.

Trustees and directors

4. Members of governing bodies are charitable trustees and, in some cases, directors of companies. As such, HEFCE **requires** compliance with the Charities Acts and, if applicable, the Companies Acts. In particular, HEFCE requires trustees to discharge their duties of compliance, prudence (including to ensure financial solvency) and care, and to accept ultimate responsibility for the affairs of the charity. HEFCE **will report material non-compliance with** trustee obligations to the Commission. The duties on trustees and directors (as set out in chapter 2 of part 10 of the Companies Act 2006) are similar in that they require board members to promote the interest of the organisation and to act with integrity, care and prudence. These duties reflect the expectations that HEFCE has for the governors of HEIs.

Constitutional requirements

5. HEFCE **requires** that governing bodies discharge the obligations imposed on them by institutions' constitutions (charters and statutes or instruments and articles of government). In particular, governing bodies must:

- ensure that the finances of the institution are managed in order to ensure solvency and sustainability
- appoint and supervise and, if necessary, suspend or dismiss the vice-chancellor or principal
- ensure the welfare of students is secured
- ensure that there is an effective framework – overseen by its senate, academic board or equivalent – to manage the quality of learning and teaching and to maintain academic standards.

HEFCE will **exceptionally enforce** these requirements by exercising its power in a lawful and reasonable manner to make conditions of grant to ensure that the obligations are met.

Good governance

6. HEFCE **expects** governing bodies to organise and conduct themselves in accordance with the good practice guidance and principles set down by the Committee of University Chairs (CUC). HEFCE **expects** governing bodies to adopt the CUC Governance Code of Practice and to report on their compliance with the CUC guidance every year in their financial statements – or to explain why their governance arrangements differ from those recommended by the CUC.

7. HEFCE **expects** each governing body to adopt a statement of primary responsibilities in line with CUC guidance in which the governing body delegates to the head of institution responsibility for the management of the institution and its policies.

Members' conduct

8. HEFCE **expects** members of governing bodies to conduct themselves in a manner appropriate to public office holders and to adhere to the seven principles of public life which are set out by the Committee on Standards in Public Life for the benefit of individuals who serve the public in any way:

Selflessness: Holders of public office should act solely in terms of the public interest. They should not do so in order to gain financial or other material benefits for themselves, their family, or their friends.

Integrity: Holders of public office should not place themselves under any financial or other obligation to outside individuals or organisations that might seek to influence them in the performance of their official duties.

Objectivity: In carrying out public business, including making public appointments, awarding contracts, or recommending individuals for rewards and benefits, holders of public office should make choices on merit.

Accountability: Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.

Openness: Holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and restrict information only when the wider public interest clearly demands.

Honesty: Holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.

Leadership: Holders of public office should promote and support these principles by leadership and example.

Governance evaluations

9. HEFCE **expects** governing bodies to undertake periodic reviews of their effectiveness, and to produce reports and action plans for improvement that are made public. In our view, such reviews will inspire greater confidence if governing bodies engage persons independent of the institution to assist in the process.

Annex J

Model letters of appointment for new head of institution and the accountable officer

Dear …

I write to congratulate you on your new role as Vice-Chancellor/Principal of … with effect from … I hope this proves to be both a challenging and rewarding position.

May I draw your attention to the attached formal letter outlining your responsibilities as the Accountable Officer. Please take time to read this and the accompanying documentation and kindly return the acknowledgement form to me.

My colleagues in the HEFCE institutional team should already have been in contact with you to discuss ways in which HEFCE will work with your institution, and will be happy to provide any other information or advice you may need. I would also welcome a meeting with you at an early opportunity, and my office will be in contact shortly to arrange a suitable date.

Finally, if you feel that I can help at any time, please do not hesitate to ask.

I look forward to working with you.

HEFCE Chief Executive

Dear …

Responsibilities of Accountable Officers

In accordance with the revised Financial Memorandum between the Council and institutions that came into force on 1 August 2010 (HEFCE publication 2010/19), I am writing to you formally in my capacity as the Accounting Officer of the Higher Education Funding Council for England (HEFCE) to outline the responsibilities expected of a higher education institution's accountable officer.

As the head of your institution, you have a general responsibility for ensuring that all public funds you receive are used properly and achieve value for money. Your role as accountable officer also incorporates specific responsibilities.

As accountable officer you are required by the Financial Memorandum with HEFCE to advise the governing body on the discharge of all its responsibilities under the Financial Memorandum and the Audit Code of Practice. You are also required, jointly with the governing body, to ensure that all such responsibilities are discharged.

You are required to advise the governing body if, at any time, any action or policy under consideration by the governing body appears to you to be incompatible with the terms of the Financial Memorandum. You are further required to inform me in writing immediately if the governing body decides nevertheless to proceed with such an action or policy.

As accountable officer you are responsible and accountable to your governing body, and in turn to HEFCE (and ultimately to Parliament) for ensuring that the uses to which your institution puts funds received from the HEFCE, the Skills Funding Agency (SFA) and the Training and Development Agency for Schools (TDA) are consistent with the purposes for which those funds were given and comply with the conditions attached to them, including those set out in the Further and Higher Education Act 1992 and in the Financial Memorandum with HEFCE. As Accounting Officer of HEFCE, I am required by the Department for Business, Innovation and Skills to be able to demonstrate that I am satisfied that your institution has the financial management systems to enable it properly to administer the grant received from the HEFCE, SFA or TDA.

As accountable officer you have a personal responsibility for propriety and regularity in the use of the funds received from the HEFCE, the SFA and the TDA; you also have a duty to ensure that such funds are properly, prudently and economically managed.

As accountable officer you are required to inform the chair of your audit committee, the chair of your governing body and myself, as Accounting Officer of HEFCE, of:

- any adverse variance in the financial position which in your judgement is material to the institution's sustainability; and
- any serious weaknesses, significant frauds or any major accounting breakdown reported to you by external or internal auditors or which come to light by any other means.

As accountable officer you are responsible for ensuring that your institution's annual accountability returns are submitted to HEFCE.

As required by the Audit Code of Practice, your institution must make its books and records open to inspection by the Comptroller and Auditor General, who may carry out value for money studies of the institution's use of resources. If the Public Accounts Committee of the House of Commons wishes to discuss any matter relating to your institution's grant, they may need to examine you alongside the Accounting Officer of HEFCE and the Principal Accounting Officer of the Department for Business, Innovation and Skills. You may therefore be called before the Public Accounts Committee on matters of regularity, propriety or value for money relating to your institution's grant.

Finally, as accountable officer you and the governing body, are required to have regard to any further guidance on the responsibilities of accountable officers as may be issued from time to time by HEFCE. This will include any subsequent versions of the Financial Memorandum.

If you have any questions on these matters, either now or subsequently, please contact Paul Greaves, Head of Assurance, on 0117 931 7378.

I would be grateful if you could sign the attached form **[not included in this model letter]** and send it to me by return to confirm that you understand and accept the responsibilities outlined above and the detailed responsibilities set out in the Financial Memorandum.

Yours sincerely

HEFCE Chief Executive

Annex K

Model letter of appointment for new chair of a governing body

Dear

I write to congratulate you on your appointment as the chair of the board/council of …….. and to draw your attention to the responsibilities which you and your members have under the terms of the Financial Memorandum (FM) between the institution and the Higher Education Funding Council for England (HEFCE).

To ensure the proper stewardship of public funding, it is important that the conditions attached to HEFCE grants are satisfied and that the collective duties of the members of the board as charitable trustees are properly discharged. I enclose a copy of the FM and would particularly draw your attention to Annex A which summarises the institution's mandatory responsibilities to HEFCE. The head of institution (normally the Vice-Chancellor or Principal) is designated as the accountable officer, responsible for assuring your board/council and HEFCE that our conditions of grant and the other requirements of the FM are being met. I imagine that you will want to talk this through with [him/her].

I am sure that you will also want the institution to have high standards of corporate governance, and commend the 'Guide for Members of Higher Education Governing Bodies in the UK' published by the Committee of University Chairs which is readily available.

Finally, I wish you every success in your new appointment. The higher education sector in England is well served by its council/board members, who bring great experience, insight and professionalism to the work of universities and colleges. I thank you and your colleagues for contributing in this way. If you would like any help or advice in your new role please do not hesitate to contact me or your HEFCE associate director [name].

Yours sincerely

HEFCE Chief Executive

Definitions and abbreviations

1992 Act	Further and Higher Education Act 1992
Accountable officer	Head of an institution responsible and accountable to HEFCE (and ultimately to Parliament) for ensuring that the institution uses HEFCE funds in ways that are consistent with the purposes for which those funds were given, and complies with the conditions attached to them. These include the conditions set out in the Further and Higher Education Act 1992 and in this Financial Memorandum
Accounting officer (of HEFCE)	As accounting officer, the chief executive of HEFCE has a personal responsibility to safeguard public funds and achieve value for money as set out in HM Treasury guidance, 'Managing Public Money' and any subsequent guidance. This includes responsibility for the public funds allocated by the Council to higher and further education institutions and other bodies for education, research and associated purposes.
Annual accountability returns exercise	A streamlined accountability process between HEFCE and institutions, linked to an assessment of institutional risk, which comprises an exchange of documents and dialogue during a specific period each year
BIS	Department for Business, Innovation and Skills
CAG	Comptroller and Auditor General
CUC	Committee of University Chairs
DEL	Department for Employment and Learning in Northern Ireland
FEC	Further education college
FRS	Financial Reporting Standard
Governance Code of Practice	'Guide for Members of Higher Education Governing Bodies in the UK: Governance Code of Practice and General Principles' (HEFCE 2009/02)
Governing body	The university council, board of governors or other body ultimately responsible for the management and administration of the institution's revenue and property, and the conduct of its affairs
HE	Higher education
HEFCE	Higher Education Funding Council for England
HEFCEAS	HEFCE assurance service
HEI	Higher education institution
HESA	Higher Education Statistics Agency
HESES	Higher Education Students Early Statistics
IIA	Institute of Internal Auditors
JANET	High-speed computer network supported by all the four higher and further education funding bodies, which links universities and colleges in the UK. SuperJANET is the enhanced network

Legally distinct entity	An organisation receiving HEFCE grant funding from an HEI to which it is accountable, but operating independently from that HEI
NAO	National Audit Office
Propriety	Propriety in the use of public funds concerns conduct, behaviour and corporate governance. It embraces fairness, integrity, the avoidance of personal profit, even-handedness, open competition, and the avoidance of waste and extravagance
QAA	Quality Assurance Agency for Higher Education
RB	Related body (a non-HEI/FEC body through which significant levels of HEFCE funding are distributed or activities promoted)
Regularity	Regularity is a public finance requirement for funds to be applied only to the extent and for the purposes authorised by Parliament
Secretary of State	Secretary of State for Business, Innovation and Skills
SFA	Skills Funding Agency
SLC	Student Loans Company Limited
TDA	Training and Development Agency for Schools
the Code	HEFCE's Audit Code of Practice
the Commission	Charity Commission
VFM	Value for money

References to the **financial position, financial statements, financial commitments or borrowings** of the institution mean the consolidated financial position, financial statements, financial commitments or borrowing of the institution and its subsidiary undertakings, as defined in the Companies Act 1985 and revised by the Companies Act 1989 and 2006, and in accordance with generally accepted accounting principles.

Shall and **must** denote mandatory requirements, and **should** denotes our view of good practice.

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