9. THE RULES

9.1 As a governor you need to know what the rules are for the financial governance of HEIs. Apart from the general law, there are two key sources. The first is the national funding council, which distributes government grants to HEIs; these are public funds, with all that entails in terms of accountability. Their requirements are set out in a financial memorandum (FM). HEIs are also charities, and whilst exempt from registration and regulation as charities, they are not exempt from charity law. However, once the appropriate legislation is in force, in England they will be regulated by Hefce rather than the Charity Commission, in order to avoid duplication. The Charity Commission publishes lots of guidance for charity trustees (which includes HEI governors)[27]. HEIs in Wales will be regulated by the Charity Commission directly. Regulatory requirements in Scotland and Northern Ireland will be confirmed in due course.

9.2 The FM is important and short enough for you to get your hands on and read[28]. Indeed, in Northern Ireland, this is a firm recommendation. Whilst national versions differ in detail, there are many common issues.

"It's not that I don't trust the finance officer or the clerk, but how do I know - I mean how can I be really sure - that the governing body is doing everything it's required to do?"

STAFF GOVERNOR

Accountability for public funds, financial management and control

9.3 All FMs have similar requirements concerning accountability. For example, the Welsh version states that:

- "The governing body has ultimate responsibility for the proper stewardship of public funds, ensuring that these funds are used for the purposes intended and deliver value for money.
- The governing body shall ensure that the institution has a sound system of internal financial management and control.
- The institution shall keep proper accounting records which will comply with the Council's Accounts Direction.
- The governing body of the institution shall plan and conduct its financial and academic affairs to ensure that it remains solvent and that, taking one accounting period with another, its total expenditure is not greater than its total income.
- The institution shall not have a material deficit in two consecutive years unless the deficit is covered by reserves which can be applied at the discretion of the institution (discretionary reserves). Material negative discretionary reserves must be cleared by the end of the third accounting period after the deficit began to accumulate. Material deficits are deficits that exceed the lower of 0.5% of total income or £300,000.
- The institution shall notify HEFCW of any event that is likely to have a material adverse impact on the financial position of the institution as soon as this becomes apparent."

27 A useful introduction is 'The Essential Trustee - What you need to know' at www.charity-commission.gov.uk/Library/publications/pdfs/cc3text.pdf
28 England - www.hefce.ac.uk/pubs/hefce/2008/08_19/
Scotland - www.sfc.ac.uk/information/information_gmap/financial_memorandum_jan_06.html
Wales - http://194.81.48.132/FinanceAssurance_Docs/Financial_Memorandum.pdf
Northern Ireland – available from the Department of Employment and Learning, Northern Ireland - www.delni.gov.uk

9.4 Note the role of the governing body itself in the first two sections. The control on deficits is less rigid than might be expected, but the funding council's response to the news of deficits in the institution's financial strategy and forecasts will have more practical impact. Any governing body faced with more than one year's forecast deficit should not need to consult the FM before challenging budget proposals.

9.5 For completeness, it should be noted that the English, Welsh and Northern Ireland funding council operate their financial memorandum in two parts. Part one is about the financial rules. Part two is effectively a funding agreement, setting out the student number provision against which the institution's future grants will be judged.

Accounts Directions

9.6 In addition to a financial memorandum, the funding councils issue an Accounts Direction to institutions each year, specifying certain requirements for the preparation of financial statements and information which must be included in them. The main items in the English version are:

- The Sorp is mandatory.
- A sound system of internal control must be maintained and reviewed each year.
- Effective risk management must be in place.
- Accounts must contain a statement on internal control and risk management.
- Accounts must also contain a statement on corporate governance.
- Emoluments of the head of institution and other higher paid staff must be disclosed.
- Details of any severance payments for such staff must be disclosed.

Property acquisition and disposal and associated borrowing

9.7 An important part of each financial memorandum is the restriction on borrowing, since this has led to past financial problems. The restrictions on long term borrowing are fairly standard. This is the Scottish version: "the institution shall obtain prior written consent from the Council before it undertakes a level of capital finance where the annualised costs of all capital finance (being the sum of the servicing and capital repayment costs of each loan or other arrangements spread evenly over the period of the relevant loan or arrangement) would exceed four percent of total income".

9.8 However, the Welsh council goes on to require prior consent for significant acquisitions if its grants are to be used for that purpose. Both the Scottish and Welsh councils require prior consent for the grant of any security using property acquired, improved or maintained with council funds; in practice, few properties will have been maintained in any other way, so this constraint will apply to most property transactions.

9.9 Disposing of assets which were funded by HM Treasury is still subject to prior consent by the Welsh and Scottish funding councils and to prior notification in Northern Ireland, and there are also rules for dealing with the proceeds of sale. English institutions are no longer subject to such constraints under normal circumstances of estate management, following agreement on a method of recording and eliminating the Treasury's interest after a reasonable period of use.

Short term borrowing

9.10 Recourse to overdrafts may be a sign of financial weakness or strength, depending on the underlying financial position of the institution and its relationship with its bankers. Some finance directors prefer to run on very low liquidity levels, knowing they have firm overdraft arrangements in place if needed, in order to optimise the net cost of working capital. This is because simultaneously borrowing and depositing money usually carries a net interest cost. However, long term borrowing should be distinguished from short term overdrafts - they are very different things.

9.11 So the message to be taken from an overdraft needs to be judged carefully. However, both the English and Welsh Councils have imposed firm limits on what might be a dangerous development. This is the English version: "the institution shall obtain written Council consent before its negative net cash (ie cash and bank deposits repayable on demand, less overdrafts) exceeds 5% of total income, for more than 35 consecutive calendar days".

9.12 Note the definition of cash in this constraint. It excludes both long term borrowing and any investments which are not convertible into cash within 24 hours. The Scottish Funding Council doesn't impose a specific constraint on short term borrowing.

Duty to notify adverse events

9.13 The financial memorandum will typically contain provision for notifying the funding council of significant adverse events, whenever they arise. This is the Scottish version: "the chief executive officer of the institution must inform the accountable officer of the Council without delay of any circumstance that is having or is likely to have a significant adverse effect on the ability of the institution to maintain its capacity to deliver relevant education programmes, research and related activities".

9.14 In addition, the Audit Code may contain a similar duty, especially in relation to financial control. Here is the English version of that requirement: "the HEI's designated office holder must report any material adverse change - such as a significant and immediate threat to the HEI's financial position, significant fraud or major accounting breakdown - without delay to 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 and the Hefce chief executive".

Costing and pricing of activities

9.15 UK higher education has traditionally been reluctant to charge the full market price for its services, an attitude brought about by a mixture of high principle - that education should be free - and the availability of other sources of money, especially government funds, to pay for people and goods. This attitude is changing slowly under pressure from lack of resources and government itself. The latter is expressed through the FM - here is the English version: "as part of ensuring its long term viability, an institution should know the full economic 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 into financial difficulty. We expect our funds not to subsidise non-public activities"[29].

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29 See www.hefce.ac.uk/pubs/hefce/2008/08_19/ (page 6)

Audit and monitoring requirements

9.16 The funding councils' requirements for audit are dealt with in a separate volume in this series. The appointment of an audit committee along with internal and external auditors are the main obligations on HEIs. The councils also have annual monitoring requirements in order to keep their risk assessments of individual institutions up to date. As well as five year financial forecasts and copies of audit reports, Hefce requires an annual monitoring statement, reporting on the use of any strategic special funds allocated to the institution, and a corporate planning statement, reporting on the institution's progress towards its strategic aims and objectives. This information eventually leads to an annual risk assessment report (which is provided to the institution). In England, the monitoring process is reinforced by a five yearly visit by members of the Council's assurance team.

Guidance on good practice

9.17 Although this chapter is about the rules, you might want to make use of some of the good practice guidance published by the funding councils. For example, Hefce publishes information on[30]: costing and pricing; financial strategies; governance; fraud; investment decision making; legal services; procurement; public private partnerships and the private finance initiative; related companies; strategic planning; strategic management (incorporating value for money); financial management; risk management; audit arrangements; and internal and external auditors guidance. This is not to suggest that you should be poring over endless funding council guidance documents. What it might help you do is make an occasional check on whether your institution has good policy coverage of these areas, or whether the internal audit plan covers them all.

Charity law and Charity Commission guidance

9.18 There have been various references to charity law and governance in these materials (see paragraphs 4.6 and 6.12 for example) and it is worth emphasising that all HEIs are charities. Even though they may be regulated by a funding council - rather than the Charity Commission - the same law applies. If you are unfamiliar with charity governance, it's worth looking at the Charity Commission's guidance for trustees; it's a concise and readable document[31]. It requires trustees to:

- Have and accept ultimate responsibility for directing the affairs of a charity.
- Ensure that it is and remains solvent.
- Use charitable funds and assets reasonably, and only in furtherance of the charity's objectives.
- Avoid undertaking activities that might place the charity's endowment, funds, assets or reputation at undue risk.
- Take special care when investing the funds of the charity, or borrowing funds for the charity to use.
- Use reasonable care and skill in their work as trustees, using their personal skills and experience as needed to ensure that the charity is well run and efficient. This includes taking external advice on all matters where there may be material risk to the charity, or they may be in breach of their duties.

SUGGESTED TASK

This guidance points to a level of prudence beyond what would be expected in a commercial operation, where business risk is of the essence. In a charity, risk is a necessary adjunct to delivering public benefit - a key distinction. If you have experience of other sectors what do you see as the main differences re the implications of charitable status?

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30 www.hefce.ac.uk/finance/goodprac/
31 www.charity-commission.gov.uk/Library/publications/pdfs/cc3text.pdf

9.19 Your finance director should be able to provide more details of charity law and the implications for your governing body.

Self-challenge questions

- How do you know that your institution is complying with all its legal requirements concerning finance?
- Whose permission is required for purchase of property?
- Where does the formal accountability for financial matters rest?