Governors' briefing notes

18. Finance

Introduction and aim

This briefing note examines the area of finance. Higher education institutions (HEIs) are independent entities and governing bodies need to oversee the institution's financial health. They need to ensure the institution is both solvent and sustainable.

Topics covered

- Governing body responsibilities
- The annual budget
- The level of surplus
- Income
- Revenue expenditure
- What to look for?
- Making comparisons
- Capital expenditure
- Funding capital expenditure
- Cash flow
- Solvency
- Sustainability
- Safeguarding assets
- Annual financial statements
- In-year reporting
- Finance committees
- Questions to consider

1. Governing body responsibilities

A governing body has significant financial responsibilities, typically covering:

- The annual budget
- The solvency of the institution
- Safeguarding assets, property and estate
- The annual financial statements

2. The annual budget

Ahead of the year to which it relates, the governing body approves the institution's annual budget of income and expenditure. Governors should examine the levels and main components of both income and expenditure and review the projected surplus.

3. The level of surplus

While 'public' higher education institutions do not exist to maximise profit, governors should consider the level of surplus the institution needs to generate. Surpluses increase an institution's financial resilience by enabling debt to be repaid, reserves to be accumulated or capital expenditure to be funded. For English HEIs reductions in levels of the capital funding previously received from government have increased the need to generate larger surpluses. Accumulated surpluses reduce the risk of an institution becoming dependent on external borrowings to fund capital expenditure, and increase the institution's resilience to external shocks.

4. Income

As well as giving consideration to the overall surplus, governors should also examine the main components of income and expenditure. The reliance on different sources of income will vary by institution. Teaching income will form the largest source of funds for those institutions with limited funded research. By contrast, research income will have greater significance for research-intensive institutions. In each case governors should consider what factors underpin the income estimates contained in the budget, and the associated risks of these estimates not being fulfilled. For example, income from teaching will depend on the institution's targets for student recruitment being met. How easy will it be to achieve these targets? Is there a significant risk that weaknesses in student recruitment will mean that some of the planned income with not be achieved? If this occurs how will the institution manage?

5. Revenue expenditure

Revenue expenditure relates to items whose costs are fully written-off (expensed) during budget year. Capital expenditure is discussed later.

Revenue expenditure is normally grouped into staff and non-staff expenditure. Staff costs will normally form the largest single category of spending. Managing the staff budget is a key determinate of total expenditure. In setting the staff budget, the resources required to enable delivery of the institution's planned activities should be balanced with affordability. More expenditure will provide additional resources, but these may be unaffordable. Too restrictive a staff budget may impair delivery, but by constraining costs lead to a healthy financial surplus. Judging the appropriate level of expenditure on staff needs to take account of both academic needs and affordability.

Non-staff costs include all other revenue costs associated with the delivery of the institution's activities. Typically, these include utilities, campus services and buildings' maintenance and minor works.

6. What to look at?

Governors should examine trends and reasons, as well as the levels of income, expenditure and surplus in the proposed budget. For example, is there a tendency for income levels to improve, as a result of, say, better student recruitment or securing larger research contracts? What factors are responsible? Are they one-off factors, or do they reflect an emerging trend, which is likely to continue?

Governors should also closely examine expenditure. For example, is expenditure on staff increasing year-on-year? Is this the result of pay awards or an increase in the number of staff on the payroll? Are non-pay costs being well managed? When putting income and expenditure together what is the forecast surplus?

7. Making comparisons

Governors should compare the budget both with outcomes for the previous year, and look beyond the budget year at future projections for, say, the next 2/3 years. Future projections should be based on an assessment of the institution's operating environment and its own plans and activities. Do the future projections suggest emerging issues? If so, do these need to be addressed now?

To assist the review of trends, key performance indicators (KPIs), often expressed as a ratio, may be used. These may be calculated for, say, a five-year period encompassing past, current and future performance. Examples of KPIs include operating surplus as a percentage of income, staff costs as a percentage of expenditure and the ratio of capital expenditure to depreciation. Ratios often make it easier to see trends, and identify areas where governors need to increase scrutiny.

8. Capital expenditure

Institutions need to determine the level of capital expenditure they wish to undertake. Although part of the annual budget process, the institution's level of capital expenditure in any one year is likely to be part of a longer-term plan reflecting the strategic development of the institution. Institutions may, for example, have a period when expenditure is high reflecting expansion or campus refurbishment. Currently many institutions are making significant infrastructure investments to improve their facilities as part of a strategy of attracting more students or research income to strengthen their competitive position.[1] Governors should scrutinise any planned capital expenditure to ensure it brings sufficient benefits to the institution to justify the spending, and that it is affordable.

Governors should agree the level of capital expenditure planned for the forthcoming year. Capital expenditure is the purchase of assets deemed to have an economic life beyond a single year. The value of the asset is capitalised and placed on the balance sheet. This value is reduced each year by an annual depreciation charge. This is an estimate of the amount of the asset used up in the year. The depreciation is charged to the revenue budget, but the most important impact of capital expenditure is on the institution's cash flow statement.

9. Funding capital expenditure

The purchase of new capital assets or the refurbishment of existing assets (eg. a teaching or research building) will have a cash cost. This needs to be funded. Institutions with accumulated cash reserves will be able to drawn on these reserves to fund in full or part their expenditure. Institutions with insufficient cash reserves will need to borrow funds to enable the expenditure to take place. Major capital expenditure may therefore see institutions acquiring additional debt, which will subsequently need to be serviced through the making of interest payments.

10. Cash flow

Capital expenditure is shown on the institution's cash flow statement. The cash flow statement shows how cash is generated (cash inflows) and how it is used (cash outflows). A net cash inflow (or surplus) allows cash to be accumulated or debt repaid. A net cash outflow (or deficit) is funded through reducing accumulated cash reserves or new borrowings. An institution's ability to operate with a net cash outflow is constrained by its accumulated cash reserves and its ability to borrow. A sufficiently large or persistent cash outflow may exhaust both sources of funding. If this point is reached, the institution will be in financial difficulty and at risk of closure.

11. Solvency

Institutions are separate legal entities and the governing body needs to ensure they remain solvent. ie they can meet their financial commitments and continue to operate. Solvency is normally taken as being able to pay the bills over the forthcoming twelve month. Solvency is normally judged on whether the institution has sufficient liquid assets: those assets that can be turned quickly and easily into cash.

12. Sustainability

Increasing attention is being directed at the question of sustainability. Sustainability is about 'operating today in a way which does not inhibit an institution's ability to operate tomorrow.' It requires resources to be managed so the current capacity of the institution is at least maintained and it is able to respond effectively to changing needs.[2] It requires governors to look beyond the immediate trading period and consider if the institution can operate successfully in the longer-term. For English HEIs, Hefce is introducing the Annual Sustainability Assurance Report (ASSUR), requiring governing bodies, annually, to review the institution's sustainability.

13. Safeguarding assets

Governors are expected to safeguard the institution's assets. They should be mindful of how the assets are used and avoid unacceptable risks that might result in their loss. Governors are responsible for the stewardship of the institution, and should be mindful of safeguarding the institution purpose and function. This aspect of their role aligns with their responsibilities as trustees of a charity.

14. Annual financial statements

The governing body receives and approves the annual report and financial statements. These detail the financial outcomes for the preceding accounting period. For 'public' institutions the accounting period normally runs from 1 August to the 31 July. The financial statements are audited by external auditors, and are the formal record of the institution's financial performance. They are normally reviewed by the Audit Committee and, if one exists, the Finance Committee, prior to being considered by the governing body. The annual report also contains public benefit and corporate governance statements, and the names of the trustees.

15. In-year reporting

During the year the governing body should expect to receive regular updates at its meetings on the institution's financial performance showing actual income and expenditure against the budget values. These reports should contain sufficient detail to enable the identification of variances for the main categories of income and expenditure and, if necessary, to prompt the instigation of appropriate action.

16. Finance committees

The governing body cannot delegate its responsibilities for the oversight of financial matters. However, a significant number of higher education institutions, but by no means all, choose to have a finance (or equivalent) committee of the governing body. This is normally mandated to examine and consider financial matters in detail, reporting back to the governing body and making recommendations as appropriate.

17. Questions to consider

- What are the principle sources of income?
- Is expenditure, and, in particular, staff costs well managed?
- Is the operating surplus sufficient?
- What is the level of capital expenditure, and how is it being funded?
- Is the institution operating with a net cash deficit or surplus?
- Is the institution sustainable?

End notes and further reading

1 For example, Hefce indicates English HEIs are planning to invest on average £3,811m per annum for the next 4 years, a level of investment some 50 per cent higher than in the previous period. Further, Hefce states that they '… expect borrowing to increase from £6.2 billion at the end of July 2013 to £8.3 billion by the end of July 2017.' And suggest 'this trend is not sustainable in the long term' See Financial Forecasts for the Higher Education sector, 2013-14 to 2016-17.

2 For further discussions see Committee of University Chairs (CUC) Report on the Monitoring of Institutional Performance and use of Key Performance Indicators, November 2006.