

Getting to grips with

# Finance

A guide for governors

# Contents

Produced in association with

Overview	<b>Ten key financial issues for governors Page 4</b>
Chapter 1	<b>Governing the institution's finances Page 5</b> <i>What is the role of governors? What are the key financial tasks? Why is it difficult? What's in this guide?</i>
Chapter 2	<b>Where to start: The big picture Page 9</b> <i>What are the institution's current vision and priorities? How is the strategic plan reflected in financial strategies and policies? How are strategies reflected in budgets and capital plans? Is the institution sustainable?</i>
Chapter 3	<b>Making sense of financial strategy Page 13</b> <i>The principles of a financial strategy. What are the benefits and implications for institutions? Five principles. Let's be practical – key checks.</i>
Chapter 4	<b>Key elements of financial management Page 17</b> <i>Securing stewardship – control, probity, compliance and accountability. Supporting performance. Enabling transformation.</i>
Chapter 5	<b>Where the money comes from Page 20</b> <i>Tuition fees and education contracts. Funding body grants. Research grants and contracts. Other income. Donations, endowments and investment income. 'Soft money'.</i>
Chapter 6	<b>Where the money goes Page 24</b> <i>Staff costs. Fundamental restructuring costs. Other operating costs. Depreciation. Interest and finance charges. Taxation.</i>
Chapter 7	<b>Capital funding Page 27</b> <i>Government grants. Other grants. Borrowing. Internal sources. Disposals and impairments. Student residences.</i>
Chapter 8	<b>Demystifying HEI's accounts Page 30</b> <i>What are accounts for? What do governors need to look for? The statement of comprehensive income. The statement of changes in reserves. A diversion into capital accounting – why do we need it? The balance sheet. The cash flow statement – last but not least. Other information in the accounts. The strategic report. Reporting to students and other stakeholders.</i>
Chapter 9	<b>The rules Page 38</b> <i>Accountability for public funds, financial management and control. Accounts Directions. Property acquisition and disposal and associated borrowing. Short term borrowing. Duty to notify of adverse events. Audit and monitoring requirements. Charity law and Charity Commission guidance.</i>
Chapter 10	<b>The transparent approach to costing (TRAC) Page 42</b> <i>The aims of TRAC. Annual TRAC. TRAC for teaching. Full economic costing. The TRAC dispensation. Sources of guidance and support.</i>
Chapter 11	<b>Trading for profit Page 44</b> <i>The range of trading activities. Strategic issues. Governance issues.</i>
Chapter 12	<b>Measuring financial performance and sustainability Page 47</b> <i>Financial performance and sustainability. Financial health.</i>
Chapter 13	<b>The auditors Page 51</b>
Chapter 14	<b>Working with the management Page 52</b> <i>Working with the management and the finance director. What financial information should be provided to governors? What can go wrong?</i>
Chapter 15	<b>The future Page 58</b> <i>Pensions. Strategic change and investment. Innovative financing strategies. Student numbers. Scrutiny and oversight. The challenge for governors.</i>
	<b>Some key references / A quiz / Suggested answers to governors' dilemmas From page 61</b>



# Foreword

Aaron Porter, Associate Director  
(Governance), Leadership Foundation

[aaron.porter@lfhe.ac.uk](mailto:aaron.porter@lfhe.ac.uk)

As higher education governance evolves, there are major implications for members of governing bodies: increasing expectations about how they undertake their role; a greater focus on measuring institutional performance with associated implications for information and strategy; coming to terms with an increasingly complex governance environment; and so on. All this means that governors (particularly new ones) need to be well prepared for the challenges they face, so that they can contribute effectively to their boards from the outset.

To support governors in this challenge, this set of materials has been commissioned by the Leadership Foundation for Higher Education and the Committee of University Chairs (CUC) to help governors get to grips with the key resource areas for which they are unambiguously responsible. Produced with financial support from all the UK higher education funding councils (coordinated through HEFCE), five different volumes make up the complete set of materials on risk, audit, human resources, estates/infrastructure and - this one - finance.

In an easy to read format, this particular volume is intended to provide the core information that all governors need for a basic understanding of their responsibilities for finance. It is not intended to provide the specialist information that members of finance committees (or equivalent) might need, although references to such material are provided.

To support the text there are quotations from governors<sup>1</sup>, self-challenge questions, suggested tasks, and critical incidents called 'governors' dilemmas'. The quotations - some provocative - do not represent any 'agreed' view of the topic concerned, but are rather designed to illustrate different opinions. Similarly, the self-challenge questions at the end of each chapter are to enable readers to reflect on key issues for them, and not to be used as a vehicle for governors to place unreasonable demands on their governing body clerk or secretary!

For these reasons, the materials – self-evidently – do not represent any agreed view which governing bodies are expected to adopt, but rather are intended to encourage self-reflection, debate, and critical thinking. Although we expect that readers will agree with most of what is written, we also hope that some things will be contested.

The materials are intended to be used in different ways: as resources for individual governors (designed to be read as individual chapters rather than in one go); by HEIs for in-house governor development; or as web based material (see [www.lfhe.ac.uk/governance](http://www.lfhe.ac.uk/governance)). The text does not consider broader issues concerning the overall responsibilities of governors and how their effectiveness might be determined. Readers interested in this should consult an earlier companion volume called 'Getting to Grips with Being a New Governor' produced in 2006.

<sup>1</sup> The quotations have been obtained from a wide range of sources, including personal meetings with governors. Where the background of the source governor is known it has been provided at the end of the quotation.

## A note on terminology and diversity

As most governors know, governance in higher education is complicated by the use of different terms for similar functions, so for simplicity some key words have been standardised throughout the five volumes. In all the materials the terms 'governing body' and 'board' are used generically to include: the governing bodies of post-1992 institutions; the councils of pre-1992 universities; and courts in Scotland. Similarly the word 'governor' indicates a member of these different bodies; 'chair' is used for the person convening governing body meetings; 'head of institution' for the vice-chancellor or principal; and 'executive' for members of the senior management team. Finally, the abbreviation 'HEI' is used as the widely accepted shorthand for 'higher education institution'.

UK higher education is very diverse, and this means that some aspects of governance may differ between HEIs. Moreover, governors will have legitimately different views on the issues presented in this material, as will heads of institutions and other senior managers. It follows that if after working through the text important issues are raised for governors about practice in their own HEI (and we hope they will be), then they may need to obtain more detailed information from the clerk or secretary of their board or its chair. However, throughout the need to distinguish between governance and management has been reinforced.

Because higher education is the responsibility of the devolved administrations within the UK, another aspect of diversity is the need to recognise differences in governance arrangements in HEIs in England, Scotland, Wales and Northern Ireland. This is particularly the case with some financial issues, and variations which exist within the different jurisdictions are pointed out in the text. Where no separate discussion of the different jurisdictions occurs, readers can assume that the content applies to all four higher education systems. The term 'funding councils' is used to indicate the public body which provides primary funding to HEIs in each jurisdiction, although in Northern Ireland this is done directly by the Department for Employment and Learning with no actual funding council intermediary.

Happy reading!

“On behalf of the Leadership Foundation I would like to thank the British Universities Finance Group (BUFDG) and the Committee of University Chairs (CUC) for their advice and guidance in producing this edition of the report, and also the funding councils of UK higher education for the feedback on the publication.” **AARON PORTER**

The Leadership Foundation continues to provide invaluable support.

# Overview: The key financial issues for governors

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In the following pages a large number of financial issues are identified for you to consider as a governor. However, a quick overview of ten key points may be helpful for you to think about:

The governing body must ensure financial sustainability. This is not just short term, but involves effective long term strategic planning for which governors have ultimate responsibility.

See chapter 2

Financial management must be effective and robust. The governing body must be confident about this, and satisfied that any financial problem areas are being effectively dealt with.

See chapters 4 & 14

Cash is the ultimate resource which secures all other resources. So cash forecasts, borrowing limits and banking covenants should be watched carefully. If your HEI is borrowing, as a governor be clear about the reasons and the possible outcomes.

See chapter 7

Financial information presented to the governing body must be timely, accurate, provide the data required by the governing body, and generally meet good practice standards.

See chapters 8 & 9

The governing body must ensure that effective performance management systems are in place, including the use of benchmarking financial performance.

See chapter 12

Future investment decisions need to be soundly based and carefully assessed, with your HEI investing enough in people, property and systems to survive and prosper. The governing body should ensure that tomorrow is not sacrificed for today.

See chapters 5 & 6

The governing body needs to understand where both the current and future major financial risks are, and act accordingly.

See chapter 3

Enterprise activities sometimes present particular challenges for HEIs, and their governing bodies need to be confident that they are performing well and being effectively managed.

See chapter 11

The governing body needs to be serious about ensuring the HEI continually seeks to ensure the value for money and financial sustainability of its activities.

See chapter 12

Finally, looking ahead to the longer term, governing bodies need to encourage a debate in their institutions about what new future business models might be, and what needs to be done to prepare for them.

See chapter 15

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“As a staff governor the thing I struggle most with is understanding finance.” **ELECTED STAFF GOVERNOR**

# 01 Governing the institution's finances

In its annual overview of the higher education sector in England<sup>2</sup>, HEFCE confirmed that the financial health of government-funded higher education institutions in England is currently stable overall. However, and perhaps somewhat worryingly, it noted that there are significant variations in the financial performances of individual institutions across the sector, with financial projections for the period ending 31 July 2017 showing that, overall, the sector is predicting lower surpluses, a fall in cash levels and a rise in borrowing. As a governor, it is your responsibility to ensure that your institution is building a sustainable future. But how can you do that? What questions do you need to ask? This material provides some help.

Whatever your background, as a governor it may be difficult to understand the finances of your HEI. However, you are not alone, and other governors are likely to be in the same position. There are various sources of support. Within the executive three members are crucial: the vice-chancellor or principal as head of institution; the finance director (on whom your board depends for most of its financial information); and the clerk or secretary to your board. Without them, you will not be able to begin to assess whether the finances are in good shape, whether money is being properly applied to agreed objectives, and whether your HEI is using its resources wisely to drive itself forward in the thick of increasingly fierce competition. Other sources of support include: longer serving governors, the internal and external auditors, bankers and the funding bodies. In addition there is, of course, information from the general and specialist press, plus the wealth of information available on the internet. For example, nearly all HEIs publish their annual accounts on their websites, and it is rare not to find something of interest in the small print in each.

Of course, not every governor has to be a financial specialist, and an inquiring mind may be as valuable as a financial qualification. However, to make a significant contribution on financial issues governors have no alternative but to get to grips with the issues discussed in this material.

A member of staff or a student elected to the governing body brings a very different perspective from an external or 'lay' member. They will be in touch with those at the working face of the HEI, and in a good position to understand the financial realities on the 'front line'. These governors will know the institution much better than independents, but the mix can be richer for the presence of both. It is important to note, though, that all governors have the same responsibilities, regardless of how they were appointed.

All this presents real personal challenges for many governors, so:

- How comfortable are you in dealing with financial and related issues?
- How familiar are you with key financial documents for which you (as a board member) are responsible? For example, have you actually read the financial memorandum from your funding body?
- If you don't understand some financial data what do you do - if anything?
- If necessary are you able constructively to challenge financial data and the proposals on which they are based?

This material is intended to help address some of these challenges, although it is only a starting point. The separate companion volumes on audit and risk also contain valuable information which should be consulted.

“At my first few board meetings I felt completely lost. At the first one the Finance Director asked members for opinions and I had nothing to say. I felt completely out of my depth.” **LAY GOVERNOR**

<sup>2</sup> HEFCE (2015) Higher Education in England 2015: Key Facts, [http://www.hefce.ac.uk/media/HEFCE,2014/Content/Analysis/HE,in,England/HE\\_in\\_England\\_2015.pdf](http://www.hefce.ac.uk/media/HEFCE,2014/Content/Analysis/HE,in,England/HE_in_England_2015.pdf) <sup>3</sup> Committee of University Chairs (2014) Higher Education Code of Governance, <http://www.universitychairs.ac.uk/wp-content/uploads/2015/02/Code-Final.pdf>

## What is the role of governors?

Governors have lots of important tasks. The Committee of University Chairs' Higher Education Code of Governance<sup>3</sup> identifies the following primary elements of governance:

- The governing body is unambiguously and collectively accountable for institutional activities, taking all final decisions on matters of fundamental concern within its remit.
- The governing body protects institutional reputation by being assured that clear regulations, policies and procedures that adhere to legislative and regulatory requirements are in place, ethical in nature, and followed.
- The governing body ensures institutional sustainability by working with the Executive to set the institutional mission and strategy. In addition, it needs to be assured that appropriate steps are being taken to deliver them and that there are effective systems of control and risk management.
- The governing body receives assurance that academic governance is effective by working with the Senate/Academic Board or equivalent as specified in its governing instruments.
- The governing body works with the Executive to be assured that effective control and due diligence take place in relation to institutionally significant external activities.
- The governing body must promote equality and diversity throughout the institution, including in relation to its own operation.
- The governing body must ensure that governance structures and processes are fit for purpose by referencing them against recognized standards of good practice.

## What are the key financial tasks?

A robust system of financial management, which ensures that resources are used economically, efficiently, effectively and in accordance with the purpose for which they were given, lies at the heart of any institution's long term viability and success. And it is the governors' responsibility to ensure that such a system is developed and maintained. In its Memorandum of Assurance and Accountability<sup>4</sup> with institutions, HEFCE makes it clear that governors should seek specific assurance that their institution:

- Has a robust and comprehensive system of risk management, control and corporate governance. This should include the prevention and detection of corruption, fraud, bribery and irregularities.
- 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.
- Uses public funds for proper purposes and seeks to achieve value for money from public funds.

The Chartered Institute of Public Finance and Accountancy (CIPFA) takes a broader approach to defining financial responsibilities. Discussing the role of financial management more generally (as opposed to the governors' role)<sup>5</sup>, it sees three key tasks:

- Securing stewardship - an emphasis on control, probity, meeting regulatory requirements and accountability.
- Supporting performance - responsive to customers, efficient and effective and with a commitment to improving performance.
- Enabling transformation - strategic and customer led, future orientated, proactive in managing change and risk, and outcome focused.

"Frankly, I feel I'm wasting my time talking to the governors about finance. There are only two or three of them who understand. The others try but don't really have a clue." **FINANCE DIRECTOR**

<sup>4</sup> Available at [http://www.hefce.ac.uk/media/hefce/content/pubs/2014/201412/HEFCE2014\\_12.pdf](http://www.hefce.ac.uk/media/hefce/content/pubs/2014/201412/HEFCE2014_12.pdf) <sup>5</sup> CIPFA (2005) Getting the Finances Right: A briefing for non-executive board members of public sector organisations, <http://www.cipfa.org/policy-and-guidance/reports/getting-the-finances-right-a-briefing-for-nonexecutive-board-members-of-public-service-organisations>

This is a useful summary of whether the conduct of financial management as a whole is fit for purpose.

Perhaps the most important point which follows from these statements of responsibilities is that it is the whole board that has a collective responsibility for ensuring financial health, and that this is not something that can be left to the finance committee (or equivalent), still less to the executive. Of course, the board's job is to govern and not manage, but it has ultimate responsibility, and all individual governors need to feel capable of exercising it even though they may not be financial specialists.

### Why is it difficult?

There are several reasons, some concerning financial management and others specific to higher education. For governors without a background in finance, the challenge of ensuring financial health can seem daunting. In the past, in a much less competitive and turbulent environment, the governor's role tended to emphasise accountability and ensuring financial control: still potentially challenging, but there was always another member with financial experience or the auditors to get assurance from. However, the emphasis has changed, and the language confronting governors is more difficult: strategic positioning, value for money, ensuring sustainability, achieving optimal asset utilisation, and so on. Throw in future threats to income and costs from demographic trends, reductions in funding, tuition fees, the lifting of the student number cap, threats to the future of pensions funds, and so on, and the future financial challenge facing governors is – generally – much greater than in the past. No governor can afford to simply 'leave it to the financial experts'.

Other difficulties come from the nature of many HEIs. Most are complex and multi-faceted, with a mix of teaching, research and enterprise activities. Sources of income may be diverse, and some may receive substantial funds from charities especially if they have a medical faculty. Institutions are often major property owners or occupiers and some operate large accommodation services for students. They may be involved in consultancy or publishing activities. Some will have substantial investments to manage, perhaps associated with an in-house pension fund. In addition, governors may in some cases also have a duty of oversight over the finances of the institution's Students' Union.

Ethos is also important. Most academic staff will be committed more to their subject than the financial 'bottom line', and what happens in their own HEI may be of little concern so long as facilities continue to be provided for them. And when academics do consider the financial aspects of their activities, they tend to focus solely on income generation (i.e. turnover) rather than on the surplus or deficit associated with such activities when expenditure is taken into account. In an HEI there is never a shortage of things on which to spend money, and academics will almost always feel that their own subject area demands investment. Moreover, funding an HEI with a legitimate aspiration for excellence (still more the over used concept of 'world class') involves very different financial demands from one that simply seeks 'fitness for purpose'.

There is also history – more influential in older universities perhaps. Despite a turbulent external environment, there is still some resistance to a managerial approach, and the belief that collegial decision making is not to be discarded lightly. Such critics are right to argue that plans and priorities handed down from above will not work in a context where management control is rarely tight, but the pace of change in higher education (as elsewhere) argues against too much dependence on consensus, particularly in relation to difficult financial decisions about competing priorities.

"Now I'm retiring from the board, I feel ready (and have the knowledge) to govern the institution!" **LAY GOVERNOR**



## What's in this guide?

Reading this guide is not intended to make you a financial expert, but it should help you to identify what you need to do to undertake your financial responsibilities as a governor. It also lists some of the other resources available to support effective financial governance. For example, there are several useful documents for governors listed at the end of this chapter, which you should know about. If you don't, you will have a useful question to ask your clerk or governing body secretary next time you meet.

However, most importantly this guide is to help you perform your role effectively. As well as the rules and where to find them, it discusses what the rules don't say and what an experienced governor might say to you at the outset of your time on a board. Good governance is often about knowing what questions to ask, as officials usually wait to be asked - which may be no bad thing if the alternative is bombarding you with information, or, worse still, providing undigested data which you cannot put into context. Long and complex board papers are rarely a sign of good governance.

### Suggested task



*As a governor, reflect on where you find the financial information you need. Does it give you what you want? If not, what else do you require? And are key messages being lost in excessive reporting?*

Of course, good governance is not management. If you study all the guidance you'll be offered, you may be tempted to run away or try to do the management's job. But you must navigate a fine line between governance and management - one that is often unclear and may well shift over time. You may have to test it to find it - but then stay on your side. You need to know, from what you read, see or hear that your HEI's finances are being effectively and efficiently managed, and this material will help you find that out. But don't hesitate to go and see the key players. A good finance director will be pleased to see you, and will not expect you to understand higher education finance beforehand. Indeed, an HEI which takes governance seriously may already have arranged such a meeting for you. It is also worth noting that, while a good finance director will welcome constructive challenge, nit-picking over minor details is rarely helpful.

As a first step, you might find it useful to assemble some important source documents (to which reference will be made later):

- The Committee of University Chairs' Higher Education Code of Governance.
- The latest report from your funding body on the financial health of the higher education sector – these are usually published annually.
- Some key institutional documents: the latest financial statements; the financial forecasts; the strategic plan; and the financial strategy.
- The financial memorandum for your own HEI as issued by the relevant funding body. ■

“From a private sector perspective my HEI’s strategic plan is weak. It lacks detail and KPIs, and I get the feeling that the executive wants it that way as it makes it harder for us to hold them to account.” **LAY GOVERNOR**

# 02 Where to start: The big picture

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Chapter 1 identified some of the challenges governing bodies face in governing the complex finances of an HEI. This chapter expands on those issues, and suggests ways in which governors can build up their knowledge about the finances of their institution and how it works.

In practice, many key financial issues facing governors emerge from an analysis of four basic questions, and each is considered in turn:

- What are the institution's current vision and priorities?
- How are they reflected in financial strategies and policies?
- How are they reflected in budgets and capital plans?
- Is the institution sustainable?

## What are the institution's current vision and priorities?

There are over 160 HEIs in the UK. They are not identical and will probably be more different in the future. The ways in which they develop will be substantially influenced by government policy, student and employer demand, resource constraints and a host of other factors. All HEIs need to be responsive to such changes, but this will not be sufficient to create the successful institution that you and your fellow governors seek. More likely the board would prefer a clear vision with associated priorities as the basis for financial decisions and knowing where to invest or divest. Where can you find such information? The obvious place to look is the strategic plan.

Every HEI has a strategic plan, partly because the funding council insists. But you will need to ‘drill down’ from an overall strategy to ascertain the real institutional priorities, and its commitments to them when resources are scarce and awkward choices are necessary. It’s not difficult to write platitudes about what an HEI would like to see happen and which will satisfy all constituents because it doesn’t threaten or offend any. Strategic plans need to be aspirational, but not unrealistically so. The better plans set out steps which will be taken to realise the vision and priorities, the milestones to measure realisation, responsibility for delivery, and the resources needed.

All governors should have been given a copy of their institution’s strategic plan when they were appointed; if not, your clerk or secretary should provide one. As a development exercise, you might like to compare it with a few others which can be obtained on the websites of many HEIs.

More formally, the CUC Code of Governance<sup>6</sup> notes that “the governing body is responsible for the mission, character and reputation of the institution at a strategic level, and members will need to be adequately informed in order to carry out this key responsibility. They can expect the head of the institution to help them by providing strategic advice and guidance on the mission and strategic development of the institution.” Furthermore, it goes on to say that “the strategic plan plays a crucial role in ensuring the successful performance of the institution, and the governing body will want to demonstrate its commitment to and support for the plan by formally approving or endorsing it in accordance with its constitution.” When properly written, such plans give governors opportunities to understand and approve where an HEI wants to go, and gives a framework for the next task of aligning resources with plans. They set priorities - that’s why they’re useful.

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<sup>6</sup> Committee of University Chairs (2014) Higher Education Code of Governance, <http://www.universitychairs.ac.uk/wp-content/uploads/2015/02/Code-Final.pdf>

## How is the strategic plan reflected in financial strategies and policies?

A good strategic plan will be accompanied by a number of subsidiary ones, setting out an HEI's more detailed ideas in key areas, e.g. teaching and learning, research, enterprise, finance, estates, human resources, etc. However, finding and reading all these at once is not recommended!

There are, perhaps, two critical questions here: first, are all these strategies and plans consistent? This should not be assumed; remember that the strategies will probably have been produced by different people, and may have been approved in different committees, so consistency cannot be guaranteed. The board has a real role here: to probe, test, constructively challenge, and ensure consistency. Failure to do so may result in scepticism from the academic community about the value of the strategies, as governors can be sure that staff will spot the inconsistencies quickly.

The second key question is: quite simply, do an HEI's strategic aspirations match its resources? The only way of checking is a robust and convincing financial plan, which takes account of all those associated strategies, targets and milestones. As a governor it's not your job to do this, but it is your job to check that it's been done. It is not helpful for an HEI to publish a strategic plan before checking whether the figures add up!

### Suggested task

Watch out for important documents like strategies as they arrive in governing body papers, extract them and build up a working file. They can be hard to find subsequently.



While different institutions will have different aims and different ways of achieving them, there are three main factors that play a significant role in how the institution works:

**People** – academic and professional services staff;

**Place** – the institution's campus (if it has one), its estate and other facilities; and

**Information** – how the institution measures what is important and how it uses this to make effective decisions.

Each of these factors should be considered carefully, both separately and as a whole. Because of this, they usually each warrant their own specific strategy, which ties into the institution's overall aspirations.

## How are strategies reflected in budgets and capital plans?

Each spring, HEIs enter their annual budgeting process, which should lead up to a presentation to the governing body in early summer. Whilst the principal objective is to set a series of subsidiary budgets, income targets and expenditure limits for operational use and subsequent monitoring, the process should be accompanied by a longer term view.

Though there will be uncertainties in the budget for the following year (student recruitment being the most obvious) it is important to have a robust budgeting process in place. It is the foundation of financial control.

There is a difficult balancing act here. The board needs enough data to know that the budget is deliverable, but not so much that it cannot see the overall picture. You need to question how the budget process has been influenced by the strategic plan. Is there evidence of appropriate prioritisation in resource allocation - indeed, is there any prioritisation at all? What strategic priorities will be affected?

There is a good case for governors (or a subgroup, perhaps) having a preliminary or strategic discussion about budget priorities, well before numbers are considered. At this stage, it will be much more practical to consider what elements of the strategic plan might be prioritised in the year ahead, what key assumptions should be made (and thus better understood by governors) and what areas should come under special scrutiny as the detailed debates about budgets go on in management meetings.

The extent to which the governing body is involved in the setting of priorities and budgets will vary from institution to institution. In some cases, the governing body will set broad targets for surpluses, cash flow and other key ratios and then delegate to management the responsibility for the detailed budgets required to meet these targets. In other cases, the governing body may play a more intensive role in agreeing the detail of the budget.

Whilst the main purpose of the discussion in the governing body will be to approve the budget (or not - it should never be a foregone conclusion), there should be an opportunity to discuss the annual financial forecasts which funding councils require. This is a very important opportunity to check whether the institution's plans are consistent, and at least one institutional failure of governance would have been avoided if some robust questions of this nature had been asked at the right time.

Obviously, budgets and forecasts contain estimates, and associated risks should be spelt out for the governing body. The degree of tolerance in any estimate is critical and not easily discovered without considerable experience. It may be worth asking for a 'worst case scenario'. The whole issue of risks in relation to financial issues is discussed in separate material in this series.

### Is the institution sustainable?

This question leads naturally from the last paragraph. In the end, it is the key question. It arises at two levels - immediate and long term. The immediate is the state of next year's budget. If the executive has a track record of both delivering results close to budget and also producing a budget for next year which predicts a surplus in line with the financial strategy, there will usually be no need for close questioning of what is presented to the board. But if the record is not good, or a deficit is forecast, the lack of a serious debate about the budget by the governors (and perhaps the finance committee before that) could have serious consequences.

Budget deficits can arouse strong feelings. In some cases, institutions are historically rather risk averse and do not consider the risk of missing promising opportunities. Other HEIs have been prepared to tolerate a deficit in suitable circumstances - a major build up in a new venture, perhaps, or the costs of winding down an existing activity. If such a budget is to be accepted, clear arguments will be an essential part of the short term strategy and they should include robust recovery processes.

Budgets are not the only aspects of institutional finances which may show signs of distress. The outcomes of the 'credit crunch' show that 'cash is king' when avoiding cash flow problems. If an HEI cannot pay its bills, it will be under a legal duty to seek the appointment of a receiver to manage its affairs - a disastrous turn of events which would in all probability be terminal. In practice, modern financial and risk monitoring processes should have led to funding council intervention effectively overriding governors. Governors should also be mindful of banking or other financial covenants, performance against which should be subject to regular scrutiny.

Longer term sustainability has more to do with the overall state of the educational 'business' than its finances. Clearly a financially over stretched HEI has long term problems as well as short term ones. But the state of recruitment to its courses, its research performance, the enthusiasm and skills of its staff and the state of its property and equipment, and the quality of its leadership, will have more impact on its future. As such, long term sustainability requires sufficient investment in people, property and systems to maintain operating efficiency and productive capacity. Sacrificing tomorrow for today is unwise. The link to a robust and consistent strategy may be evident, but may not be easy to achieve.

## Self-challenge questions

- Is your institutional financial strategy still current? If not why not?
- Are your HEI's main financial priorities clearly identified for the next few years, and do all governors have a similar understanding of them?
- Are the links to all other strategies (eg learning and teaching, research, estates, etc) consistent? If not why not?
- Is your institution financially sustainable, and has sustainability been properly considered by your governing body?
- Has your governing body been told of the worst case financial scenario?

### A GOVERNOR'S DILEMMA 1:

The outcome of a strategic review of your HEI (initiated by your governing body) is that it has an uncertain future and may not be sustainable, and a merger has been suggested. Your HEI's finances are stable, but not strong. It has recorded small deficits in each of the past three years (1-2% pa), has limited cash reserves and has significant outstanding bank loans.

The HEI is heavily focused on art and design, with some teacher training. It has recruited undergraduate students well in recent years, but has struggled with postgraduate courses. The outcome of its last REF submission was disappointing. Some key staff saw this as a signal to leave for HEIs with a stronger research base. The head of institution has decided to retire.

The choice of merger partner lies between two other HEIs, both located in your city. One is a member of the Russell Group of 24 research-intensive HEIs, and the other is in the Million+ Group and achieved university status in 1992. The former generally recruits well qualified students easily, has an extensive range of postgraduate activity and substantial research income. It has a large estate in a good state of repair and a major overseas campus. Its finances are unusual; it has made a very small surplus in each of the last three years (and this after property disposals have boosted income), limited cash reserves and a high level of borrowing. This institution has no existing art and design activity, but does have some secondary teacher training in other areas.

The second HEI also recruits well in general, but struggles with some of the more traditional academic subjects. It also has a strong postgraduate portfolio, especially in business and law and has strong research ambitions. Being in the city centre, it has major opportunities to rationalise its over-generous property portfolio in partnership with commercial developers and is in the process of doing so. It has a strong relationship with the city council. Its finances are more conventional. It has made a surplus of over 4% in each of the last three years and has strong cash reserves. This HEI has substantial existing art and design activity and a lot of secondary teacher training.

As a governor, what are the key factors that would influence your decision and why? ■

"We have a real problem in that the Finance Director always tries to present us with a 'fait accompli', and if we try and change something he says it's too late."

**LAY GOVERNOR**

# 03 Making sense of financial strategy

Institutions need to have a clear vision of their objectives and how they will be realised - a roadmap, perhaps. However, there are many ways of expressing that vision and map. Indeed, some would argue that a map is too prescriptive and that another navigational aid - a compass - might be more appropriate. In the difficult environmental conditions in which higher education exists, the landmarks, roads and milestones which a map requires may not be apparent - until you look back that is, when it is rather late to decide future direction.

This chapter looks at some of the ways in which institutions can cope with uncertainty and plan their way forward. Risk management is an important technique to support that process and it is covered in other material in this series.

## The principles of a financial strategy

This chapter does not give you a comprehensive guide on 'how to do it'. Quite simply, there is no correct way, but there is a right way - the one that fits your institution. It needs to fit in with several other strategies and plans, including: the overall strategic plan; the teaching and learning, research and enterprise strategies; the estates strategy; and the human resources strategy.

However, it is also important to fit in with:

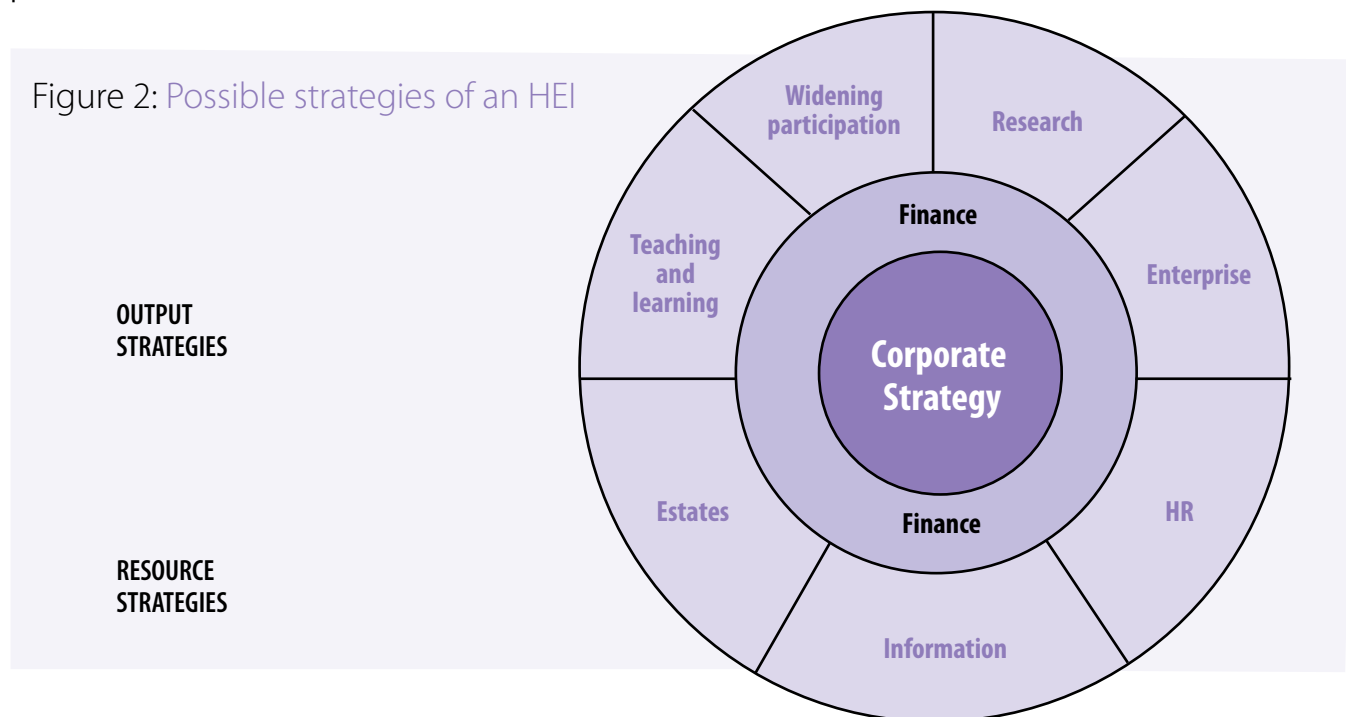
- the culture of your institution, its history and values, and how it goes about planning;
- the structure of your institution and the way in which it reaches decisions;
- the current financial and other resource position - your room for manoeuvre; and
- the skills of your management, who will have to deliver it.

The purpose of a financial strategy is to organise the financial resources required to deliver the institution's strategic plan. The principal academic strategies (teaching and learning, research and enterprise) will be the main drivers for realising institutional objectives. The role of the financial strategy is enabling - to ensure that the right financial resources are in place to support those academic objectives. The first chart overleaf illustrates this view of the role of a financial strategy:

Figure 1: Possible strategies of an HEI (not all links shown)



Some argue that the financial strategy is rather more central than a simple enabler, and see it as the glue that holds the other strategies together and as the guardian of the sustainability of the institution. This view, illustrated with the second chart, is useful because it emphasises the critical importance of integrating all the strategies into something that is deliverable. There is little point in having several strategies which make no concessions to each other. So it is important not to consider the financial strategy in isolation from other important institutional strategies – human resources and estates being two obvious ones, though information technology strategies now also increasing in both prominence and cost!



### What are the benefits and implications for institutions?

Developing an integrated financial strategy will help institutions to ensure viability and coherence (or balance) in their activities, in that it will allow them to:

- set priorities and manage operations, recognising the financial climate and the constraints it may place on their ability to generate surpluses;
- identify and quantify future resource needs, including the need for investment to protect future productivity;
- evaluate strategic opportunities such as for collaboration, e-learning and new teaching methods, and for business development;
- make an integrated response to funding initiatives and opportunities which create long term financing implications;
- manage resources effectively in a way that satisfies external stakeholders without damaging the culture of the institution; and
- mitigate financial risks.

### Five principles

Guidance issued by HEFCE in 2002<sup>7</sup>, but still relevant today, identifies five key principles for a financial strategy which are worthy of attention:

- Ensuring long term viability and matching resources with objectives.
- Maintaining productive capacity to meet current objectives.
- Financing development and investment.
- Evaluating strategic alternatives and managing risks.
- Integrating financial and other corporate strategies.

<sup>7</sup> HEFCE (2002) Financial strategy in higher education institutions.

### Principle 1: ensuring long term viability and matching resources with objectives

A strategy should set the financial performance objectives for a viable level of academic and other activity by the HEI - in line with its strategic plan and strategic positioning - while matching resources with objectives in the long term and incorporating the known risks. The Guide suggests that this is tested through a series of questions, for example:

- What are the financial implications of our current academic positioning?
- Are our objectives, resources and infrastructure in an appropriate balance?

In seeking answers to these questions, the underlying purpose is to test for the thoroughness and depth with which the job has been done. The planning department may have done a first class job in writing an outstanding strategy, but behind that you need to know about any lack of integration of the various plans, strategies and policies or the absence of a serious analysis of options for existing and future activities, especially those which are struggling. Other questions should test whether costing and pricing, pressing for better value for money, and resource allocation methods are aligned with the overall strategy.

Of increasing relevance here is the question of 'cross-subsidy' of some academic departments and courses by others. For example, it is usually cheaper to teach a student on an undergraduate humanities-based course than one studying the natural sciences, but both students will normally be charged the same tuition fee. So the humanities course is likely to generate a surplus, while the natural science course may well result in a deficit. Governing bodies will need to decide the extent to which each academic department or subject area must 'wash its face' and under which circumstances cross-subsidy will be permitted.

#### Suggested task

Imagine that the Dean of your institution's business school is lobbying for the school to retain all of the (considerable) surplus that it generates from its teaching and research activities. She claims that this is what happens elsewhere and that cross-subsidising other subject areas is putting the school at a commercial disadvantage. Consider how you might respond to the Dean's concerns.

### Principle 2: maintaining productive capacity to meet current objectives

A strategy should address the investment needs of the institution to maintain the value and contribution of human resources, physical assets, intellectual assets and information and systems, and to deliver the various resource strategies which support the mission and current academic objectives. This is sustainability in action. Suggested questions include:

- Do we have the right level of productive capacity in each key resource?
- Are we investing at an adequate level to maintain physical capacity?

These questions should be addressed through other strategies. Again, their purpose is to test the firmness of the planning ground.

"In truth, we have a financial strategy in name only. If the VC or director of finance wants something they do it, and tell the board afterwards."

**LAY GOVERNOR**



### Principle 3: financing development and investment

A strategy should provide for the appropriate levels of financing for capital development and other investments, including the use of borrowing and other external sources of finance. Such developments should be supported by business cases, considering a range of options. Suggested questions include:

- How do we know the total cash and capital needs of the institution?
- How do we decide whether to bid for publicly funded special initiatives and projects?

Unless these questions are answered, your governing body cannot know what annual surplus to seek or what level of borrowing might be tolerated.

### Principle 4: evaluating strategic alternatives and managing risks

A strategy should provide a framework to help the institution assess the implications and consequences of potential strategic developments and decisions, and to evaluate and manage risks which threaten delivery of the strategic plan. For example:

- How can the financial strategy help to support and prioritise strategic opportunities?
- How can we minimise the impact of unexpected downturns?
- How can we mitigate exchange rate risk if we have significant overseas activities?

### Principle 5: integrating financial and other corporate strategies

A strategy should be integrated with the output and other resource strategies, understood and owned by those involved in the management of activities and resources, based on a realistic strategic analysis, and supported by a process of monitoring and review. Questions include:

- How do we ensure that the financial strategy is properly integrated with the output strategies (academic and enterprise) and other resource strategies of the institution?
- Do senior academic and other managers understand and accept the consequences of the financial strategy?

### Let's be practical - key checks

There is enough in the above lists of questions for several governor awaydays! Indeed, governors who seek detailed answers to each question will keep officers fully occupied for a long period, presumably to the detriment of running the institution. That isn't governance.

Instead, let's go back to the purpose of a financial strategy: whether it's just a check on how all the other strategies can be afforded or the glue which holds them all together doesn't matter too much. The key issues and self-challenge questions for governors are:

- Are all strategies integrated - are they consistent with one another?
- Has each one been prepared thoroughly - including serious consultation with interested parties?
- Can they be afforded - is the institution likely to have enough resources to deliver them?
- Have we managed the main risks?
- Are the indicators established to check progress?

By all means ask questions which test these issues, but remember it may be a case of 'less is more'. A concise list of priorities, widely supported around the institution, may be the most effective corporate strategy of all because of the ease with which it can be communicated and progress measured. All a financial strategy has to do then is line up the money behind them and check for deliverability. ■

"My board is getting better at understanding the need for risk management. A few years ago they all made jokes about it, but now they are starting to see its potential."

**LAY GOVERNOR**

# 04 Key elements of financial management

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The key elements of financial management referred to in Chapter 1 were:

- Securing stewardship - an emphasis on control, probity, meeting regulatory requirements and accountability.
- Supporting performance - responsive to customers, efficient and effective and with a commitment to improving performance.
- Enabling transformation - strategic and customer led, future orientated, proactive in managing change and risk, outcome focused and receptive to new ideas.

These are elements of good management, not governance. However, the dividing line between the two is not rigidly fixed, either by rules imposed from outside or over time or even between different personalities. To some extent, it is where the parties agree it should be - which is why each party needs to know what is expected of the other. This conversation doesn't occur often enough - if necessary, you should initiate it. With that caveat, this chapter is about what you as a governor might reasonably expect your finance function to do.

## Securing stewardship - control, probity, compliance and accountability

Stewardship of money lies behind all the basic financial operations. What should you look for in practice? First and foremost is a sound budgeting and forecasting process; by 'sound' is meant a process that is owned by the HEI and those who have to deliver its outcome. Writing a budget is the easy part, the hard part is engaging support for it; this is one of the key skills of your finance and planning team. It is also a structural issue; budget preparation takes place within a management structure which must be able to resolve the inevitable choices and challenges which will be encountered. It's not the job of the governing body to negotiate the budget: either approve it or refer it back. But your response will set the tone.

Associated with sound budgeting is reliable and timely management accounting and reporting. The frequency and level of such reporting will depend on the likely extent of variation from the predictions in it. Monthly reports may be desirable, but can become too frequent to have the desired impact when serious drift is occurring. Quarterly reports, especially if considered by a finance committee (or similar), may be more effective in sending out the message that budgets matter. A summons to meet such a committee, perhaps containing a mixture of governors and senior management, is a very powerful incentive to operational managers to seek help quickly if targets seem likely to be missed. Whatever: if you think the present position is unsatisfactory, don't wait too long to step up monitoring of budgets - subsequent intervention can be too little, too late.

The third element of control is secured through financial regulations. These are the rules for financial transactions, including levels of signing authority for budgets, procurement of goods and services, cash handling, petty cash, security of assets and disposal of redundant items, travelling and subsistence expenses. These and other procedures will be designed to ensure that the institution's funds are handled properly, its income collected and its assets safeguarded. It is not sufficient, though, merely to have a good set of financial regulations. They also need to be adhered to in practice! This requires a strong culture of financial control, effective staff training and regular reviews of compliance. And any breaches of compliance with the financial regulations should be addressed swiftly and effectively.

A further practical aspect of this control is a governing body needing to be clear about financial accountability through an agreed schedule of delegated powers being in place. This will define authorised levels for spending approval, and the limits of authorisation of each budget holder. Typically, governing bodies will only need to approve spending on large amounts, but in small HEIs boards may be involved in formally authorising expenditure for smaller sums. Such powers will also define the circumstances under which a specific governor (usually the chair of the board or the chair of the finance committee - or equivalent) can act on behalf of the full board in approving expenditure between meetings.

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However, whatever amounts are involved, as a governor you must be clear about who is authorised to spend up to defined limits and in what circumstances.

As a public body and charity, an HEI must account for how it has used its funds. Moreover, the financial memorandum imposes a requirement to show that funding council grants have been applied for the purposes intended. Charity law imposes an obligation to show that all expenditure has been directed towards realising an HEI's charitable objectives. This is the role of the financial accounting team, and it is their job to demonstrate the necessary probity, compliance and accountability through the preparation of the statutory financial statements to the SORP's specification, the Accounts Directions' requirements and the satisfaction of the external auditors. This is not the glamorous side of finance, but it can lead an HEI into just as much trouble as weak budgetary control. Here, as elsewhere, governors need to 'set the tone' by giving attention to the auditor's work and referring back unsatisfactory issues to the audit committee.

As an aside, being able to give a complete and reliable account of the institution's stewardship of its resources depends on having a reliable accounting system. Many HEIs have struggled with new computer based accounting systems, some with serious consequences.<sup>8</sup>

Treasury management (the management of cash, both borrowed and deposited) will require a strategy and associated policies. Substantial cash flows occur at various times of the year and can be traps for the unprepared leading to major risks if not effectively controlled, especially in relation to interest rates. The involvement of the finance committee (or equivalent) is essential, and the full board should approve the overall treasury strategy.

## Supporting performance

Effective stewardship of an institution's resources is vital and their control is essential, but just recording transactions is not enough. Good financial management has a cultural aspect as well. The finance department is in an excellent position (working alongside the planning department) to take the lead in using the information in its hands to improve both the performance of an HEI as a whole and its own service to it.

So far as the finance department's own services are concerned, this focus on performance should translate into providing services for the whole institution with features like these:

- Staff committed to supporting the mission of the institution and the academic cause.
- Management information, which is reliable, fit for purpose and timely.
- A structured performance and feedback system, which enables users of financial services to influence their future development and comment on what is currently provided.
- Regular benchmarking against similar providers.
- Year on year efficiency improvements.
- Enthusiasm for technology to improve services or cut costs.
- Commitment to training and development of staff.
- Influence over pricing decisions.

As a governor you will need to have confidence in the finance department, and you will have opportunities - or you can make them - to discover its standing in the institution. For example, is it perceived as a scorekeeper rather than a coach, is it committed to better financial management throughout the institution, and is it a beacon for service improvement and customer response?

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<sup>8</sup> Shattock M (2006) *Managing Good Governance in Higher Education*, Open University Press, pp.95-98, 13.

### Enabling transformation

The wider task of supporting the performance of the institution as a whole is a major opportunity for those responsible for financial management to make a difference. Here are some of the ways in which this might become apparent to you as a governor:

- Enthusiasm for producing and disseminating key performance indicators (KPIs). The detail is discussed in Chapter 12, but the question here is whether the finance and planning departments lead or follow in making them available. KPIs need to be made available at all levels - and staff helped to understand them, if necessary - so that there is widespread understanding and commitment to their improvement, or meeting targets.
- Using the resource allocation system to support improved performance. Can the resource allocation system be explained to your satisfaction?
- Finding reliable benchmarks or comparative data for KPIs, to help understanding of the institution's position in the sector.
- Seeking to improve the budget process. Simply adding an amount to expenditure budgets to cover inflation misses an opportunity to see where additional spending might generate more value, whether less would not make a dramatic difference to outcomes, or if improved efficiency might be available if the incentives were available.
- A balanced approach to financial reporting of previous periods, budget monitoring of the current period and predicting the financial situation about three years ahead.
- Similarly, are income targets ambitious and based on a realistic assessment of what the market will bear? Are prices tested against competitors?
- Acceptance that risk management is a key financial management tool, regularly featuring in financial presentations.
- Making sure funds are available for investment, especially in unexpected opportunities.
- A commitment to expanding financial literacy through training and support.

#### Suggested task

Go and see the finance director to discover his or her view on the right approach to financial management.



The key word here is 'confidence'. From what you see and hear, do you have confidence in your finance director's contribution to the strategic direction of the institution, whilst playing a part in improving its performance, keeping the score and satisfying regulatory requirements? The finance director will have his or her own professional obligations, which may mean that he or she may from time to time consider it necessary to challenge other senior managers and the governors? One of your roles is to ensure there is a dialogue between senior managers (not just the FD) and governors, so that potential problems can be shared.

### Self-challenge questions

- Is the institutional resource allocation system regarded as broadly fair by the governing body, and how does it know?
- As a governor do you know how investment opportunities are assessed, and pricing decisions made?
- Does your governing body receive regular and timely budget reports? If not why not? ■

"The board is getting much better at understanding financial information, and the Finance Director tries hard to explain things. But it is not so successful in getting the Vice-Chancellor to drive change through performance management." **LAY GOVERNOR**

# 05 Where the money comes from

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There are a fairly small number of determinants of income for HEIs. It's worth getting to know how they work because of their impact on institutions, which depends on market position and individual mission. Student numbers and tuition fee levels are the most obvious, together with the balance between home and overseas students. Aspiration in research is another example – though critical for some and largely irrelevant for others. So you need to know first of all what the character or mission of the institution is – back to the overall strategy. The extent to which these drivers are out of the hands of individual HEIs also varies, and government policy is one area where forecasting is risky.

## Tuition fees and education contracts

Tuition fees and education contracts make up, in most cases, the most significant proportion of an HEI's income. This is due in no small part to the increase in the level of fees that can be charged, the associated reduction in government grant funding and the relaxation of student number controls. For many HEIs an increasing proportion of tuition fee income – over a quarter, in fact, across the sector – comes from full fee international students (from outside the EU).<sup>9</sup> This is a lucrative but potentially volatile market, and sharp reductions in international numbers have occurred previously because of regional or global factors. As a result, many boards have encouraged the production of an international strategy to enable a risk based approach to expansion. A useful source of information on international student recruitment is the UK International Unit.<sup>10</sup> In other institutions, income from NHS contracts can also be significant.

The second decade of the twenty first century brings considerable and sustained uncertainty to the UK higher education sector. A new teaching funding regime, a revised model for allocating research income, a relaxation of student number controls, increasing global economic and political volatility, a toughening up of student visa requirements, stringent government funding cuts and a whole host of other factors have conspired to create a university planner's nightmare. And while some institutions have benefited from the various changes, others will inevitably lose out.

Adjusting to sudden falls in fee income is a major challenge for HEIs. Many are not used to reacting quickly because their 'product cycle' is typically at least four years (recruiting students is a commitment to teach them for at least that period). They also find it difficult to adjust expenditure commitments, especially to staff. In a 'nutshell', HEIs have to make many long term decisions, but are inherently funded on a short term basis - which for many in the commercial world would seem unthinkable. And they are doing so in what has become a much more competitive environment.

"As an experienced private sector finance director, when I first became a board member I was amazed at the number of income streams my university has."

**LAY GOVERNOR**

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<sup>9</sup> For more data on HEI income sources, see <https://www.hesa.ac.uk/stats-finance> <sup>10</sup> See [www.international.ac.uk](http://www.international.ac.uk)

### Funding body grants

With the new funding regime for teaching and the continued focus on government budget cuts, the higher education funding bodies in the UK home nations now provide a much lower proportion of HEIs' income than was previously the case. In the 2006-07 academic year, for example, HEFCE provided English HEIs with £5.4 billion of recurrent teaching and research funding. By 2015-16, this had gone down to £2.9 billion. However, the funding bodies' role as regulators remains unchanged. Consequently, they still play a significant role in the sector. And they continue to provide some funding to support both teaching and research activities, even if this funding is much reduced.

Funding council grants come in two main forms, teaching and research; both are performance related. (We are interested here in revenue grants; capital grants are looked at later on.)<sup>11</sup> Teaching grants depend on the recruitment and retention of students (within a margin of tolerance) and relate to the subject and level of study (undergraduate or postgraduate) and whether full or part-time. This funding relates, however, only to a small number of high cost subjects, such as clinical, science and engineering subject areas. More recently, grants have been introduced to encourage institutions to widen the access to higher education of some socioeconomic groups, to increase recruitment of applicants with non-standard educational qualifications and to improve the retention of existing students. Beyond this, the details of funding vary in the different UK jurisdictions, and information is available from HEFCE,<sup>12</sup> SFC<sup>13</sup> and HEFCW<sup>14</sup> (Northern Ireland operates broadly the same model as England).

An increasingly important technical issue about which governors need to be aware, is what counts as a student for funding purposes. The details of this are too complex to set out in full, but traditionally an HEI received no funding for students who 'dropped out' during their year of study. However, now that widening participation is a policy objective, some HEIs have been penalised financially through having unfavourable student retention rates resulting from trying to implement government policy. The various funding bodies have reacted to this in different ways, and both in Scotland and Wales a credit based system for funding teaching is now in place, which funds on the basis of modules completed rather than participation for an academic year. In England, HEFCE has introduced – within its 'student opportunity' funding stream – specific funding to assist institutions in improving retention. This funding is allocated on the basis of a number of student characteristics and other factors, which have been identified as contributing to retention issues.

Finance for research from the funding councils depends on academic performance in the Research Excellence Framework (REF)<sup>15</sup> where the quality of an institution's research – and of the research-active academics within it – is judged using a process of expert review. The formula for allocating funds changes after each REF to deliver what is thought to be a fair amount of money to each HEI. However, this approach has become more selective over time, and in 2015-16 just 10 English HEIs got over half of HEFCE's £1.6 billion of research funding allocations. Therefore any HEI thinking of entering this particular race for the first time (and without having the benefit of the existing research funding) will need very deep pockets and a very brave board.

A 'third stream' of funding has been growing in recent years, aimed at improving HEIs' ability to transfer their knowledge for the benefit of the economy. This 'knowledge exchange' may take several forms: spin out companies; patenting and licensing; industrial collaboration projects; specialist courses, perhaps for a single company; and consultancy. In England, HEFCE now emphasises the future importance of this area by reclassifying it as 'second mission' for those HEIs not intensively engaged in research.

Some HEIs in England also receive substantial grants from three other main sources: the National College for Teaching and Leadership for their teacher training work, the National Health Service, and the Skills Funding Agency for activities classified as further education. Other bodies provide similar functions and grant funding in Scotland and Wales. These grants carry similar performance related conditions. Some specialist HEIs may attract additional funding from their funding council, as may those with staff liabilities inherited from when they were maintained by local authorities. Capital grants are considered in a subsequent chapter.

"When I became a board member I was effectively told that the funding council were the enemy. In some ways they still are, but I've come to understand that they can also be very helpful if approached early on about a problem." **STAFF GOVERNOR**

<sup>11</sup> It is worth noting, though, that some funding council grants have both a capital and a revenue element. <sup>12</sup> [www.hefce.ac.uk](http://www.hefce.ac.uk) <sup>13</sup> [www.sfc.ac.uk](http://www.sfc.ac.uk) <sup>14</sup> [www.hefcw.ac.uk](http://www.hefcw.ac.uk) <sup>15</sup> For more information on the REF, see [www.ref.ac.uk](http://www.ref.ac.uk)

“We [our board] have an ongoing battle to stop the executive chasing after the latest pot of money, and stick to the strategy. They think too much about the potential income and not enough about delivering a high quality outcome.” **LAY GOVERNOR**

## Research grants and contracts

In addition to REF-based income, most HEIs seek research or contract funding from a wide range of external bodies. The largest source of such income is the research councils.<sup>16</sup> The extent of this varies widely from Oxford (£478m in 2013-14; 41% of total income), to very small amounts for HEIs not active in this area. All this income has to be won competitively from some sophisticated awarding bodies. For example, the research councils distributed over £1.7bn to HEIs in 2013-14 in response to individual project bids from HEIs which were assessed by academic peers. Many other bodies fund research through grants and contracts. Most government departments do so - the Ministry of Defence being a major contributor. Industry and commerce are another major source of funding, along with charities, who are mostly concerned with medical research. For example, at the time of writing the Wellcome Trust has recently announced that it aims to invest £5 billion over the period from 2015 to 2020 in improving health.

HEIs have an unenviable record of subsidising research and taking research grants and contracts at marginal cost, ie recovering only the additional costs incurred, with inadequate compensation for overheads. Nevertheless, research performance is frequently a key to academic recognition and promotion, so staff have a strong incentive to do research using facilities and services already in place which have been funded through other routes. This culture is slow to die, and challenging it is an important role for governors.

The funding bodies and research councils are keen for institutions to enhance their financial sustainability by securing funding for the full cost of their research activities. To this end, the sector has adopted the Transparent Approach to Costing (TRAC), about which more in chapter 10, as the accepted way of calculating the full cost of research projects. However, the research councils fund projects at only a percentage of the calculated full cost – and while this approach is accepted by some non-research council funders, others will still seek to fund only the direct costs of research.

## Other income

Wide variation exists in the sources of other income, including student accommodation, conferences, catering, consultancy, exploitation of intellectual property, use of sports facilities, and so on. Some HEIs have substantial income from the NHS, especially those engaged in operating joint facilities in medical schools, or training nurses and other health professionals. Funding provided through Local Enterprise Partnerships or local authorities may also be significant. Whilst the nature of the academic portfolio has an effect on an HEI's ability to earn additional income from non-mainstream activities, there is also an entrepreneurial effect. Some HEIs have deliberately sought to expand this income to make up for other shortfalls - with mixed success. Warwick is perhaps the best known, though others are making significant inroads into this arena, too.

Making optimum use of expensive property and equipment - 'sweating the assets' - is an important part of achieving better value for money. However, it may involve very different risks. Most HEIs are not usually organised for commercial operations, and the exploitation of intellectual property is a very different challenge from creating it in the first place. Indeed several HEIs have suffered significant governance problems as a result of misjudged commercial ventures. Special skills might be usefully coopted to the governing body or to an enterprise committee (or equivalent) to ensure effective governance in this difficult area. Whether all this activity is profitable is also a very different question addressed in Chapter 11 on trading. The extent to which it can divert attention from performing the principal tasks of the institution can also be a worry.

<sup>16</sup> For a summary of the work of the research councils see [www.rcuk.ac.uk](http://www.rcuk.ac.uk)

## Donations, endowments and investment income

A few HEIs have substantial endowments - money or other assets they have been given with the intention that the capital will be kept intact and the income used as required. It is possible that even the capital may be spent - it depends on the way in which the gift was formulated. As of 2013-14, UK HEIs had at their disposal nearly £4.8 billion of endowment assets. Impressive, surely, but a relatively meagre proportion of these institutions' total assets. And certainly nothing to rival the endowments held by their counterparts in the United States. (For example, at the time of writing the value of the Harvard University's endowment alone was \$37.6 billion.<sup>17</sup>) The same goes for donations to support HEIs in their teaching and research activities. They are there, but significant donations are the exception rather than the rule.

For most HEIs income from other investments is from interest on bank deposits or other short term investments. Many HEIs are depositors as well as borrowers, so the net interest received or paid is an important figure to note. Investment risk is ever present (as the credit crunch demonstrated), so a clear treasury management policy is critical, and should be approved by the board. Borrowing simply to make financial investments is beyond the powers of most HEIs and may be expressly forbidden in financial regulations.

### Suggested task

Compare your institution's budget with its strategic plan. Are the key elements of income reflected in the topics covered in the plan?



### 'Soft money'

This is a term often used in HEIs to distinguish sources of income with a limited life from those that are more permanent, such as funding council grants. Typically, research grants and contracts, consultancies, many postgraduate courses and many other types of income will come and go, as particular contracts are won and later expire, often without extension. The key issue here is avoiding as far as possible long term commitments to spend against such sources - not always easy to do, especially since employment legislation restricts the use of limited term staff contracts.

### Self-challenge questions

- What are the dominant influences on your HEI's income and how volatile are they?
- How effective is governing body monitoring in this area?
- Who decides what overheads are recovered on research grants?
- What are the arrangements for managing enterprise activities?
- How does your institution seek to protect and leverage its intellectual property assets?

### A GOVERNOR'S DILEMMA 2:

As part of a strategic review, the head of institution proposes to focus on greater international presence through the establishment of several overseas operations, the first being in Malaysia. The business plan suggests that up to 5,000 students will be attending your HEI from there after seven years. Although there are bound to be losses in the first few years, break-even will be reached by year five and the losses recovered within a few years afterwards. An experienced member of the academic staff is keen to take this project on and a wealthy former student in Malaysia has offered to provide loans to cover the initial losses. As a governor you have been asked by the chair of the governing body to suggest what questions she might ask when the project comes forward to the board for approval. ■

<sup>17</sup> [http://www.hmc.harvard.edu/docs/Final\\_Annual\\_Report\\_2015.pdf](http://www.hmc.harvard.edu/docs/Final_Annual_Report_2015.pdf)



# 06 Where the money goes

Like any large organisation, higher education institutions cost a considerable amount of money to run. In addition to the direct costs of teaching and research activities, they incur a broad range of overhead charges. The cost of borrowing must also be serviced. And while most of an HEI's core undertakings are exempt from taxation, the tax implications of new developments or commercial activity must not be ignored.<sup>18</sup>

## Staff costs

The expenditure patterns of HEIs vary much less than their income. Staff are much the largest component of expenditure - averaging around 55% in non-specialised HEIs. Despite predictions to the contrary and trends in other sectors, national pay bargaining is still the norm in higher education. Final salary pension schemes are also the norm for many existing staff, though this is usually no longer an option for new joiners as pension schemes seek to reduce their financial liabilities.<sup>19</sup> Redundancy is a key issue and likely to stir strong emotions and action - and be a lengthy process in any event.

Much more information and comment is available in the separate materials on human resources in this series. The important points to note for financial purposes are the dominance of staff costs in institutions' budgets, their rigidity (the difficulty of adjusting to lower levels of income), and the rate at which such costs are increasing as HEIs compete for the best staff, and legislation and pensions add to the upward pressure. Governors need to be aware that they will come under significant pressure if HEIs attempt to reduce staff costs.

## Fundamental restructuring costs

With institutions across the sector working hard to respond to the changes in the current higher education environment, the fundamental restructure of what they do and how they do it is becoming more and more common. Where such a restructure takes place, financial reporting rules require the institution to disclose separately the costs involved. This will include the cost of the staff time involved in designing and implementing the restructure, as well as other costs such as consultancy fees and redundancy payments.

## Other operating costs

HEIs incur a multitude of other costs, but the cost of the institution's estate - the buildings and facilities that it uses - is usually one of the more significant. In 2013-14, for example, such estates costs made up 11.6% of total sector expenditure. That is without counting capital spending on additional property or major refurbishment. Most HEIs have substantial and growing estates, requiring expenditure on maintenance, utilities, rents, insurance and local taxation. The extent to which spending is adequate is a key question for long term sustainability, but the associated question of operating efficiency should not be ignored. Does your HEI have too much space - or a lot that is not really fit for purpose? Such questions are addressed in the separate materials on estates in this series.

"Several departments are always in deficit in our cost model, but just carry on regardless and the dean finds the money to subsidise them from elsewhere. However, the board is now starting to look hard at this, and there may be a battle ahead."

**FINANCE DIRECTOR**

<sup>18</sup> For a quick start guide to tax in HEIs, BUFDG has produced a document that should interest governors <http://www.bufdg.ac.uk/ViewDocument.aspx?t=1&ID=2303&GUID=75f0d898-f2d9-476a-b6da-789c8415062d&dl=1> <sup>19</sup> For more information on HE sector pensions see <http://www.employerspensionsforum.co.uk/en/pension-schemes/>

Another significant area of expenditure encompasses a broad and growing range of activities which might be termed 'academic services'. These include libraries, IT provision and educational technology. Decisions on the desirable level of spending in this area are very difficult, not least because of the pace of change in the IT world.

Expenditure on administration and central services amounts, on average, to around 16% of total expenditure across the sector. However, as estates professionals work hard to improve the efficiency of institutions' facilities, and academic support services try to support more students with the same level of resources, this administration budget is coming under increasing pressure, too.

Whilst HEIs have made available scholarships and bursaries as an aid to recruiting, the introduction of tuition fees in England and Wales in 2005 was accompanied by a requirement to make available substantial numbers of bursaries for students, to ensure that money was not a bar to their entry and continuation. HEIs wishing to charge higher fees are required to negotiate a suitable agreement with the Office for Fair Access (OFFA) in England and with HEFCW in Wales. Similar arrangements operate in Northern Ireland where access agreements are approved by the Department for Employment and Learning based on advice from OFFA.

There are many other categories of expenditure, including laboratory equipment and supplies, stationery and printing, telephones, travelling, conferences and training. Depending on the structure of an HEI, much of this spend will be in the hands of academic and support service departments. The main issue here is procurement policy and practice. Even a medium sized HEI can spend £50m each year on these items, and purchasing decisions are often distributed widely. To what extent are purchasers trained, coordinated, monitored and measured? This is a useful line of value for money enquiry for a board to pursue through the audit committee. There is also an increasing amount of European legislation impacting on procurement, which must be taken seriously, if only because of the penalties for non-compliance. The sister guide to this publication, *Getting to Grips with Procurement*, provides further guidance in this area.<sup>20</sup>

### Depreciation

This is the annual charge representing the consumption of the value of buildings and equipment. Capitalisation is effectively a way of deferring costs to later accounting periods, when the benefits of the investment appear. It has its dangers. What is and what is not capitalised is an important issue where discretion can be exercised (especially in relation to refurbishment costs), and the subject is worth debate at both the finance and audit committee. Note that depreciation is an accounting device and not a cash outflow, and the distinction is critical - see Chapter 8.

### Interest and finance charges

The contents of this line in the accounts are self explanatory. However, note the use of the word 'payable' when discussing finance charges, ie liable to be paid because a loan has been in the HEI's hands, whether actually paid in the accounting period or not. This is another important area of difference between accounting for a cost and actually paying out cash. Lenders may well be prepared to 'roll up' interest with capital for a period, ie wait for the interest, in order to allow a project to start generating cash. There is another area of discretion to be exercised here. Some HEIs add interest charges incurred during construction of a new building to the capitalised cost of that building, before starting the writing off process once the building is complete.

Capital expenditure is dealt with in Chapter 7.

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<sup>20</sup> [www.lfhe.ac.uk/en/research-resources/publications/index.cfm/G2G%20-%202012](http://www.lfhe.ac.uk/en/research-resources/publications/index.cfm/G2G%20-%202012)

## Taxation

The liability of HEIs to direct and indirect taxation is an extensive topic which cannot be fully covered here. The key points are:

- The provision of education is an exempt activity for VAT. This means that input tax on direct purchases cannot be recovered as there is no output tax to be set against, resulting in irrecoverable VAT which is an additional cost for HEIs. There are though some activities (which are either zero or standard rated), where the input VAT on good and services directly purchased for those activities can be offset against the output VAT. In addition, a proportion of costs (ratio of VAT recoverable to exempt) which cannot be attributed directly to activities can also be recovered through what is known as partial exemption. This is a complex area best explained by the director of finance.
- As HEIs are charities they do not pay corporation tax. This applies to activities which are carried out in accordance with their charitable objectives and for the public benefit. However, where HEIs carry out business activities (mainly to generate income) these may be liable to corporation tax. This can be managed through such taxable activities being delivered through a wholly owned subsidiary company and any profits covenanted back to the HEI. This is perfectly allowable and is accepted by H M Revenue and Customs. Again this is complex and best explained by the director of finance.
- As charities, HEIs in England, Scotland and Wales currently receive 80% relief from business rates. Once again, this relief is limited to charitable activities as defined in legislation and case law. Universities UK has produced a useful guide to business rates.<sup>21</sup> The requirements of charity law are covered more fully in Section 9.

### Suggested task

After reading this chapter, consider again the relationship between expenditure patterns and the priorities of the strategic plan.



## Self-challenge questions

- What proportion of total expenditure in your HEI goes on staff costs? Is it increasing or decreasing? What is the view of the governing body about whether this position is satisfactory?
- Has the institution's procurement policy been approved by the governing body? What performance indicators are being used to measure its effectiveness?
- Has the governing body discussed and approved an IT strategy?
- Has spending by activity been benchmarked against peers? ■

<sup>21</sup> [www.universitiesuk.ac.uk/highereducation/Documents/2015/RatingRevaluation2017%20introduction.pdf](http://www.universitiesuk.ac.uk/highereducation/Documents/2015/RatingRevaluation2017%20introduction.pdf)

# 07 Capital funding

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The way in which capital is accounted for in higher education accounts is discussed in Chapter 8. This chapter is concerned with the sources of capital funds and the various issues which surround them.

## Government grants

In addition to core funding, the government makes special grants available to higher education through a series of initiatives. Most of these are for capital purposes. In England for 2014-15, for example, HEFCE paid out nearly £450m of capital funding for institutions, through a number of different funding streams. Your finance director can advise you which are most important for your HEI. Different arrangements apply in Scotland and Wales.

A study undertaken for HEFCE by Frontier Economics<sup>22</sup> found clear evidence that capital expenditure is associated with significant positive changes in a number of outcomes at HEIs, including student numbers, numbers of researchers and contract and consultancy research income. The study also found, though, that capital spending fell between 2008 and 2014 in 50 per cent of institutions, and by as much as 25 per cent in a third of institutions. The authors argue that there is clear evidence of the ongoing need, on the part of government and the sector itself, for further capital investment in the sector, to continue to attract the best students, lecturers and researchers in the world.

However, government capital grants for higher education have a chequered history. The capital funding tap has been turned on and off at various times, depending on political attitudes and the state of the Treasury's coffers. The same applies, to varying degrees, within the devolved arrangements. For those reasons, it is not sensible for HEIs in England, or elsewhere, to plan on the basis that capital funding will continue at current levels. Institutions should also be mindful of the revenue implications of capital projects and should ensure that they will have sufficient funds to meet any additional revenue costs that such projects may generate.

## Other grants

There are many other sources of capital grants for higher education, for example: government departments (as well as the main sponsor, the Department for Business, Innovation and Skills); charities and trusts - especially in the medical field; companies; the National Lottery; local authorities; and private donors.

Many HEIs are now turning their attention to raising money from a wider range of sources - this is often called 'advancement' or 'development'. Governors can be expected to play an important role in representing their institution to those in a position to help it. This is not necessarily copying the US model where trustees are often expected to put their hands in their own pockets, but it is more to do with governors using their contacts to explain what their institution is trying to achieve and what it needs to do that.

## Borrowing

There is also a history to the borrowing record of UK higher education. The pattern has been largely in an opposite direction to government grants. As the latter have declined, so HEIs have sought to keep up with their capital needs by resorting to borrowing. More recently, however, capital expenditure has also been financed through sale of surplus assets and through internal cash savings.

Attitudes to borrowing vary considerably; some HEIs will not do it because they see it as mortgaging the future - failing to strike a fair balance between today's and tomorrow's interests. In 2013-14, a small minority of HEIs did not have any external borrowing. Most, however, did - with the sector average for external borrowing as a percentage of annual income lying at just over 26%. These measures should help governors to decide what a tolerable level of borrowing might be.

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<sup>22</sup> Available at [http://www.hefce.ac.uk/media/HEFCE,2014/Content/Pubs/Independentresearch/2015/A,review,of,HEFCE,capital,expenditure/2015\\_capitalreview.pdf](http://www.hefce.ac.uk/media/HEFCE,2014/Content/Pubs/Independentresearch/2015/A,review,of,HEFCE,capital,expenditure/2015_capitalreview.pdf)

“The vice-chancellor wanted to borrow up to the hilt to fund planned expansion, and many of us were very worried that we were getting in over our head. However, there didn’t seem much that we could do as the chairmen agreed with him, and the finance director stayed fairly silent. Part of the problem was that he didn’t seem to mind about ‘taking the board with him’. The attitude was rather if ‘you don’t agree with me you must be stupid’.

**STAFF GOVERNOR**

The figures are published, so the exercise can be refined by looking for the position of similar HEIs. The key test is what annual outflow of cash on interest and debt repayment can be tolerated. If budgets are already under pressure, further borrowing would be best avoided. But if the underlying financial position is strong (and an HEI’s operating position healthy) it might be good sense to continue an investment programme which shows signs of success, even at the cost of higher borrowing.

There was also a view that borrowing could only be justified against a clear ‘income stream’ (the most common example being student residences), and that a clear link should be evident between the investment and the income that would be generated. Here again, views have changed and borrowing is sometimes seen as a justifiable way of realising academic strategies. To some extent, the attitude of banks and other lenders has softened at the same time; the sector is seen as well regulated and able to avoid any practical risk of loss for the lender. So with lending margins quite favourable and long term interest rates relatively low, considerable amounts have been borrowed.

Although arrangements to repay borrowing will always exist, in practice many HEIs are viewing a block of long term debt as a sensible part of treasury or balance sheet management. At reasonable levels, such debt may be seen as a strength rather than a weakness, if it allows an institution to maintain its strategic investment programme through the ups and downs of other capital sources. Naturally, lenders do not hand over money unconditionally. They will impose ‘covenants’ or conditions on the institution, typically requiring observance of some financial limits eg:

- A debt servicing ratio - a minimum ratio of surplus plus interest (payable less receivable) plus depreciation to interest payable plus debt repayable in one year.
- A borrowed funds to reserves ratio - a maximum ratio of all debt to reserves.
- A capital adequacy ratio - a minimum ratio of reserves to assets.
- A net borrowed funds ratio - a maximum ratio of net debt to reserves.

As well as these monetary limits, there will frequently be restrictions on significant disposals of property or parts of the institution, a ban on granting any other lender a better security and a requirement for regular supply of financial information and meetings, especially if there are adverse events. Indeed, in extreme cases, such an event will trigger immediate loan repayment - a crisis situation requiring urgent action. Even a technical infringement, which might have been overlooked in happier economic times, might be used as a lever to lift the interest rate or impose tighter covenants.

It has become increasingly common for institutions to obtain credit rating scores from Standard & Poor’s, Moody’s or other agencies. This is not a simple or short process and has, in the majority of cases, been done as part of a public bond issue. Banks have traditionally been reasonably comfortable lending money to UK higher education institutions because of the level of regulation to which they are subject and because of the stable nature of their funding streams. However, with government funding for higher education being reduced and greater reliance being placed on tuition fees and potentially volatile student numbers, securing affordable bank finance is becoming more difficult. For this reason, a number of institutions have resorted to other ways of financing capital development projects, notably the issue of bonds. This is, however, a highly complex area and should not be entered into without appropriate professional advice.

“Some members [of the governing body] seem not to be very good at thinking about borrowing in terms of risk. Their immediate reaction to an idea is to think ‘yes we should fund it’ or ‘no we shouldn’t’ without thinking through all the risk appetite issues.”

**LAY GOVERNOR**

The banking relationship is a critical one and the finance committee or its equivalent should receive regular reports about it. It is also good practice to ask the internal auditors to examine covenant compliance annually. Many finance directors would argue that the small print of loan agreements is more important than securing a few more base points off the interest rate. The agreements are there to govern the relationship when things get rough; that's the time when banks want to call in their loans and look for triggers in the agreement.

### Internal sources

In the long run, borrowing has to be repaid and government grants may dry up. The requirement for sustainability of an institution's asset base will require it to generate annual surpluses of sufficient size for investment in plant and equipment to avoid any repetition of the backlog problem. Surpluses generate cash, assuming people eventually pay their bills.

The keenly fought debate about what surplus is desirable needs to take place in the context of an institution's need for cash for investment - not for its own sake. There is evidence from the property profession that about 4.5% of the value of an organisation's property portfolio should be invested each year in improvements and replacements. If an institution is generating cash at something close to that figure year on year, then other things being equal, it is in a stable state, maintaining its property portfolio to meet its operational needs. Of course, if it is expanding or contracting, the cash generation can be adjusted accordingly.

The funding councils are showing increasing interest in the financial sustainability of institutions and have in recent years developed various metrics to assess this. At the time of writing, the approach used in England is under review, with the aim of integrating it into the funding council's annual accountability process. Governors should familiarise themselves with the metrics used and should seek to understand how their institution uses them to assess its own performance and to report to the relevant funding body. We consider this more in Chapter 12.

### Disposals and impairments

For completeness, it is worth noting here that some funding councils have imposed rules on the disposal of property. It is also important to know that any impaired properties (ie ones with serious structural or operational problems) must affect the institution's accounts - in ways which may be uncomfortable because they impose an immediate charge to that year's income and expenditure account. In other words, if serious structural problems are discovered in a building which significantly affect its value, the reduction in value must be treated as an additional depreciation charge in the year of discovery. This might be a very significant sum.

### Student residences

These were mentioned above as a common example of where institutions had felt borrowing was justified because an identifiable income stream would be created. Compared with new teaching or research facilities, the additional revenue from students was felt to be much more secure. Yet there is risk in both cases. Student taste for living in HEI owned accommodation cannot be taken for granted; nor can students' ability to pay for relatively expensive rooms with en suite facilities be assumed as a permanent feature. Privately built and financed student accommodation means that there is a choice - should scarce institutional capital (or borrowing capacity) be used to build student residences, or conserved for other needs which the private sector will not normally fund? This is a difficult choice, not made easier (for on campus accommodation) by the tight conditions often imposed by the private developer (or, more usually, their bank).

### Self-challenge questions

- Do I understand the institution's banking covenants? How close is the HEI to breaching them?
- Do I understand how cash flow differs from surplus?
- What level of annual surplus should we be seeking?
- What would happen to our investment programme if the funding council suddenly stopped making capital grants? ■

“It’s like bloody algebra to me -  
I don’t understand a word.”  
**STAFF GOVERNOR ON ACCOUNTS**

# 08 Demystifying HEI’s accounts

This chapter is a brief and basic guide in how to understand the annual accounts - nowadays called financial statements. At the time of writing, a new standard for financial reporting – Financial Reporting Standard (FRS) 102 – has just been introduced and is in the process of being adopted by the sector. Consequently, your institution’s financial statements will look different in future to how they have looked before. This includes changes – outlined later in this section – both to the presentation of the statements and to some of the accounting policies that your institution may have used.

## What are accounts for?

The annual accounts are a formal, historical record of the institution’s stewardship of its financial resources. They are an important element of accountability, besides being a very useful source of information. They are necessarily an overview - only really significant transactions will be spelled out. The thousands of day to day receipts and payments will have been sorted into like items and summarised. So there will be much more financial information available behind them, some of which governors should see as part of routine financial reporting during the year. But the accounts are the public record and will carry an independent audit certificate to give assurance to readers that they can be relied upon. What that audit certificate means is an important issue for governors and others, and is explained in Chapter 13.

## What do governors need to look for?

The accounts must conform to a specific format set out in the Statement of Recommended Practice: Accounting in Further and Higher Education (SORP).<sup>23</sup> With the adoption of FRS 102, the SORP has also been updated to reflect the new accounting requirements. The SORP requires four main (or ‘primary’) statements within the accounts:

- The statement of comprehensive income (SCI), which is designed to show what has been earned during the reported year, and what it has cost to earn it; in other words, what is the financial result of normal, regular operations?
- The statement of changes in reserves (SCR), which explains the movement of resources between the internal reserves that make up the institution’s total funds.
- The balance sheet, which is designed to tell the HEI what it was worth on the last day of that financial year (August to July); in other words, what did it own and what did it owe and what was the net difference?
- The statement of cash flows, which is designed to show how much cash has been received and how much has been spent in the year to 31 July; arguably this statement is the most important of the four.

These four accounts may look like an over complicated way of telling the HEI what it has received and what it has spent in the year, plus what’s in the bank at the end. Is it just accountants justifying themselves by making simple things complicated? Accounts are certainly more complicated than they used to be, but much of that has been a necessary response to deficiencies in the past, and financial scandals in the world at large. Of course, few of these occurred in higher education, but the raising of accounting standards generally could not be ignored in the sector.

The underlying reason for these primary statements is to give answers to three key questions, no one of which gives a complete picture:

- What was the financial result of regular operations? A deficit means that normal income is not covering running costs - possible in the short term (if planned), but not sustainable for long.
- How financially strong are we at the year end? Not only how much cash do we have, but how much are we owed and how much do we owe? If we owe more to others than they owe us, can we pay our bills?
- Are we generating enough cash from our operations to sustain ourselves in the long term? Borrowing is useful, but it has to be repaid! How is it repaid? By cash generated from operations plus grants and donations.

<sup>23</sup> Available at <http://www.fehesorp.ac.uk/>

In the primary statements presented in this chapter, readers will note two columns of financial results, one labelled 'university' and the other labelled 'consolidated'. While the former is fairly self-explanatory, the latter may not be. The 'consolidated' figures include all entities operating with the institution's 'group' structure, combined so as to exclude any transactions between these entities. Such entities may include, for example, companies set up by the institution to run its student accommodation or conferencing activities. Governors should understand their institution's group structure, as this can vary significantly between institutions.

### The statement of comprehensive income

The following is an example<sup>24</sup> of the statement of comprehensive income. Note that it shows the results for the year in question and the year prior to that, so that users of the financial statements are able to compare performance across the two years.

	Notes	Year ended 31 July 201Y		Year ended 31 July 201X	
		Consolidated £000	University £000	Consolidated £000	University £000
<b>Income</b>					
Tuition fees and education contracts	1	56,040	56,040	51,600	48,823
Funding body grants -	2	35,441	35,441	32,677	-
Research grants and contracts	3	31,000	31,000	28,337	998,607
Other income	4	37,961	37,961	35,640	1,053,100
Investment income	5	1,955	1,955	2,160	2,150
		162,397		150,414	
Total income before other grants and donations					
Donations and endowments	6	21,628	21,628	10,383	10,383
Total income		<b>184,025</b>	<b>178,751</b>	<b>10,383</b>	<b>156,037</b>
<b>Expenditure</b>					
Staff costs	7	92,941	92,657	87,707	87,512
Fundamental restructuring costs	9	2,888	2,888	-	-
Other operating expenses		59,047	54,151	52,915	48,499
Depreciation	12	8,715	8,426	7,717	7,443
Interest and other finance costs	8	2,530	2,530	3,514	3,514
Total expenditure	9	<b>166,121</b>	<b>160,652</b>	<b>151,853</b>	<b>146,958</b>
Surplus/deficit before other gains losses and share of operating surplus/deficit of joint ventures and associates.		17,904	18,099	8,944	9,069
Gain / (loss) on disposal of fixed assets		758	758	758	758
(Loss) / Gain on investments	25/26	(112)	(112)	138	-
Share of operating surplus (deficit) in joint venture	17	(311)	-	(150)	-
Share of operating surplus (deficit) in associate	18	(11)	-	10	-
Surplus / (Deficit) before tax		18,228	18,745	9,700	9,955
Taxation	10	(209)	-	(46)	-
Surplus / (Deficit) for the year		18,019	18,745	9,654	9,955
Unrealised surplus on revaluation of land and buildings	12	2,520	2,520	-	-
Actuarial (loss) / Gain in respect of pension schemes	35	(220)	(220)	2,067	2,067
Change in fair value of hedging financial instruments		-	-	-	-
Total comprehensive income of the year represented by:		<b>20,319</b>	<b>21,045</b>	<b>11,721</b>	<b>12,032</b>
Endowment comprehensive income for the year		1,242	1,242	1,240	1,240
Restricted comprehensive income for the year		318	318	629	629
Unrestricted comprehensive income for the year		18,759	19,485	9,852	10,163
		<b>20,319</b>	<b>21,045</b>	<b>11,721</b>	<b>12,032</b>
<b>Surplus for the year attributable to:</b>					
Non controlling interest		(42)	-	-	-
University		18,061	18,745	9,654	9,965
<b>Total comprehensive income for the year attributes to:</b>					
Non controlling interest		(42)	-	-	-
University		20,361	21,045	11,721	12,032

<sup>24</sup>The example statements used in this chapter have been provided by the British Universities Finance Directors Group (BUFDG). We are grateful for BUFDG's permission to reproduce them here.



The income and expenditure categories towards the top of the statement will be familiar to readers from previous chapters in this guide. However, the statement of comprehensive includes also a number of additional elements of income and expenditure, some of which have a direct and immediate financial impact and others of which relate to income or expenditure that has not yet been realised. The important thing to note, though, is that the statement does not stop with the surplus (or deficit) of income over expenditure. The figures that come after this are equally important – and governors should ensure that they understand what these figures mean. Your finance director should be able to provide a suitable explanation for the figures as they relate to your institution.

Of course, this is only a snapshot. There is much more to the institution's financial position to be studied, some of which appears below (and what is not published but you should see as a governor, such as the financial forecasts). But you can start to detect important elements of this particular institution's finances, its key dependencies and what room for financial manoeuvre it might have. More importantly, however, you can start to look for trends. Such financial problems as have occurred in UK higher education have rarely happened overnight. With hindsight, trends could have been detected which should have raised alarms about the future. It is not difficult to watch key lines in these accounts year on year and to seek comment on what is causing a trend.

### The statement of changes in reserves

While the institution's financial resources are held in one or more bank accounts, they are accounted for within a number of different accounting 'reserves'. The statement of changes in reserves reconciles the position in these reserves at the beginning of the financial year to the position at the end of it. Changes result from a range of different transactions, such as the surplus or deficit for the year being added to or subtracted from the income and expenditure reserve. Again, your finance director should be able to explain any transactions appearing in this statement.

### A diversion into capital accounting - why do we need it?

Quite simply, the aim of capital accounting systems is to distinguish regular, routine expenditure transactions from those irregular ones which produce assets with enduring value. Take as an example a new building, which could be expected to last for say 50 years. Should that be treated wholly as an expense in the year in which it is bought or constructed? Wouldn't that have a major distorting effect on that year's financial result? How can this problem be resolved?

The accounting resolution is to 'drip feed' the cost to the income and expenditure account over the expected life of the building - this is the annual depreciation charge. So in this example one fiftieth of the cost would be charged as depreciation to each year's statement of comprehensive income for the next 50 years. This could be regarded as a charge for the consumption of the asset in the normal operations of the HEI, reflecting the gradual obsolescence or deterioration of the building as use or time takes its toll. Of course, there are issues about predicting building life and unexpected deterioration to be dealt with, but mechanisms exist to handle them in the accounting rules.

A more difficult issue is the effect of inflation on asset values. It is quite possible for an asset to appreciate in value rather than depreciate, despite its use. It is allowable, but not mandatory, for HEIs to revalue their property periodically and reflect the changed value (in either direction) in their annual accounts. Increased values will usually lead to higher annual depreciation charges as the remaining value to be written off has risen whilst the predicted remaining life of the building has probably not changed.

But what happens to the remaining value of the building, that which has not yet been recognised as expenditure, is held on the balance sheet - a statement of the institution's assets and liabilities. This outstanding balance will be written off over time to the statement of comprehensive income, as the value of the asset is 'used up' by the institution. It's time to review this important statement, a key indicator of an institution's financial strength.

"Our problem is that every time the Finance Director does the sums he comes up with a different result, and it always sounds persuasive!" **LAY GOVERNOR**

## The balance sheet

Put simply, the balance sheet is a statement of what the HEI owned, was owed by others and owed to others, with whatever was left being its reserves or net worth - equivalent to the equity in a commercial entity. For a householder, it's the value of your house less your mortgage. In other words, the assets and liabilities, with the difference between the two being its net worth. Again a practical example will help.

Here is an example of the balance sheet.

	Notes	Year ended 31 July 201Y		Year ended 31 July 201X	
		Consolidated £000	University £000	Consolidated £000	University £000
<b>Non-current assets</b>					
Intangible assets and goodwill	11	8	8	-	-)
Negative goodwill arising from the acquisition of ABC College	15	(3,297)	(3,297)	(3,431)	(3,431)
Fixed assets	12	227,310	218,047	199,458	196,064
Heritage assets	13	1,500	1,500	1,300	1,300
Investments	16	277	8,727	323	727
Investment in joint venture	17	1,259	-	1,470	-
Investment in associate	18	-	-	-	-
		<b>227,057</b>	<b>224,985</b>	<b>199,120</b>	<b>194,660</b>
<b>Current assets</b>					
Stock	19	1,062	1,954	1,499	3,462
Trade and other receivables	20	8,981	7,696	13,267	14,817
Investments	21	26,223	25,352	33,324	32,314
Cash and cash equivalents	27	5,634	<b>5,094</b>	<b>15,020</b>	<b>13,235</b>
		41,900	40,096	63,110	63,828
Less: Creditors: amounts falling due within one year	22	(52,286)	(49,131)	(46,511)	(44,210)
Share of net liabilities in associate	18	(9)	-	-	-
<b>Net current (liabilities) / assets</b>		(10,395)	(9,035)	16,599	19,618
<b>Total assets less current liabilities</b>		216,662	215,950	215,719	214,278
Creditors: amounts falling due after more than one year	23	(42,861)	(42,861)	(60,825)	(60,825)
<b>Provisions</b>					
Pension provisions	24	(17,503)	(17,503)	(16,673)	(16,670)
Other provisions	24	(12,526)	(12,526)	(14,768)	(14,768)
<b>Total net assets</b>		<b>143,722</b>	<b>143,060</b>	<b>123,453</b>	<b>122,015</b>
<b>Restricted Reserves</b>					
Income and expenditure reserve - endowment reserve	25	2,863	2,863	1,621	1,621
Income and expenditure reserve - restricted reserve	26	1,446	1,786	1,468	1,468
<b>Unrestricted Reserves</b>					
Income and expenditure reserve - unrestricted		121,782	120,676	100,001	98,551
9,955					
Revaluation reserve		17,735	17,735	20,375	20,375
		143,826	143,060	123,465	122,015
Non-controlling interest		(54)	-	(12)	-
<b>Total Reserves</b>		<b>143,772</b>	<b>143,060</b>	<b>123,453</b>	<b>122,015</b>

The balance sheet is a statement of two halves. The first half ends with a summed total of the institution's net assets, which is made up of its assets less its liabilities. The second half of the statement shows the reserves in which the value of these assets is accounted for. Crucially, the figures for 'total net assets' and 'total reserves' should be the same, so that the first half of the balance sheet balances with the second.

Within the balance sheet, we see two types of assets. Non-current assets are those that the institution holds for a long period of time, such as land, buildings and investments in other organisations. Current assets are things that the institution will hold for only a short period, such as stock held for sale, income due from students or customers and short-term financial investments. There is a similar distinction within the institution's liabilities, where we categorise them according to whether they are payable within one year (such as amounts due to suppliers) or further into the future (such as bank loans).

Provisions are funds put aside for payments that will have to be made at some point in the future. The pension provision is the amount that is payable in retirement benefits to current and former employees of the institution, net of the assets already held by the relevant pension schemes. So while this money will have to be paid, it will not have to be paid now and it will not all have to be paid at once. Nevertheless, any pension provision will need to be managed carefully. Your finance director should be able to provide you with further details as to how this is being approached.

"In truth, the board completely relies on the audit committee, and the finance director to look at the accounts. No one asks any questions at board meetings unless there is a real problem."

**LAY GOVERNOR**

## The cash flow statement - last but not least

There is an old adage that some finance directors use: 'cash is king', and it is a surprise to find that it is regularly forgotten. Higher education is not immune and a small number of HEIs have suffered cash crises. The key point here is that there comes a point at which banks will stop lending, especially on a short term overdraft basis. There will have been warning signs, but have the signals got through to you as a governor?

The cash flow statement looks specifically at the actual cash flowing into and out of the institution. Here is an example.

	Notes	31 July 201Y £000	July 201X £000
<b>Cash flow from operating activities</b>			
Surplus for the year		<b>18,061</b>	<b>9,654</b>
<b>Adjustment for non-cash items</b>			
Depreciation	12	8,715	7,717
Benefit on acquisition of ABC College released to income	15	(134)	(456)
Amortisation of goodwill	11	2	-
Investment income	5	(1,955)	(2,160)
(Loss) / Gain on endowments, donations and investment property		122	(138)
Decrease / (increase) in stock		437	(169)
Decrease / (increase) in debtors	20	4,286	(264)
Decrease / (increase) in creditors	22&23	10,703	6,908
Decrease / (increase) in provisions	24	(2,242)	(420)
Receipt of donation equipment		(170)	(20)
Pension costs less contributions payable	35	848	436
Share of operating surplus / (deficit) in joint venture	17	311	150
Non controlling interest		42	-
Share of operating surplus / (deficit) in associate	18	11	(10)
<b>Adjustment for investing or financing activities</b>			
Investment income		(1,955)	(2,160)
Interest payable		2,530	3,514
Profit on the sale of fixed assets		(758)	(758)
<b>Net cash inflow from operating activities</b>		<b>38,844</b>	<b>21,824</b>
<b>Cash flows from investing activities</b>			
Proceeds from sales of fixed assets		13,428	2,511
Non-current investment disposal		46	(7)
Investment income		1,955	2,160
Endowment funds invested		(2,078)	(3,050)
Withdrawal of deposits		7,139	1,177
Payments made to acquire fixed assets		(46,917)	(18,695)
		<b>(26,427)</b>	<b>(15,904)</b>
<b>Cash flows from financing activities</b>			
Interest paid		(2,290)	(3,236)
Interest element of finance lease rental payment		(240)	(278)
New secured loans		-	-
Repayments of amounts borrowed		(18,195)	(1,969)
Capital element of finance lease rental payments		(1,124)	(1,100)
		(21,849)	(6,583)
<b>(Decrease) / increase in cash and cash equivalents in the year</b>		<b>(9,432)</b>	<b>(663)</b>
Cash and cash equivalents at beginning of the year		14,924	14,261
Cash and cash equivalents at the end of the year		5,492	14,924

As is apparent from the example, the cash flow statement starts with the surplus (or deficit) for the year and then adjusts it to take account of a range of items that do not include cash flows. This leaves us with a sub-total for the net cash inflow (or outflow) from operating activities. When cash flows from investing and financing activities are also taken into account, we end up with the total increase or decrease in cash over the course of the year.

## Other information in the accounts

The accounts will contain a large amount of further explanation about the four main statements along with some items which may not be capable of quantification, but might affect a fair understanding of them. For example, the institution may be engaged in significant litigation, the outcome of which is unpredictable, or it may have discovered an as yet unquantified building problem. It may be involved in joint ventures or off balance sheet funding; these can be difficult to reflect fairly in the statements. These topics can form the basis of useful questions when the annual accounts come to the board.

## The strategic report

The SORP requires that institutions prepare a strategic report and present this report alongside its financial statements. Where an institution is required by a regulator to include certain content in this report then these requirements must be followed. The SORP suggests that disclosure of the following items is best practice for all institutions:

- its objectives and strategy for achieving those objectives;
- its development and performance throughout the financial year and position at the end of the financial year;
- its future prospects;
- a description of the principal risks and uncertainties being faced; and
- its key performance indicators.

The strategic report should be prepared from the point of view of the institution's governing body and should focus on matters that are relevant to the interests of funders or financial supporters. It should be forward-looking and should be balanced, dealing even-handedly with both positive and negative aspects of the institution's performance. The report should, it should hopefully go without saying, be comprehensive and understandable. And it should complement, as well as supplement, the information presented in the institution's financial statements.

### Suggested tasks

Look at the financial statements for your institution and two or three others. Where are the institutions similar and where do they differ? What do the financial statements tell you about the different institutions?

Compare your institution's strategic report with the most recent strategic plan. Do they match up?

## Reporting to students and other stakeholders

For institutions in England, HEFCE is keen to promote the provision of financial information to students and other institutional stakeholders. To this end, in 2014 it asked institutions to consult with their current students and to identify an appropriate way of providing them with information in respect of the institution's income and expenditure. There is an expectation that this information will be provided online and that it will be updated annually.

## Self-challenge questions

- What are the major changes between this financial year's accounts and last year's for your HEI? Do you understand why they have come about?
- How much could we borrow in both the short and long term? What is our debt burden, and are we close to the limit?
- What are our principal funding dependencies?
- What's our cash position? Is our cash flow healthy?
- How much cash should our HEI be generating to meet future strategic needs?

You may want to discuss some of these with your finance director.

## FRS 102 and SORP 2015: The key changes

The introduction of Financial Reporting Standard (FRS) 102 and the new Statement of Recommended Practice: Accounting in Further and Higher Education (SORP) have resulted in a number of significant changes to how institutions account for various aspects of their activities. We summarise here some of the main changes.

Terminology	The names of some of the primary financial statements have changed. The Income & Expenditure Account and the Statement of Recognised Gains and Losses (STRGL) have become the Statement of Comprehensive Income and the Statement of Changes in Reserves respectively. The Balance Sheet and the Cash Flow Statement have retained their names, though their format has changed.
Endowments	Previously, endowments were credited to the Balance Sheet though the STRGL, so that they did not appear in the Income & Expenditure Account. New revenue recognition rules mean that most endowments and other donations will need to be recognised in the Statement of Comprehensive Income before being transferred to reserves. This makes it more likely that income figures will fluctuate from year to year.
Capital grants	Capital grants used to be held on the Balance Sheet and then 'drip fed' to the Income & Expenditure Account to match the expenditure to which they related. Now, most capital grants will need to be recognised in full in the Statement of Comprehensive Income when they are received. This will result in fluctuating income figures from year to year as well as more volatile surpluses and deficits.
Employee benefits	Deficit recovery plans (i.e. how the scheme plans to tackle any deficit) for multi-employer pension schemes, such as the Universities Superannuation Scheme, now need to be accounted for by member institutions as a liability in their accounts. The initial liability will need to be charged to the Statement of Comprehensive Income and then recorded as a liability on the balance sheet. This liability will then be 'unwound' as it is paid off. When the pension scheme is revalued (as happens every three years), any changes to the valuation of the liability will need to be recognised in the same way as the initial valuation. The effect of this is that it may increase reported liabilities and will distort reported surpluses/deficits.
Service concessions	Under previous accounting standards, some assets (such as student residences) developed by third parties and 'leased' back to institutions have been held 'off-balance sheet', so that the institution recognises in its accounts neither the asset nor its liability to the provider. Under new rules, however, a significant proportion of such schemes will now need to be recognised in institutions' accounts. This means that institutions will be required to recognise both the asset and the corresponding liability, similar to the treatment for a finance lease. ■

<sup>25</sup> This includes 'The Essential Trustee: What you need to know, what you need to do', which is available at <https://www.gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3>

# 09 The rules

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), which for institutions in England is now known as the Memorandum of Assurance and Accountability (MAA). HEIs are also charities, and whilst exempt from registration and regulation as charities in England, they are not exempt from charity law. However, in England they are now 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).<sup>25</sup> Universities in Scotland are registered by and must report to the Office of the Scottish Charity Regulator (OSCR); in Wales HEIs are registered by the Charity Commission and in Northern Ireland by the Charity Commission for Northern Ireland.

The FM is important and short enough for you to get your hands on and read.<sup>26</sup> Indeed, in Northern Ireland, this is a firm recommendation. Whilst national versions differ in detail, there are many common issues.

## Accountability for public funds, financial management and control

All FMs have similar requirements concerning accountability. For example, the English version states that the governing body of a higher education institution “is collectively responsible and has ultimate responsibility that cannot be delegated for overseeing the HEI’s activities, to determine its future direction, and to foster an environment in which the HEI’s mission is achieved”.

The English financial memorandum goes on to state, as has been mentioned earlier in this guide, that there should be effective arrangements for providing assurance to the governing body that the institution, among other things:

- has a robust and comprehensive system of risk management, control and corporate governance. This should include the prevention and detection of corruption, fraud, bribery and irregularities;
- 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 the funding council of any change in its circumstances which – in the judgement of the accountable officer and in agreement with the governing body – is a material change, including any significant developments that could impact on the mutual interests of the institution and the funding council;<sup>27</sup>
- uses public funds for proper purposes and seeks to achieve value for money from public funds; and
- 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.

“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**

<sup>26</sup> England: <http://www.hefce.ac.uk/reg/MAA/>; Scotland: [http://www.sfc.ac.uk/guidance/GovernanceGuidance/FinancialMemorandum/financial\\_memorandum.aspx](http://www.sfc.ac.uk/guidance/GovernanceGuidance/FinancialMemorandum/financial_memorandum.aspx); Wales: [http://www.hefcw.ac.uk/working\\_with\\_he\\_providers/institutional\\_assurance/institutional\\_assurance.aspx](http://www.hefcw.ac.uk/working_with_he_providers/institutional_assurance/institutional_assurance.aspx); Northern Ireland: available from the Department of Employment and Learning, Northern Ireland - [www.delni.gov.uk](http://www.delni.gov.uk)

<sup>27</sup> This is likely to apply equally to your institution’s bankers, especially if you have significant bank loans. Like the funding councils, banks usually respond with displeasure to any unexpected deficits or other material governance or financial concerns.

### Accounts Directions

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; and
- details of any severance payments for such staff must be disclosed.

### Property acquisition and disposal and associated borrowing

An important part of each financial memorandum is the requirement to seek consent to borrowing beyond a certain measure, since this has led to financial problems in the past. 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”.

However, the Welsh council goes on to require prior consent for disposal of land and buildings where these were purchased with HEFCW grant, i.e. where there is an exchequer interest in the asset, and for the use of the proceeds of such disposals to purchase/develop other assets.

### Property acquisition and disposal - exchequer interests

Where a funding council has provided grant for the construction or purchase of an asset, that asset has an ‘exchequer interest’ in it. That is, the funding council is able to place restrictions on transactions affecting that asset, in a similar manner to the way a mortgage lender might impose covenants over a building on which it has lent money.

Requirements in respect of exchequer interests are broadly similar between the funding councils. For instance the requirement that the exchequer interest becomes repayable should the institution become insolvent, and that the institution be able to account for the exchequer interest held.

However, there are a number of differences and governors should be aware of the requirements as they apply to their own institution. The English funding council, for example, writes down the exchequer interest over a ten year period; the Welsh funding council does not and assumes an ongoing exchequer interest.

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.

Disposing of assets in which there is an exchequer interest is still subject to prior consent by the Welsh and Scottish funding councils and to prior notification in Northern Ireland, and there are also restrictions over 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.



## Borrowing

An important part of each financial memorandum is the restriction on borrowing, since financial over-commitments have, in the past, led to financial problems. Where previously, FMs tended to distinguish between long-term and short-term borrowing (for example, 25-year loan vs overdraft), that distinction has become increasingly blurred, as new forms of finance have emerged such as “revolving credit facilities” (short-term borrowing that can be extended and perpetuated many times, effectively therefore having hallmarks of long-term borrowing). Thus the Welsh and English funding councils now place restrictions over total borrowing rather than solely long-term borrowing; however, others, such as the Scottish funding council, have opted to maintain the restriction only over long-term borrowings.

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”.

The English and Welsh Councils currently require institutions to seek written permission from the relevant council before agreeing to any new financial commitments, where such commitments would cause the institution’s total financial commitments to increase beyond a threshold. This threshold is based on five times that institution’s earnings before interest, taxes, depreciation and amortisation (EBITDA). At the time of writing, however, the way in which this threshold is calculated is under review.

## Short term borrowing

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.

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 borrowing of this nature. The English version, which previously differentiated between short- and long-term borrowing, currently requires institutions to seek written permission from HEFCE before agreeing to any new financial commitments, where such commitments would cause the institution’s total financial commitments to increase beyond a threshold based on five times that institution’s earnings before interest, taxes, depreciation and amortisation (EBITDA). At the time of writing, however, the way in which this threshold is calculated is under review.

## Overdrafts

Whilst some forms of short-term borrowing resemble long-term borrowing, it is useful to consider the specific merits and drawbacks of overdraft facilities. 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. So the message to be taken from an overdraft needs to be judged carefully.

## Duty to notify of adverse events

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 deliver its education programmes, research and other related activity”. The English version offers a little more detail:

“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 impropriety or major accounting breakdown – to all of the following:

- l the chair of the HEI’s audit committee;
- l the chair of the HEI’s governing body;
- l the HEI’s head of internal audit;
- l the external auditor; and
- l the HEFCE chief executive.

The HEI’s accountable officer must also inform HEFCE about major changes in strategy, plans for major restructuring or merger with another institution or organisation.

The governing body must inform HEFCE’s assurance service without delay of the removal or resignation of the external or internal auditors before the end of the term of their appointment.”

### Audit and monitoring requirements

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. HEFCE, for example, requires submission of a suite of annual accountability returns, which consider financial, governance and other matters. 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.

### Charity law and Charity Commission guidance

There have been various references to charity law and governance in these materials 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.<sup>28</sup> It requires trustees to:

- l have and accept ultimate responsibility for directing the affairs of a charity;
- l ensure that it is and remains solvent;
- l use charitable funds and assets reasonably, and only in furtherance of the charity’s objectives;
- l avoid undertaking activities that might place the charity’s endowment, funds, assets or reputation at undue risk;
- l take special care when investing the funds of the charity, or borrowing funds for the charity to use; and
- l 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 tasks

The Charity Commission 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?

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

### Self-challenge questions

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

<sup>28</sup> [www.charity-commission.gov.uk/Library/publications/pdfs/cc3text.pdf](http://www.charity-commission.gov.uk/Library/publications/pdfs/cc3text.pdf)

# 10 The transparent approach to costing (TRAC)

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TRAC is the standard method used to answer the all-important question of 'how much does it cost?' for UK HEIs.<sup>29</sup> It is a way of allocating total costs to a UK HEI's specific income-generating activities, so that an institution can determine the full cost of each of these activities.

HEIs need a bespoke costing methodology because building up costs is not as easy as it would be for a standard 'widget maker'. For example, the cost of teaching a course is not just that of the lecturer's salary. Institutions must also factor in things like the cost of heating, powering and cleaning the lecture theatre or seminar room, as well as the cost of providing administrative and management support to those teaching the module. The full cost should also include a proportion of the overhead costs incurred by the institution, such as student support services, library and other central services.

## The aims of TRAC

TRAC is a detailed framework that aims to facilitate the production of high quality, comparable information on the cost of activities across the UK HE sector. This is achieved by establishing a robust and consistent approach to costing different activities. Further, by increasing awareness of the costs involved, it seeks to help UK HEIs to improve their financial sustainability; that is, their ability to continue to fund their activities in the longer term. As the name suggests, TRAC also aims to be transparent to its users and to promote accountability across the sector for the use of public funds.

In its implementation, TRAC seeks to work on a practical, as well as a theoretical, level. It is designed specifically for the UK HE sector and so is appropriate to the ways in which individual institutions operate. It also espouses the principle of materiality, meaning that it focuses on the most significant costs, rather than trying to account for every penny. Consequently, institutions may be exempted from specific requirements if the resources required to collect certain information would outweigh the benefits of doing so.

## The TRAC dispensation

From the 2013/14 academic year, institutions with annual research income from public sources that is below £3 million (previously £0.5 million) when calculated on the basis of a five-year rolling average have been eligible to apply a specific TRAC dispensation, exempting them from certain requirements.

"When I first became a board member some years ago, I just couldn't believe how little the board knew about costs. Trying to get better VfM was like trying to read in the dark." **LAY GOVERNOR WITH FINANCE EXPERTISE**

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<sup>29</sup> The material in this chapter is adapted from the British Universities Finance Directors Group (BUFDG) publication 'The Transparent Approach to Costing (TRAC): A short introductory guide for senior managers and governors'. We are grateful for BUFDG's permission to reproduce it here.

## Sources of guidance and support

The main source of information on TRAC requirements is the official guidance, which is published on the HEFCE website.<sup>30</sup> This is accompanied by a range of annexes, giving further information and worked examples in respect of particular issues. Of particular use is the 'Statement of Requirements', which provides a detailed breakdown of the TRAC compliance requirements.

Institutions are also able to draw on the support of self-help groups, which are organised on a regional basis. These groups meet regularly to share information, to discuss common issues and to provide support.

Additional support and guidance is available to institutions through the TRAC Support Unit, which is operated by KPMG on behalf of the TRAC Development Group. The unit has a range of roles, including the ongoing development of the TRAC guidance and the provision of the TRAC Helpdesk. The helpdesk is available to all institutions free of charge.

## Self-challenge questions

- How do you know if your institution is complying with the TRAC requirements?
- How well do you understand the income and costs associated with your institution's teaching, research and other activities?
- Do you feel able to review and challenge your institution's TRAC returns effectively? ■

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<sup>30</sup> <http://www.hefce.ac.uk/funding/finsustain/trac/>

# 11 Trading for profit

Until relatively recently, few HEIs strayed much beyond their mission of teaching and research. However, attitudes have changed as funding has become less generous, governments have pressed for 'relevance', 'enterprise' and 'knowledge transfer', and many HEIs themselves have wanted to develop a wide range of for-profit activities. The word 'profit' in this context refers to the financial result of a particular activity - ideally the surplus of revenue generated over the full economic cost incurred. If it refers only to the surplus over the direct costs incurred, an HEI may be subsidising such activities and they are unlikely to be sustainable.

Although some HEIs have been very successful in their trading activities, others have not. A fresh set of management skills is required, risks can be very different, and resources of staff and facilities may need to be organised differently and rewarded unconventionally. Not the least concern is that of HM Revenue and Customs in activities which may stray outside the realms of charitable objectives.

There have also been some failures (including in setting up overseas operations) but most of these have not entered the public domain. Providing the investment is modest whilst a project is at the proving stage, that is not a matter for criticism. There is no such thing as a risk free investment - even in mainstream activities of teaching and research, there are no guarantees that a new course will attract students or that research will not lead up a blind alley. Providing there is the potential of significant public benefit, a risk can be justified, even for a charitable institution.

In practice, the distinction between for-profit and not-for-profit activities may not always be clear: for example, some courses for employers may attract public funding, whereas similar ones taught as continuing professional development may be explicitly profit seeking. Of course, not all ventures with employers are designed to operate on a for-profit basis (although they should run on a full economic cost basis), but may be run because of the academic or strategic benefits involved.

## Suggested task

Review the information supplied to your governing body on your HEI's trading activities. Does this provide a clear view of what is going on?



A particular problem in many academic institutions is an inability of staff and managers to recognise the difference between sales and profits - a fairly fundamental issue in running trading ventures! Of course, this has not been helped by a tradition of not identifying full economic costs (see Chapter 9). Any governing body considering proposals for new trading ventures (particularly in HEIs with little experience of doing this) would be wise to ensure that a realistic and robust business plan exists, and the managers concerned are aware of the old adage 'sales are vanity, profit is sanity!'.

There are numerous challenges for governors here, which are summarised below, but perhaps the three main ones are: first, ensuring that governance arrangements (including the expertise available to the board) are robust enough to ensure effective monitoring and control. Most of the failures in this area have been where boards did not have such processes in place, and were unable to keep pace with the enthusiasm of the head of institution or other senior manager concerned. Second, avoiding the trap of the institution becoming over reliant on commercial sources of revenue and thus avoiding the discomfort which would be felt if they dried up. Thirdly, testing that the institution has the necessary commercial skills available to it to support any significant intentions in this area.

"I don't think we gave enough thought to setting up the company in the first place. It seemed like a good idea at the time (and probably was), but we didn't have enough experience and the mistakes we made took some while to sort out." **LAY GOVERNOR**

### The range of trading activities

Among a wide range, the following are the principal activities:

- Academic services (eg short courses, consultancy, etc).
- On-campus services (eg bookshops, gift shops, catering etc).
- Social and community services (eg arts centres, sports facilities etc).
- Spin out companies, designed to exploit the intellectual property of staff, perhaps with injections of capital from banks or other investors.
- Collaborative arrangements with industries and commercial organisations, e.g. science parks.
- Conference centres (whether building on vacation occupation of student residences or purpose built).
- Overseas ventures.

Each will have specific issues about how it fits into an HEI, illustrated by the issues a governing body might have to deal with:

- Licensing versus spin out companies.
- Funding spin-outs.
- Monitoring substantial investments in spin-outs.
- Handling potential conflicts of interest.
- Valuing and selling intellectual property rights.
- Agreeing borrowing policy for subsidiaries.
- Monitoring overseas activities.
- Confidentiality, especially in joint ventures.

“Our problem was the speed of developments. The timescale for the company was weeks (sometimes days) and for the board it was the next meeting three months away. With hindsight the problems we got ourselves into were self-inflicted.” **LAY GOVERNOR**

### Strategic issues

There is sufficient emphasis on ‘third leg’ or entrepreneurial activity nowadays for it to merit a specific strategy, and most of the funding councils strongly encouraging this. Where should these activities fit in an HEI’s plans and in its risk profile? In the competition for resource, what priority should they have? Who will carry responsibility for their overall direction? What should the board’s involvement be? How will surpluses be utilised?

In practice, the way commercial operations are created, operated and monitored needs a clear structure approved by the governing body. If a company, a board of directors will be required, and the directors will need to understand their duties under the 2006 Companies Act, and very clear reporting lines must be established. Regular formal reporting to a supervisory group is good practice, even if steady progress towards approved budgets and plans means there is no need for meetings or intervention.

A good mix of governors and management can work well in this context, with both parties bringing something and learning much. However, appointing governors to the boards of legally independent subsidiaries is not without risk for the individuals concerned, especially if things go wrong. A company director’s first duty is to the company and to act in its best interests, so a member of the governing body appointed to act as a director of a subsidiary would have a conflict of interest if the best interests of the two diverged. Recruitment to this group from outside the institution of people with relevant skills may also be useful. Investment appraisal of new ventures or the expansion of existing ones needs a degree of formality, even if the funding is internal. In short, commercial operations need to be managed commercially - they are sufficiently different from academic operations to be kept separate from academic decision making and control.

But that is only half the story. More difficult issues arise when activities bridge the academic and commercial, a common example being science parks. In most cases, HEIs have created (or helped to create) science parks for non-commercial reasons, as they have potential to bring partners together to support knowledge transfer and opportunities to cooperate in research. It follows, that where science park objectives are broader than just generating income, its strategic direction and operational decision making cannot simply be hived off to a quasi-independent management board, accompanied by a set of targets. The latter may well be required, but as a framework which sets minimum performance levels, and allows the wider academic interests of the HEI to develop and prosper.

For several reasons (including tax) these activities (especially the straight commercial ones) may need to be treated on an 'arms length' basis, so far as use of institutional staff and facilities is concerned. That does not mean that grants or other investment should be refused, but there should be no hidden subsidies caused by weak resource allocation or costing systems.

## Governance issues

There are numerous governance issues in this area and structures need to be adapted to fit different types of activity. First, those ventures that are almost wholly for-profit generally require a commercial structure, with substantial freedom to operate like any other commercial venture and survive on the results of their decisions. Investment will need to be on a strict commercial basis, and performance monitored regularly against clear plans and rewarded accordingly. Governing body involvement will generally be limited to investment appraisal plus regular and rigorous monitoring. Tax issues need careful attention to avoid penalties for non-charitable trading. There should be an expectation that the finance director is fully 'on top' of the financial issues involved, although this can be a challenge if the venture is large enough to employ its own finance staff. In such circumstances a governing body will need to look very carefully at the financial picture, and may involve internal audit more than might usually be the case.

Second, for ventures which bridge the academic and commercial (eg overseas initiatives) a firm link with core academic strategy is critical. The key here, of course, is to identify clearly what those objectives are - easily overlooked in the rush to create something exciting - and not an easy task anyway. A realistic business plan is essential and may justify specialist advice. Such ventures should, of course, provide regular financial reports, which particularly in the early years can help build confidence all round.

Third, in terms of governance structure, governing bodies deal with trading activities in different ways, although those that are most active often have a small specialist subcommittee for commercial activities. Where this exists it is likely to have specialist members (perhaps some coopted) with substantial experience of running private ventures. Such a committee may work in a different way from others, for example it may meet more regularly in order to ensure that it can take decisions in a timely way. Where this happens the forms of reporting to the main governing body need to be clear, as does the explicit extent of any delegated powers.

From the perspective of the individual governor, probably the most important issue is to have confidence that the board has established explicit and robust processes for dealing with trading activities, and that regular performance management data is provided. Most of the failures in HEIs have been where this did not occur. Governors should however remain watchful, and running and governing successful trading ventures remains one of the most difficult areas for many HEIs. For the moment, real success stories remain relatively few and far between.

## Self-challenge questions

- How are proposals for trading activities assessed by the governing body, and are robust internal controls in place?
- Has the governing body approved a workable overall strategy for trading activities?
- Does the governing body have confidence that the key managers involved in trading activities understand the difference between sales and profits?
- Are charity and tax issues being properly addressed in relation to trading activities, and how do I know as a governor? ■

"Dealing with the enterprise park was a nightmare. The Vice-Chancellor wanted to keep it out of the hands of the governing body, and we had no idea of what was going on until it was too late. Then the whole pack of cards collapsed!"

**MEMBER OF AUDIT COMMITTEE**

# 12 Measuring financial performance and sustainability

Ensuring financial health is one of the most important tasks of any governing body. There are numerous indicators that can be used to monitor such financial health,<sup>31</sup> though it is important that no one indicator is used in isolation. Consequently, the use of a varied 'basket' of indicators is usually the most prudent approach.

The funding councils have recently introduced a new approach to the way in which they monitor the overall performance and sustainability of institutions, which is known as the ASSUR process.<sup>32</sup> This approach – which has so far been implemented as a voluntary 'pilot' – requires institutions to develop suitable indicators – and accompanying targets – in a number of different areas of performance, namely:

- teaching, learning and the student experience;
- research outputs and sustainability;
- financial performance and sustainability;
- financial health; and
- other areas, as deemed relevant by the institution.

Institutions – or, more specifically, their governing bodies – are required to report annually on their performance against these indicators. In allowing institutions to develop their own performance indicators, it is hoped that this approach will be sufficiently robust while also being sensitive to the different priorities and activities of institutions across the sector. The exception is the indicators for (a) financial performance and sustainability and (b) financial health, which are laid down by the funding councils. As these are the most pertinent areas to this guide, we shall consider each of them in further detail.

## Suggested task

How is your institution performing against its targets for the different performance indicators? Where is it performing well and where is it performing less well? Why is this the case? Does anything here cause you concern?

## Financial performance and sustainability

The financial performance and sustainability indicator focuses on operating cash generation. To do so, it uses the metric of earnings before interest, taxes, depreciation and amortisation (EBITDA), which is a measure of operating surplus, excluding the major accounting adjustments and finance charges. It provides a useful comparator as it measures operating performance before local decisions on accounting and finance policies are taken into account. Furthermore, it provides a good indicator of financial capability to service debt and/or finance capital expenditure from internally generated cash. However, the introduction of FRS 102 and the new SORP may require the use of this metric to be reconsidered.

"Of all the things we do, checking the KPIs is the most important."

**LAY GOVERNOR**

<sup>31</sup> This chapter draws on the CUC publication 'Monitoring of Institutional Performance and the Use of Key Performance Indicators'. This is a comprehensive guide to this topic for anyone who wants more detail. [https://www.hefcw.ac.uk/documents/working\\_with\\_the\\_providers/leadership\\_governance\\_and\\_management/CUC\\_report\\_on\\_KPIs\\_case\\_studies\\_2008.pdf](https://www.hefcw.ac.uk/documents/working_with_the_providers/leadership_governance_and_management/CUC_report_on_KPIs_case_studies_2008.pdf) <sup>32</sup> <http://www.hefce.ac.uk/funding/finsustain/trac/>



## Financial health

The funding councils have for many years used a small number of actual and forecast financial health metrics, derived from institutions' financial forecasts. In developing the ASSUR process, the funding councils have acknowledged that these metrics have been a common feature in the financial strategies of many institutions. Whilst institutions may monitor internally more or different financial performance indicators beyond these, the funding councils have agreed to continue to use these indicators within ASSUR.

These financial performance indicators are as follows:

- historical cost surplus as % of income;
- discretionary reserves (excluding pensions) as % of income;
- external borrowing as % of income;
- net cash flow as % of income;
- net liquidity days; and
- staff costs as a % of income.

We consider each of these indicators in more detail below. The funding councils usually publish information on overall sector performance in respect of these indicators on an annual basis.

It is important to note at this stage that any financial performance indicators that relate to an institution's income should be treated with caution. This is because with the introduction of FRS 102 and the new SORP, accounting policies adopted by institutions in respect of capital expenditure and grant income could result in fluctuations in income from year to year. At the time of writing, the funding councils are considering how best to address this issue within the ASSUR process.

### a) Historical cost surplus (or deficit) as a percentage of income

This is a relatively simple, but fundamental, measure: put simply, is an HEI paying its way, year on year? In other words, is it covering its operating costs with operating income and by how much? A percentage normalises the result in the context of HEI size, so a surplus of £1m at a small, specialist HEI would be an excellent result at some 6% of income, whilst at a large research-intensive institution a £1m surplus on a £600m turnover (less than 0.2%) would be much less satisfactory. Of course, there may be distortions making one year's figure unrepresentative, so it is normal to look at a three year record. Property disposal may have produced substantial one off receipts which might flatter the underlying result - that's why such amounts are shown separately on the income and expenditure account. Staff restructuring costs may also distort.

A frequent question is what size of surplus is desirable? The answer must be derived from targets in the strategic and financial plans. In the long run, surpluses generate investment cash - indeed for most HEIs this will be the main source of such finance. If there is resistance to surplus generation, it is always useful to ask where else investment money will be found. Borrowing is all very well, but lenders will want their money back. And capital grants are becoming harder and harder to obtain. Generating a surplus to finance investment is no longer a luxury - it is essential.

### b) Discretionary reserves as a percentage of income

Discretionary reserves are institutional 'equity', what would be left if all assets were realised and all debts settled. They can be a useful long term indicator of financial health, especially if negative, but carry a serious health warning. Reserves do not equal cash. It is no use going into a shop and offering to pay with reserves - cash or a credit card are necessary. Positive reserves are no indicator of short-term health because they may not be represented by cash - 'cash backed' in banking parlance. Even long term, the amount which could be realised from the sale of an HEI's assets may be unpredictable - what market exists for specialised buildings used by HEIs? If reserves are not cash backed, they give little insight into an HEI's finances.

Significant negative reserves are very serious and may lead to a potential breach of the financial memorandum. Apart from some exceptional circumstances (connected with property), they would arise from deficits on the income and expenditure account exceeding previous surpluses. Serious action would have to be taken (even if caused by unusual circumstances), and close consultation with the funding council would be essential.

### c) External borrowing as a percentage of income

This indicator is a measure of the burden of institutional debt. The need to pay interest on borrowing and to repay the money is a key element in judging the overall position. Many HEIs have borrowed to invest in new facilities and refurbish the old, usually against a business plan showing how the investment would be recovered. For example, student residences have often been financed through borrowing, as the revenue they would generate was relatively easy to predict. Where institutional borrowing is well managed, and is used to generate an income stream that pays back (at the very least) the cost of the borrowing, it is a perfectly legitimate part of an institution's financial arsenal.

### d) Net cash flow as a percentage of income

We have discussed in a previous chapter the importance of a positive cash flow. Indeed, it is often said by accountants that while turnover is vanity and profit is sanity, it is cash flow that is king. This indicator measures, in essence, how much cash an institution has generated over the course of the year. While generating a surplus is important, turning that surplus into actual cash is perhaps even more so.

When considering new initiatives or strategic developments, therefore, governors should consider now only the income and expenditure that they will generate, but also the pattern of the associated cash flows. It is, after all, only cash in the bank that can be used to pay staff salaries and to settle invoices from contractors.

### e) Liquidity against expenditure

In principle, this is the hard test of short term survival. What cash could an HEI lay its hands on quickly? It's usually expressed in terms of 'survival days' - how many days normal running costs would an institution's cash reserves – or 'liquid' assets that can be converted easily to cash – cover? If that number is small, the institution may be sailing very close to disaster.

However, this indicator must also be treated with caution, and finance directors vary in their attitude to liquidity. Some prefer to have significant cash in the bank, whilst others see that as unnecessary, preferring to have a firm banking arrangement for overdraft facilities on demand. An HEI with a substantial line of bank credit (to be drawn down without notice), can be argued not to need any cash at all! Usually, there is a margin between interest rates paid on deposits and those charged on borrowing, so it may well pay to keep minimal cash holdings. But how reliable is the bank? Withdrawal of overdraft facilities may be unlikely, but is not unknown. This is a matter for the finance committee, and different governing body chairs are likely to have different views.

### f) Staff costs as a percentage of income

The salience of this measure seems to have grown significantly over the last few years, to the extent that it is now seen as a key indicator of performance. The aim of this particular measure is to ensure that institutions are controlling (a) staff numbers and (b) staff costs effectively.

While this is a relatively straightforward measure to calculate, it is substantially more difficult to know what an acceptable benchmark would be. After all, there is nothing intrinsically wrong with employing staff. In fact, when it comes to teaching performance measures such as staff/student ratios, more staff are arguably better than fewer.

This emphasises the importance of not looking at any one measure in isolation, but rather of considering a suite of indicators to assess institutional financial performance in the round.

### Self-challenge questions

- How effectively does your governing body measure financial performance?
- Of all the possible financial indicators, which ones have been adopted as KPIs by your governing body?

### A GOVERNOR'S DILEMMA 3:

As a governor you have been asked to join a small group meeting applicants for the vacant position of vice-chancellor in your institution and to focus on financial aspects. If the candidates ask the following questions, what evidence would you put forward to answer them?

1. Is the institution's financial position stable?
2. What are the major risks to your stability?
3. Do you have control of your staffing costs?
4. How much scope will there be to invest in additional staff?
5. Do you have a lot of borrowing? Could you borrow more?
6. Could you withstand a few years of deficits?
7. Do you think you are sustainable?
8. How effective is your financial management? ■

"The Council had a real bust-up about it. The VC and a couple of governors wanted to borrow up to the hilt and won the day. Some of the rest of us were against it." **LAY GOVERNOR**

# 13 The auditors

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There is a separate volume in this series on audit, but no introduction to finance would be complete without just a brief note on the importance of audit to governors. Governance is always one step away from 'the action'. It is the management's job to run an HEI, implement strategy, realise mission, stay true to its values and take all the myriad decisions required to operate organisations spending many millions of pounds a year. The simple question is: in order to meet your financial responsibilities how do you as a governor know what's going on?

A key role for auditors - especially internal auditors - is to give you some assurance that what you have decided as a governor is being implemented, and that the basic systems of financial and other forms of control are in place and working satisfactorily. Accordingly the auditors need to be proactive, and need to be selected carefully. It is not their job just to tell the governing body things it already knows: the point is to try and avoid the iceberg ahead and not to be told that you have just hit it! External auditors are there specifically to give you an opinion on your annual financial statements. What that opinion means is addressed in the separate volume on audit.

It follows that auditors primarily exist to support governance. Their role is to do what you cannot do yourself - inspect the work of the HEI and test it against what should be happening, both in terms of strategy and operational practice. In short, they should be your allies.

This won't happen automatically. It needs the involvement of a good audit committee, chaired by one of the most senior governors, prepared to devote time and energy to steering the auditors' work - again, especially the internal auditors, whose brief is (or should be) very wide ranging. Checking compliance with things like procurement regulations and travel expenses policies is important; asset registers should be inspected (a pain to maintain, but absolutely critical when a major loss occurs); good record keeping all round the HEI should be expected and monitored by them. But this might occupy only half their time.

The other half should be at a higher level and deal with the implications of implementing the main corporate plan and associated financial strategy. Through a cyclical programme of visits to all areas of an institution, a good auditor should be able to build up and communicate an accurate picture of what is going on - an extremely valuable source of input for all governors (and not just the audit committee) to digest.

Financial crises in HEIs are uncommon, but they do happen. And in almost every one, there is either no audit committee or it is ineffective for one reason or another. Audit work is unglamorous, but the assurance it can provide is a vital part of effective governance. Any audit committee member will be disheartened if the governing body fails to devote time and interest to the committee's work - in other words 'sets the tone'.

## Self-challenge questions

- Is the report of the audit committee received by your governing body comprehensive when judged against its terms of reference?
- Do financial warning signs reach the full governing body?
- Are the auditors sufficiently independent and high level? ■

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"I didn't understand that the governing body could ask the internal auditors to look at particular things, I just thought that they chose to look at whatever they wanted." **STAFF GOVERNOR**

“Relationships on our board are really good. The Vice-Chancellor is supportive, the admin is first class, the chairman really knows his stuff, and the whole board feels able to contribute to the full.” **LAY GOVERNOR**

# 14 Working with the management

In order to undertake their financial responsibilities effectively, boards need to have complete confidence in the head of institution, and the finance director. Such confidence cannot be assumed - indeed that is why the appointment of the head of institution and other senior staff is amongst the most important things that a governing body does. It also means that all parties have to work at the relationship, and not assume that matters can simply be dealt with in formal governing body meetings.

However, it is not just about having confidence that senior managers are prepared to exercise leadership and take tough financial decisions, but more generally about the way that the governing body engages with the executive on financial issues. This should include:

- A ‘no surprises’ policy whereby the governing body is informed at very early stages of any potentially significant financial problem.
- An income and cost driven budgeting and accounting system showing the financial result of an activity, and providing data to drive change.
- A systematic and institution wide review process which looks at performance and helps to understand what is happening in each area.
- Having a set of governing body KPIs based on the core elements of the financial strategy which are robust and constantly updated.

Conversely, the executive (including the finance director) must have confidence in the governing body, and its members need to be credible to it. A board where the majority of its members do not understand even relatively basic financial matters is not asking to be taken very seriously!

A real test for the governing body will come when a financial crisis occurs. Too often in the past, the only time governors were brought into major decisions was when a problem occurred, and failure to involve governors in the routine review and monitoring processes can be a serious weakness. However, if this still occurs it would be a serious indictment of the board itself, and its failure to be assertive. This goes back to the importance of the relationship between the board and the executive, and where the head of institution or finance director doesn’t welcome board engagement, the governing body is often placed in a difficult position.

## Working with the management and the finance director

The commonplace distinction between the roles of governor and manager is fundamental to achieving an effective working relationship over financial affairs. The boundary between them is not fixed and it is commonplace that officers wait to be asked for information and governors wait to be told. That gulf needs bridging by regular dialogue outside formal meetings of the board or committees, so that each party can understand the needs of the other and confidence is built into the relationship.

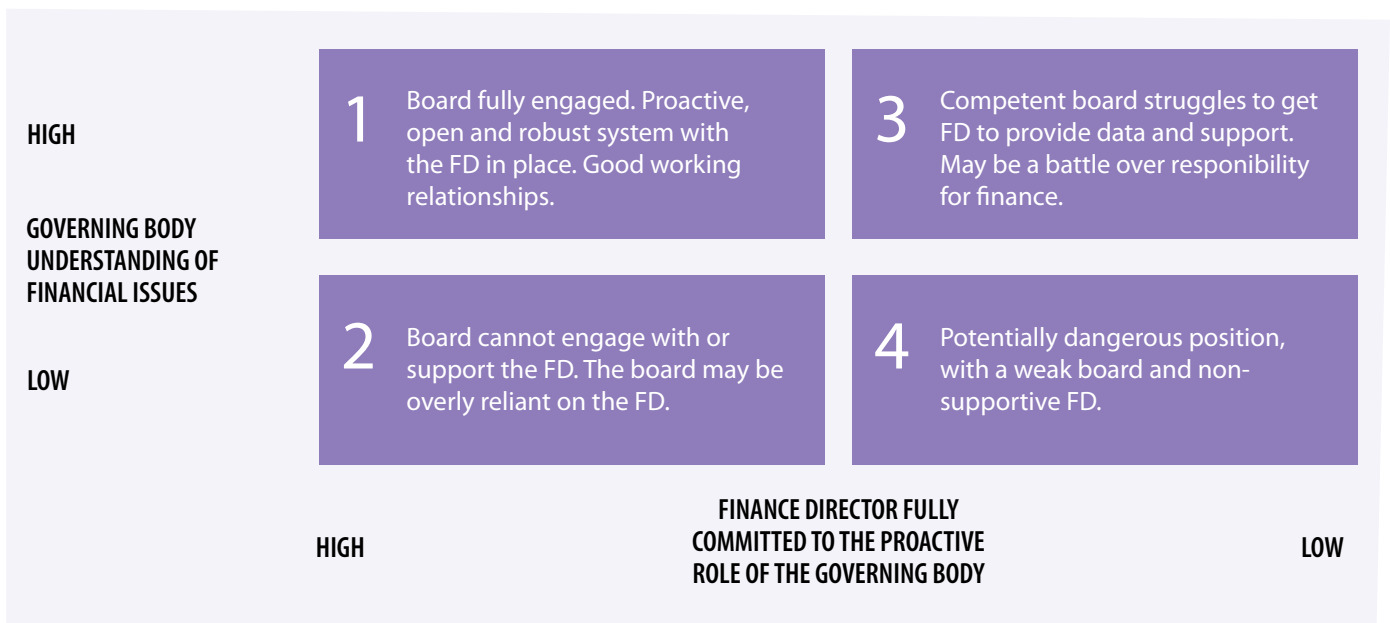
Of course, it will sometimes be necessary for the finance director to report unwelcome developments to the board, and these may even relate to questions about his or her own effectiveness. This is a crucial test of a key relationship. If unwelcome information is withheld (either at the behest of the finance director or under instructions from the head of institution), the board will probably be unaware of problems. There is a judgement to be made here, as the board will not want to know about every minor issue, and executives must judge the point at which the board must be warned.

“To get good financial information is like pulling teeth... you can see that the Finance Director really resents the board asking. It’s not that he wants a quiet life, but he just thinks it’s his job and not ours to look after finance.” **LAY GOVERNOR**

Occasionally, a board may believe that executives are not addressing a problem with sufficient urgency or vigour. Whilst the governing body chair (and others) may act privately outside board meetings (and may be provoked into doing so by calls from board members), there may be no substitute for a robust debate in a board meeting. This will test personal relationships, especially between board members and the chief executive.

Matters become more difficult if the finance director is unhappy with a course of events, but is unable to speak frankly to the board because of an instruction by the head of institution - a rare but not unknown situation. The chair of the finance committee (and, perhaps, the audit committee) should be in regular contact with the finance director and may be able to provide a bridge to help resolve any problem. Certainly, this sort of situation demands urgent senior governor involvement, and could have serious repercussions. The governing body culture is a key influence here. If it is normal for issues to be discussed openly and without personal affront, a robust debate should be possible, without the threat of repercussions outside the meeting.

The health of the relationship between the governing body and the FD can be expressed in a simple diagram as follows:



Suggested task

Think about which of the four cells in the diagram most closely represents the position in your own HEI. What are the implications?



“The governing body is very supportive, but can be quite tough - which is as it should be. There are a lot of people with senior finance experience, and I learned early on that they were not going to be messed around. It’s quite challenging, but I enjoy it and it keeps me on my toes.” **LAY GOVERNOR**

The position in cell 1 is the position advocated in these materials: an informed and constructively robust governing body supported by an FD who is fully committed to the proactive role of the board on financial matters. This can be the basis of good financial governance and sound working relationships with both the FD and the executive more generally. The other three cells all have significant weaknesses, particularly cell 4.

There are structural issues to be considered here. In the past, it has been common for HEIs to have a finance committee or equivalent. In many older institutions, there has also been an office of treasurer, occupied by a senior non-executive governor, who was expected to take a close interest in financial affairs and could form a valuable link with the FD. However, such arrangements can also cloud the distinction between management and governance and some HEIs have moved away from them. A useful test is to refer back to Chapter 1 and the CUC Code's primary elements of governance, together with your institution's responsibilities to the funding council under the terms of your financial memorandum. Is your HEI's finance committee (and the role of the treasurer, if it exists) the most effective way of carrying out these responsibilities, or perhaps the finance committee is doing jobs which the governing body itself should do?

### What financial information should be provided to governors?

The short answer is everything suggested in these materials, but there are a few issues to be teased out in answering this question within individual HEIs. Clearly, the main need of governors is for information to be of high quality, with some of the following features:

- | Timely - delay means any reaction will be later than is desirable.
- | Relevant - focussed on key issues.
- | Benchmarked or normalised - with year on year comparators or marked against national statistics; even better against peer institutions.
- | Well designed - so that key messages are clear.
- | Accurate and reliable - so that consequent decisions are soundly based.
- | Readable - over long papers are rarely a sign of good governance.

Management also needs to know from governors what they require, and it's important for them to tell management what they don't want, as well as what they do.

It is also important that wherever possible information is presented in ways consistent with other board papers, and the clerk or secretary to the governing body should try and ensure this. Many governing bodies are now using presentational devices such as 'balanced scorecards' or 'traffic lights' and these should also be considered for financial matters.

A checklist of financial monitoring data for governors might include:

- | A budget presentation in sufficient detail to allow governors to understand the main decisions and parameters on which it was based.
- | Annual five year financial forecasts, showing the implementation of the financial strategy and highlighting the main risks.
- | Regular in year reports of budget performance at the institution and main operating unit levels.
- | Regular cash and borrowing reports and forecasts.
- | Regular reports on the achievement of agreed financial KPIs and other performance measures.
- | Funding council financial memorandum compliance reports.
- | Banking covenant compliance reports.
- | Financial strategy compliance reports.
- | Capital expenditure plan and progress report.
- | Comparative analysis of the institution's financial position in the sector.
- | The annual risk assessment from the funding council.
- | The external auditors' management letter.
- | The annual report of the internal auditors.

Regular non-financial monitoring data is equally important:

- Reports on student numbers (actual, forecast, and completions).
- Applications made and forward order book for contract research.
- Staffing, including recruitment and departures, vacancies, promotions, and any redundancies or tribunal cases.
- Quality assessments, of teaching, research and enterprise activities.

In practice, how such data is presented will vary depending upon the governance structure, and if no finance committee exists it may be sensible to create a monitoring group charged with assessing this information and providing an analysis of it for the whole governing body. That is, of course, not to say that the full data should not be seen by the whole governing body.

A fairly common cause of concern to governors is a significant difference between the formal end of year financial statements and the management accounts which have been presented during the year, showing progress against the annual budget and often including a forecast of the surplus or deficit for the full year. Whether it is significantly better or worse, it still tends to undermine confidence that the institution is in control of its finances. There are several typical causes:

- One is the working assumption in the finance department that budgeted amounts will be received or spent in full; frequently they are not. However, much of higher education works on an annual cycle, so mid-year forecasting can be problematic and may depend on making contact with large numbers of budget holders. But failure to check for significant variances and reforecast is not acceptable; a check should be made at least quarterly so that timely corrective action can be taken if necessary. Understanding the basis on which the management accounts have been prepared is quite important for governors.
- Large amounts of income and associated expenditure in institutions are 'self funding'; in other words, a grant for a specific purpose is received and the money spent on that purpose, so that the impact on the surplus or deficit may be minimal. Again, reliance on initial estimates means that insufficient scrutiny is being given to what is happening during the year.
- Careful consideration of the accounting treatment of some expenditure items when the year end statements are being prepared (probably after discussions with the auditors) may lead to substantial amounts being recorded as capital (and thus depreciated to the income and expenditure account over a period of years) instead of being written off as was expected when the budget was prepared. The process can also occur in the opposite direction, so that more is charged to the Statement of Comprehensive Income than expected, perhaps leading to a deficit on the year. Of course, this has no effect on cash flow, a point worth remembering when reviewing the three main statements.

Governors should expect a reconciliation of the two sets of information, setting out the principal reasons for the differences.

### What can go wrong?

Serious financial problems in HEIs have been relatively rare, and the improvement actions taken in response to them have usually been sufficient to prevent new problems occurring. Where things have gone wrong they have almost always occurred because of some kind of breakdown in the working relationship between the governing body and senior management.

In his book 'Good Governance in Higher Education',<sup>33</sup> Michael Shattock describes the details of some of those universities that have suffered financial problems, and there are a number of valuable lessons to be learned. The first is the critical importance of governor independence, the lack of which is the common thread which runs through many problems. Too often, a board simply did not challenge an executive's presentation of an HEI's position, or consider how proposals would be more widely perceived. This, of course, is not easy, and may test the motivation of a voluntary unpaid governor to challenge a persuasive head of institution.

"The problem was that the lay members either didn't understand what was going on or didn't care enough. As staff governors we knew, but they didn't listen to us." **LAY GOVERNOR**

<sup>33</sup> Shattock M, (2006), Good Governance in Higher Education, Open University Press, pp 84-88



The second lesson is the importance of having a process for assessing risk and sticking to it irrespective of the pressures for immediate action to seize a perceived opportunity. Accordingly it is important for all governors to have a basic understanding of the governance implications of risk management, and this is presented in the separate materials in this series.

A third lesson is for a board to be aware that occasionally members of the executive may get so closely involved in the management of major initiatives that there is a danger that they will not be able to stand back and take an objective view of progress and implementation. In such circumstances the future of such an activity becomes a battle for the credibility of the executive member concerned, with obvious consequent difficulties. Of course, it is similarly important that senior governors are also not directly involved in such ventures.

Fourth, a board needs to assure itself that its HEI is complying with its legal and regulatory requirements. In practice, boards are largely dependent on their clerk, and several boards require annual compliance checks to ensure that all is well, and that the advice they are receiving is accurate. In such cases the internal audit - or in extremis external consultants - might be used to provide a second opinion.

The consequences of non-compliance were illustrated in 2008 by a reduction of £15m in the grant for 2008-9 of one HEI, with the threat of clawback for earlier years, following a data audit which looked at student course completions. This institution is not alone in facing such problems, which stem from the quality of data held about students that form the basis of returns to the funding councils. Since grants to HEIs are based on those returns, data inaccuracy can lead to substantial over or under payments, and for this reason all the funding councils are asking audit committees to validate some institutional data returns.

Fifth, there may be particular challenges in small institutions, where potential problems include: the disproportionate amount of resource spent on governance; the difficulty of getting and keeping good staff; and the likelihood that one adverse event will present a serious problem that a larger institution might be able to take in its stride.

In practice, most of these problems go deeper than just being concerned with finance, and are fundamentally about ensuring the effective working relationships between executive and board discussed above. Knowledgeable and motivated governors (supported by an effective chair and clerk) can do much to stop such problems occurring, and create high expectations where managers know that corners cannot be cut.

### Self-challenge questions

- Is there evidence that the executive and finance director openly engage with the governing body and take its views seriously?
- Are potential financial problems being brought to the board's attention at an early stage?
- Is the financial information presented to governors relevant, concise, timely and reliable? In what way could it be improved?
- Is the committee structure for finance as effective as it might be?

"It was very difficult as it was the VC's own pet scheme. If it had been anything else he would have acted, but he was so close to it that he couldn't see it was going wrong. When the chairman intervened it caused all kinds of bad blood which lasted for a couple of years." **LAY GOVERNOR**

#### A GOVERNOR'S DILEMMA 4:

As a governor you joined the finance committee of your HEI last year. At your first meeting in November, it considered the draft annual Financial Statements. These showed deficits of over 3% two years running and gearing in the top quartile for the sector, but no immediate liquidity issue. There are reserves, but they are smaller than the pension scheme deficit. There is a vague reference towards the back of the Statements to outstanding litigation in respect of a major building project. The external auditors' management letter raised no serious concerns but you thought the Committee's discussion with the finance director was somewhat bland and relaxed; the whole topic was dealt with in about ten minutes.

As background information, you note from a recent strategy document produced by the new head of institution that the HEI plans to relocate from seven sites to a large new campus two miles away from the city centre. The cost will be met largely from disposal of the seven sites, which have considerable development value. The new buildings will be constructed before the old ones are sold. They will include a new building for nurse education (which is expected to grow in numbers) and a research centre to house the expected growth in such activity. The HEI's research income is currently about 3% of the total.

At the same time, the HEI plans to double its courses in management, which have been attracting outstanding students in large numbers. Additional high quality residential accommodation on the new site is also planned to house this expansion. The new programme director has been recruited from the City and is keen to examine novel ways of financing this expansion.

You have taken to arriving at the University a little early for meetings, so that you can walk around and form your own impressions of the state of affairs. Some buildings clearly need attention and the general level of housekeeping is poor. The students' union is a particularly bad example – but does that matter? You are beginning to feel uneasy. Can you pinpoint your concerns by listing 10 questions for the head of institution when he appears before the finance committee? ■

# 15 The future

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This final chapter looks forward, and briefly considers some of the key financial challenges that governors might have to get to grips with in the next few years. It is necessarily speculative, and readers will need to put the general observations into the specific context of their own institution.

The higher education sector seems poised between a recent period of relative plenty and a future of potential relative famine. The introduction of tuition fees in England, Wales and Northern Ireland in 2006 and the recognition by government that capital funding was necessary produced substantial new money for HEIs. However, with the introduction of the new funding regime and the ongoing programme of government cuts, many in the sector are nervous about the prospects for the next few years.

## Pensions

A major challenge for many boards is likely to be the future funding of pensions. Higher education has not been immune from the turmoil in the pensions world of the last decade or so, and costs have increased and seem likely to continue doing so in all the various schemes operated by HEIs. Most academic and related staff in the pre-1992 institutions are members of the Universities Superannuation Scheme, which is the second largest pension fund in the UK. It is a funded scheme (ie it owns assets with which to pay pensions), but despite its size has needed to change the terms of the benefits that it offers its members in response to funding pressures. In the post- 1992 HEIs, academic staff are usually members of the Teachers Pension Scheme. It is not funded and contributions go to the Exchequer, which accepts liability to pay pensions.

Pension arrangements for non-academic staff also vary, but the pattern is different. For historical reasons, many are members of local government superannuation schemes. These are funded schemes, but their investment performance has shown considerable variation. Employers' contribution rates have been rising steadily for some years. Nevertheless, many of these schemes continue to manage significant long-term funding shortfalls.

In many pre-1992 HEIs, non-academic staff are (or were, since some schemes have been closed) members of 'in house' schemes, operated by the institutions themselves (though governed by trustees in compliance with relevant legislation). These also have had varying investment experience, with a variety of funding positions and contribution rates similar to those for local government schemes. Funding deficits in several of these schemes have led to them being closed to new members and replaced with defined contribution schemes, where the risk is placed more on the employee.

Pensions represent something of a 'ticking bomb' for HEIs. Contribution rates seem likely to keep going up, with the benefits available being reduced, but advertised salaries rarely make reference to the fact that higher education pension schemes are among the most generous on offer. Unreformed final salary schemes are now the exception rather than the norm, but attempts to carry out such a reform have proven highly contentious. Even a move to a structure which bases pensions on average career salaries (rather than final salaries), now common in other not-for-profit sectors, received a less than warm reception when the Universities Superannuation Scheme went down this route. It is also worth noting at this point that the costs generated by pension schemes can make the restructuring of certain groups of staff prohibitively expensive.

## Strategic change and investment

Given the rapid and sustained pace of change across the sector, many institutions are seeking to attract students and ensure their future financial sustainability through a process of strategic development and adaptation. This might include, for example, the redevelopment of campus infrastructure, a streamlining of the academic programmes offered, or an intensification of research activity in specific subject areas.

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Such strategic change is, however, rarely cheap. Consequently, institutions will need to generate the funds required to finance the changes that they wish to make. This might include securing government grants, but is also likely to require external borrowing, the solicitation of investment from industry and the reallocation of internal resources. Or, more likely, all of these!

Governors should expect to see a thorough business case for strategic investments of this nature, which sets out clearly what the investment seeks to achieve, how it will contribute to the achievement of the institution's strategic aims and how it will be delivered in practice. The business case should also, it goes almost without saying, explain how the investment will be financed and what the associated income and expenditure will look like over the lifetime of the investment.

### Suggested task

Considering the return on strategic investments is not always about purely financial factors. Think about how you would assess the return on (a) a new multi-storey car park, (b) a new student residence and (c) a new library?

Analysing and assessing such business cases may require input from various committees, such as the estates committee to look at property development aspects and the finance committee to consider the financing arrangements. This makes it important that the roles and remits of such committees are clearly defined, so that duplication can be avoided – and so that nothing falls through the cracks.

### Innovative financing strategies

The need to fund capital investment has led to several institutions exploring more innovative ways of securing the necessary finance. For instance, a small number of institutions have entered into government-backed bond issues to raise the money to fund campus development projects. Others have sought – and received – loans from the European Investment Bank and other sources.

While such financing strategies are commonplace in parts of the commercial world, they are still relatively new to higher education. Consequently, it may be highly unlikely that governors will have the skills and experience to subject them to the necessary level of scrutiny and challenge. In such circumstances, governors may wish to seek appropriate independent advice on the suitability – and affordability – of any such arrangements.

### Student numbers

Student numbers are likely to be affected by many factors. Demographic change will inevitably play a part, though the relaxation of student number controls and the future level of tuition fees – potentially with a link to teaching performance – are likely to have a significant impact on the numbers of students applying to study at different institutions.

Internationally the position is also likely to be challenging. Despite the huge growth in international recruitment in the past few years, there are some pressures that may limit demand. The global economic situation may well affect the numbers coming from overseas, and increased competition from other countries may have an impact.

Of course, not all HEIs will be adversely affected by threats to student numbers, but sector wide most indications do not look encouraging. There will be winners, sure, but there will also be losers.

“We need a radical rethink about how we’re going to afford to run this place in the future. It’s not enough just to try and break even, but we need to generate substantial surpluses.” **LAY GOVERNOR**

## Scrutiny and oversight

In recent years, institutions have come under greater pressure to demonstrate that their activities represent good value for money in terms of the use of public funds. And even now that much of this public funding has been replaced by tuition fee income, these pressures have not disappeared. The consequence of this is likely to be ever greater scrutiny of the sector and of the actions of the institutions within in.

On a related note, Parliament's Public Accounts Committee (PAC) has also made several forays into the funding of the higher education sector, most recently in respect of funding made available to alternative providers. While such examinations have focused so far on the work of government departments and the funding councils, individual higher education institutions are by no means immune from the gaze of this and other oversight bodies.

## The challenge for governors

In the whole panoply of higher education (at least since its post-war expansion) there have been remarkably few serious financial problems, so governors shouldn't lose too much sleep over the operation of financial processes. Moreover, improved controls and monitoring will probably prevent past problems recurring.

However, the basic problem may be a business model for funding higher education which is becoming exhausted. Most HEIs face a rate of cost increase which is twice the rate of inflation generally. But most sources of income are only rising by a lower rate. Seeking additional income is a constant challenge and can easily lead to management 'drift', taking the corporate eye off the main task of performing in teaching and research. The alternative is simply to cut staff numbers to balance the books, hopefully through increased efficiency, but more likely where posts become vacant through natural wastage. This is not a recipe for great success and there is an urgent need for fresh thinking in institutions if they are to sustain themselves. The old ways will not work for much longer.

In the face of such financial pressures the case for mergers and closer institutional collaboration is likely to become strong, and governing bodies have a major role to play here. Mergers are rarely popular with staff, and may be seen by many senior managers as undesirable outcomes because they usually reflect badly on those whose institution is forced to merge. However, if carefully implemented they may be of strategic benefit. In such a situation it may be that a governing body that has to drive consideration of merger and collaboration forward, as a fundamental part of its strategic role. More widely, collaboration on a regional or specific service basis which stops short of merger might be a more practical way of securing the benefits of scale.

In the meantime, the essentials of financial governance remain: good internal control, effective risk management and governance which works through commitment and knowledge. But governors should keep an eye open for some of the signs of distress which could suggest the need for investigation. They include:

- Actual and predicted deficits - why?
- Poor liquidity.
- High levels of borrowing relative to peers.
- Tight banking covenants.
- Over reliance on unstable sources of income.
- Inability to adjust spending to short term income fluctuations.
- Poor sector comparisons.
- Poor quality statistics and management information.
- The quality of the estate.
- Lack of openness on the part of officers - keeping governors at too great a distance.
- Falling forward research order book.
- Poor student recruitment performance.
- Unwillingness to confront the need for change. ■

# Annex A: Some key references

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There are a large number of references about the many different aspects of financial governance, but the following will be of interest to governors new to the topic.

## About the higher education sector

HEFCE (2015) Higher Education in England 2015: Key Facts, [http://www.hefce.ac.uk/media/HEFCE,2014/Content/Analysis/HE,in,England/HE\\_in\\_England\\_2015.pdf](http://www.hefce.ac.uk/media/HEFCE,2014/Content/Analysis/HE,in,England/HE_in_England_2015.pdf)

## About higher education governance

Committee of University Chairs (2014) Higher Education Code of Governance, <http://www.universitychairs.ac.uk/wp-content/uploads/2015/02/Code-Final.pdf>

Universities UK (2014) Statement of recommended practice: Accounting for further and higher Education, <http://www.fehesorp.ac.uk/>

## About financial performance in the higher education sector

HESA finance statistics, <https://www.hesa.ac.uk/stats-finance>

Financial health of the higher education sector, <http://www.hefce.ac.uk/funding/finhealth/>

## About charity governance

Charity Commission (2015) The Essential Trustee: What you need to know, what you need to do, which is available at <https://www.gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3>

## Financial advice

The British Universities Finance Directors Group (BUFDG) is the representative body for higher education finance staff in the United Kingdom. The members are the Directors of Finance and Chief Financial Officers of almost all UK higher education institutions. <https://www.bufdg.ac.uk> ■

## Annex B: A quiz

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Sorry, we couldn't resist a test! Below are twenty financial terms in common use and considered in the text of these materials. Why not spend a few minutes working through them to make sure that you understand what each means. The answers are over the page:

1. What does 'sustainability' mean in financial terms?
2. What is liquidity and what is the usual measure in higher education?
3. What does TRAC mean?
4. What are full economic costs?
5. What are endowments?
6. What is depreciation and how is it calculated?
7. What is an income stream and what is its relevance?
8. What is a banking covenant?
9. What is a debt servicing ratio?
10. What is a borrowed funds to reserves ratio?
11. What is a capital adequacy ratio?
12. What is a net borrowed funds ratio?
13. What is an income and expenditure account?
14. What is a balance sheet?
15. What is a cash flow statement?
16. What is a historic cost surplus?
17. What are short term investments?
18. What is cash in a balance sheet?
19. What are debtors and creditors?
20. What is the unfinanced capital investment requirement? ■

Turn over the page to see your score...

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## Annex B: Quiz: Suggested answers

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1. Sustainability means the ability of an institution to maintain its operational or productive capacity from its own financial resources.
2. Liquidity is the availability of cash and short term investments to meet immediate liabilities. The usual measure is cash plus short term investments, less overdrafts, divided by total expenditure. It shows how long (in days) an institution would survive without additional cash.
3. TRAC means the transparent approach to costing.
4. Full economic cost means the total of all costs directly or indirectly attributable to an activity or project; it thus includes an appropriate allocation of overhead costs.
5. Endowments are gifts of money or other assets which have been given to the institution with the intention that the capital will be kept intact and the income used for the purpose specified (if any). It is possible that even the capital may be spent - it depends on the way in which the gift was formulated.
6. Depreciation is the annual charge to the income and expenditure account representing the gradual consumption of the value of buildings and equipment. It is calculated by estimating the useful life of an asset and dividing the original cost by that period to produce a charge.
7. An income stream is a regular source of income resulting from an activity or investment. It's relevance is through the ability to match it with regular outgoings eg the repayment of a mortgage taken out to finance the investment.
8. A banking covenant is an undertaking to do (or not do) something (or not to exceed a limit) in a loan agreement.
9. A debt servicing ratio is a minimum ratio of surplus plus interest (payable less receivable) plus depreciation to interest payable plus debt repayable in one year.
10. A borrowed funds to reserves ratio is a maximum ratio of all debt to reserves.
11. A capital adequacy ratio is a minimum ratio of reserves to assets.
12. A net borrowed funds ratio is a maximum ratio of net debt to reserves.
13. An income and expenditure account is designed to tell what has been earned during the reported year, and what it has cost to earn it; in other words, the financial result of normal, regular operations.
14. A balance sheet is designed to tell what an entity was worth on the last day of a financial year; in other words, what is owned and what is owed and what was the net difference.
15. A cash flow statement is designed to tell how much cash has been received and how much has been spent in the year.
16. A historic cost surplus is based on depreciating assets at their original cost only, ie ignoring inflation.
17. Short term investments can be converted into cash within one year, not necessarily at face value.
18. Cash in a balance sheet means money that can be realised within 24 hours.
19. Debtors owe money to the HEI, creditors are owed money by the HEI.
20. The unfinanced capital investment requirement shows what capital will be required by the institution (during a planning period) beyond what it is likely to generate from internal sources. ■

And your score out of 20 was:

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# Annex C: Suggested answers to governors' dilemmas

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## Dilemma 1

Of course there is no simple answer! Firstly, however, it should be emphasised that decisions of this nature should never be determined by financial considerations alone. The question of strategic and cultural fit should take precedence, with financial and other matters taking a secondary role.

1. **Estates** - what is the first institution's estate plan? Although its estate is said to be in a good state of repair, is it also fit for purpose, or are there major alterations required as academic subjects change the way they work? The second institution is tackling its over generous estate and its good relations with the city council are a plus, but are its development partners robust enough to withstand a serious economic downturn? Operating in the centre of a city is often more expensive than a suburban campus base - will this put increasing cost pressure on the institution? Does either institution see you as a prime opportunity to rationalise property holdings and dispose of your site?
  2. **Finance** - the first institution's finances look stretched already. It has been struggling to make surpluses, liquidity is low, cash generation is negative (presumably because it has been spending heavily on property) and borrowing is already high. It will not be easy for this institution to tackle your institution's estate backlog. The second institution is clearly in a better position to spend money on your backlog.
  3. **Academic** - only third in this list because this is material on finance; its rightful place is first! The obvious question here is 'fit'. Will your institution be better joining another which already has your academic portfolio (how will your staff be regarded?) or one which has not (will they regard art and design as sufficiently 'academic')? Where will your institution's entry qualifications fit best? Is either institution looking for expansion in the areas in which your own institution is strong? Does the 'shape' of either institution suggest that they would be a more natural merger partner, marrying your strengths with theirs, or areas they are keen to strengthen and vice versa.
  4. **Research** - the first institution has a track record, the second ambitions. Will your staff fit in better with the first (can you get up to speed with them?) or second (a good match with your own ambitions, if they are realistic)?
  5. **Staff** - nothing is mentioned about staff relations at either institution, yet this is always a critical issue in mergers.
  6. **Collaboration** - is there any existing relationship which would suggest a favourable outcome with either?
  7. **Other** - the fact that the head of institution has decided to retire may be a positive factor (fresh leadership for new opportunities) or negative (leaving the HEI leaderless at a time of great change and uncertainty).
-

## Dilemma 2

1. What is your HEI's international strategy, and does the proposal fit it? Will this make the HEI over reliant on the stability of one country?
2. Is five years to break even acceptable, given the current situation? What is the payback of the original investment? What happens if losses continue?
3. What interim capital might your institution have to inject, and what are the opportunity costs of using it in this way?
4. How much staff time (also opportunity costs) - including management time - will be required to support this initiative?
5. Does the Malaysian government support the proposal? What is the evidence?
6. How firm is the former student's pledge of funding? What are the terms? Is the money repayable?
7. Is there any local competition? Has any other institution tried to establish itself there?
8. How has local demand – and at what fee levels – been tested?
9. What subjects are proposed to be taught? What evidence is there that these will be popular?
10. How will the operation be staffed? What evidence is there that staff of the appropriate quality can be recruited (and retained)?
11. Who will manage the project? How will the project be monitored? What KPIs are proposed?
12. What is the risk profile? Is there an acceptable risk management strategy? Have the risks been assessed thoroughly?

## Dilemma 3

These questions should be addressed in the light of your understanding and judgement of your own institution. As for evidence, however, you might use the following:

1. Financial stability - time series of annual surpluses, liquidity, borrowing and cash generation.
2. Risks to stability - this should be based on a risk assessment of threats to your major revenue sources and expenditure commitments.
3. Control of staff costs - a time series of cost per head (with projections) would be revealing.
4. Investment in new staff - the evidence is in revenue surpluses, staff turnover statistics and projected growth.
5. Borrowing - the headroom between banking covenants and current position.
6. Ability to withstand deficits - the reserve position (but willingness is another matter).
7. Sustainability - a time series of cash generation, showing ability to finance capital requirements year on year with relatively few estates issues outstanding.
8. Effectiveness of financial management - all the previous answers should deal with this question!
9. A return question to the aspiring applicant would be to test their understanding of the institution's financial position, as they also should have done their own homework!

## Dilemma 4

Numerous elements of this scenario may be investigating, including:

1. Has the campus relocation plan been independently tested?
2. How secure are the forward plans for nurse education?
3. Research funding from the funding councils is increasingly highly selective. What evidence is there that your HEI can break into the research intensive group?
4. Have you met the auditors recently? Did they have any concerns about the HEI's financial health?
5. Has the funding council provided any information about its risk assessment of the institution ?
6. What is the real state of the litigation mentioned in the accounts? Who is managing it?
7. Programmes in management have been a success at this HEI, but what evidence is there that it will continue to grow?
8. Does the institution need the new student accommodation? If so, should it plan to out source it?
9. Where is the refurbishment of the students union on the estates plan? What is the impact of the present poor accommodation on student recruitment and retention?
10. Is there a financial strategy for the whole period of the plan and has it been independently reviewed? Special emphasis should be placed on cash flow projections.
11. What changes in the cost base of the institution are expected?
12. Has there been a comprehensive risk analysis of the proposals? ■

# The Leadership Foundation

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## About the Leadership Foundation

The Leadership Foundation is a membership organisation that delivers leadership development and consultancy advice to higher education institutions in the UK and around the world. The focus of the Leadership Foundation's work is to improve the management and leadership skills of existing and future leaders of higher education. The services provided include consultancy, leadership development programmes and events, including a major series of events for governors. This work is supported by a highly regarded research and development programme that underpins the leadership development programmes and stimulates innovation.

The Leadership Foundation has a small team of experienced leadership and organisational development professionals drawn from higher education, other parts of the public sector, and also from the private sector. Much of the Leadership Foundation's work is delivered in partnership with the higher education sector and other partner organisations.

**[www.lfhe.ac.uk](http://www.lfhe.ac.uk)** ■

# About the authors

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## Michael Pearson Author 2009

Spent most of his career on the finance staff at Loughborough University, becoming bursar and finance director from 1990 to 2007 where he was responsible for the financial direction and business management of the University, including estates, student residences, sports facilities and commercial operations.

In 1984, he was awarded a Commonwealth Universities Fellowship to travel overseas, and later seconded to the National Committee of Inquiry into University Efficiency (the Jarratt Committee). He was Chairman of the British Universities Finance Directors' Group from 1999-2002. He currently chairs the boards of a housing association and a group of independent schools.

## Simon Perks Author 2015 update

Simon is the founder and director of Sockmonkey Consulting, which provides research and consultancy services to organisations in the public, not-for-profit and social enterprise sectors. He is a CIPFA-qualified accountant as well as a skilled coach and mentor. Before setting up his own practice, Simon worked for over a decade in the public sector arm of a leading international audit and consultancy firm.

As well as being an experienced consultant, Simon has degrees in political science and theoretical physics. He speaks English, French, German and Russian fluently and can get by in Dutch, Mandarin Chinese and Spanish. When he is not working, he enjoys a range of outdoor pursuits, such as hiking, running, sailing and kayaking. He is also a keen writer, photographer, gardener, baker and tea drinker. ■



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Leadership Foundation for Higher Education

Peer House

8-14 Verulam Street

London

WC1X 8LZ

E: info@lfhe.ac.uk

[www.lfhe.ac.uk](http://www.lfhe.ac.uk)

 @LFHEMarketing

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Contact us at

**info@lfhe.ac.uk**

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