

December 2009/46

**Core funding/operations
Consultation**

Responses should be e-mailed to
HEFCE by Friday 5 March 2010

This is a consultation on changes to the Financial Memorandum between HEFCE and higher education institutions. It incorporates a consultation on revisions to the Accountability and Audit Code of Practice. Amended versions are to take effect from 1 August 2010.

Revisions to Financial Memorandum

**Consultation on changes to the
funding agreement between HEFCE
and institutions**

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Revisions to Financial Memorandum

Consultation on changes to the funding agreement between HEFCE and institutions

To	Heads of HEFCE-funded higher education institutions Heads of HEFCE-funded further education colleges Heads of universities in Northern Ireland
Of interest to those responsible for	Audit, Finance, Senior management, Governance
Reference	2009/46
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Enquiries to	Paul Greaves tel 0117 931 7378 e-mail p.greaves@hefce.ac.uk

Executive summary

Purpose

1. This is a consultation on changes to the Financial Memorandum (FM) between HEFCE and higher education institutions. It incorporates a consultation on revisions to the Accountability and Audit Code of Practice (Code). Amended versions are to take effect from 1 August 2010. We are undertaking a parallel consultation about the information requirements for HEIs to enable us to fulfil our role as charities regulator 'Regulating higher education institutions as charities: consultation on HEFCE's information requirements as principal regulator' (HEFCE 2009/45).

Key points

2. The Financial Memorandum sets out the conditions attached to HEFCE funding, with which institutions must comply. The FM includes the Accountability and Audit Code of Practice, which sets out our audit and accountability requirements. Compliance with the Code is one of the conditions of funding.
3. The FM and Code are being reviewed at this time to incorporate a new framework for borrowing consents that has been developed with the sector over the past year and to make changes that are necessary following developments in the higher education risk environment since the last FM was published.

Financial Memorandum

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

5. The FM aims to make more clear the responsibility of institutions and their governing bodies for compliance with the conditions of grant.

6. There are two new proposed mandatory requirements, for institutions to:

- ensure that arrangements for the assurance of academic standards are effective
- comply with published directions on data quality.

Action required

7. Responses to HEFCE are invited by e-mail by **Friday 5 March 2010**, using the electronic version of the form at Appendix B, which can be downloaded from the HEFCE web-site, www.hefce.ac.uk, with this document under Publications.

Consultation process

8. This draft document contains our proposed new Financial Memorandum (FM) to take effect from 1 August 2010. It will replace the FM issued in 2008 (HEFCE 2008/19).

9. We now seek views on the new FM. Responses should be made by e-mail, using the electronic version of the form at Appendix B, which can be downloaded from the HEFCE web-site,

www.hefce.ac.uk, with this document under Publications. Please e-mail the completed form as an attachment to fmcodeconsultation@hefce.ac.uk by **Friday 5 March 2010**. All responses received by the deadline will be taken into account but it will not be possible to discuss individual responses.

10. Following sector consultation, we will issue the final version of the FM, to be effective from 1 August 2010.

Summary of proposed changes to Financial Memorandum between HEFCE and institutions

11. The principal changes to the current version of the Financial Memorandum published in 2008 (HEFCE 2008/19) are set out below. The changes include four proposals (a, f, h and i, below) on which we seek responses in this consultation although we also welcome views on the other changes and will take these into account in preparing the final version. The FM is attached as Appendix A, in which areas where significant new text is being proposed for the new FM are indicated by the use of italics.

- a. We propose to change from the term ‘designated officer’ to that of ‘accountable officer’ to describe the role undertaken by heads of institution involving ensuring compliance with this FM. The new term more closely suggests the duties involved without compromising the full Accounting Officer responsibility that rests with the HEFCE Chief Executive. We are reserving the right to reject the nomination of an accountable officer and will require the governing body involved to seek HEFCE’s agreement to them appointing an individual other than the head of institution to this role. We are setting out for the first time the need for an interim accountable officer to be notified to us as a matter of urgency where such an appointment becomes necessary (paragraphs 1, 21, 23).
- b. We intend to stress much more clearly than in the past that institutions are publicly accountable bodies (paragraph 5).
- c. We intend to make clear that there may be circumstances in which we will make our institutional risk assessments known, in the public interest (paragraphs 11, 16).
- d. We intend to expand our definition of an institution at higher risk to include concerns about risk management, control and governance. This makes explicit something that was previously implicit (paragraph 12 and Annex D, paragraph 8).
- e. We intend to remind institutions that we will soon be the charities regulator and that, following a parallel consultation, they will need to supply us with information to enable us to discharge this duty (paragraph 13).
- f. We propose to cover more fully the responsibilities of governors, while also acknowledging that their responsibilities are very considerable, and to set down our intention to tackle failures of governance and to use our powers to the full. We are proposing to introduce an engagement letter for chairs akin to that for new heads of institution (paragraphs 15, 16, 17).
- g. We intend to increase the emphasis on institutional data and to underline that the

prime responsibility for the quality of data lies with institutions (paragraph 18).

- h. We propose to include in the FM for the first time a statement that underlines the necessity for the governing body and accountable officer to be able to assure themselves about the HEI's academic standards (paragraph 19).
- i. We are proposing to adopt a new methodology for agreeing HEIs' proposals for long-term borrowing commitments (paragraphs 27-30 and Annex F).
- j. We intend to include in the final version of the FM our requirements for carbon management plans, following our forthcoming consultation on the Capital Investment Framework (paragraph 32).
- k. We intend to give detailed guidance about what is a material adverse variance that should be notified to us (Annex B, paragraph 20).
- l. We intend to stress that internal auditors should not only be risk-based but must also provide assurance about fundamental financial controls (Annex B, paragraph 54).
- m. We intend to recommend that the letter of representation from the institution as client to its external auditor should explicitly record any known or potential threats to future HEFCE funding, for example, brought about by recoveries of overpaid grant. This is to ensure that risks to HEFCE funding are brought to the attention of the auditor by those with the responsibility for doing so (Annex B, paragraph 88).
- n. We intend to clarify that we will recover overfunding identified during our data audit and reconciliation processes (Annex C, paragraphs 10, 11).
- o. We intend to make clear that our support strategy interventions might be aimed at institutions heading for difficulty as well as those at higher risk formally (Annex D, paragraph 3).
- p. We intend to clarify that institutions will have to comply with special conditions of grant, so long as they are reasonable (Annex D, Table 1).

Appendix A

June 2010/##

Core funding/operations Report

Effective 1 August 2010

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

Model Financial Memorandum between HEFCE and institutions

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Financial Memorandum between HEFCE and institutions

The text of this document is the subject of consultation. Significant additional text is shown in italics.

In this memorandum the definitions listed at Annex J apply.

Purpose of this document

1. This Financial Memorandum sets out the formal relationship between HEFCE and the governing bodies and *accountable officers* of the higher education institutions (HEIs) it funds. It reflects our responsibility to provide annual assurances to Parliament that:

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

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

References to the memorandum embrace both Part 1 and Part 2.

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

4. This memorandum takes effect from 1 August 2010, as does the Accountability and Audit Code of Practice (Annex B).

Our responsibilities to institutions

5. We will work with institutions and the higher education sector to the high standards of openness, integrity and consistency expected of public sector

bodies. We recognise that institutions are autonomous bodies and will act reasonably and *acknowledge that institutions accept that they are accountable for the public funds they receive*. We will not ask for information that we already have, and as far as possible we will rely on data and information that institutions have produced to meet their own needs. We will try to make regulation efficient and ensure that its benefits outweigh the costs to institutions, ourselves and other parties.

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

7. Our grants to institutions are to fund activities defined by the Further and Higher Education Act 1992 (‘the 1992 Act’). For higher education institutions (HEIs) these are:

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

8. For further education colleges (FECs), we fund the provision of ‘prescribed’ courses of higher education.

9. Our funding is subject to certain conditions, as set out in the 1992 Act. The Act allows us to add certain conditions to our funding including special conditions for particular HEIs. We will consult the sector on any material changes to general conditions *and summarise these and other changes in an annual update*.

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

11. We will review an institution's annual accountability returns to us and give to the accountable officer and governing body a confidential risk assessment. We will not make our risk assessments public until three years have elapsed. This period, based on advice from the Information Commissioner, gives an institution at higher risk time to address its problems. *We will make our risk assessments available within this time period, on an exception basis, to other public funders to enable those bodies to make their own assessments of risk and to the National Audit Office who may exceptionally need to discuss those assessments at the Public Accounts Committee. We must do this to minimise the risk to public funds distributed by those bodies. We may also make a risk assessment public at any stage if we have strong grounds for believing that it is in the public interest to do so. This would be because the institution was at short-term risk of financial failure or because it was not being effectively governed. We will only share or publish our risk assessments having notified the institution concerned in advance.* When we assess an institution to be 'at higher risk', we will engage with it in line with our institutional engagement and support strategy (see Annex D).

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

- faces threats to the sustainability of its operations either now or in the medium term
- has serious problems relating to propriety, regularity or value for money, or
- *has ineffective risk management, control or governance.*

More detail is given in Annex D, paragraph 8.

Institutions' responsibilities to HEFCE

13. HEFCE is the major public sector funder of HEIs as a whole and has lead public accountability for them. As a result, institutions need to provide certain information about their viability and the way they operate. *HEFCE is also now the principal regulator of HEIs under the Charities Act, and*

institutions have to supply information to enable us to fulfil this role. The information is summarised at Annex H and it largely draws on existing returns that institutions make.

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

15. *The responsibilities of governing bodies of HEIs and of individual members are summarised in Annex I. Taken together, the responsibilities of members of a governing body and of the governing body collectively are considerable and must be complied with. Members are trustees of charitable bodies and have the responsibilities and potential liabilities that go with trustee status. Members who act prudently, lawfully and in accordance with the governing instrument should not find themselves liable for their actions. However, HEFCE will use its powers and consider all options to ensure that members discharge their duties and are held to account for their actions and the Charity Commission has the power to take proceedings against trustees who have acted imprudently. Trustees need to be particularly careful when the institution is entering into substantial contracts or borrowings to ensure that the charity has the means to meet its obligations.*

16. *One situation in which HEFCE will designate an institution as at higher risk is if it has firm grounds for believing that a governing body is not discharging its duties and is unable or unwilling to commit to improvement. HEFCE would expect to arrive at such a judgement on the basis of an assessment of the institution's governance. In such a case, HEFCE would make its risk assessment known, because it would clearly be of public interest that a publicly funded body was subject to ineffective governance. HEFCE may place conditions of grant on the institutions that fail to address the risks of ineffective governance that puts public funding at risk.*

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

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

- has a robust and comprehensive system of risk management, control and corporate governance
- has regular, reliable, timely and adequate information to monitor performance and track the use of public funds
- plans and manages its activities to remain sustainable and financially viable
- informs us of any change in its circumstances which, in the judgement of the accountable officer, is a material adverse change, *as well as any significant developments that could impact on the mutual interests of the institution and HEFCE*
- uses public funds for proper purposes and strives to achieve good value for money from public funds
- complies with the mandatory requirements relating to audit, set out in our audit code and our annual accounts direction
- sends us:
 - the annual accountability returns
 - other information we may reasonably request to understand the institution's risk status

– any data requested on our behalf by the Higher Education Statistics Agency (HESA)

- has effective arrangements for the management and quality assurance of data submitted to HESA, HEFCE and other funding bodies (we reserve the right to use our own estimates of data where we have reason to believe institutional data are not fit for purpose). *Responsibility for the quality of data used for internal decision making and external reporting rests with the institution itself. Data submitted for funding purposes must comply with the directions published by HEFCE; if in doubt institutions should ask their HEFCE regional consultant to provide an authoritative, written ruling*
- considers our assessment of its risk status and takes action to manage or mitigate the risks we identify.

19. *The governing body and accountable officer of the institution must ensure that confidence can reasonably be placed in the soundness of the institution's present and likely future management of the academic standards of its awards and in the soundness of the institution's present and likely future management of the quality of the learning opportunities available to students.*

20. The governing body is responsible, under this Financial Memorandum, for the use of funds. To assist and enable it to discharge this responsibility and to provide clear accountability, the governing body will designate the head of the institution as the 'accountable officer'. On their appointment, HEFCE will write to the head of institution explaining what the responsibilities of an accountable officer involve.

21. *The accountable officer is personally responsible for ensuring that the terms of this Financial Memorandum are complied with and for providing clear assurances to this effect. In exceptional circumstances, if in HEFCE's view the accountable officer cannot be relied upon, HEFCE will explain its reasons and require the governing body to take steps to rectify the position. The governing body will need either to appoint a new head of institution or seek HEFCE's exceptional*

agreement to its accountable officer being an officer other than its head of institution. HEFCE's agreement to such an arrangement would need to come from its Board.

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

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

24. Institutions shall subscribe to HESA and the Quality Assurance Agency for Higher Education (QAA), and ensure that their use of JANET¹ and SuperJANET networks conform to acceptable practice and current legislation.

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

26. Institutions may only use Council funds for activities eligible for funding under the 1992 Act and other relevant legislation. This condition applies where the HEI passes on part of its HEFCE grant to another legally distinct entity – a 'connected institution' – for the provision of facilities or learning and teaching or for research to be undertaken. In such cases, as set down in Section 27 of the Teaching and Higher Education Act 1998, the institution must obtain the Council's consent before passing HEFCE funds to the connected institution. *Consent is also required where the institution passes on part of its grant (via a franchise or indirect funding agreement) to an institution that is neither an HEI nor FEC supported from public funds.*

Financial management and sustainability

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

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

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

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

- *the risks and affordability of any new on- and off-balance sheet financial commitments must be properly considered*
- *any commitments must be consistent with the strategic plan, financial strategy and treasury management policy*
- *the source of any repayment of any financial commitment must be identified and agreed at the point of entering any financial commitment*
- *the length of financial commitments must match the life of the underlying assets or other purpose being funded*

¹ See Annex J for definitions.

- *planned financial commitments must represent value for money.*

30. *Annex F sets out when an institution must get written consent from us and the information we need to assess requests. An institution should follow the principles set out above and determine a level of borrowing that is both affordable and consistent with its financial strategy. We ask the institution to demonstrate this in any case presented to us, show that the proposal represents good value and confirm that the approval of its governing body has been given. In responding to requests for consent we aim to be helpful and pragmatic, taking into account the circumstances of each proposal.*

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

Estate management and exchequer interests

32. Institutions should manage their estate in a sustainable way, in line with an estates strategy and the requirements of HEFCE's Capital Investment Framework. The strategy should be written with reference to guidance available to the sector, including that from HEFCE. *Institutions are required to have carbon management plans and the precise nature of this mandatory requirement will be finalised following our forthcoming consultation on the Capital Investment Framework. Performance against carbon management plans will be a factor in capital allocations from 2011, as requested by the Secretary of State in his 2009 grant letter to HEFCE.* Institutions should review their current and expected use of land and buildings, and consider rationalising and disposing of assets no longer needed. Former voluntary colleges and other institutions holding land and buildings not covered by exempt charitable status shall also take into account the requirements of the Charity Commissioners.

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

Diversity and equality legislation

34. *Institutions are subject to the public sector duties listed within the Race Relations (Amendment) Act 2000, the Disability Discrimination Act 2005 and the Equality Act 2006. These laws impose positive duties on all public bodies – including HEIs and HEFCE – to promote race, disability and gender equality in everything that they do. HEFCE has a statutory duty to monitor the sector for any adverse and differential impact on race, disability and gender equality arising from its policies and actions.*

Accountability and risk assessment

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

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

37. Institutions should send us their accountability information on the specified dates in December of each year. We will review this and give each institution a confidential, formal assessment of its risk status. For those we consider to be 'not at higher risk' – in our experience to date, the vast majority – save in the case of an unanticipated change in circumstances, there will be no need for further information or discussion of accountability

until the next year's return. Sometimes we will ask for more information to clarify uncertainties.

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

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

Revisions to the Memorandum

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

Annex A

Mandatory requirements of the Financial Memorandum and Accountability and Audit Code of Practice

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

2. The governing body must ensure that the institution meets its responsibilities as set out in the Financial Memorandum: *the governing body and accountable officer must comply with the general conditions of grant set out in this Financial Memorandum. They must also comply with any special conditions of grant. Save in a case where urgent action is required to safeguard public funds, special conditions of grant will only be imposed after HEFCE has consulted the institution about the conditions.*

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

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

5. *The governing body and accountable officer of the institution must ensure that confidence can reasonably be placed in the soundness of the institution's present and likely future management of the academic standards of its awards, and the present and likely future management of the quality of the learning opportunities available to students.*

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

7. Each HEI must have an effective audit committee which produces an annual report for the governing body and the accountable officer. The audit committee annual report must relate to the financial year and include any significant issues up to the date of preparing the report which affect the opinion. The audit committee annual report must

include the audit committee's conclusions on the adequacy and effectiveness of:

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

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

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

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

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

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

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

14. Subject to legislative constraints, the HEFCE assurance service must have unrestricted access to information – including all records, assets, personnel and premises – and can require anyone to give any explanation which it considers necessary to fulfil its responsibilities. This includes access to any work of the internal and external auditors, or correspondence between internal and external auditors. For access to external audit work, the HEFCE assurance service will exchange letters (where necessary) with both parties to deal with confidentiality and the terms under which access is given.

15. HEIs must not agree to any restriction in external auditors' liability in respect of the external audit of their annual financial statements, except as specified at Annex B, paragraph 100.

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

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

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

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

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

Annex B

Accountability and Audit Code of Practice

Executive summary

Purpose

1. This Code sets out our requirements for higher education institutions' (HEIs') accountability and audit arrangements and the broad framework in which they should operate. Its status is that of an annex to the Financial Memorandum and compliance with the Code is therefore a condition of grant.

HEFCE chief executive

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

Introduction

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

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

5. We also fund and have relationships with a number of related bodies. These are independent bodies established to assist HEFCE and the HE sector to deliver higher education strategy. Each

related body is required as a condition of its funding with HEFCE to conform to this Code as far as is appropriate and practical.

6. There are a number of mandatory requirements which are conditions of funding under the Financial Memorandum between HEFCE and HEIs. These are set out in Annex A of the Financial Memorandum.

7. We may update the Code on the HEFCE website at any time. We will consult sector stakeholders about significant changes, particularly where they affect mandatory requirements. We may also supplement the Code with occasional circular letters specifying guidance and requirements. They will be developed in consultation with the representative bodies in higher education, and will be incorporated into any subsequent revision of the Code.

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

9. The Code is primarily for use by internal and external auditors, HEIs' senior management, members of the governing body and audit committees. It may also be of interest to other stakeholders. More detailed advice on any aspect of the Code is available from the HEFCE assurance service.

Corporate governance

10. The corporate governance arrangements of an HEI are the means by which strategy is set and monitored, the executive is held to account, risks are managed, stewardship and trustee responsibilities are discharged, and sustainability is ensured. A more complete description of corporate governance in an HEI can be found in the guide by the Committee of University Chairs (CUC) – 'Guide

for members of higher education governing bodies in the UK' (HEFCE 2009/14). The responsibilities of a governing body as to conditions of HEFCE funding can be found in the Financial Memorandum.

11. The CUC Guide includes a Governance Code of Practice, against which CUC and HEFCE commend institutions to evaluate themselves. The principle should be that institutions 'comply or explain' and the outcome of each periodic evaluation should be published, ideally in the Corporate Governance Statement or Statement on Internal Control in the published financial statements.

Higher education audit framework

12. In accordance with the Financial Memorandum, HEIs must have effective risk management, control and governance arrangements. Other funding bodies also have an interest in these control arrangements, including Parliament, BIS, the Learning and Skills Council (LSC) *and its successor bodies, the Students Loan Company (SLC)*, Research Councils UK, the Department for Employment and Learning (DEL) in Northern Ireland, and the Training and Development Agency (TDA) for Schools.

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

Parliament

14. Parliament's interest is to see that public funds are properly applied and accounted for and used economically, efficiently and effectively by recipients. The Comptroller and Auditor General (CAG), head of the National Audit Office, is the external auditor of HEFCE. The CAG has the right

to inspect the accounts of any HEI that receives HEFCE grant, and the right to carry out value-for-money (VFM) investigations. The National Audit Office is selective in its use of inspection rights: much of its audit work is undertaken at HEFCE, and VFM investigations normally involve only a sample of institutions at any one time.

Department for Business, Innovation and Skills

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

HEFCE

16. Under the Financial Memorandum with BIS, HEFCE's chief executive is accounting officer for the funds received from BIS and is accountable to Parliament for them. This applies both to money we spend directly on our own operations and to money spent by the HEIs and other entities that receive HEFCE funds. *Accordingly, HEFCE operates an internal audit function and a separate team that is responsible for monitoring institutions. This team (the HEFCE assurance service) operates our regulatory framework, undertakes audit work in institutions and assesses institutional risk.* Both the institutional work and HEFCE's internal audit are carried out in accordance with professional audit standards. In common with the arrangements in HEIs, there is an audit committee to assist the HEFCE chief executive and board in discharging their accountability and audit responsibilities, both in respect of HEFCE and of HEIs and other entities.

17. The governing body of an HEI is responsible for ensuring the proper use of public funds. Under the Financial Memorandum with HEFCE the governing body is required to designate a principal

officer known as the accountable officer. The governing body will, unless agreed exceptionally by HEFCE, designate the institution's vice-chancellor, principal or equivalent to this role. He or she should satisfy the governing body in respect of the use of public funds, and may be required to appear before the Public Accounts Committee of the House of Commons, alongside HEFCE's chief executive, on matters relating to the use of HEFCE funds. The chair of the governing body may also be required to appear before the Public Accounts Committee.

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

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

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

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

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

20. *We provide the following guidance about what should be notified to HEFCE although the list is not exhaustive and the accountable officer may judge that there are other circumstances that warrant notification:*

- *any financial loss or reduction in income or working capital which is significant enough to*

materially impact on the financial outturn or the cash position

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

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

Other public bodies

22. All HEIs receive and process funds from the SLC and many receive funds from the LSC or the TDA, who therefore also have an interest in their management and accountability. To avoid unnecessary duplication, the SLC, LSC and TDA will rely on the accountability and audit framework set out in this Code. They are not directly involved in auditing HEIs, except that they may occasionally request specific audit work to be undertaken in accordance with their own funding conditions. HEFCE and these bodies have formal protocols for this work.

General principles for internal and external auditors

Duties

23. These general principles for auditors are intended to supplement, not replace, those issued by the recognised professional bodies (including the Ethical Standards issued by the Auditing Practices Board), which we expect auditors to follow as well. The principles set out our requirements for the standards for HEIs' internal and external auditors, and are the standards to which our own auditors operate, in recognition of the high level of probity demanded where public funds are involved.

Objectivity

24. Auditors should ensure that the HEI's audit committee is appropriately informed on a timely basis of all significant facts and matters that bear upon the auditors' objectivity and independence. In particular, auditors should avoid the following:

- official, professional and personal relationships which might cause the auditor to limit the extent or character of the audit
- any responsibility for the executive management of the HEI
- any interest, financial or non-financial, direct or indirect, in the HEI (other than the normal employee or contractor relationship, or the funding of any prize, scholarship or academic appointment).

25. Notwithstanding the need for objectivity, the external and the internal auditors of an HEI should aim to ensure that their work programmes complement each other to optimise the effectiveness of their services.

Dual appointments

26. Provision of both internal audit and external audit services to an HEI by the same firm or provider is not permitted under this Code, because this compromises auditors' objectivity. The only permitted exception is where an external auditor carries out a limited amount of (typically specialist) work in support of the internal audit service, and the extent of this should be monitored by the audit

committee. Further guidance on this subject can be found in Ethical Standard 5 of the Auditing Practices Board.

27. External auditors need to form a view on the quality and coverage of the internal auditors' work, to determine the extent to which they can rely on this to underpin their own work. It is not acceptable for a firm to provide an opinion as external auditor about the same firm's work as internal auditor. Governors and managers need such opinions to be objective and independent. It is also useful to governors and managers to obtain two independent views on risk management, control and governance, reflecting the different perspectives of internal and external auditors.

Due professional care

28. Internal and external auditors are expected to exercise due professional care in their work and should refer to the published standards of their professional bodies (Institute of Chartered Accountants in England and Wales, Association of Chartered Certified Accountants, Chartered Institute of Public Finance and Accountancy, Institute of Internal Auditors) for further guidance.

Audit and risk assessment of HEIs by the HEFCE assurance service

Role and scope

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

30. All the activities of HEIs are within the remit of HEFCEAS. HEFCEAS works in accordance with the standards for internal audit in the Government Internal Audit Standards issued by the Treasury, and guidance from relevant professional auditing and

accountancy bodies. It will consider whether risk management, control and governance arrangements are adequate to manage risk and to secure propriety, efficiency, economy and effectiveness in all areas. It will seek to confirm that management has taken the necessary steps to achieve these objectives.

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

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

Reporting

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

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

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

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

- report on coverage achieved
- provide audit performance measures.

Ongoing risk assessment

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

Annual accountability assessment

37. Every year HEFCE will assess the extent to which each HEI's audit and related reports, supported by any other relevant information, demonstrate the effectiveness of risk management, control and governance arrangements. The work will take place after receipt of HEIs' financial statements and other audit returns (the annual accountability returns exercise). The conclusions from the assessments will be taken into account when HEFCE makes its overall risk assessment of each HEI, and will be reflected in the resultant annual letter notifying our risk assessment to the HEI's accountable officer. Where HEIs' reports are not provided to us, or where they reveal inconsistencies or other concerns, we will take appropriate action. This may include the HEFCE assurance service undertaking audit work or asking for audit work to be done.

38. The specific sources of assurance that influence our assessment include the financial statements and the reports of the audit committee and the internal and external auditors: the detailed requirements for these will be published each year. In addition we will require an annual assurance return from the accountable officer which confirms compliance with the Financial Memorandum (see Annex E to the Financial Memorandum). It should be noted that a specific assurance on data quality is required as part of this return.

HEFCE audit work in institutions

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

40. In adopting a risk-based approach, HEFCE will need to undertake more frequent reviews or conduct different sorts of enquiries if an institution does not meet its obligations under this Code or gets into difficulty. There are a range of possible HEFCE engagements with institutions at risk, and these are set down in our institutional engagement and support strategy.

Data assurance

41. HEIs are required to supply us with data to inform our allocations of funding generally and in response to specific initiatives and responsibility for the reliability and accuracy of that data rests with the institutions alone. To avoid duplication we will wherever possible use data that are already supplied through HESA or HESES.

42. *Within HEFCE, our institutional teams monitor the reasonableness of data and our analysts undertake verification, validation and reconciliation work. We also undertake limited, periodic, data audits in each institution. These assurance arrangements do not absolve HEIs from their ultimate responsibility for the integrity of data.*

Regularity, propriety and value for money

43. There is an underlying duty of care to ensure that public funds are spent on the purposes for which they are intended, that propriety is ensured and that good value for money (VFM) is obtained. This duty falls on HEFCE and on the HEIs that we fund. Further guidance on VFM is provided in guidance on the HEFCE web-site.

Audit committees in HEIs

Scope

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

Operation

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

46. HEFCE's position is that governing bodies and audit committees should conduct themselves in line with the CUC's principles and practices, and that where they believe they differ in any material respects then this should be explained and made public. Overall we aim to be content to rely on the accountability provided by an audit committee following CUC practice and by a governing body able to exercise accountability on behalf of external investors. We therefore support the principle of an external majority on an HEI governing body.

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

Reporting

48. The audit committee must produce an annual report for the governing body and the accountable officer. The audit committee annual report must cover the financial year and include any significant issues up to the date of preparation of the report.

The audit committee annual report should normally be submitted to the governing body before the members' responsibility statement in the annual financial statements is signed. The internal auditor's annual report as well as the audit committee report must be submitted to HEFCE according to the timetable to be published annually in a circular letter. This informs our institutional risk assessment.

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

- risk management, control and governance
- economy, efficiency and effectiveness (value for money)
- management and quality assurance of data submitted to HESA and to HEFCE and other funding bodies. This latter assurance is to ensure adequate governance oversight of the systems used to generate funding data by the HEI since poor data may represent a significant financial risk for HEIs that audit committees need to consider. *This assurance requirement was initially introduced for a limited period but has now been extended indefinitely.* Further guidance for audit committees on data assurance can be found on the HEFCE website, www.hefce.ac.uk under Finance & assurance/Assurance and institutional risk/Guidance/Audit arrangements.

50. The audit committee opinions should be based on the information presented to the committee. The data management assurance does not require audit committees to verify data: that is the responsibility of management. The audit committee's interest should be in the management and quality assurance of data. Standards which can be used in audit or management evaluations are published in Appendix 1 of 'Improving information to support decision making: standards for better quality data' published by the Audit Commission in November 2007². Such evaluations can be used to inform the audit committee.

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

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

52. The report might also identify any key issues for the HEI arising out of its activity over the year.

Internal audit arrangements in HEIs

53. Each HEI is required by its Financial Memorandum with HEFCE to have an internal audit function.

54. Internal audit should follow a risk-based approach. The introduction of risk management in the sector, following the adoption of the revised Combined Code and associated principles from other sectors, has brought considerable change in the approach to governance, management and internal audit – moving away from a purely systems-based approach to one which primarily reflects inherent and perceived risk. *It is still essential, however, for internal auditors to be able to support management and governing bodies by providing fundamental assurance about the key elements of internal financial control.*

55. HEFCE guidance on internal audit practice in HEIs is that we endorse the approach set out in the Code of Ethics and International Standards (March 2004)³ of the Institute of Internal Auditors (IIA) and that organisation's 'Position statement on the role of internal audit in enterprise-wide risk management' (September 2004)⁴. Accordingly, we do not include in this Code detailed guidance on the practice of internal audit.

56. Within the HE sector, the prime responsibility of the internal audit service is to provide the governing body, the accountable officer and the other managers of the HEI with assurance on the

² Available at www.audit-commission.gov.uk under Reports and publications/Audit Commission reports.

³ Available at www.theiia.org under Standards & Practices/Code of Ethics.

⁴ Available at www.theiia.org under Standards & Practices/position papers.

adequacy and effectiveness of risk management, control and governance arrangements.

Responsibility for these arrangements remains fully with management, who should recognise that internal audit can only provide 'reasonable assurance' and cannot provide any guarantee against material errors, loss or fraud. Internal audit also plays a valuable role in helping management to improve risk management, control and governance, thereby reducing the effects of any material adverse risks faced by the HEI.

57. Internal audit can also provide independent and objective consultancy advice specifically to help management improve risk management, control and governance, thereby contributing to the achievement of corporate objectives. Such advisory work contributes to the opinion which internal audit provides on risk management, control and governance although care should be taken to ensure it does not compromise the auditor's independence.

Operation

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

- The HEI's objectives are achieved as far as possible and associated risks are managed.
- The economic, efficient and effective use of resources is promoted.
- There is adherence to management's policies, directives and established procedures, and compliance with any relevant laws or regulations including charities legislation.
- The HEI's assets and interests are safeguarded – particularly from losses arising from fraud, irregularity or corruption.
- As far as reasonably practicable, the integrity and reliability of accounting records, data and other information is maintained. This includes data supplied to HESA, HEFCE and other funding bodies.

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

responsibilities for other bodies. It should cover all activities associated with the institution, including those not funded by HEFCE. For example, it should consider controls that protect the HEI in its dealings with any subsidiary or associated company or student union, or any other activity in which the HEI has an interest. In following a risk-based approach the internal auditors will undertake whatever work they and their accountable officer judge necessary to provide assurance on the management and quality assurance of data, as determined by where data is positioned in the overall institutional risk register or equivalent.

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

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

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

have unrestricted access to all records, assets, personnel and premises, and be authorised to obtain whatever information and explanations are considered necessary by the head of the internal audit service.

Reporting

63. The reporting requirements for any internal audit service are discussed in Government Internal Audit Standards and in IIA standards. It is a requirement of this Code that the internal audit service produce an annual report of its activities. The internal audit annual report must relate to the financial year and include any significant issues, up to the date of preparing the report, which affect the opinion. This should be addressed to the governing body and the accountable officer, and should be considered by the audit committee. The audit committee may forward the report to the governing body with its own report. The report must be submitted to HEFCE after it has been considered by the HEI's audit committee.

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

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

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

Provision of service

66. There are a variety of ways to acquire an internal audit service and we do not favour one approach above the others. One option is to appoint a head of internal audit and staff as necessary. An 'in-house' team may also be

supplemented at a variety of levels by external consultants or contractors, under the direction of the head of internal audit, for instance to meet peaks in workload or to provide specialist skills.

67. Another option is to form a consortium with one or more HEIs, on a geographical or common interest basis. A consortium may be organised in-house, be provided externally or as a mixture of the two. A number of HEIs have set up such consortium arrangements.

68. A third option is to contract directly with an external provider, such as another HEI or an accountancy firm.

69. Each HEI, advised by its audit committee, should establish which is the most suitable and cost-effective way of obtaining internal audit services. However, every five years at least, it should consider market testing internal audit services where those services are provided by outside contractors, since this provides a powerful incentive to maintain quality and cost-effectiveness. Where internal audit is an in-house service, there should be periodic consideration of whether this continues to be the appropriate type of provision for the institution.

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

Removal or resignation of auditors

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

72. Where internal auditors cease to hold office for any reason, they should provide the governing body with either a statement of any circumstances connected with their removal which they consider should be brought to the governing body's

attention, or a statement that there are no such circumstances. The internal auditors may also request an extraordinary general meeting of the governing body to consider the statement. Any such statements should also be sent to the HEFCE assurance service by the HEI – or, if it fails to do so, by the outgoing internal auditors.

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

Restriction of auditors' liability

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

Fraud and corruption

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

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

Relationship with other auditors

77. There should be regular liaison between internal auditors and the HEI's external auditors to optimise the service provided to the HEI. External auditors should be given access to the internal audit service's working papers and plans so that their work programmes can be adjusted accordingly, and so that the extent of their reliance on the work of the internal audit service can be determined.

78. Copies of the internal audit service's reports should be available to the external auditors. The internal audit service should also receive copies of the external auditors' plans and management letters, and any other relevant reports produced for the HEI by other agencies. HEFCE must be allowed access to any work of the internal auditor, including the annual report, or correspondence between the internal and external auditors.

External audit arrangements in HEIs

Introduction

79. Institutions in the sector are expected to follow the Statement of Recommended Practice (SORP): accounting for further and higher education published by Universities UK, and the accounts direction published as a circular letter every year by HEFCE. The 2007 SORP introduced a requirement for an operating and financial review, and institutions are encouraged to use this as an opportunity to demonstrate their effectiveness, accountability and performance.

Role of external auditors

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

81. We accept that we are not the direct client of the external auditor and that the auditor does not have a ‘private law’ duty of care to us. However, we require that external audit engagements in the sector meet the requirements of this Code *and that this is reflected in the external audit engagement letter.*

Qualification of external auditors

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

Selection criteria and procedures

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

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

Additional services

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

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

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

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

Letter of representation

88. *In order to undertake their work, external auditors seek from management a letter of representation providing details of any material changes that need to be brought to the auditors’ attention to enable them to complete their work in an effective manner. HEFCE recommends that auditors satisfy themselves that management have provided all necessary evidence to confirm any potential significant adjustments to past or future HEFCE funding.*

Management letter

89. External audit should report to the institution by way of a management letter which highlights any significant accounting and control issues arising from the audit. The HEI’s management should provide written responses to any recommendations made or issues raised. The Code is not prescriptive about the format or title of a management letter, but it should enable the HEFCE assurance service to see what observations have been made about the internal control system and how management has responded.

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

91. The letter, with management responses, must be made available to the HEI’s audit committee in time to inform the committee’s annual report. HEIs must send a copy of the final management letter

(incorporating management responses) to the HEFCE assurance service according to the timetable published annually in a circular letter. External auditors should attend audit committee and/or finance committee meetings at which the audited financial statements are discussed, and attend governing body and other meetings when appropriate.

Audit report

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

- a. The financial statements give a true and fair view of the state of the HEI's affairs, and of its income and expenditure, recognised gains and losses, and statement of cash flow for the year. They should take into account relevant statutory and other mandatory disclosure and accounting requirements, and HEFCE requirements.
- b. The financial statements comply where appropriate with the Statement of Recommended Practice (SORP) on Accounting in Further & Higher Education, and the Companies Acts (where the HEI is incorporated under the Companies Act), and/or other legislative or regulatory requirements.
- c. Funds from whatever source administered by the institution for specific purposes have been properly applied to those purposes and, if relevant, managed in accordance with relevant legislation.
- d. Funds provided by HEFCE have been applied in accordance with the Financial Memorandum and any other terms and conditions attached to them. In particular, auditors should have regard to the specific requirements of the Financial Memorandum, such as compliance with the short-term and long-term borrowing conditions.

93. HEFCE publishes as a circular letter an annual accounts direction and institutions and their external auditors are required to conform to it. The accounts direction summarises and updates HEFCE's financial reporting requirements.

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

Reappointment of external auditors

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

Removal or resignation of auditors

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

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

meeting and to be heard on any part of the business which concerns them as former auditors of the HEI.

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

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

Restriction of auditors' liability

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

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

HEFCE access to external auditors

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

Annex C

Allocating and paying funds

1. Each year we determine how much money to allocate to each institution. In doing so we may distinguish between recurrent and capital funds, and between formula capital and project capital.
2. Higher education institutions (HEIs) should use this money only for the proper purposes, as defined in the Further and Higher Education Act 1992 or other relevant legislation.
3. The above condition applies if an HEI passes on money to another body or organisation to provide education, research or related activities. The HEI remains responsible for controlling such activities. There should be a written agreement with the other body covering financial accountability and quality assurance. However, this is not necessary if the other body is an HEI or HEFCE agrees to the arrangement.
4. Sometimes we pay funds to an HEI or further education college (FEC) as the lead institution for a consortium of universities and colleges. In such cases, there should be a consortium agreement setting out how the money is passed on to the consortium members. Guiding principles for agreements are published in HEFCE 00/54.
5. An institution must use specific or capital funding for those purposes only. If it uses them for other purposes, it must let us know as soon as it becomes aware of the fact.
6. We will tell institutions their allocation of formula funds as soon as we can in advance of the academic year to which they relate: normally by 31 March. We will normally pay such funds in monthly instalments. The profile of payments will take into account the expected needs of the sector as a whole and the receipt of tuition fees from students and the Student Loans Company.
7. We will pay formula funding for widening access and improving retention only where institutions have sent us widening participation strategies and action plans that we find acceptable.
8. We will consider requests from individual institutions to alter the profile of payments, provided that such payments are not in advance of the institution's need to spend the money.
9. Our capital grants are administered through our Capital Investment Framework. Institutions that meet the framework requirements will have discretion over the use of capital funds in line with their estates' strategies. We will continue to require other institutions to send us details of capital programmes and projects to which we may contribute costs, in line with criteria we set. We will set out conditions for such grants and agree a payment profile with the institution. All institutions are expected to work towards satisfying the requirements of the Capital Investment Framework.
10. We will require an institution to repay part or all of a grant payment if it does not comply with the conditions we attach to the grant or if it is found to be over-funded as a result of our audit and reconciliation work. We may reduce or withdraw funding from an HEI or FEC that fails an audit re-inspection by the Quality Assurance Agency for Higher Education. In these cases we may require the institution to pay interest, at 2 per cent above the Bank of England base rate, for the period before it repays the funding to us.
11. If we overpay grant as a result of using estimated data, we will recover the amount overpaid, plus interest, as set out in the previous paragraph.

Annex D

Institutional engagement and support strategy

Introduction

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

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

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

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

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

Normal contact

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

Focused dialogue

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

Support strategy

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

7. Through these annual returns or our regular contact with an institution or RB, there may be issues that require further discussion. All institutions face business and operating risks. The

issue is therefore about managing risk; putting in place systems to identify, mitigate and report on risk. In many cases, as a result of further discussions, we will conclude quickly there is no cause for concern.

8. *We will consider an institution or RB to be at higher risk if there are significant concerns in one or more of the following areas:*

- *financial position or prospects for sustainability*
- *cash position or liquidity*
- *levels of on- and off-balance sheet financing*
- *student recruitment and the student experience*
- *reliability or use made of the institution's systems of financial control*
- *assessments of teaching or research quality*
- *rates of student non-continuation and/or non-completion*
- *management and governance processes*
- *risk management*
- *management and sustainability of the organisation's infrastructure including its estate and information systems*
- *overall market position and strategic direction*
- *non-compliance with the Financial Memorandum – including the requirements to use funds for the purposes intended, to provide data that have been subject to effective management and quality assurance, and to meet HEFCE's annual accounts direction*
- *value for money*
- *propriety in the use of funds*
- *public accountability.*

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

sets out the range of possible actions, though sometimes we will agree a different approach with an HEI or RB.

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

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

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

Possible HEFCE actions

Overall

We may require institutions to make changes as conditions of grant if we feel that risks to our funding and the interests of students and the public are not being addressed. We will only do so after due consideration and consultation and only on the basis of appropriate advice. Thus it will always be our intention to make only reasonable demands of institutions. If institutions do not comply with conditions of grant we will take steps to enforce compliance or withhold funds.

In addition to the actions below we will consider any other action that we believe is necessary to support institutions at risk and protect the interests of the public and the taxpayer.

At governor and senior manager level we will:

- Engage with senior management, including the accountable officer.
 - Assess the accountable officer's compliance with the Financial Memorandum, including the requirement to have effective management and quality assurance arrangements over data supplied to the Higher Education Statistics Agency, HEFCE and other funding bodies.
 - Inform the governing body of our change in risk assessment and seek commitments to improvement. *We will notify other public funders, as appropriate, of any ‘at higher risk’ assessment, and exceptionally we will make such an assessment public at any time where we consider it to be the public interest to do so.*
 - Engage *directly* with the chair of the board and/or chair of the audit committee.
 - Engage with the whole governing body and, *if necessary, take steps to ensure improvements are made to governance arrangements.*
 - *Require* observer status at governing body or audit committee meetings. *This could be for individual meetings or over a period of time. Our observer will always be a senior HEFCE officer.*
 - Request the appointment of interim managers.
-

Regarding information and audit we may:

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

Regarding planning and strategy we may:

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

Regarding funding we may:

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

As risks decline we will:

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

Annex E

Annual assurance return from institutions

This return is to be submitted as part of the annual accountability returns exercise return, the timetable for which will be specified annually in a circular letter. The purpose of the return is to confirm that the institution has met its obligations to HEFCE under the Financial Memorandum. The return should be signed by the accountable officer and should be copied to the institution's governing body.

Institution
Year ended
Return completed by accountable officer (enter name of head of institution)
Can you confirm that in this period the institution has met its responsibilities to HEFCE (conditions of grant) as set out in the Financial Memorandum?	
Have there been any changes of senior officer in the period that have not been notified to HEFCE, including the chairs of the governing body and audit committee and the heads of finance and internal audit?	
Have there been any material adverse changes that should have been notified during the period that now need to be brought to our attention in line with paragraph 18 and Annex B, paragraphs 18-21, of the Financial Memorandum? If so, please provide details.	

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

Signed

Dated.....

Annex F

Consent for financial commitments

Introduction

1. Institutions are required to obtain consent as set out below. The framework is designed to be risk-based and light touch and to reflect the complexity of financing arrangements that are available to the sector.

Requirements for consent

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

a. Long-term commitments –

- where an institution is informed that it is ‘at higher risk’
- where its total financial commitments would exceed 50 per cent of income (gearing)
- where an institution’s cash debt service cover is below 1.5 (except where there is sufficient net liquidity to meet debt servicing costs over the forecast period)
- where an institution’s cash interest cover from net operating cash flow is below 2 (except where there is sufficient net liquidity to meet interest payments over the forecast period).

b. Short-term financial commitments –

- where negative net cash exceeds 5 per cent of total income for more than 35 consecutive days or where an institution is informed that it is ‘at higher risk’.

Definitions

3. The terms used in our requirements above are defined as follows:

Total income

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

Cash debt service cover

Ratio of net operating cash flow to capital and interest payments.

Cash interest cover

Ratio of net operating cash flow to interest payments.

Net operating cash flow

Net cash inflow/(outflow) from operating activities as reported in the cash flow statement. This should be calculated on a three-year rolling average.

Short-term commitments

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

Long-term commitments

‘Long-term financial commitments’ refers to amounts which are due for payment after more than 12 months, in accordance with generally accepted accounting practice (GAAP). These include:

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

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

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

Consent is not required if refinancing existing commitments results in lower gearing.

Our response

5. The Council will try to give a response to a request for consent within 15 working days of the receipt of all relevant information. Where the proposed gearing for **long-term financial commitments** is above 75 per cent of income or the institution is ‘at higher risk’, approval must come from the HEFCE Board. This will extend the period needed by us to deal with the request and institutions should discuss this with us when they are planning to seek consent. We accept, however, that very occasionally an institution may need to get a faster response, in which case it should discuss this with us at an early stage in developing its plans.

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

Information required

7. We set out in Table 1 the information we require to consider a request for consent. This addresses the issues we would expect the institution's own

governing body to seek assurance on before approving additional financial commitments. The main focus is on affordability and risk, not necessarily on the individual project.

Table 1 **Information required by HEFCE to consider a request for consent for new financial commitment(s)**

Long-term financial commitments

1. There should be a reasonable case for the new investment.

Information required:

- a. Brief description of the new investment.
- b. An explanation of how it broadly fits with the institution's mission and strategic priorities.
- c. Confirmation that the institution has followed HEFCE guidance on appraising investment decisions.

2. The new financial commitment or refinancing arrangement should be consistent with the institution's financial strategy and represent good value for money.

Information required:

- a. An explanation of why additional finance or refinancing is necessary and how this fits with the financial strategy.
- b. The forms of finance considered and the selection process and criteria.
- c. The net present value for each financing option and a brief explanation of why the chosen method was selected.

3. Details of the new financial commitments.

- a. Details of the chosen option, including: name of lender, sum borrowed, loan period and basis of repayment.
- b. Terms and conditions of the financing (for example, a copy of the offer letter) and an evaluation of the risks and uncertainties.

4. The new investment and financial commitments must be affordable.

Information required:

An update of the latest financial forecasts, to include the impact of the new investment and financial commitments, and demonstration that they are affordable. This update must include any other material changes in the institution's financial prospects, including guarantees to third parties.

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

Information required:

- a. Details of when the governing body approved the new investment and financial commitments and a minute of the decision reached.
- b. A summary of the information the governing body received in reaching its decision.

6. Details of the new threshold.

Information required:

- a. Details of continuing financial commitments (including the lender, loan term and gearing level) and of the new financial commitment.
- b. The revised threshold (in £) and the period for which this is required.

Short-term financial commitments

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

Information required:

- a. Brief description of why increased short-term finance is necessary, and how this fits with the financial strategy.
- b. Cash flow forecasts which show the need for the increased borrowing.
- c. The forms of finance considered and the selection process and criteria.
- d. Brief explanation of why short-term finance was selected.

2. Details of the new financial commitments.

- a. Details of the arrangement, including: name of lender, sum borrowed, loan period and basis of repayment.
- b. Terms and conditions of the arrangement (for example, a copy of the offer letter) and an evaluation of the risks and uncertainties.

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

Information required:

- a. Details of when the governing body approved the arrangements and a minute of the decision reached.
- b. A summary of the information the governing body received in reaching its decision.

4. Details of the new threshold.

Information required:

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

HEFCE guidance that may be helpful

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

- 'Financial strategy in higher education institutions' (HEFCE 2002/34)
- 'Investment decision making: a guide to good practice' (HEFCE 2003/17)
- 'Practical guide to PFI for higher education institutions' (HEFCE 2004/11)
- 'Guide for Members of Higher Education Governing Bodies in the UK' (HEFCE 2004/40)
- 'Borrowing in the higher education sector: 2004 update' (HEFCE 2004/44).

Annex G

Exchequer interests

Introduction

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

Requirements

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

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

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

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

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

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

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

8. As repayment of exchequer interest is a remote event contingent upon the occurrence of what are likely to be exceptional circumstances (see below), it does not need to be disclosed as a contingent liability in the institution's annual accounts.

Circumstances in which the exchequer interest becomes repayable

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

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

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

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

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

13. This second trigger has been designed to ensure that HEIs are not discouraged from generating

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

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

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

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

Annex H

Information requirements for charities compliance

This annex will be added after a consultation has concluded on how higher education institutions are to provide information to HEFCE to enable us to fulfil our new statutory role as principal regulator of HEIs as charities ('Regulating higher education institutions as charities: Consultation on HEFCE's information requirements as principal regulator', HEFCE 2009/45).

Annex I

Summary of responsibilities of members of governing bodies

Introduction

1. HEFCE is the lead public funder of higher education institutions and also acts in the interests of fee-paying students. HEFCE requires the institutions that it funds to have high standards of corporate governance.

HEFCE corporate governance requirements

Financial Memorandum

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

Legislative obligations

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

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

HEFCE is **not empowered to enforce** these laws directly but will consider major legal breaches to be potentially failures of corporate governance.

Trustees and directors

4. Members of governing bodies are charitable trustees and, in some cases, directors of companies. Those members who are not company directors are in an analogous position to company directors. As such, HEFCE requires compliance with the charities and companies acts (by analogy in the case of members of an HEI which is not a company incorporated under

the Companies Acts). In particular, HEFCE requires trustees to discharge their duties of prudence (including to ensure financial solvency) and care. HEFCE will report material non-compliance with trustee obligations to the Charity Commission. Regardless of the legal form of their HEI, HEFCE also requires members to comply with the duties detailed in chapter 2 of part 10 of the Companies Act 2006 (applied with any necessary modifications to reflect the particular status of an HEI).

Constitutional requirements

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

- manage the finances of the institution in order to ensure solvency and sustainability
- appoint and supervise and, if necessary, suspend or dismiss the vice-chancellor or principal
- ensure the welfare of students
- determine and oversee the academic character and policy of the institution, as appropriate in conjunction with the senate.

HEFCE will **exceptionally enforce** these requirements by using its power to make conditions of grant to ensure that these obligations are met.

Good governance

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

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

Members' conduct

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

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

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

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

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

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

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

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

Governance evaluations

9. HEFCE expects governing bodies to undertake periodic independent reviews of their effectiveness and to produce reports and action plans for improvement that are made public.

Annex J

Definitions and abbreviations

1992 Act	Further and Higher Education Act 1992
CAG	Comptroller and Auditor General
Capital expenditure	Expenditure used to create or purchase a new asset, replace an existing asset, or refurbish or remodel an existing asset
Combined Code	'The Combined Code on Corporate Governance', July 2003, Financial Reporting Council
CUC	Committee of University Chairs
Governance Code of Practice	'Guide for Members of Higher Education Governing Bodies in the UK: Governance Code of Practice and General Principles' (HEFCE 2009/02)
DEL	Department for Employment and Learning in Northern Ireland
Accountable officer	Head of an institution responsible and accountable to HEFCE (and ultimately to Parliament) for ensuring that the institution uses HEFCE funds in ways that are consistent with the purposes for which those funds were given, and complies with the conditions attached to them. These include the conditions set out in the Further and Higher Education Act 1992 and in this Financial Memorandum
BIS	Department for Business, Innovation and Skills
FEC	Further education college
FRS	Financial Reporting Standard
Governing body	The university council, board of governors or other body ultimately responsible for the management and administration of the institution's revenue and property, and the conduct of its affairs
HE	Higher education
HEFCE	Higher Education Funding Council for England
HEFCEAS	HEFCE assurance service
HEI	Higher education institution
HESA	Higher Education Statistics Agency
IIA	Institute of Internal Auditors
JANET	High-speed computer network supported by the seven higher and further education funding bodies, which links universities and colleges in the UK. SuperJANET is the enhanced network
Legally distinct entity	An organisation receiving HEFCE grant funding from an HEI to which it is accountable, but operating independently from that HEI
LSC	Learning and Skills Council
NAO	National Audit Office
QAA	Quality Assurance Agency for Higher Education

RB	Related body (a non-HEI/FEC body through which significant levels of HEFCE funding are distributed or activities promoted)
Secretary of State	Secretary of State for Business, Innovation and Skills
Annual accountability returns exercise	A streamlined accountability process between HEFCE and institutions, linked to an assessment of institutional risk, which comprises an exchange of documents and dialogue during a specific period each year
SLC	Student Loans Company Limited
the Code	Accountability and Audit: HEFCE Code of Practice
TDA	Training and Development Agency for Schools
VFM	Value for money

1. References to the **financial position, financial statements, financial commitments or borrowings** of the institution mean the consolidated financial position, financial statements, financial commitments or borrowing of the institution and its subsidiary undertakings, as defined in the Companies Act 1985 and revised by the Companies Act 1989 and 2006, and in accordance with generally accepted accounting principles.
2. **Shall** and **must** denote mandatory requirements, and **should** denotes our view of good practice.

Appendix B

Consultation questions on the Financial Memorandum

Please complete the electronic version of this form, which can be downloaded from the HEFCE web-site, www.hefce.ac.uk, alongside this document under Publications. Text boxes may be expanded to the required length and 'Yes/No' should be deleted appropriately. Please e-mail the completed form as an attachment to fmcodeconsultation@hefce.ac.uk by **Friday 5 March 2010**.

Consultation question 1: Do you agree that the term 'accountable officer' should replace that of designated officer, and with the arrangements being proposed for the approval of accountable officers?

Yes/No

Comments

Consultation question 2: Do you agree that the FM should consider the responsibilities and duties of governing bodies and their members more fully?

Yes/No

Comments

Consultation question 3: Do you agree that the subject of academic standards should be introduced into the FM?

Yes/No

Comments

Consultation question 4: Do you accept our proposal for a new long-term borrowing framework?



Yes/No

Comments

Consultation question 5: Are there any other aspects of the new FM that you would like to comment upon?

Yes/No

Comments



**Higher Education Funding Council for England
Northavon House
Coldharbour Lane
BRISTOL
BS16 1QD**

**tel 0117 931 7317
fax 0117 931 7203
www.hefce.ac.uk**