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Cylchlythyr | Circular

Consultation on Financial Memorandum: Responses

Date:	21 December 2015
Reference:	W15/31HE
To:	Heads of higher education institutions in Wales Principals of directly-funded further education colleges in Wales
Response by:	No response required
Contact:	Name: Matt Lody Telephone: 029 2068 2306 Email: matt.lody@hefcw.ac.uk

This circular provides an overview of the responses received to the circular 'Consultation on revisions to the financial memorandum' (W15/16HE), setting out our responses to those points as well as the changes made as a result.

The circular also introduces the new Financial Memorandum under the name 'Memorandum of Assurance and Accountability'.

The Memorandum of Assurance and Accountability is effective from 24 December 2015.

If you require this document in an alternative accessible format, please telephone us on (029) 2068 2225 or email info@hefcw.ac.uk.

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Overview of consultation

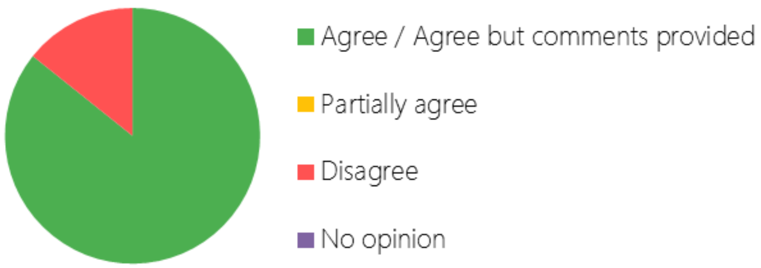
1. The consultation on revisions to the Financial Memorandum ran between 17 July 2015 and 7 September 2015. Seven responses were received to the consultation. We accepted two further responses after 7 September 2015 which expanded upon earlier responses.

2. The consultation was circulated via HEFCW's normal circular mailing list across 91 stakeholder organisations. The circular was also brought specifically to the attention of the Directors of Finance and the Clerks to the Governing Bodies of all institutions in Wales.

Summary of consultation responses with resulting changes

3. This section lists each question, along with a narrative which summarises the responses received and the changes made to the document as a result of those responses.

4.1 Question 1: Do you agree that HEFCW should, if possible, maintain parity with HEFCE in setting thresholds for borrowing consent?



4.1.1. Six of seven respondents agreed that HEFCW should, if possible, maintain parity with HEFCE in setting thresholds for borrowing consent. It was suggested that this would be useful from the perspective of lenders, who would be able to assess the creditworthiness of institutions in England and Wales on the same basis. This consideration was considered to be of importance in a competitive student demand environment, with one respondent noting that in order to compete with student experience improvements across the UK, it was important that Welsh HEIs were given the same opportunities to borrow against their assets to invest in continuous improvements.

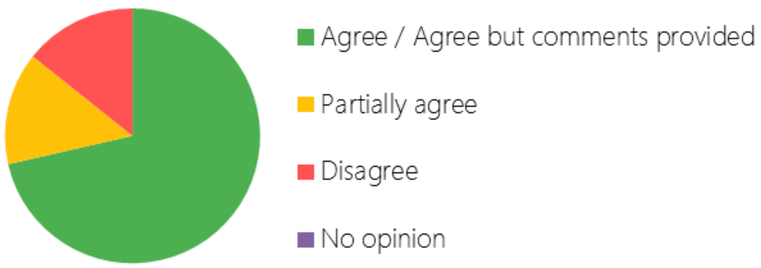
4.1.2. One respondent agreed that it is desirable to have consistent standards, but considered that the method of calculation using an EBITDA (Earnings Before Interest, Taxation, Depreciation and Amortisation) measure was flawed, since it sets a ratio from the Income and Expenditure Statement against the Balance Sheet where the liability is recorded. It was suggested that either a gearing ratio or debt service/interest cover ratio be used instead.

4.1.3. **HEFCW response:** No changes have been made. The EBITDA-based threshold is currently under review by the British Universities Finance Directors Group (BUFDG) and we expect it to be replaced shortly with an alternative measure. To respond to the specific point concerning EBITDA being an income-based measure of a balance sheet commitment, it should be noted that:

a) We consider the prime concern to be whether the institution is able to generate sufficient surplus and consequently cash (of which EBITDA is a proxy measure) to repay debt in a sustainable manner. Income-based measures are important in considering the ability of the institution to pay back both interest and capital elements of borrowing; and

b) The threshold is only intended to be the point at which a discussion occurs with the Funding Council as to the viability of an institution's overall borrowing proposals. It is not a threshold that cannot be increased, however any increase would be subject to Funding Council agreement

4.2 Question 2: Do you agree that the current distinction between short-term and long- term borrowing is no longer appropriate, and should discontinue within future arrangements? Do you have any other comments?



4.2.1. Three of seven respondents fully agreed that the current distinction between short and long-term borrowing is no longer appropriate. Comments recognised that lenders have been reluctant to lend for long periods since the financial crisis and consequently there was now a spread of various funding forms in operation. One comment recognised that HEFCE (in consultation with BUFDG) is currently considering the measure by which the borrowing threshold is set, and considered that it was sensible to await the outcome of these discussions.

4.2.2. Two further respondents agreed and considered that it was correct to include short-term borrowings in HEFCW's considerations of total borrowings, but considered that a supplemental metric was needed for short-term borrowings to consider the liquidity of the institution.

4.2.3. One respondent agreed that the distinction between short and long-term borrowings is no longer appropriate, but noted that the upcoming introduction of FRS102 will bring volatility to EBITDA year on year and as a result the proposal to take five times the EBITDA surplus level may become unworkable. This respondent also noted that some institutions carry significant cash or investment balances and as such a measure of net debt could be a more appropriate mechanism for reviewing when consent for further borrowing is required. Another respondent noted that the EBITDA-based measure does not deal easily with instruments such as bonds.

4.2.4. Finally, one respondent disagreed with the proposal, considering that a single EBITDA-based measure could not wholly assess the two issues of the ability to make repayments and the ability of the balance sheet to support the overall gearing implied by the debt. This respondent considered that 'off-balance-sheet' borrowings such as student accommodation should not be included in the calculation, since they recover their costs over a longer time period. This respondent considered that applying a requirement that all debt be serviced by five years 'earnings' would severely constrain the ability of any University to proceed with long-term investment.

4.2.5. HEFCW response: No changes have been made. Whilst we consider the suggestion in paragraph 4.2.2 to have merit, we have decided not to make changes to this measure as a result of that suggestion for the following reasons:

a) As stated above, the threshold is only intended to be the point at which a discussion occurs as to the viability of an institution's overall borrowing; and

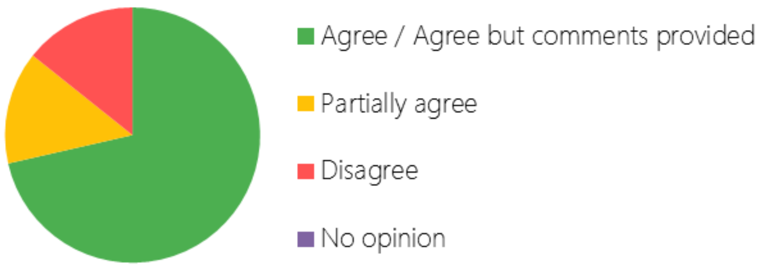
b) BUFDG are currently examining this measure and we expect the measure to change in the short term future.

Furthermore, the suggestion in paragraph 4.2.3 that net debt be used also appears to have some merit. However, we consider that the principal concern is the ability of the institution to generate sustainable surpluses that can be used to repay debt, rather than whether there is cash on the balance sheet at the time the commitment is entered into. In the example given, significant cash or investment balances would presumably be held for a specific reason, and therefore use of a net debt ratio could allow borrowing to be entered into after which cash reserves are subsequently expended (for example, on capital projects). We also consider that an institution with a small net debt ratio should be able to easily demonstrate this fact upon reaching the threshold figure, and this therefore should not cause a concern in our considerations.

In relation to paragraph 4.2.4, we do not disagree with the statement concerning balance sheet gearing, but would reiterate that the threshold marks the beginning of engagement, at which point such issues can be examined.

It is worth reiterating that the threshold is the point at which we review the debt level, and subject to HEFCW being content, based on the assurances provided by the Universities' governing bodies following their review and approval of the borrowing proposals, that debt can be managed sustainably, the institution will ordinarily be able to increase its borrowing threshold.

4.3 *Question 3: Does the draft financial memorandum adequately place the collective student interest alongside the public interest? Do you have any comments?*



4.3.1. Four respondents agreed that the revised draft financial memorandum adequately placed the collective student interest alongside the public interest. A number of comments were received indicating that the proposed approach mirrored the approach taken by HEFCE in England. It was added that the alignment would be an important aid to Welsh universities which recruit from the rest of the UK and who would be keen to demonstrate clear parity about commitment to the student interest and academic quality. It was considered that UK students would require assurance that the student interest is as central to the relationship between HEFCW and Welsh universities as it is between other UK Funding Councils and their universities. This was considered important in order that student decisions about which university to attend are not driven by any perception of lack of commitment to the student interest of a certain jurisdiction, but rather by academic considerations relating to the academic provision in institutions. One of these respondents suggested that the inclusion of areas such as student interest, equality and diversity meant that the Financial Memorandum should be renamed, and suggested "Operating Memorandum" as being more appropriate.

4.3.2. It was also suggested that whilst the reflection of the student interest was to be welcomed within the memorandum, one respondent would have concerns if this was used to introduce further regulation to the sector, given that regulation already exists in this area.

4.3.3. One respondent considered that HEFCW make clear that we would only make public a risk assessment if the student interest outweighs the detrimental effects the release of the risk assessment might have on the commercial activities of an institution.

4.3.4. Finally, one respondent queried whether HEFCW should have a role in protecting the student interest and suggested that the public interest and the collective student interest are one and the same, and that since the Governing Body already took its responsibilities towards students seriously, it was unnecessary to reference it within the memorandum.

4.3.5. **HEFCW response:** We are making three updates following the consultation responses:

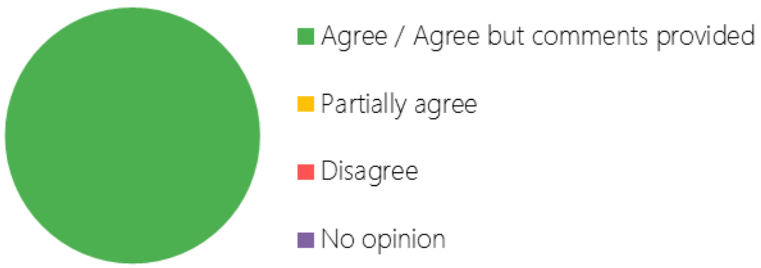
a) Expanding upon the rationale for including the student interest in our considerations by highlighting the need to maintain parity with the rest of the UK, so that we continue to offer a competitive environment for students at Welsh institutions;

b) Outlining that we will, as we do at present, take into account the detrimental nature of making public a risk assessment; however, we have not stated that we will place this interest above that of the student; and

c) A change of name from ‘Financial Memorandum and Audit Code of Practice’. As suggested by one respondent, a change of name will help to reflect the focus of the document, which now, under sections relating to the institution’s own responsibilities and those of HEFCW, brings together our terms and conditions of funding with our approach to risk assessment. It should be noted that HEFCE also changed the name of their document to ‘Memorandum of Assurance and Accountability’ following their last Financial Memorandum consultation. Changing the name also has the added advantage of helping to reduce confusion when we introduce the Financial Management Code under the HE Act 2015 .

   We put forward proposed names to the Welsh Higher Education Finance Director’s Group and HEFCW’s Audit and Risk Committee and following this we have adopted the name ‘Memorandum of Assurance and Accountability’. It was felt that, in addition to best reflecting the content and context of the new document, it would also help to reduce confusion amongst third parties such as lenders, who were used to dealing with HEFCE’s document.

4.4 *Question 4: Do you agree that the revised Audit Code of Practice at Annex A to the draft financial memorandum is sufficient to set out HEFCW's requirements? If not, what changes would you suggest? Do you have any other comments?*



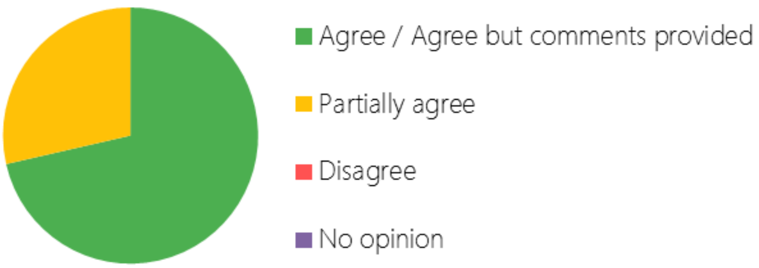
4.4.1. Six of the seven respondents fully agreed that the Audit Code of Practice was sufficient to set out HEFCW's requirements, with the reduction in size being welcomed. The remaining respondent agreed that the Audit Code of Practice was sufficient but suggested that it would be sensible to harmonise the time required for the market testing of both internal and external audit. This respondent also noted that a reference to the Companies Act 1985 may need updating in light of Part 42 of the Companies Act 2006.

4.4.2. **HEFCW response:** We are making two changes as a result of these responses.

We agree with the response suggesting that the time period for the external market testing of internal and external audit could be harmonised. The consultation draft states that market testing of outsourced internal audit should be completed at least every five years; and external audit every seven years. We have changed the requirement to five years for both internal and external audit. This takes the form of a 'should' provision rather than 'must' – that is, we propose it as good practice rather than as a condition of funding. As part of this change, we have clarified that the external audit partner may be appointed for a period of seven years provided that the requirements of the Auditing Standards Board Ethical Standard 3 are met.

We also agree that the reference to the Companies Act 1985 should be updated to Part 42 of the Companies Act 2006, and have made this change accordingly.

4.5 *Question 5: Do you agree that the institutional engagement and support strategy strikes an appropriate balance between institutional autonomy and the protection of public funds, the student collective interest and the sector's financial reputation?*



4.5.1. Five of the respondents fully agreed that the institutional engagement and support strategy strikes an appropriate balance between institutional autonomy and the protection of public funds, the student collective interest and the sector's financial reputation. One of these respondents suggested greater clarity was needed in linking the memorandum with the principles by which we will engage; that is, to avoid it reading as HEFCW making public its concerns without giving the HEI a chance to address these.

4.5.2. One respondent, whilst welcoming the principles , considered that the sanctions identified would be to the detriment of the collective student interest, and considered that the process for determining a "high risk" institution would benefit from greater clarity.

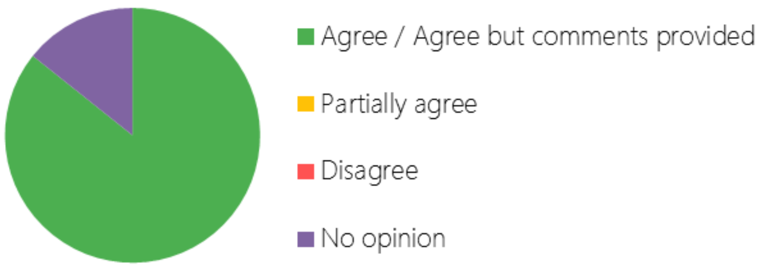
4.5.3. Finally, one respondent considered that the strategy was 'possibly' successful in balancing the issues, but considered that there was the potential for misunderstanding by introducing other areas such as strategy and risk into the document.

4.5.4. **HEFCW response:** We have made one change as a result of these responses. We agree that greater clarity in linking the memorandum with the principles by which we will engage would be useful. We have therefore, in accordance with the respondent's comments, included within paragraph 20 a cross reference to paragraph 137 and Annex B.

We do not believe that the identified sanctions would be to the detriment of the collective student interest. The document makes it clear (cf: Table 1: HEFCW support strategy for institutions at 'high risk') that we will first seek to put in place a support strategy and only when we have exhausted the elements of this will we consider sanctions .We also make it clear, within the same section, that we will only apply sanctions where we believe it to be in the student interest. We feel this approach helps to protect the student interest whilst giving the institution a fair opportunity for addressing and correcting risk issues.

We note one respondent's view that integrating the risk approach into the document may lead to misunderstandings as to where requirements are stated. We are of the opinion that the risk approach complements the terms and conditions of funding and audit requirements and that the response that HEFCW will take to issues concerning these areas logically sits beside these areas. We believe that this should lead to an accessible document which sets out the requirements, the steps taken to assess compliance with those requirements, and the sanctions to be taken should the requirements not be met. Given that there was only one comment in relation to this concern, we have not adopted a different approach.

4.6 Question 6: Do you agree that the requirement to report the exchequer interest is necessary for helping to ensure the appropriate use of exchequer assets?



4.6.1. Four of the respondents fully agreed that the requirement to report the exchequer interest is necessary for helping to ensure the appropriate use of exchequer assets.

4.6.2. One respondent agreed in principle but noted that it places additional reporting mechanisms on institutions and requested that HEFCW consider whether asset data already in existence could be used to reduce the burden. This respondent also requested that the requirement should mirror that of HEFCE.

4.6.3. One respondent noted that they agreed in principle but would want to see the proposed return to consider whether it was a reasonable request.

4.6.4. One respondent provided no opinion on the question.

4.6.5. **HEFCW response:** We have not made any changes as a result of these responses.

In respect of paragraph 4.6.2:

a) HEFCW is currently unable to adopt the same approach to the monitoring of exchequer assets as the approach adopted by HEFCE. In 2006, HEFCE undertook a detailed exercise to determine the exchequer interest existing in each institution[1]. We consider that this approach, whilst having merit, is too onerous for the small number of institutions we have in Wales, and we consider that we can materially arrive at the same position through the measures outlined; and

b) We agree that where possible it would be best to use existing asset data to identify the exchequer interest. We have made arrangements to convene a sub-group of the Welsh Higher Education Finance Director's Group (WHEFDG) to examine the details of this reporting process.

4.7 *Question 7: Do you have any other comments on the proposed revised financial memorandum that have not been covered in the preceding questions?*

4.7.1. We received a range of comments to this question. The following were the major themes or issues identified and our response to them:

a. **Senior Executive Team** – the draft made reference to the 'Senior Executive Team' and a number of respondents were unclear as to who would be caught by this definition. A number of respondents noted that the size and composition of the executive will vary between institutions.

One respondent agreed that the requirement to inform HEFCW of changes to senior roles represents good practice and is appropriate to HEFCW's process of assessing institutional risk; however, another questioned the purpose and need for this requirement.

We have addressed the issue of the definition of the senior executive team by reference to Financial Reporting Standard 102 (FRS 102),[2] which defines key management personnel as:

> *"those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity".*

This is consistent with the approach that institutions will be required to take in identifying their senior executive team for financial statements from 2015/16 prepared under the new FEHE Statement of Recommended Practice[3].

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[1] http://webarchive.nationalarchives.gov.uk/20100202100434/http:/www.hefce.ac.uk/pubs/circlets/2006/cl12_06/

[2] https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-102-The-Financial-Reporting-Standard-appli-%281%29.pdf

[3] www.fehesorp.ac.uk/sorp2015/

b. **Composition of Governing Body** – One respondent considered that this area was sufficiently outlined in the existing Committee of University Chairs (CUC) Code of Governance, and suggested that there was a lack of clarity as to whether open advertising was being mandated.

We have clarified, within paragraph 37 of the document that open advertising is recognised good practice, but not mandatory, provided a fair and reasonable appointment process has been conducted.

c. **Review of Clerk's independence** – One respondent considered that the requirement to review the clerk's independence annually in open discussion was too onerous and the wording of the document setting out the manner in which this should be assessed was overly prescriptive.

We have amended paragraph A6 to require that the assessment of the clerk's independence is made regularly and at least every three years, rather than annually. We have also amended the wording to reflect that it is for the Governing Body to determine how this assessment is best made.

d. **Application of principles** – The principles outlining how HEFCW had approached the revision (within the consultation document) should be set out in the introduction of the document itself, since this would be a standalone document after the consultation. It was also noted that the equivalent HEFCE and SFC documents set out similar principles and it would be useful to set the context of the document.

We have included the principles set out in paragraph 14 of the consultation circular ('How we've approach the proposed revision') in the introduction to the memorandum, at paragraph 3.

e. **Notification of disagreements** – One respondent considered that where a member of the senior executive, governing body, audit committee, finance committee, human resources committee or a clerk to one those bodies resigns from their post due to disagreement there should only be a duty to report where the reason for resignation relates to the strategy, financial viability or sustainability of the institution.

We have not restricted the requirement to notify us to events of strategy, financial viability or sustainability of the institution. We consider that such an event would usually only occur in exceptional circumstances. Furthermore, whilst those circumstances may not be directly related to strategy, financial viability or sustainability of the institution, they may be indicative of other issues relating to the governance of the institution. We therefore consider it to be important that we are notified of all resignations due to disagreement.

Another respondent considered that it was irregular to request this notification in events of disagreement, but not when a member is dismissed or forced to resign for any other reason.

The intent of the original wording was to use 'disagreement' as an umbrella term to include dismissals and forced resignations. However, we agree that the wording could be clarified and have updated the memorandum accordingly to also reference dismissals and forced resignations.

f. **Length of document** – One respondent considered that the proposed Financial Memorandum and Audit Code of Practice was too long and suggested it was longer than the equivalent HEFCE and SFC document.

We approached this revision with a view to streamlining the document. By word count, the new memorandum is considerably shorter than the current document, and slightly shorter than HEFCE's equivalent document.

g. **Breadth of document** – One respondent considered that the document should be restricted to solely financial affairs and that the document's scope had increased, particularly in relation to governance arrangements. It contended that the responsibilities HEFCW would have under the new memorandum would directly conflict with the Governing Body's responsibilities.

Our requirements in terms of Governing Body composition are set out in five short paragraphs between paragraph 35 and 39. This section has deliberately been kept short as a consequence of the CUC guidance on this area. We set out one requirement here in relation to:

- A requirement to inform HEFCW if 'open' recruitment methods have not been used.

As well as three 'good practice' views (formulated with the use of 'should'):

- Recruitment exercises not conflating ability with experience, and our expectation that open advertising is brought to the attention of under-represented groups; and

- Our expectation of the maximum term for Governing Body members.

We consider this requirement and these good practice views to be supplemental to the CUC Code of Governance and consequently have not modified the document.

h. **Use of ‘must’ vs ‘should’:** One respondent noted that ‘Where we use the term ‘must’, we mean it is a specific legal or regulatory requirement. Institutions must comply with these requirements. We use ‘should’ for items we regard as minimum good practice, but for which there is no specific legislation or regulatory requirement.’ and considered that there were instances where the document referred to ‘must’ where they did not understand there to be a specific legal or regulatory requirement.

We have clarified the definition of ‘must’ and ‘should’ within the document. Our intent in the use of ‘regulatory requirement’ in the following definition is to set out what we consider to be a condition of funding under this memorandum:

> *“Where we use the term ‘must’, we mean it is a specific legal or regulatory requirement. Institutions must comply with these requirements. We use ‘should’ for items we regard as minimum good practice, but for which there is no specific legislation or regulatory requirement. We will, however, consider the extent to which an institution has adopted the ‘should’ provisions (or alternative, equally robust arrangements) in our annual assessment of risk”*

We have replaced the use of ‘regulatory requirement’ with ‘condition of funding under this memorandum’.

Furthermore, we have provided better linkages between paragraph 9 of the memorandum and the Audit Code of Practice, to be clear that mandatory requirements in both documents form conditions of funding.

We have also made clear within paragraph 8 that where terms and conditions of funding are not complied with, we will initiate the support and safeguarding functions.

i. **Relationship to the HE Act Financial Management Code** (FMC) – One respondent noted that following the introduction of the Financial Management code there will be two documents regulating the financial affairs of institutions and stated that ideally these would be identical in their requirements. The respondent requested details on the plans and provisions HEFCW have in place for dealing with any differences and whether the document will be amended following the issue of the FMC.

We agree that it will be important to be clear about the relationship between the Financial Management Code and the memorandum. The relationship between the Memorandum of Assurance and Accountability will be clarified during the development of the Financial Management Code.

j. **Application to Further Education institutions (FEIs)** – One respondent stated that since the memorandum would not apply to further education institutions, it would lead to different conditions being attached to funding for different institutions. The response posited that this would raise potential difficulties for HEFCW in exercising its statutory duties, since HEFCW would be attaching no formal conditions to the funding it grants, and relying on the Welsh Government's document instead. It was considered that the memorandum should continue to apply to all institutions in receipt of funding.

This consultation was concerned with the draft Financial Memorandum (part 1) only, which includes the Audit Code of Practice as a component. The memorandum is split into two parts: part 1, which sets out the terms and conditions which apply in common to all institutions as well as the Audit Code of Practice, and part 2, which is an annual funding agreement that gives conditions specific to that institution.

HEFCW will continue to apply conditions to funding provided to FEIs through the annual funding agreement which sets out the specific terms and conditions attached to their funding.

We have also changed the terms of application from 'majority funder' to 'majority provision' as a result of this review.

This is an area that will need to be examined again when preparing the Financial Management Code (FMC) under the Higher Education Act 2015, since all regulated providers will become subject to the FMC.

k. **Ministerial override in respect of exchequer interests** – One respondent noted that paragraph 45 of the existing Financial Memorandum contains a ministerial override in respect of exchequer interests; that is, that the Minister may, after consultation with HEFCW, specify conditions under which (s)he would waive the requirements in respect of exchequer interests. The respondent noted that this override was not referenced within the proposed document and expressed a wish for it to be included.

The Minister continues to have this power despite the draft Financial Memorandum making no reference to it. In the interests of brevity, this wording was omitted from the draft.

However, given the concerns of the respondent, we have included a statement within the memorandum to the following effect:

> *"The Welsh Ministers may, after consultation with the Council, specify conditions under which (s)he would waive the application of paragraphs XX"*

l. **Institutional autonomy** – One response contended that the power to designate an officer other than the Vice Chancellor or Principal as the accountable officer, in conjunction with the monitoring of the equality and diversity of the student body (which implies a role in admissions) would reduce institutional autonomy to such an extent as to "affect the charitable and ['Non-Profit Institutions Serving Households'] status of universities, despite any statement to [the] contrary".

There are two aspects to the comments raised:

a) Monitoring of equality and diversity across the student body – We have previously considered the institution's equality and diversity within our risk review for some time; we do not, and do not intend to impose conditions of funding upon the equality and diversity of the student body; the updated wording merely reflects this; and

b) Accountable Officer –This approach mirrors the approach followed by HEFCE within their comparable memorandum. As made clear in the memorandum this approach would only be taken "in extremis" and consequently we do not consider that it should impact on the classification of institutions as Non-Profit Institutions Serving Households.

Further information

4. For further information, contact Matt Lody (tel 029 2068 2306; email matt.lody@hefcw.ac.uk).

Assessing the impact of our policies

5. We have carried out an equality impact assessment (EIA) screening to help safeguard against discrimination and promote equality. We also considered the impact of policies on the Welsh language, and Welsh language provision within the HE sector in Wales. Contact equality@hefcw.ac.uk for more information about EIAs.