NATIONAL AUDIT OFFICE

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

The Financial Health of Higher Education Institutions in England

HC 13 Session 1994-5
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John Bourn
Comptroller and Auditor General

National Audit Office
18 November 1994

The Comptroller and Auditor General is the head of the National Audit Office employing some 800 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

Contents

Summary and conclusions

Background and scope

(Part 1)

1 The Further and Higher Education Act 1992 abolished the binary line dividing universities from polytechnics and colleges. From 1 April 1993, it established the Higher Education Funding Council for England (the Funding Council) with responsibility for funding teaching, research, and related activities in 148 higher education institutions in England. The main sources of public funding of higher education in England, excluding student maintenance grants and loans, are expected to total about £5.1 billion in the academic year 1994-95. Institutions' other income is estimated to amount to £2.7 billion.

(paragraph 1.25)

2 Good financial health depends on a mix of factors. An institution must not only be solvent but it must be sound in its management of academic activities and other activities which support them. On the basis of financial criteria alone an institution can be judged as healthy but may be engaged in activities which are not viable and which can eventually impact on overall health, for example, courses which do not attract sufficient students, research work which fails to attract financial support, and an infrastructure which is inefficient or under invested. Good financial health is also dependent upon quality: quality in teaching, in research, in support activities, and in management, both financial and more generally.

(paragraphs 1.9 - 1.10)

3 One of the main responsibilities of the Funding Council is to monitor the financial health of institutions and institutions in turn are required to maintain their financial solvency. Higher education institutions are autonomous, independent bodies established by Royal Charter or Act of Parliament. Neither the Department for Education nor the Funding Council have specific powers to intervene directly in the affairs of a particular institution although the Funding Council may attach conditions to their grant. The Funding Council pursue an active approach to the monitoring of institutions' financial performance and health and to the provision of support and guidance.

(paragraphs 1.4 - 1.7)

4 The 1987 White Paper, "Meeting the Challenge", which set out the Government's strategy for higher education, anticipated growth in student numbers along with wider participation and access. In 1992-93, there were some one million students in higher education in England. This represented a 44 per cent increase since 1988-89. The Government had not expected student numbers to reach this level until 1995 and introduced a three year period of consolidation of student numbers to 1995-96. The period of consolidation has since been extended a further year to 1996-97. In the five years to 1993-94, public funding per student for universities and colleges has reduced by 26 per cent in real terms. Changes in Government policy, such as the move from expansion to consolidation, can affect the income of an institution.

(paragraphs 1.20 - 1.23)

5 The financial difficulties facing some higher education institutions have been of concern to Committees of Public Accounts in two of their Reports. In their 1st Report of Session 1989-90, they addressed the severe financial problems at University College, Cardiff, and expressed concern at the deficits being incurred by some institutions and the lack of accuracy in forecasting. In their 4th Report of Session 1992-93 on the Polytechnics and Colleges Funding Council, the Committee stated that they were encouraged by the positive approach adopted by the former funding council and individual institutions in responding to the challenges of their new responsibilities following the institutions' transfer from local authorities. The Committee also stressed once again the need for sound financial forecasts and the importance of monitoring by the former funding council of the strength of local management. The Funding Council and their predecessor councils have applied themselves seriously to all the recommendations made.

(paragraph 1.26)

6 Against this background the National Audit Office examined:

- the financial position of the English higher education sector and monitoring by the Funding Council (Part 2);
- the underlying factors that can affect the financial health of institutions - the financial control of teaching and research, the financial control of support and other activities, and the strength of local management (Parts 3-5).

(paragraphs 1.27 - 1.28)

7 A central part of the National Audit Office examination was a survey in the Summer of 1993 of the 148 higher education institutions in England. The National Audit Office also analysed the consideration given by the Funding Council to 20 institutions where actual or potential financial difficulties had arisen. Appendix 4 gives the lessons to be learned from these 20 cases. Significant factors in these 20 cases included a failure to meet student recruitment targets, the absence of general reserves when problems arose and general financial management problems, such as inadequate control of expenditure, shortcomings in financial management information and general cash flow problems.

Financial position of the sector and current Funding Council monitoring

(paragraphs 2.11 - 2.12, Table 1 and paragraphs 2.15 - 2.16)

8 Overall the sector has been showing healthy operating surpluses in the three years to 1992-93 and, in July 1994, these were forecast to continue in 1993-94. This was against a background of a reduction in public funding per student of 26 per cent in real terms over the five years to 1993-94. Operating surpluses are forecast to reduce marginally in 1994-95 and then to fall to a level of around £90 million in each of the three years 1995-96 to 1997-98. Therefore, consolidation of student numbers appears not to have had a significant impact on the projected operating surplus position of the sector as a whole in 1993-94 and 1994-95. But the combination of consolidation and further planned productivity gains (amounting to an 11 per cent reduction in real terms in public funding per student over the period 1994-95 to 1996-97) is likely to be reflected in the reduced operating surpluses which are forecast between 1994-95 and 1997-98.

(paragraph 2.13)

9 Within the sectoral surpluses lies a wide range of results. For example, in 1992-93, 12 institutions had operating deficits which together totalled £12 million. However, a deficit in a particular year does not necessarily mean that an institution is in difficulty, as it may be planned by the institution or covered by reserves.

10 The National Audit Office concluded that:

(paragraphs 2.32 - 2.34)

- The Funding Council have well-established arrangements in place for detailed monitoring of institutions facing actual or potential financial difficulty.

(paragraph 2.16)

- During the current period of consolidation of student numbers and further planned productivity gains, the Funding Council will, as they have recognised, need to continue to put great emphasis on their monitoring of individual institutions.

(paragraphs 2.21 - 2.22 and 2.32)

11 The Funding Council, having regard to a wide range of factors, have identified institutions facing immediate financial difficulties. In September 1994 there were six in this category. These institutions are subject to particularly detailed monitoring. It is up to the institution to secure its own recovery, with the Funding Council monitoring progress and offering advice as required. Most institutions in difficulty have taken action through a combination of cost control, particularly on staff costs, efforts to increase income and the sale of assets.

12 The National Audit Office concluded that:

(paragraphs 2.22 and 2.25)

- There is scope for the Funding Council to improve their internal documentation of their financial health monitoring with the criteria underlying their judgements on the financial health classification of each institution being clearly identified. The Funding Council have recognised the need to do so and have acted upon this.

(paragraphs 1.28, 2.35, 5.55 and Appendix 4)

- The Funding Council need to disseminate lessons learned from past cases of institutions where actual or potential financial difficulties have arisen. The National Audit Office review of 20 such cases (Appendix 4) and of the lessons emerging, detailed in Parts 2-5 of this Report, should provide a good base for this.

Financial control of teaching and research

(paragraphs 3.59 - 3.64)

13 To promote stability in the sector, the Funding Council have introduced measures to ensure that no institution receives an unmanageable year on year change in the level of its funding. In this way, the Funding Council are seeking to prevent such changes being the cause of any financial difficulties at an institution. This should be distinguished from the Funding Council's policy of not providing additional financial support to institutions in trouble.

(paragraph 3.65)

14 The National Audit Office concluded that:

- In determining the mechanism which triggers the level of any additional transitional funding to counter the impact of unmanageable change, the Funding Council are conscious of the need to ensure that this additional funding does not act as a disincentive to efficiency and effectiveness.

(paragraphs 3.5 - 3.11)

15 The Funding Council have developed a funding method for teaching designed to promote stability and efficiency. Institutions are guaranteed a very high percentage of their previous year's funding for teaching as long as they recruit students to the level agreed with the Funding Council. However, teaching funding will be withheld if they fail to recruit students to that level. Institutions may also be penalised if they over-recruit students receiving publicly funded tuition fees.

(paragraphs 3.12 - 3.20)

16 The National Audit Office concluded that:

- Accurate forecasting of student numbers and keeping student recruitment in line with the targets set are important to institutions' financial health.

- By including the financial impact of under-recruitment of students as a scenario within the sensitivity analysis of the financial forecasts required from institutions in July 1994, the Funding Council have strengthened their monitoring arrangments.

(paragraphs 3.26 - 3.28 and 3.34 - 3.35)

17 The Further and Higher Education Act 1992 places a statutory requirement on the Funding Council to ensure that provision is made for assessing the quality of the higher education which they fund. Institutions will have the relevant part of core funding immediately or successively withdrawn if, after two visits by the Funding Council's assessors, they continue to receive an unsatisfactory rating in any subject taught. The first assessments were carried out in 1993. The results published as at September 1994 relate to law, history, chemistry, and mechanical engineering. Virtually all teaching provision was rated as satisfactory or better in each of the four subjects. Only two institutions had a subject rated as unsatisfactory, one in law and one in mechanical engineering.

(paragraphs 3.30 - 3.32, Table 2 and Paragraph 3.36)

18 Recent expansion has been accompanied by significant increases in student:staff ratios. In 1989-90, only 14 per cent of institutions had student:staff ratios over 15:1, but by 1995-96, 62 per cent of institutions predict that they will be in that situation. Whilst over 40 per cent of institutions responding to the National Audit Office survey thought that teaching quality had not suffered, a similar proportion said that it was impossible to tell. 11 per cent of institutions thought that quality had suffered.

19 The National Audit Office concluded that:

(paragraphs 3.30 and 3.36)

- Recent expansion has been accompanied by significant increases in student:staff ratios.

(paragraphs 3.28 and 3.35)

- Virtually all of the teaching provision in the four subjects assessed by the Funding Council to date has been rated as satisfactory or better. Only two institutions have had unsatisfactory ratings and may therefore be liable to have the relevant part of core funding withdrawn.

(paragraphs 3.38 - 3.49)

20 In accordance with Government policy, the Funding Council are allocating research funds selectively to encourage institutions to concentrate on their strengths, and thereby improve quality. The Funding Council's research allocation formula gives greater weight to those departments receiving higher quality ratings in the periodic research assessment exercise. Between 1989 and 1992, overall quality ratings for institutions of the former "old" university sector showed an increase of 15 per cent, indicating an improvement in quality in that part of the sector. The National Audit Office survey found that most institutions intend to maintain or develop a broad research base, whilst allocating research funds more selectively to departments of recognised strength.

21 The National Audit Office concluded that:

(paragraphs 3.37 - 3.39 and 3.48)

- The Funding Council allocate research funds selectively to improve quality by encouraging institutions to concentrate on their research strengths. 94 per cent of the Council's £0.6 billion funding for research in 1994-95 has been allocated by reference to quality criteria.

(paragraphs 3.43, 3.44 and 3.49)

- Most institutions are intending to maintain or develop a broad research base whilst allocating funds more selectively. The Funding Council believe that this is a matter for institutions to determine in accordance with their own policies and priorities.

(paragraphs 3.50 - 3.58)

22 In 1994-95, the Funding Council are allocating £20 million of the £0.6 billion research funding to institutions weighted on the basis of successful overhead cost recovery on research contract work. This acts as an incentive to institutions to charge the full economic cost for commercially supported research. In the National Audit Office survey a quarter of all institutions said they had not determined the full overhead recovery rate and were therefore not in a position to know whether or not they were recovering their full costs. 10 out of the 89 institutions which had determined the full overhead recovery rate were recovering costs at this rate.

(paragraph 3.58)

23 The National Audit Office concluded that:

- The Funding Council should continue to work with the Committee of Vice-Chancellors and Principals and the Standing Conference of Principals to develop best practice for costing and pricing research contracts.

(paragraphs 3.66 - 3.71)

24 Although the Funding Council separately identify funds for teaching and research for each institution, they treat recurrent grant as a block grant and it is for individual institutions to determine how their grant should be applied in delivering teaching and research. Thus, funds for teaching may be used on research and vice versa. From 1994-95, institutions will become accountable to the Funding Council for how they allocate research funds but, as now, they will not be required to account separately for expenditure on teaching and research.

(paragraph 3.72)

25 The National Audit Office concluded that:

- The requirement by the Funding Council for institutions to be accountable for the allocation of research funds is a move in the right direction. It will provide the Funding Council with a greater assurance that institutions at least plan to spend research funds for the purposes given. In due course, the Funding Council need to return to consideration of how institutions should account for expenditure on teaching and research.

Financial control of support and other activities

(paragraph 4.5 - 4.9 and 4.36 - 4.40)

26 Institutions have made good progress in producing estate strategies. By linking funds for future capital projects with estate strategies, the Funding Council are encouraging institutions to consider their estates as a strategic resource. Pressures on institutions' buildings are likely to continue with the expected rise in student numbers towards the end of the decade, although changed teaching methods and possible changes to the structure of the academic year may help to reduce such pressures. Funding Council guidance encourages institutions to include in their estate strategies methods for improving space utilisation. Charging for space is one means by which this can be achieved and one third of institutions have systems for attributing the cost of space occupied. Other methods of improving space utilisation include space audits, spot checks and the application of performance indicators.

(paragraph 4.39)

27 The National Audit Office concluded that:

- Institutions need to consider whether existing space is being used efficiently. There is scope for institutions to extend the practice of attributing the cost of space occupied where appropriate.

(paragraphs 4.2 - 4.4 and 4.10 - 4.26)

28 Capital grants are provided to institutions by the Funding Council but over the years the capital grants paid by the Funding Council and their predecessors have substantially reduced. The sector is therefore expected to fund new building projects mainly from internally or externally generated funds. Under the Government's Private Finance Initiative, institutions are being encouraged to borrow from the private sector to finance new capital projects, so enabling them to acquire new assets sooner than they could have done from public funds. The long term liabilities of the sector are projected to increase from

£1.2 billion in 1992-93 to £2.2 billion in 1997-98. The risks involved in institutions borrowing on the security of Exchequer and local authority funded assets are that, in principle, if an institution were to default on a loan, teaching and research facilities might be jeopardised and the property originally funded from the public purse might be lost to the commercial sector. As yet, no institution has been in this position.

(paragraph 4.27)

29 The National Audit Office concluded that:

- The Funding Council are playing a crucial role in approving borrowing requests and assessing the institution's financial health. They need to continue to ensure that their controls are sufficient to identify those cases where borrowing could put the institution's financial health at risk.

(paragraphs 4.28 - 4.34)

30 A backlog of maintenance work, and work needed to comply with new health and safety legislation, are putting pressure on the majority of the sector. The National Audit Office survey found that 58 per cent of institutions considered that they had not put aside sufficient provision in their July 1993 financial forecasts to deal with all the maintenance backlog.

(paragraph 4.35)

31 The National Audit Office concluded that:

- Institutions could face financial difficulties if they have to undertake urgent repairs to buildings for which no financial provision has been made. The Funding Council will, as they recognise, need to focus on this issue in their review of institutions' accounts, forecasts and estate strategies.

(paragraph 4.49 - 4.52)

32 The Funding Council expect residence and catering at individual institutions to be self-financing in the long term. The sector as a whole had a small surplus for 1992-93. Within the sectoral total, about half of all institutions had deficits on their residence and catering accounts although the bulk of these were planned. In some instances, deficits on these accounts at individual institutions can be a contributory factor to financial problems.

(paragraph 4.53)

33 The National Audit Office concluded that:

- Institutions should be planning at least to balance their residence and catering accounts in the long term.

The strength of local management at institutions

(Part 5)

34 Good financial health depends on strong institutional management. Changes to the organisation and management of institutions, if not well managed, increase the risk that financial control is weakened. The Funding Council pay particular attention to monitoring the strength of local management and the Funding Council's Audit Service has been able to provide assurance that institutions have appropriate arrangements for financial management and accounting. This was supported by the evidence in the National Audit Office survey.

35 The National Audit Office concluded that the Funding Council could encourage institutions to take action in the following areas:

(paragraphs 5.22 and 5.25)

- About one third of the sector apportions the cost of central support services to users. There is scope, where appropriate, to extend this practice, which, if properly managed and monitored, encourages more efficient usage.

(paragraphs 5.23 and 5.26)

- Over half of the sector identifies which budget centres (mainly academic departments) are in deficit and require cross-subsidy from others. Financial management is improved if such information is produced. Institutions can then make informed decisions on whether to subsidise budget centres or require them to find savings.

(paragraphs 5.28 and 5.32)

- Half of the sector includes outstanding orders/commitments wherever appropriate in the formal financial management reports to heads of institutions and finance committees. The other half could improve their financial reporting by adopting this practice. Also, two thirds of the sector include their current and projected cash flow position in such reports, and this practice could usefully be extended to the other third.

(paragraphs 5.45 - 5.46 and 5.51)

- About three quarters of institutions make explicit provision for strategic developments and contingencies to give themselves additional flexibility. The remainder might consider doing so, if they have the funds available.

Overall conclusions

36 Since 1990 the sector has improved its financial position and continued financial health is projected. There are only six institutions whose financial health is currently a cause of concern to the Funding Council. This is against a backdrop of rapid change, first expansion and now consolidation of student numbers allied with a 26 per cent real terms cut in public funding per student in the five years to 1993-94. Such change can put the finances of institutions under strain. The strains may be exacerbated by increasing pressures on institutions' buildings, the reduced contribution towards capital funding from the Funding Council, and the significantly higher levels of borrowing projected by the sector to fund capital projects.

37 The new Funding Council were established in April 1993 and have already made good progress in developing and refining their arrangements for monitoring the financial health of individual institutions and they should continue to do so. They need to remain vigilant in the light of the strains associated with the changes outlined above. This Report points to a number of areas where actions are in hand, as well as areas in which financial management at institutions could be improved. The Funding Council are discussing with institutions' representative bodies how to develop and promote guidance on best practice in these areas.

Part 1: Introduction

The new framework for higher education

1.1 The Further and Higher Education Act 1992 (and parallel legislation for Scotland) implemented the proposals in the 1991 White Paper "Higher Education: A New Framework" (Cm 1541). It abolished the binary line dividing universities from polytechnics and colleges. From 1 April 1993, it dissolved the Universities Funding Council and the Polytechnics and Colleges Funding Council and replaced them with three separate funding councils in England, Scotland and Wales.

The English higher education sector

1.2 Under the 1992 Act, the Higher Education Funding Council for England (the Funding Council) undertook responsibility for funding teaching, research, and related activities in 148 higher education institutions in England. These comprise 72 universities, 48 colleges of higher education, and 28 schools of the University of London (eight funded directly by the Funding Council and twenty funded centrally by the University). Thirty-three of the universities are former polytechnics which have been granted university status and two are former colleges of higher education. Three institutions, the Open University, the Royal College of Art, and Cranfield University were formerly funded directly by the Department for Education (the Department). Two institutions, Wimbledon School of Art and the College of Guidance Studies, were formerly funded by local education authorities. The map at Appendix 5 shows the locations of the 148 institutions.

1.3 The Funding Council also fund higher education courses in 77 colleges of further education. From 1 August 1994, three of these colleges became higher education institutions. The National Audit Office examination did not cover further education colleges. Years in this Report relate to the academic year ending 31 July unless otherwise stated.

Government strategy for higher education

1.4 Current Government strategy for higher education was originally set out in the 1987 White Paper "Meeting the Challenge" (Cm 114) which stated that the main aims and purposes of higher education were to serve the economy effectively, to pursue basic scientific research and scholarship, to have closer links with industry and commerce, and to promote enterprise. It also placed emphasis on the further promotion of teaching and research quality, the latter through greater selectivity in funding, and the achievement of greater efficiency through institutional management improvements. Growth in student numbers along with wider participation and access were anticipated.

1.5 Subsequently the 1991 "New Framework" White Paper reaffirmed these aims and purposes. It described the Government's view of the achievements of the higher education sector since 1987, namely, that teaching and learning had been enhanced during a period of rapid expansion, and higher education was more efficient and effective, more accessible to people of all ages from all sections of society, and increasingly responsive to the needs of industry and commerce.

1.6 The Government's 1991 White Paper projected that approaching one in three young people under 21 would enter full-time higher education by the year 2000. In 1992-93, there were some one million home and European Union students in higher education in England - a 44 per cent increase over the four years from 1988-89. In the same period, the participation rate of young people under 21 nearly doubled from 15 per cent to 28 per cent. The number of mature students also increased so that a half of all students entering the system was aged 21 or over. Higher education institutions' response to the policy of expansion was such that the Government's plans for home and European Union student numbers for 1995-96 were achieved by 1992-93 along with a 23 per cent reduction in real terms in the public funding per student. This represented a substantial efficiency gain delivered by the higher education sector.

1.7 In November 1992, the Government announced that there would be a period of consolidation over the three years 1993-94 to 1995-96 followed by renewed growth to the year 2000. The policy of consolidation would apply to home and European Union students awarded grants for tuition fees and on full-time and sandwich courses. The policy would not apply to part-time students except in very limited circumstances. In 1993-94 the participation rate of young people under 21 rose again by a further two per cent to around 30 per cent because of the strong expansion factors still working through the system. Therefore, in November 1993 the Government extended the period of consolidation a further year to 1996-97 and asked the Funding Council, through its funding for universities and colleges, to ensure that the planned student numbers were met. In 1993-94 the public funding per student reduced a further three per cent, representing a 26 per cent reduction in real terms in the five years from 1988-89.

Financial responsibilities and accountabilities

1.8 The role and responsibilities of the Funding Council are set out in the Further and Higher Education Act 1992; and the Secretary of State for Education in his letter of 23 June 1992 gave broad guidance to the Chairman of the Funding Council on the functions of the Funding Council, on Government policies relevant to the exercise of these functions, and on other matters to which the Funding Council should have regard. The formal financial relationship between the Department and the Funding Council is set out in a Financial Memorandum.

1.9 Similarly, a Financial Memorandum between the Funding Council and each higher education institution sets out the terms and conditions on which grant is made and reflects the provisions in the Memorandum between the Department and the Funding Council. The Department's powers are limited by statute whereas the Funding Council's specific powers are limited to attaching conditions to the grant paid to institutions. Details of the main responsibilities and accountabilities in these documents are at Appendix 1. One of the main responsibilities of the Funding Council is to monitor the financial health of institutions. The Funding Council pursue an active approach to the monitoring of institutions' financial performance and health and to the provision of support and guidance.

1.10 Higher education institutions are autonomous, independent bodies established by Royal Charter or Act of Parliament. Each institution produces its own mission statement and corporate or strategic plan. The aims and objectives will reflect the nature of that institution and have regard to Government policy. The Governing Body of each institution is ultimately responsible for ensuring that its institution complies with the Further and Higher Education Act 1992 and the terms and conditions of the Financial Memorandum between the Funding Council and the institution. These include requirements that an institution:

- conduct its financial and academic affairs so as to ensure that its total income is at least sufficient taking one financial year with another to meet its total expenditure;
- maintain its financial solvency; and
- have sound systems of internal financial management and control.

1.11 The right balance between autonomy and accountability of institutions needs to be achieved. Therefore, the Financial Memorandum between the Funding Council and each institution requires the institution to have appropriate arrangements for financial management and accounting and makes the institution responsible and accountable to the Funding Council for the funds it receives from them, and ultimately to Parliament via the Committee of Public Accounts. Parliament's interest is to see that public funds are properly accounted for and used economically, efficiently, and effectively. Accordingly, the Comptroller and Auditor General, head of the National Audit Office, as the external auditor of the Funding Council, has the right to inspect the accounts of any institution in receipt of grant and carry out value for money investigations. The National Audit Office exercise their inspection rights by, for example, undertaking value for money investigations which include visits to a sample of institutions.

1.12 To avoid duplication of effort, on matters relating to individual institutions, the National Audit Office seek to rely on the work of the Audit Service of the Funding Council. The Audit Service in turn seeks to rely on the work of institutions' internal and external auditors and institutions' audit committees. In order to rely on this work, the Audit Service assesses each institution's compliance with the Funding Council's Audit Code of Practice, which sets out the minimum requirements for internal and external audit arrangements and model terms of reference for audit committees. The extent of work that the Funding Council's Audit Service carries out directly at institutions will depend on the reliance that can be placed on the current control arrangements at individual institutions.

1.13 Among the Funding Council's responsibilities is the promotion of good value for money at institutions. The Funding Council, and their predecessors, have supported a broad range of initiatives to monitor institutional performance and to encourage institutions' efforts in pursuit of better value for money, such as on improved purchasing practices and on harnessing technology to improve the quality of teaching and learning. Moreover, the Funding Council's current method for funding teaching is related directly to institutional efficiency.

1.14 In April 1993, the Funding Council, following consultation with the sector, agreed proposals for value for money auditing as an additional wide-ranging value for money tool. Subsequently, in January 1994, a United Kingdom Steering Group was established with the Scottish and Welsh funding councils. The Steering Group has decided that the first national studies will be on treasury management and energy management. In addition, the Funding Council have allocated up to £100,000 in 1994-95 for support of smaller scale value for money projects.

Funding of higher education

1.15 Public recurrent funding of higher education in England, excluding student maintenance grants and loans, is expected to total about £5.1 billion in 1994-95 and is allocated to institutions in three main ways:

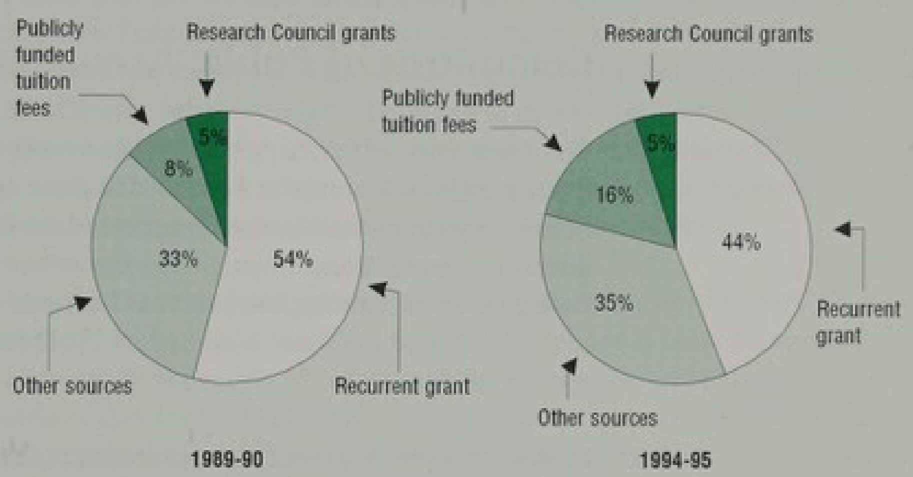
- recurrent grant, with teaching and research components, allocated by the Funding Council, and capital grants released in the year, in total amounting to £3.5 billion;

- tuition fees paid by the Department through local education authorities and estimated to total £1.2 billion; and

- research grants and contracts paid by the Research Councils, amounting to £0.4 billion.

1.16 Institutions' income from other sources (fees from overseas students, special and short courses, consultancies, residence and catering, donations and appeals, research grants and contracts paid by Government departments, health and hospital authorities, European Union sources, industry and charities etc) is estimated to amount to about £2.7 billion in 1994-95. The main sources of Government funding of higher education as at paragraph 1.15 above are therefore expected to provide about two thirds (65 per cent) of higher education's total income (£7.8 billion) in 1994-95 and have been around that level since 1989-90 (Figure 1).

Figure 1: Comparison of sources of higher education income in England between 1989-90 and 1994-95



Source: The Higher Education Funding Council for England

In 1994-95, Government will provide two thirds of higher education income through recurrent grant, tuition fees and Research Council grants. This fraction has not changed significantly since 1989-90. The most significant change is the shift in the balance of funding from recurrent grant to tuition fees.

1.17 Over the years, there have been many changes in Government policy on higher education which have necessitated changes in funding methodology. For example, in 1990-91 to encourage growth in student numbers the balance in public funding was shifted from recurrent grant which is cash limited to tuition fees which are not. In effect, this gave institutions the financial incentive to recruit "fees only" students, that is, students not funded from recurrent grant, because the higher tuition fee levels were often sufficient to cover the marginal costs of expansion. The incentive was reinforced by the policy of awarding places funded from recurrent grant partly on the basis of the previous year's recruitment of "fees only" students.

1.18 Figure 1 illustrates how between 1989-90 and 1994-95 the overall balance in public recurrent funding has shifted from recurrent grant to tuition fees. In 1993-94 and 1994-95, with the need to consolidate student numbers, there was some shift back to the cash limited recurrent grant compared with earlier years. The shift in the balance of funding from tuition fees to recurrent grant in any one year is financially neutral for the same number of students but the effect is to curb the recruitment of "fees only" students and hence the additional income available to institutions from this source.

1.19 Changes in higher education funding flowing from changes in Government policy can lead to variations from year to year in the amount of income earned by an individual institution. It is important therefore for institutions to be able to recognise and assess the impact of these and any other external changes. The Funding Council are fully aware that changes in their funding methodologies can lead to changes in the level of funding provided to individual institutions from one year to another. Consequently they operate a policy of not imposing unmanageable rates of change on institutions due to the introduction of a changed funding methodology. Appendix 2 shows some of the main funding changes in recent years.

Committee of Public Accounts

1.20 The Committee of Public Accounts last considered the financial health of the former university sector in 1989-90. In their 1st Report 1989-90 on Financial Problems at Universities, the Committee addressed the difficulties faced by a number of institutions, in particular the severe financial problems at University College, Cardiff, arising from serious financial mismanagement. They returned to the topic again in their 36th Report 1989-90 on Restructuring and Finances of Universities.

1.21 In these reports the Committee expressed concern at the extent of the deficits being incurred at some institutions and the lack of accuracy in institutional forecasting. The financial problems highlighted at University College, Cardiff, acted as a catalyst for the former University Grants Committee to introduce the financial monitoring of institutions. The former Universities Funding Council (successor to the University Grants Committee) and the Polytechnics and Colleges Funding Council built on this base and financial monitoring has been further strengthened by the current Funding Council.

1.22 In their 4th Report 1992-93 on the Polytechnics and Colleges Funding Council, the Committee stated that they were encouraged by the positive approach adopted by the former funding council and individual institutions in responding to the challenges of their new responsibilities following the transfer of these institutions from local authorities. The Committee stressed once again the need for institutions to produce sound management information and financial forecasts, and to be particularly aware of the sensitivity of their financial forecasts to changes in key assumptions. They also emphasised the importance of both former funding councils monitoring the strength of local management at institutions. The Committee concluded that the Polytechnics and Colleges Funding Council and institutions had responded to the pressures to improve quality, to meet demands for growth, and to tackle possible financial difficulties at an early stage.

1.23 The problems which had arisen at the Dartington College of Arts Limited were also considered by the Committee. These problems had been due to organisational changes, poor financial control and expertise, and inaccurate forecasts. In another case examined by the Committee, the financial forecasts for South West London College (now closed) had not examined the sensitivity of the financial position to a significant fall in student recruitment, although in other respects the forecasts were on a realistic basis. As the subsequent findings show, the new Funding Council have applied themselves seriously to all the Committee's recommendations.

Scope of the National Audit Office examination

1.24 In order to understand the key drivers that influence the financial health of higher education institutions, the National Audit Office undertook a pilot study along with their consultants (Segal Quince Wicksteed Limited, Economic and Management Consultants) visiting five institutions (two in England, two in Scotland and one in Wales). The two in England were the University of Warwick and Middlesex University. Many instances of good management practice were identified during the five visits. The pilot study was undertaken to prepare the ground not only for this review of the English higher education sector but also to inform subsequent reviews of the Scottish and Welsh sectors.

1.25 The financial health of an institution will depend on a mix of factors. To have sound financial health, it must not only be solvent but it must be sound in its management of academic activities and other activities which support them. On the basis of financial criteria alone, an institution can be judged as healthy but may be engaged in activities which are not viable and which may eventually impact on overall health, for example, courses which do not attract sufficient students, research work which fails to attract financial support, and an infrastructure which is inefficient or under invested. Good financial health is also dependent upon quality: quality in teaching, in research, in support activities and in management, both financial and more generally. The National Audit Office examination therefore extended to the economic, efficient and effective management of the sector's main and other activities. Management in this context relates to the overall management, both general and financial.

1.26 Against this background the study:

- assesses the financial position of the English higher education sector and monitoring by the Funding Council (Part 2);

- examines the factors affecting the financial health of institutions and identifies the steps that the Funding Council have already taken and which the Funding Council might take in future to enhance their monitoring in relation to:

  a) the financial control of core academic activities - teaching and research (Part 3);

  b) the financial control of support and other activities (Part 4); and

  c) the strength of local management (Part 5).

1.27 A central part of the examination was the issue of a questionnaire to each higher education institution. The survey had a 100 per cent response rate from the 148 institutions. The National Audit Office followed up the survey with visits to three "old" universities, one "new" university, one business school, two general colleges and two specialist colleges (Appendix 3). The majority of the visits were in the Greater Manchester area because of the variety of institutions located there.

1.28 The National Audit Office also analysed the data held by the Funding Council and reviewed the methodology for funding institutions and for monitoring their financial health. The Funding Council's papers on 20 of the institutions where actual or potential financial difficulties had arisen during the four years 1990 to 1994 were examined. Factors which had given rise to the actual or potential financial difficulties at individual institutions had already been considered by the Funding Council and their predecessors. Appendix 4 gives the lessons learned from these 20 cases which are referred to in Parts 2-5 of the Report. Significant factors in the 20 cases were the failure to meet student recruitment targets, the absence of general reserves when problems arose and general financial management problems, such as inadequate control of expenditure, shortcomings in financial management information and general cash flow problems.

Part 2: The financial position of the English higher education sector

2.1 Under the terms of the Financial Memorandum between the Funding Council and the Department, the Funding Council are required to monitor the financial health of institutions and, as part of this, to keep the level of institutional balances under review. Monitoring is undertaken to gain assurance that institutions are capable of continuing to deliver the teaching and research for which they are funded and also to protect the public investment in institutions and their assets.

2.2 The institutions themselves, as autonomous organisations, have direct responsibility for maintaining their financial solvency and for resolving their own financial difficulties. The Funding Council have a policy of not providing additional financial support to institutions in trouble. Instead they work with institutions to resolve any problems. (These were also the policies of the former funding councils.) This part of the Report reviews the financial position of the sector and the monitoring currently being undertaken by the Funding Council.

The consistency of financial data available

2.3 It is important that higher education institutions provide consistent, accurate and reliable information about their financial position which meets the needs of the major stakeholders in the sector. The users of an institution's reports and financial statements include, for example: the institution itself, grant-awarding bodies, donors, benefactors, Parliament, and the institution's current and prospective lenders. These users have differing needs but certain key elements, including the general need for accountability, are common to all. They need to have available a true and fair view of the institution's financial position, including full details of its income and expenditure, its assets and liabilities, the adequacy of its working capital, its practical solvency (or insolvency), its investment performance, and any known or probable circumstances which might significantly affect its financial position.

2.4 Since 1989 the "old" universities have been preparing their accounts according to a Statement of Recommended Practice, and since 1990 the accounting policies of the former polytechnics and colleges have been based on accounting standards which differed in some respects from those used by the "old" universities. Accounting years also differed. Accounts for the old universities were for the academic year ending 31 July whereas those of the former polytechnics and colleges were mainly for the financial year ending 31 March.

2.5 A very significant difference between the two former secors in 1989 was that "old" universities, as autonomous legal entities, had been able to accumulate reserves and endowments, whereas many of the institutions of the former polytechnics and colleges sector, as part of local education authorities, had no reserves.

2.6 Other differences between the two former sectors relate to the need for the former polytechnics and colleges to account for the following:

- Inherited liabilities, namely, payments on property loans, leases and rentals, enhanced pension and salary costs, to the local education authorities which formerly maintained these institutions. Although the Funding Council reimburse institutions for these liabilities, the institutions need to make appropriate and full provision in their accounts. The Funding Council take this into account for monitoring purposes and this has the effect of restating current and long term external liabilities;

- Enhanced pension costs. The Funding Council recognise that payments from provisions for these costs will be made over a long time, over the lives of former employees. The Funding Council therefore consider that this provision does not impact on the financial health of an institution in the short term. For financial monitoring purposes, it is therefore taken into account by the Funding Council. This has the effect of restating expenditure and general reserves in the short term; and

- Deferred capital grants received from the Funding Council. The accounting convention for these grants increases current and long term liabilities, in the short term. The grants are therefore taken into account for financial monitoring purposes by the Funding Council. This has the effect of restating current and long term external liabilities.

2.7 The fusion of the two sectors in 1993 has resulted in a need to produce a revised Statement of Recommended Practice for the whole of higher education based on the academic year. This new statement, which comes into force for the academic year 1994-95, has been developed by institutions' representative bodies, the Committee of Vice-Chancellors and Principals, the Standing Conference of Principals, and the Conference of Scottish Higher Education Principals in partnership with the three new funding councils for England, Scotland and Wales. The new statement has been cleared with the Accounting Standards Board.

2.8 It will be a requirement of the Financial Memorandum between the Funding Council and institutions that institutions' accounts be produced in accordance with the statement. The new statement will also form the basis of the annual forecasts produced by institutions. Thus the annual accounts and forecasts, the key financial information being supplied by institutions to the Funding Council for monitoring their financial health, will shortly be brought on to a consistent basis for the two former sectors.

2.9 Within the framework of the new statement, and in accordance with generally accepted accounting principles, institutions are being given the choice of recording fixed assets at current valuation or historical cost. If current valuation is used by institutions for the first time in 1994-95, the depreciation charges shown in the income and expenditure account will be higher. More institutions may therefore be showing an operating deficit, and others may show reduced surpluses or increased deficits. This change in accounting presentation alone would not mean a deterioration in an institution's financial health. For those institutions changing to current valuation from historical cost, there will be a historical cost reconciliation at the foot of the income and expenditure account. In such cases the surplus or deficit shown in this reconciliation will form the basis for the Funding Council's monitoring of the recurrent position.

Overall financial position of the sector from institutions' accounts and forecasts

2.10 Although the combined sector does not yet have a common format for its accounts and forecasts, there was sufficient consistency between the two sets of data to enable the National Audit Office, on the basis of data supplied by the Funding Council, to compile a simplified income and expenditure account and balance sheet for the sector (Table 1 overleaf). Nonetheless, the aggregated data in Table 1 need to be interpreted with caution (paragraphs 2.4 and 2.6).

2.11 Operating surpluses on ordinary activities of £152 million and £256 million were achieved by the sector in 1991-92 and 1992-93 respectively (Table 1). This happened at a time of rising student numbers. And the sector is projecting operating surpluses of £183 million in 1993-94 reducing to £140 million in 1994-95 and to between £87 million and £98 million in the years 1995-96 to 1997-98.

2.12 Institutions' financial forecasts received by the Funding Council in July 1994 were consistent with the March 1994 mid year forecasts. When compared with the previous years' forecasts, they showed an improved position on operating surpluses for the sector for 1993-94 and 1994-95 and a slightly worsening position for future years. Therefore, consolidation of student numbers and real terms reductions in public funding per student would not seem to have had a significant impact on the projected operating surplus position of the sector as a whole in the years 1993-94 and 1994-95, but may be reflected in the reduced operating surpluses which are forecast between 1994-95 and 1997-98.

2.13 Within the sectoral surplus, lies a wide range of results. For example, in 1992-93:

- 21 institutions' operating surpluses contributed to over half of the sectoral surplus of £256 million but 12 institutions had operating deficits which together totalled £12 million. Increased provision required to meet future pension costs accounted for the operating deficits at five of these institutions

Table 1: Higher Education Funding Council for England sector: simplified income and expenditure account and balance sheet (£m in cash terms)

	Actual 1990-91 (i) (ii) £m	Actual 1991-92 (i) (ii) £m	Actual 1992-93 (iii) £m	Estimate 1993-94 £m	Estimate 1994-95 £m	Estimate 1995-96 £m	Estimate 1996-97 £m	Estimate 1997-98 £m
Income and expenditure account								
Income	5,192	5,819	7,397	7,386	7,757	8,037	8,273	8,574
Expenditure (iv)	5,112	5,667	7,141	7,203	7,617	7,940	8,186	8,476
Surplus on ordinary activities	80	152	256	183	140	97	87	98
Extraordinary items	37	(16)	(13)	18	4	6	22	5
Surplus before transfers from/to reserves (iv)	117	136	243	201	144	103	109	103
Surplus after transfers from/to reserves	31	35	71	83	72	29	27	37
Balance sheet								
Fixed assets	5,147	5,719	6,657	7,378	8,032	8,377	8,531	8,603
Current assets	1,347	1,559	1,946	2,093	1,985	1,914	1,882	1,934
Current liabilities (vi)	899	976	1,119	1,138	1,137	1,189	1,165	1,220
Net current assets	448	583	827	955	848	725	717	714
Total assets less current liabilities	5,595	6,302	7,484	8,333	8,880	9,102	9,248	9,317
Long term liabilities (v)	647	857	1,248	1,747	2,099	2,185	2,208	2,174
Provisions	104	155	241	238	238	234	229	230
Total assets less liabilities	4,844	5,290	5,995	6,348	6,543	6,683	6,811	6,913
Capital reserve	3,604	3,954	4,190	4,262	4,352	4,416	4,450	4,456
Restricted reserve	718	744	951	1,015	1,041	1,084	1,125	1,165
General reserve (vi)	522	592	854	1,071	1,150	1,183	1,236	1,292
Total funds	4,844	5,290	5,995	6,348	6,543	6,683	6,811	6,913

Source: *Accounts and forecasts of institutions of the former Universities Funding Council sector and the former Polytechnics and Colleges Funding Council sector. These sectors operated different accounting years, policies and treatments. The aggregated data in this table need to be interpreted with caution.*

Notes:
(i) Aggregate figures for 1990-91 and 1991-92 are a combination of financial and academic years. The accounts of the institutions of the former Polytechnics and Colleges Funding Council were mainly for the financial year ending 31 March. Those of the former Universities Funding Council were for the academic year ending 31 July.

(ii) Three institutions which were formerly funded by the Department for Education and two formerly funded by local education authorities are not included in 1990-91 and 1991-92.

(iii) 1992-93 accounts for institutions of the former Polytechnics and Colleges Funding Council were for a 16 month period to bring their accounts into line with those of the former Universities Funding Council.

(iv) Transfers from capital reserve for depreciation on fixed assets for the institutions of the former Polytechnics and Colleges Funding Council have been deducted from total expenditure to bring their operating surplus position into line with institutions of the former Universities Funding Council sector.

(v) Current and long term liabilities include borrowing, deferred capital grants from the former funding councils, and inherited liabilities which are expected to be reimbursed by the Funding Council.

(vi) General reserve is after provision made for the future cost of pension enhancements, which will be paid out over many years.

Table 1 shows that the sector's operating surpluses on ordinary activities increased from £80 million in 1990-91 to £256 million in 1992-93, but thereafter are projected to fall progressively before stabilising at a level between £87 million and £98 million in the years 1995-96 to 1997-98. Also, in the years between 1990-91 and 1997-98, long term liabilities are projected to more than treble to £2,174 million and general reserves to more than double to £1,292 million. The increase in long term liabilities reflects increased borrowing to finance fixed assets which is consistent with the Government's support for increased private financing of higher education.

(paragraph 2.6). A deficit in a particular year does not necessarily mean that an institution is in financial difficulty as this may reflect a planned deficit or be covered by reserves;

- 30 institutions had negative working capital (net current liabilities). Inherited liabilities and deferred capital grant accounted for the whole of the negative working capital at eight institutions and for almost all of the negative working capital at four others (paragraph 2.6). Reasons for negative working capital at the remainder included financing of capital developments and other treasury management practices ; and

- 13 institutions had negative general reserves. Provision for enhanced pension costs accounted for the negative general reserves at virtually all these institutions (paragraph 2.6).

2.14 As part of the monitoring process of institutions, the Funding Council use a range of indicators. The three main indicators used to monitor the financial health of the sector as a whole are:

- **Strength ratio** which is calculated by dividing general reserves* by total recurrent expenditure and multiplying by 365. The strength ratio indicates that 37 days recurrent expenditure could be met from general reserves* in 1990-91. This rose to 44 days in 1992-93 and is projected to rise to 56 days in 1997-98. General reserves* represented about 10 per cent of recurrent expenditure in 1990-91 and 12 per cent in 1992-93. They are projected to increase to around 15 per cent for 1997-98 (Table 1);

- **Current asset: current liability ratio** which is a measure of short term liquidity, calculated by dividing total current assets by current liabilities**. Current assets for the sector were sufficient to cover current liabilities** about 1.5 times in 1990-91 and over 1.7 times in 1992-93. Projections show current liabilities** being covered 1.8 times in 1993-94 dropping to 1.6 times by 1997-98 (Table 1); and

- **Gearing ratio** which indicates the extent to which the sector is using long term finance (borrowings) to fund development. It is calculated by dividing long term liabilities** by general reserves*. The gearing ratio has increased from 1.2 in 1990-91 to 1.5 in 1992-93 and is projected to increase to 1.7 in 1997-98 reflecting mainly a move to greater borrowing. This is consistent with the Government's support for increased private financing of higher education. Long term liabilities** for the sector, including inherited liabilities and deferred capital grant, are set to more than treble from

* General reserves are after provision made for the future cost of pension enhancements which will be paid out over many years (paragraph 2.6).

** Current and long term liabilities include external financing (borrowing), deferred capital grants, and inherited liabilities which are expected to be reimbursed by the Funding Council (paragraph 2.6).

£0.6 billion in 1990-91 to £2.2 billion in 1997-98. General reserves are projected to more than double rising from £0.5 billion in 1990-91 to £1.3 billion in 1997-98 (Table 1).

Key points

2.15 Taken overall, the sector has been showing healthy operating surpluses in the three years to 1992-93. These are forecast to continue in 1993-94 but to reduce marginally in 1994-95 and then to fall to a level of around £90 million in the three years 1995-96 to 1997-98.

2.16 Consolidation of student numbers appears not to have had a significant impact on the projected operating surplus position of the sector as a whole in 1993-94 and 1994-95. However, the reduced forecast operating surpluses for the years 1995-96 and 1997-98 may reflect the impact of consolidation and further planned productivity gains which will require the Funding Council, as they have already recognised, to continue to put great emphasis on their monitoring of individual institutions.

Monitoring of institutions' financial health by the Funding Council

Financial health monitoring

2.17 The financial health of each of the 148 institutions covered by the National Audit Office's survey is subject to review by three divisions in the Funding Council. The Audit Service, Finance Division, and Institutions and Programmes Division all play an active role in reviewing the financial position and health of institutions. The Audit Service is responsible for evaluating institutions' financial systems whilst Institutions and Programmes Division is responsible for monitoring the financial health of institutions within a framework set up and monitored by Finance Division. The relevant staff numbering 62 in the three divisions include 13 fully qualified and three part qualified accountants, and nine who have worked before at higher education institutions. 53 of the 62 staff were employed by the former funding councils and therefore had earlier experience of the sector. The staff of Institutions and Programmes Division, usually including finance staff, aim to visit each institution at least once a year and the Audit Service visits institutions on a three year cycle.

2.18 The financial monitoring undertaken by the Funding Council for all institutions has three stages based on the following financial returns from institutions:

a) financial forecasts received each July covering the accounts for the last completed year and the forecasts for the current year and the four years ahead;

General reserves are after provision made for the future cost of pension enhancements which will be paid out over many years (paragraph 2.6).

b) annual accounts and supporting detailed financial statements received by 31 December each year; and

c) mid-year financial forecasts for the current year and the following year, received in March each year.

2.19 The Funding Council's analysis of institutions' five year financial forecasts, which includes the figures in the published accounts of the previous year, covers the following:

- the actual level of annual surplus/deficit and the trend in forecast surpluses/deficits;
- the actual general reserves and external borrowings and the forecast positions;
- the actual level of cash and liquid funds and the trend over the forecast period;
- the calculation of a number of ratios including those at paragraph 2.14;
- the degree of optimism, pessimism, and consistency of the assumptions adopted by institutions in preparing the financial forecasts, for example, assumptions about student recruitment and inflation;
- the degree of care with which the forecasts appear to have been prepared;
- the extent to which institutions had been successful in any remedial action taken previously; and
- other information available on the quality of general and financial management of institutions available from the Funding Council's past dealings and visits.

2.20 Each institution is then put into one of three categories of financial health. The categorisation is reviewed by the Funding Council at each of the subsequent two stages of the monitoring process: as part of the examination of institutions' annual accounts each December; and as part of the review of the mid-year forecasts received each March. The three categories of financial health used are:

- Category 1: institutions facing immediate financial difficulties;
- Category 2: institutions facing short term financial difficulties which are not serious or where there may be financial difficulties in the future; and
- Category 3: institutions with relatively minor financial problems or no financial problems at all.

2.21 In March 1994 the Funding Council had placed seven institutions in category 1, 30 in category 2, and 111 in category 3. The Funding Council's review of the forecasts received in July 1994 indicated that most institutions in category 1 are improving their financial position. The number in this category was reduced to six in September 1994. The efforts of the Funding Council are targeted primarily at institutions in categories 1 and 2. They aim to help resolve the problems of category 1 institutions and to prevent those in category 2 becoming category 1 cases. In 1994 a review of the monitoring process was undertaken by the Funding Council's Audit Service. The subsequent report concluded that an effective set of arrangements were in place for the identification and monitoring of institutions with financial problems.

2.22 The Funding Council have included institutions in the appropriate category of financial health. In determining the category for each institution, they take into account the range of factors at paragraph 2.19 above to arrive at a rounded view of the institution's financial health. The National Audit Office found that the Funding Council had not made clear in documented format what criteria they had applied in reaching their judgements on how each institution was categorised. The Funding Council have begun the process of bringing together all the current documentation into a new Financial Regulations Manual with supporting desk instructions.

Key points

2.23 In 1992-93, a small number of institutions experienced deficits (12). In five of these cases, this was due to accounting for enhanced pension provision. A number also had negative working capital (30). Accounting for inherited liabilities, and deferred capital grant and treasury management practice at institutions provided the explanation for the majority of these. Some institutions (13) had negative general reserves due in virtually all cases to the provision of enhanced pension costs.

2.24 The Funding Council have identified institutions facing immediate financial difficulties, having regard to a wide range of factors.

2.25 There is scope for the Funding Council to improve the documentation for their financial health monitoring with the criteria underlying their judgements on the financial health classification of each institution being clearly identified. The Funding Council have recognised the need to do so and have acted upon this.

Financial health indicators

2.26 An important part of the monitoring exercise is the use of financial health indicators. The National Audit Office survey sought the opinion of the sector on the three main indicators (paragraph 2.14). For these indicators to be meaningful for individual institutions, adjustments need to be made for the factors noted in paragraph 2.6 above. The sector thought that the most relevant indicator was the current asset:current liability ratio - only nine per cent of the sector found it not relevant. The strength ratio was thought to be relevant by 80 per cent of the sector. And 73 per cent of the sector took this view on the gearing ratio. Institutions were asked if they thought other ratios were more relevant. A number of institutions considered that there should be an indicator relating to the cash position.

2.27 In the view of the National Audit Office and the Funding Council:

- the current asset: current liability ratio is very important;
- the strength ratio is less important. The Funding Council do not now particularly rely on this ratio for monitoring purposes, having found the need to supplement it, in some instances, with the more meaningful current assets: total recurrent expenditure ratio;
- the gearing ratio will become more relevant as long term borrowing by the sector increases; and
- indicators of the level of cash at institutions are very important. As part of the continued development of the monitoring process, the Funding Council have placed greater emphasis on institutions' cash position.

2.28 The financial health indicators are currently under review by a Joint Performance Indicators Working Group, set up by the three new funding councils to help institutions identify what indicators they should be using to measure their performance. A report to the Funding Council is due in January 1995, following consultation with institutions. The sub-group on indicators of financial health reported to the main Working Group in March 1994. They recommended retention of existing indicators but with others added, making a total of 23. The emphasis was on indicators of short term solvency, retention of reserves, effective management of the estate and diversity of income sources. These indicators are designed to help the institutions themselves manage their finances. The Funding Council are reviewing these indicators and will decide which of them should be used to inform their monitoring of institutions.

2.29 Currently the Committee of Vice-Chancellors and Principals publishes indicators of institutional financial health for the "old" university sector. The indicators allow these institutions to examine their financial health relative to national averages and to comparable institutions. As yet there have been no published data on the former polytechnics and colleges sector. The outcome of the deliberations of the Joint Performance Indicators Working Group will inform decisions on which data on financial health will be published for the sector.

2.30 The Funding Council intend to disseminate to the whole of the newly combined sector key data on institutions' annual accounts. This information will enable all institutions themselves to assess their financial position relative to other institutions with which they would expect to be broadly comparable. Given the large number of institutions in the new sector, the National Audit Office consider that the data disseminated would be made more comprehensible if institutions of like nature and size were grouped together. Institutions could then compare themselves to others within the grouping.

Key point

2.31 The financial health indicators used by the Funding Council to monitor institutions have been augmented to give greater prominence to the cash position of institutions. The Funding Council intend to disseminate data on indicators of financial health to the whole of the new sector to enable institutions to assess their financial position. The National Audit Office consider that comparisons would be facilitated if institutions of like nature and size were grouped together.

Detailed monitoring of institutions in actual or potential financial difficulty

2.32 The Funding Council impose a higher level of monitoring and hold detailed discussions with institutions which are classified as category 1 to assure themselves that institutions are taking measures to secure their long term financial position. It is up to the institution to ensure its own recovery with the Funding Council monitoring progress and offering advice as required. Institutions in difficulty have taken action through a combination of cost control, particularly on staff costs, efforts to increase income, and the sale of assets. The Funding Council and their predecessors have often suggested to institutions that they seek professional advice on their problems and institutions have taken up this suggestion.

2.33 The cash flow position of one of the six institutions in category 1 as at September 1994 is being monitored on a monthly basis. The other institutions in category 1 are mainly being monitored on a quarterly basis. Three institutions have been a cause of concern for over three years.

Key point

2.34 The Funding Council have well-established arrangements in place for detailed monitoring of institutions facing actual or potential financial difficulty.

Interface with Parts 3 to 5

2.35 The findings in this part of the Report need to be considered alongside those in Parts 3 to 5, which identify some areas which could enhance the Funding Council's monitoring of institutions' financial health.

Part 3: Financial control of teaching and research

3.1 This part of the Report considers the financial control exercised by institutions over teaching and research and the Funding Council's monitoring of these activities. Good financial control in this area is important to the financial health of an institution.

Income from teaching and research

3.2 For 1994-95, higher education institutions are forecasting that income from teaching and research, their core activities, will amount to £6.6 billion. This consists of: Funding Council recurrent grant and released capital grants (£3.5 billion); tuition fees both Government and non-Government funded, including home and overseas fees (£1.7 billion); research grants and contracts both Government and non-Government funded (£1.1 billion); and other funding for teaching from endowments and education contracts (£0.3 billion). Altogether this represents 85 per cent of total income. Income from other related activities such as residence and catering, short courses and consultancies is expected to total about £1.2 billion in 1994-95 (paragraphs 1.15 and 1.16). The Funding Council's recurrent grant for 1994-95 is split as follows:

	£ billion
Funding for teaching	1.7
Tuition fee compensation (paragraph 3.7)	0.7
Funding for research	0.6
Other related funding (paragraph 3.4)	0.3
Total recurrent grant	**3.3**

3.3 Funds for teaching and research are allocated mainly by formula as a block grant which institutions spend at their discretion in delivering the teaching and research for which the funding has been provided. The Funding Council notify institutions of their individual allocations. To promote stability, the Funding Council have a policy of ensuring that no institution receives an unmanageable year-on-year change in the level of its recurrent funding. This applied to the Funding Council's recurrent grant allocations in 1993-94 and 1994-95 when they limited increases to some institutions and reduced the level of decreases to others by providing a transitional safety net.

3.4 Other related funding of £0.3 billion is to support a wide range of specific purposes such as the additional costs of institutions operating in London (£93 million) and reimbursement of inherited liabilities of institutions mainly of the former polytechnics and colleges sector (£125 million) - paragraph 2.6.

Teaching

Funding for teaching

3.5 Of the total of about £1.7 billion provided for teaching in 1994-95, the largest amount (£1.6 billion) has been allocated to core funding. Core funding is geared to provide stability and promote efficiency. It guarantees institutions a very high percentage of their previous year's funding as long as they recruit students to the level agreed with the Funding Council. But it also contains a competitive element to promote efficiency. In addition to the core funding, the Funding Council provided £68 million (marginal funding) to encourage, for example, the recruitment of part-time students and those studying science and engineering at below degree level in line with Government policy. The level of funding to be provided by the Department to the Funding Council for the financial years 1994-95 to 1996-97 inclusive, when taken together with tuition fees, equates to an 11 per cent real terms reduction in public funding per student over the same period. This reduction, together with that indicated in paragraph 1.7, represents a real terms reduction in public funding per student over the nine years 1988-89 to 1996-97 of 37 per cent.

3.6 Annually the Funding Council enter into a funding agreement with each institution. This sets out the student numbers which an institution is contracted to deliver in exchange for the grant allocated for teaching. The sector's contract student numbers for 1994-95 are 750,000 full-time and sandwich course students, and 365,000 part-time students. Where individual institutions fail to recruit students to the level of the funding provided, the Funding Council will withhold grant. In 1993-94 the Funding Council withheld grant totalling £8.2 million from 57 institutions.

3.7 In its 1993 Autumn Statement the Government extended the proposed period of consolidation of student numbers by a further year to 1996-97. Accordingly from 1994-95 the Government reduced the level of publicly funded tuition fees by 45 per cent but provided the Funding Council with additional funds in compensation (paragraph 3.2). To ensure that student numbers remain at the level assumed in the Government's expenditure plans, the Funding Council have set an upper limit for each institution of the number of students to receive publicly funded tuition fees (award holders). The upper limit is expressed as a maximum aggregate student number.

3.8 Any shortfall in recruitment against that maximum aggregate number will lead to tuition fee compensation being withheld reflecting the extent to which that maximum number has not been met. Over-recruitment will also be penalised. If institutions recruit award holders at more than one per cent above the maximum aggregate number they will be liable to a penalty equivalent to the tuition fees for those students. Thus, students enrolled above that level will yield no extra income for the institution.

Key points

3.9 The Funding Council have developed a funding method for teaching designed to promote stability and efficiency. Institutions are guaranteed a very high percentage of their previous year's funding as long as they recruit students to the level agreed with the Funding Council. Institutions are also provided with funds to encourage, for example, the recruitment of students on part-time courses and those studying science and engineering at below degree level.

3.10 The level of funding to be provided by the Department to the Funding Council for financial years 1994-95 to 1996-97 inclusive, when taken together with tuition fees, equates to an 11 per cent real terms reduction in funding per student over the same period. Over the nine years 1988-89 to 1996-97 the reduction in public funding per student will be 37 per cent.

3.11 Teaching funding will be withheld from institutions if they fail to recruit students to the funding level provided. Institutions may also be penalised if they over-recruit students receiving publicly funded tuition fees.

Forecasting and meeting student targets

3.12 Forecasting of student numbers, like any other form of prediction, is an imprecise science. It is therefore very difficult for institutions to get their forecasts completely right and to deliver exactly the number projected. These difficulties have been compounded by the change in Government policy from expansion to consolidation and also by the introduction of a new students' admissions system in 1993-94 for the 1994-95 intake. The main source of income of the majority of institutions is that relating to students. Failure to meet its own recruitment targets can therefore have a significant financial impact on an institution where the institution is unable to adjust expenditure in line with reduced income.

3.13 During this current period of consolidation, it is even more important for institutions to forecast as accurately as possible and keep student recruitment in line with their forecast. Both under and over-recruitment could mean loss of income (paragraphs 3.6-3.8). The National Audit Office compared institutions' forecasts of total student numbers for 1993-94 made in July 1993 with the outturn as measured by the Higher Education Statistics Survey in March 1994. This was to gain an insight as to the accuracy of institutional forecasting and the extent of under or over-recruitment against institutions' own targets.

Full-time and sandwich course students

- The sector as a whole over-recruited full-time and sandwich course students by 1.6 per cent (12,000 students), with 27 institutions over-recruiting by five per cent or more. In total 44 institutions under-recruited compared with their forecasts. Eight institutions had under-recruited by more than five per cent but in five of these cases this was partially offset by over-recruitment of part-time students;

Part-time students

- The sector as a whole over-recruited part-time students by 1.6 per cent (6,000 students). Forty-five institutions under-recruited compared with their forecasts with 18 of these institutions under-recruiting by more than 10 per cent. The recruitment of part-time students has been and remains difficult for some institutions in a period of economic recession.

3.14 According to the National Audit Office survey, all but five of the institutions in their financial planning processes had considered a range of assumptions relating to student intake. In providing financial forecasts to the Funding Council in July 1993, "old" universities were asked by the Funding Council to provide an illustration of the effect of adopting pessimistic assumptions on overseas students, a high risk source of income, and the former polytechnics were asked to illustrate the effect of pessimistic assumptions on student income generally.

3.15 The National Audit Office examined the details of 46 institutions which had provided sufficient information on pessimistic assumptions relating to student numbers and which had also quantified the cost of not achieving targets. Pessimistic assumptions ranged from one per cent to 10 per cent under-recruitment of full-time students. Six institutions had, in practice, under-recruited compared to forecast and four of them were in a worse position than even their pessimistic assumptions. These four institutions have taken compensatory action in response to under-recruitment and in their latest forecasts none of them are predicting deficits in 1993-94.

3.16 As a result of this exercise, the National Audit Office agreed with the Funding Council that they needed to strengthen their monitoring of student numbers by requiring all institutions to provide pessimistic assumptions for forecast numbers on all categories of students and to quantify the financial effect of under and over-recruitment. Moreover, institutions should also be asked to state what action they would take in the event of that pessimistic scenario being realised. The Funding Council required institutions to provide specific pessimistic assumptions on the under-recruitment of all students as part of the sensitivity analysis of the financial forecasts they submitted to the Funding Council in July 1994. Institutions were also required to state the financial impact and what action they would take in the event of under-recruitment at these levels.

3.17 Recognising the importance of accurate forecasting of student numbers, the National Audit Office sponsored the development of an Executive Information System for student number planning at the University of Lancaster. The model was developed to aid the setting and monitoring of recruitment targets by considering a range of scenarios for student recruitment. An extension module has now been added to translate assumptions for student numbers into financial impacts. The model will be used by Lancaster to undertake the sensitivity analysis now being required by the Funding Council. The Funding Council are aware of a number of other institutions which have developed their own models for forecasting student numbers.

Key points

3.18 Accurate forecasting of student numbers and keeping student recruitment in line with the targets set are important to institutions' financial health. Failure to meet targets can have an adverse effect. The related lesson learned is at Appendix 4, paragraph 1.

3.19 In 1994-95, to strengthen their monitoring arrangements, the Funding Council have included the financial impact of under-recruitment of all students as a scenario within the sensitivity analysis of the financial forecasts required from institutions in July 1994.

3.20 The Funding Council might encourage institutions to adopt a structured approach to student number planning through the use of modelling and other techniques, where these are not already in place.

Overseas students

3.21 In addition to helping develop academic collaborative links with other countries, there is a strong financial incentive for institutions to recruit overseas students because such students are charged a market price for fees. In 1994-95, fees from overseas students are forecast to be 4.3 per cent of the total income of the whole higher education sector and are forecast to increase marginally to 4.9 per cent of total income by 1997-98.

3.22 Traditionally Malaysia, Hong Kong and Singapore have provided the main overseas markets for United Kingdom institutions. The National Audit Office survey confirmed that this is still the case. 73 per cent of the 130 institutions actively targeting overseas students identified these three areas as a group as their top choice.

3.23 Although a significant source of income, the overseas market for students is a volatile one and this is recognised by institutions in preparing their forecasts. In 1993-94, the sector exceeded its target for overseas students (63,500) by 6.6 per cent (4,200 students). However, within the sectoral totals there were 55 institutions which had under-recruited overseas students overall. Of these 55, results ranged from 18 institutions which had under-recruited by 10 or less students to seven others which under-recruited by more than 100 students. Nineteen institutions had under-recruited full-time and sandwich course students by 20 per cent or more and 15 institutions had under-recruited part-time students by 20 per cent or more.

Key points

3.24 The overseas market for English higher education institutions is fairly narrow. In view of the intense competition for these students, many institutions need to diversify by developing links with other overseas markets to facilitate recruitment.

Continued

3.25 In 1993-94, some institutions had under-recruited overseas students by 20 per cent or more against their own targets. Institutions should continue to recognise the volatility of this market and the need to forecast realistically.

Teaching quality

3.26 The Further and Higher Education Act 1992 places a statutory requirement on the Funding Council to ensure that provision is made for assessing the quality of higher education. The Funding Council have established a Quality Assessment Committee to advise on the discharge of their statutory responsibility and a Quality Assessment Division to carry out assessments. The assessment method has three main elements:

- a self-assessment by the institution in the subject supported by relevant statistical indicators;
- examination of the self-assessment and statistical indicators by assessors; and
- independent judgement on the quality of education (which may involve a visit by a team of assessors).

3.27 There are three assessment categories: excellent, satisfactory and unsatisfactory. The Funding Council aim to ensure that all education which they fund is of satisfactory quality or better, and that unsatisfactory quality is rectified as quickly as possible. If a subject has been assessed as unsatisfactory and remains unsatisfactory following a second visit by the assessors, the Funding Council will inform the institution that the relevant part of core funding will be immediately or successively withdrawn. The results of quality assessments for each subject are published. An excellent rating is likely to give an institution a market advantage in recruiting students. On the other hand, an unsatisfactory rating is likely to deter students.

3.28 In the calendar year 1993, assessments were conducted in four subjects - chemistry, history, law and mechanical engineering. The full results from this exercise were published in July 1994. Most institutions received a satisfactory rating: 70 per cent fell into this category for law, 80 per cent for history, 83 per cent for chemistry, and 87 per cent for mechanical engineering. The remainder were rated as excellent apart from one institution which was rated as unsatisfactory in law and another which was rated as unsatisfactory in mechanical engineering. In September 1994, assessments were completed in architecture, business and management, computer science and applied social work. The results will be published in 1995. The Funding Council believe that the publication of the results of quality assessment visits will act as a catalyst to maintain or improve the quality of teaching.

3.29 The Higher Education Quality Council, an organisation established by the bodies representing the universities and colleges, is responsible for scrutinising whether institutions have suitable quality control mechanisms for teaching provision in place. All institutions have established quality control mechanisms for maintaining and enhancing teaching provision. The most common arrangements identified in the National Audit Office survey were staff development and appraisal, student feedback on courses, peer review, external examiner reports, validation, review and monitoring of courses and the use of statistical indicators.

3.30 The expansion in student numbers in recent years has been accompanied by significant increases in student:staff ratios (Table 2). To some extent, the increased ratios have been made manageable by changes in teaching methods including the greater use of information technology. The National Audit Office used these ratios to get a very broad indication of trends.

Table 2: Sectoral student:staff ratios

Ratios	1989-1990 Actual %	1992-93 Actual %	1995-96 Estimate %
Up to 10:1	17	16	15
Between 10:1 and 15:1	64	29	20
Between 15:1 and 20:1	14	44	44
Above 20:1	-	9	18
Not stated	5	2	3

Source: National Audit Office

Note: Student:staff ratios have been defined as full-time equivalent student load divided by full-time equivalent staff paid wholly from institutions' general funds.

Table 2 shows that 14 per cent of the sector had student:staff ratios of more than 15:1 in 1989-90. Over half the sector were in that position for 1992-93 and about two thirds of the sector are predicted to be in that position for 1995-96.

3.31 For the "old" universities, the student:staff ratios include numbers of academic staff engaged on both teaching and research. For this reason, they cannot be compared on a "like for like" basis with the former polytechnics and colleges which have received minimal funding for research and where their ratios will more accurately reflect the number of students to each teaching member of staff. Furthermore, differences in subject mix can make comparisons difficult. For example, medicine, dentistry and veterinary science which traditionally have much lower student:staff ratios than the average, are taught only in the "old" universities. However, trends are not affected by these differences. In 1989-90, only 14 per cent of the sector had ratios over 15:1. By 1992-93, over half (53 per cent) of the sector was in that position and about two thirds (62 per cent) of all institutions are predicting that they will be in that situation by 1995-96.

3.32 In the survey, institutions were asked whether increased student: staff ratios had affected teaching quality. Of those institutions which had experienced increased ratios, 11 per cent said that teaching quality had been affected whereas 44 per cent said that it had not and 41 per cent found it impossible to say. Four per cent had not experienced increased ratios. The main ways in which teaching had been affected for the 11 per cent were reduced student contact, fewer tutorials and increased lecture sizes.

3.33 Among the measures taken to manage the greater numbers were the development of information technology techniques, rationalisation of courses, maximising the use of accommodation, and employment of postgraduates as teaching assistants. Following initiatives by their predecessor funding councils, the Funding Council have allocated £9 million to enable new projects to be started under the Teaching and Learning Technology Programme (Phase 2) in each of the years 1993-94 and 1994-95. This was in addition to the £7.5 million commitment inherited from the former Universities Funding Council for Phase 1 of the programme.

Key points

3.34 Institutions which continue to receive an unsatisfactory quality rating in any subject taught after two visits by the Funding Council's assessors will have the relevant part of core funding immediately or successively withdrawn.

3.35 Virtually all of the teaching provision in the four subjects assessed by the Funding Council to date has been rated as satisfactory or better. Only two institutions have had unsatisfactory ratings and may therefore be liable to have the relevant part of core funding withdrawn.

3.36 Recent expansion has been accompanied by significant increases in student:staff ratios. Whilst over 40 per cent of institutions thought that teaching quality had not suffered, a similar proportion said that it was impossible to tell.
Eleven per cent of institutions thought that these increases had affected quality.

Research

Funding for research

3.37 The Funding Council have allocated £0.6 billion to fund research in 1994-95, 94 per cent of which is allocated by reference to quality criteria. Funding Council grant for research provides the funding out of which institutions meet part of the cost of premises as well as a proportion of the salaries of academic staff and central computing services. This supports basic research and underpins the "dual support" system whereby institutions receive general public funding from the Funding Council and specific project grants from the Research Councils.

3.38 The 1991 "New Framework" White Paper made it clear that funding for research should be allocated selectively to improve quality by encouraging institutions to concentrate on their strengths. Since the Funding Council's research allocation formula gives greater weight to those departments achieving higher quality ratings in the periodic research assessment exercise, research funding is being allocated increasingly to those departments with a strong research record.

3.39 The first research assessment exercise was undertaken in 1986 and was repeated with modifications in 1989 and 1992. Ex-polytechnics and colleges were included for the first time in the 1992 exercise. The quality of institutions' research is judged on a five point rating scale. Between 1989 and 1992, overall ratings for institutions of the former "old" university sector increased on average by 0.5 from 3.28 to 3.76 (15 per cent), indicating an improvement in quality.

3.40 Academic departments which received the lowest of the five ratings in the 1992 research assessment exercise are now allocated no research funding based on the quality criteria. Low ratings can mean a reduction in research funding for an institution and can contribute to actual or potential financial problems. Low ratings can also affect an institution's ability to attract research contract work from external customers. The effects of low ratings on financial health are identified at Appendix 4, paragraph 4.

3.41 Given the substantial increases in funding implied in certain cases, the Funding Council decided that the full effects should be phased in over a period. Institutions which would have had the largest increases in funding were therefore capped in 1993-94 and 1994-95, and the funds thus released redistributed to other institutions in receipt of research funding based on the quality criteria. Nonetheless, under the research assessment exercise 13 institutions are receiving 50 per cent of the available funds.

3.42 In response to the National Audit Office survey nearly all institutions in both the former sectors stated that research was one of their activities. Only 13 were not involved in any form of research. Of those institutions undertaking research:

- 90 per cent were aiming to maintain or develop a broad research base;
- 85 per cent had all academic departments engaged in research; and
- 53 per cent had all academic staff engaged on research.

3.43 The survey also found that of the institutions undertaking research 71 per cent intended to allocate research funds more selectively to departments of recognised strength. At the time of the survey, only 17 institutions intended to reduce research activity in any academic departments and only two institutions intended to actually cease research activity in a particular department or departments.

3.44 From the National Audit Office's consultations with the sector, the reasons for institutions intending to maintain or develop a broad research base, whilst allocating funds more selectively, are wide-ranging and include the following:

- The research function is related to how the institution perceives itself and is in accordance with its priorities and mission;

- The results of each research assessment exercise are unpredictable and, therefore, institutions perceive the need to: maintain the research ratings of high scoring academic departments; improve the ranking of middle scoring departments; and allow for new talent and new areas of research in other departments;

- Institutions are naturally resistant to abandoning or down-grading the research mission in a department where it has traditionally existed;

- Research scores have been rising in most subjects from one research assessment exercise to the next. Institutions with departments rated in the middle and lower range of research scores perceive that they may be able to raise their scores between assessment exercises; and

- Institutions which have not previously been in receipt of research funding from the Funding Council aspire to develop their research activities.

3.45 Funds allocated for research are part of the block recurrent grant allocated to institutions. The Funding Council believe that it is for individual institutions to decide how these funds are allocated internally to deliver the research for which the funding has been provided.

3.46 Between the financial years 1992-93 and 1994-95 funds have been transferred from the Funding Council's block recurrent grant to the Research Councils to enable them to meet more of the direct costs and to contribute to the indirect costs (overheads) of their projects. This transfer of funds was aimed at resolving confusion over the costs that should be covered by the Funding and Research Councils respectively. Prior to that time, Research Council grants covered only certain additional project costs. The Research Councils are now responsible for meeting all the costs of their projects except for academic salaries, premises, and central computing. A notional 40 per cent of direct staff costs is being paid by the Research Councils to institutions to cover overheads. Research Council grants are distributed selectively against bids on a project basis.

3.47 One consequence of the Government's decision to make this transfer of funds to Research Councils has been to add to the uncertainty institutions face in projecting research income. This has adversely affected their cash flow. The money is now received only after institutions have won research grants rather than as part of Funding Council grant. The payment profile of Research Council grants also gave rise to cash flow problems in 1992-93, but a new system designed to match cash flow to the costs incurred has now been introduced.

Key points

3.48 In accordance with Government policy, the Funding Council are allocating research funds selectively to improve quality by encouraging institutions to concentrate on their strengths. 94 per cent of the Council's £0.6 billion research funding in 1994-95 has been allocated by reference to quality criteria. Between

Continued

1989 and 1992, overall quality ratings for institutions of the former "old" university sector showed an average increase of 15 per cent, indicating an improvement in quality in that part of the sector.

3.49 According to the National Audit Office survey, which covered the whole of the new sector, 90 per cent of institutions undertaking research intend to maintain or develop a broad research base. 71 per cent of these institutions also intend to allocate research funds more selectively to departments of recognised strength. The Funding Council believe that this is a matter for institutions to determine in accordance with their own policies and priorities.

Commercially supported research

3.50 Institutions are forecasting that income from commercially supported research will be over £0.4 billion in 1994-95 rising to over £0.5 billion by 1997-98. The 1991 "New Framework" White Paper stated that commercially supported research was expected to be self-financing. Also, in his letter dated June 1992 to the Chairman of the Funding Council, the Secretary of State said that funds allocated by the Funding Council to institutions should not be used to support near market research for which commercial backing would be expected: contracts entered into by institutions for such research should be self-financing and the Funding Council should continue to monitor levels of cost recovery. The Financial Memorandum between the Funding Council and institutions states that:

"In determining the price to be charged for research contracts and other external services institutions shall have regard to the need to assess the full cost and to recover full costs unless the institution considers it appropriate to do otherwise having regard to the circumstances of the particular case".

3.51 However, the powers of the Funding Council in this area are limited as Section 65(4) of the Further and Higher Education Act 1992 prevents the Funding Council from attaching conditions to funds derived other than from the Funding Council. Also Section 66(2) requires the Funding Council not to discourage institutions from maintaining or developing their funding from other sources. In fact, elements of research funding, £20 million in 1994-95, are allocated to institutions weighted on the basis of successful overhead cost recovery on research contract work. This acts as an incentive for institutions to charge the full economic cost for all forms of commercially supported research.

3.52 The former Universities Funding Council worked with the Committee of Vice-Chancellors and Principals to develop best practice on the levying of overheads for research projects. The Funding Council recognise that the existing guidance is in need of revision and improvement and welcome the current initiative taken by the Committee of Vice-Chancellors and Principals and the Standing Conference of Principals to provide new guidance in this area. This work is already well advanced.

3.53 The National Audit Office survey enquired into the assessment and recovery of full costs. According to the responses received, a quarter of the 123 institutions involved in commercially supported research had not determined the full overhead recovery rate to be charged. Where institutions had determined the rate it varied from 16 per cent to over 120 per cent of all direct costs. Ten institutions out of the 89 which had determined the full overhead recovery rate said that they were recovering full costs.

3.54 Where full costs of commercial research are not being recovered, it is being subsidised by the institution. There may be good reasons for institutions accepting contracts at below full costs. For example, the research may be of a generic or wide-ranging nature, and of intrinsic academic interest, leading to publications. However, to inform such choices institutions need to be aware of the costs involved.

3.55 The representative bodies of the sector believe that another reason why the full costs of commercial research are not always recovered by institutions lies in the unwillingness of certain sponsors to pay full costs. These include some Government departments, the European Commission, and some commercial organisations.

Key points

3.56 The Funding Council are allocating £20 million of the £0.6 billion research funding in 1994-95 to institutions weighted on the basis of successful overhead cost recovery on research contract work. This acts as an incentive to institutions to charge the full economic cost for commercially supported research.

3.57 A quarter of all institutions had not determined the full overhead recovery rate that should be charged for research contract work and were therefore not in a position to know whether or not they were recovering their costs. These institutions need to be aware of the costs involved and the extent of any subsidy to commercially supported research in order to make informed choices about whether the work should be undertaken.

3.58 Ten out of the 89 institutions which had determined what the full overhead recovery rate should be were recovering costs at this rate. The Funding Council should continue to work with the Committee of Vice-Chancellors and Principals and the Standing Conference of Principals to develop best practice for costing and pricing of research contracts.

Funding Council initiatives to secure stability in the sector

3.59 To promote stability in the sector, the Funding Council have introduced various measures to ensure that no institution receives an unmanageable change in the level of its funding. They have also introduced measures to help institutions to cope with sudden changes in Government policy, for example, new arrangements for initial teacher training. In this way, the Funding Council as the largest single contributor to an institution's income are seeking to avoid being the cause of any financial difficulties at an institution. This should be distinguished from the Funding Council's policy of not providing additional financial support to institutions in financial trouble (paragraph 2.2). In determining the mechanism which triggers the level of any additional transitional funding, the Funding Council are conscious of the need to ensure that this does not act as a disincentive to efficiency and effectiveness.

Unmanageable changes in funding

a) On overall recurrent grant

3.60 In 1993-94 and 1994-95, the Funding Council limited increases in recurrent grant to some institutions and reduced the level of decreases to others by providing a transitional safety net (paragraph 3.3). Over these two years, the Funding Council provided a total of £7.8 million in transitional safety net funding to 31 institutions, of which two individual institutions received in total about £3.7 million. Transitional safety net funding needs to be set in the context of total recurrent grant (about £5.4 billion in total for the two years 1993-94 and 1994-95).

b) On research funding

3.61 The results of each research assessment exercise can bring unpredictable fluctuations in the research funding of an institution. Therefore, following the results of the 1992 research assessment exercise, the Funding Council have been operating a capping system to provide an element of stability. In 1993-94 no institution received an increase of more than 15 per cent of their quality related research funding over 1992-93. A smaller cap of 7.5 per cent was applied for 1994-95. The annual increase in the research funding of 12 institutions was affected by the cap in 1993-94 and seven of these were further capped in 1994-95. A strict and immediate application of the funding formula based on the results of the research assessment exercise would have meant that some of the top ranking research institutions would have received increases of more than 25 per cent and others would have had decreases of more than 35 per cent.

Policy changes

a) From expansion in student numbers to consolidation

3.62 Institutions with high rates of in-built growth were particularly affected by the change in policy from expansion in student numbers to one of consolidation. Lower than expected rates of increase in teaching income brought about actual or potential financial management problems to such institutions. The related lesson learned is at Appendix 4, paragraph 2. To alleviate such difficulties the Funding Council provided an additional £2.2 million in 1993-94 to nine institutions with high rates of in-built growth, all of which came from the former polytechnics and colleges sector. The additional funding was to assist these institutions on a transitional basis to alleviate short term financial management problems and was conditional upon these institutions taking steps to limit their student intakes. Recognising that in-built growth will flow through for a second year, the Funding Council have provided an additional £1.5 million to these institutions in 1994-95.

b) On initial teacher training

3.63 Changes in Government policy on primary and secondary teacher training, requiring increased school based provision and a change in the balance of student intakes from primary to secondary, have impacted upon institutions providing initial teacher training. Specialist colleges are more vulnerable to change because of their relatively narrow subject range and are more likely to suffer actual or potential financial difficulty. The related lesson learned is at Appendix 4, paragraph 3. The Funding Council have contributed £12 million over two years to assist institutions in adapting existing courses to meet the revised course criteria.

Key points

3.64 The Funding Council have introduced measures to ensure that no institution receives an unmanageable change in the level of its funding of recurrent grant as a whole, and of the major part of research funding, the quality element. Thus, they have limited the increase in funding to some institutions and the decrease in funding to others. In these ways, the Funding Council are taking steps to prevent some institutions getting into financial difficulty. Additional funding has also been provided to enable institutions to adapt to changes in Government policy, for example, on consolidation of student numbers and initial teacher training.

3.65 In determining the mechanism which triggers the level of any additional transitional funding to counter the impact of unmanageable change, the Funding Council are conscious of the need to ensure that this additional funding does not act as a disincentive to efficiency and effectiveness. The provision of additional transitional funding to institutions should be distinguished from the Funding Council's policy of not providing financial support to institutions in financial trouble.

Accountability for teaching and research

3.66 Under the terms of the Financial Memorandum between the Department and the Funding Council, the Chief Executive of the Funding Council must satisfy himself that the uses to which the Funding Council's payments are put are consistent with the purposes for which they have been given (Appendix 1). Payments of grant to institutions are in exchange for teaching and research and are conditional upon delivery. Although the Funding Council separately identify funds for teaching and research in accordance with the directive of the Secretary of State, the Funding Council treat recurrent grant as a block grant and it is for individual institutions to determine how their grant should be applied in delivering the teaching and research for which the funding has been provided. Therefore the Funding Council do not establish how much each institution is spending on teaching and how much on research. The Funding Council consider that there are considerable difficulties in attempting to separate the costs of these activities.

3.67 The Secretary of State in his guidance to the Funding Council in June 1992 stressed that having identified the resources being allocated for teaching and research, the Funding Council should build on this by:

- specifying clearly what institutions are expected to provide in return for the public funds for teaching; and

- requiring increased accountability from institutions about their use of research funds provided by the Funding Council.

The letter further stated that the Secretary of State would wish to consider each year the Funding Council's proposals on the proportions of funds to be allocated for teaching and research. In compliance with the first stipulation above, the Funding Council's annual funding agreement with each institution sets out the contract student numbers which the institution is required to deliver to avoid funding being withheld. On the second stipulation, the Funding Council commissioned Coopers and Lybrand to conduct a study into research accountability.

3.68 In February 1993, Coopers and Lybrand reported their findings setting out various options for improving research accountability. The Funding Council then consulted the sector. Institutions expressed widespread concern about the practical difficulties and the costs involved if they were expected to account separately for the expenditure on teaching and research. To do so with any exactitude would entail staff keeping a record of the time spent on teaching and on research. After four pilot studies, the Funding Council concluded in February 1994 that institutions should be required to report on how they have allocated research funding and not on how it has actually been spent. Institutions will first report to the Funding Council on how they have allocated research grant by 31 July 1995, to cover 1994-95 and 1995-96. This approach has been accepted by the Department for Education.

3.69 Representative bodies believe that accountability should be more about assessing outputs. It is their view that expending a significant effort on determining expenditure on teaching and research would cost more than any benefits that could be realised through increased accountability.

Key points

3.70 Although the Funding Council separately identify funds for teaching and research for each institution, they treat recurrent grant as a block grant and it is for individual institutions to determine how their grant should be applied in delivering the teaching and research for which the funding has been provided. Thus, funds for teaching may be used on research and vice versa.

Continued

3.71 The Funding Council's methods of obtaining accountability from institutions for teaching and research fulfil the Secretary of State's current requirements. Institutions must deliver the student numbers for which they are funded and from 1994-95 they will be accountable for how they allocate research funds.

3.72 The National Audit Office take the view that the requirement for institutions to be accountable for the allocation of research funds is a move in the right direction. It will provide the Funding Council with a greater assurance that institutions at least plan to spend research funds for the purposes given. In due course, they also need to return to consideration of how institutions should account for the expenditure on teaching and research.

Part 4: Financial control of support and other activities

4.1 This part of the Report considers the financial control exercised by institutions over support and other activities, which include the estate, residences and catering, and commercial services.

Management of estates

Capital funding

4.2 In the financial year 1994-95, the Funding Council will distribute over £0.3 billion in capital provision. Within this sum they will allocate £202 million for equipment, £64 million for maintenance projects, £34 million for building projects, and £22 million for estate funds not linked to specific projects.

4.3 Over the years, the capital grants paid to institutions by the Funding Council's predecessors have substantially reduced. In 1993-94, their first year of operation, the Funding Council gave priority to funding a backlog of maintenance work and were unable to allocate funds to support the first year of new major building projects. But they have set £10 million aside for this purpose in the financial year 1994-95 and £20 million in 1995-96. Typically the Funding Council would expect to fund between 25 and 50 per cent of a successful capital project bid. Therefore the sector is expected to fund new buildings mainly from internally or externally generated funds.

Key point

4.4 The sector is expected to fund new building projects mainly from internally or externally generated funds rather than from capital grant provided by the Funding Council.

Institutional estate strategies

4.5 There are pressures on institutions' buildings both as a result of the recent increase in student numbers and as a result of shortfalls in past expenditure on long term maintenance. In the short term, there can only be a modest increase in student numbers because of the policy of consolidation. In the long term, pressure on accommodation is likely to increase with the expected growth in student numbers towards the end of the decade. However changed teaching methods and possible changes to the structure of the academic year should help to alleviate some of the pressure.

4.6 The former funding councils' Working Group on Capital Policy, under the chairmanship of Sir Idris Pearce, issued a report on Capital Funding and Estate Management in June 1992. One of the key recommendations was that institutions should put in place estate strategies which were integrated with overall institutional strategies. The Funding Council responded by requiring completion of estate strategies by institutions not later than 31 March 1995. In future, bids from institutions for funds to support estate projects will only be accepted by the Funding Council if the bids are consistent with institutions' estate strategies. In reply to the National Audit Office survey in the Summer of 1993, 78 per cent of all institutions stated that they had already produced estate strategies.

4.7 Estate problems can be factors contributing to the financial difficulties at institutions. This is identified at Appendix 4, paragraph 5. Problems encountered were due to inefficient estate caused by disparate locations, previous under-investment in buildings by the local education authority, and a backlog of long term maintenance. These instances reinforce the Funding Council's requirement for a sound estate strategy with rationalisation being considered where necessary and sufficient financial provision being made for developing and maintaining the estate.

Key points

4.8 Pressures on institutions' buildings are likely to continue with the expected rise in student numbers towards the end of the decade. Changed teaching methods and changes to the structure of the academic year should help reduce such pressures.

4.9 Institutions have made good progress in producing estate strategies. By linking funds for future capital projects with estate strategies, the Funding Council are encouraging institutions to consider their estates as a strategic resource.

Borrowing to build

4.10 The Pearce Report considered in principle that institutions had sufficient income and a strong enough asset base to cope with significantly higher levels of debt. It recommended that there should be a relaxation of the controls over borrowing on the security of Exchequer funded assets. This was to bring the "old" universities in line with the institutions of the former polytechnics and colleges sector which were able to borrow on assets formerly owned by local authorities; and it was confirmed as policy in the Government's 1992 Autumn Statement effective from 1 April 1993. The National Audit Office survey found that 10 of the "old" universities intended to use Exchequer funded assets as security for loans.

4.11 The risks involved in institutions borrowing on the security of Exchequer and local authority funded assets are that, in principle, if an institution were to default on a loan, teaching and research facilities might be jeopardised and the property originally funded from the public purse might be lost to the commercial sector. As yet, no institution has been in this position.

4.12 Another of the Pearce Report's conclusions was that a financial intermediary should be established to assist educational establishments to raise loans from financial institutions. Accordingly, the three Higher Education Funding Councils of England, Scotland and Wales commissioned a report from Professor Andrew Bain of Glasgow University on Private Sector Funding in Higher Education.

4.13 The Bain report, published in August 1993, found that total borrowing from the private sector by higher education in the United Kingdom exceeded £0.8 billion at the end of 1992, of which 75-80 per cent was for student residences to which a clear income stream, namely rents, could be attached. Of the remainder some was for business schools and conference centres to which a clear income stream could also be attached, and the rest was for academic and administrative buildings which have no clear income stream.Two-thirds of the borrowing was by "old" universities. One of the key assumptions of the Bain report was that institutions needed a balanced portfolio of debt, including short term variable rate and long term fixed rate loans. The financial intermediary proposed by the Pearce Report would facilitate this by providing institutions with access to long term fixed rate funds which are only available from the (wholesale) capital markets. The Bain Report also stressed the need for future central Government recurrent funding to take into account the costs of debt servicing, thus enabling institutions to generate surpluses to finance capital developments.

4.14 A series of recommendations was made in the Bain Report including a proposal that the Funding Council be prepared to provide "letters of support" to institutions. This would be in exceptional cases in order to give sufficient reassurance to lenders where the Funding Council had not made a capital contribution to the cost of the project. The Funding Council may give guarantees or indemnities with the prior approval of the Secretary of State for Education, but have chosen not to exercise this power. They are, however, willing to clarify the role of the Funding Council in approving borrowing applications and confirm, in respect of a particular transaction, that the institution concerned has complied with the terms of the Financial Memorandum. The Funding Council also have in preparation a booklet for the benefit of potential lenders which will serve as a guide to the sector, the legislative framework in which the sector operates and how the sector is funded and monitored. Amongst other things this will explain the Funding Council's approach to funding and their regulatory role in relation to borrowing and capital transactions by institutions.

4.15 Another of the main recommendations in the Bain Report was the setting up of a vehicle company for raising capital. The three Higher Education Funding Councils of England, Scotland and Wales, along with institutions' representative bodies, the Committee of Vice-Chancellors and Principals and the Standing Conference of Principals, have completed a blueprint for this company. The representative bodies are consulting with the sector on the way forward.

4.16 Long term liabilities of the sector, which include long term loans and deferred capital grants, are projected by institutions to increase by 74 per cent between 1992-93 and 1997-98 to £2.2 billion (Table 1). This mainly relates to external borrowings (paragraph 4.10). The July 1994 financial forecasts for the period to 1997-98 show that:

- 56 institutions either intend to have no long term borrowing or to borrow up to £1 million in the period;
- 36 institutions intend to borrow between £1 million and £10 million; and
- 56 institutions intend to borrow more than £10 million.

4.17 When a comparison is made with the July 1993 forecasts, the general trend is an increase in borrowing with the number of institutions intending to borrow more than £10 million having increased by 19 from 37 to 56. Between July 1993 and July 1994 the sector has forecast increased borrowing of £0.25 billion for the years 1993-94 to 1996-97 inclusive. Five institutions, all "old" universities, are currently projecting to borrow more than £50 million each by 1997-98. This compares with the previous July 1993 forecasts when one "old" university and three "new" universities were planning to borrow more than £50 million each by 1996-97. Therefore, although some institutions may have revised their borrowing plans downwards in the light of consolidation of student numbers, others have revised their plans upwards.

4.18 The National Audit Office survey asked institutions how funds for capital development would be provided. As a first priority, 31 per cent of the sector ranked use of reserves. This was followed by borrowing (28 per cent) and sale of assets (10 per cent). When the National Audit Office survey asked institutions if they expected to increase their borrowings in the next five years, 115 (78 per cent) said that they did: 64 per cent of the sector intended to raise loans for student residences, 47 per cent for academic buildings and 41 per cent for academic support buildings.

4.19 In general, institutions have in the past found it difficult to obtain low cost, long term finance from the private sector for academic and administrative buildings because there is no easily recognisable stream of income associated with them. In the case of student residences, the income stream is from rents to which can be attached a fairly high degree of confidence because of the current shortage of residential places and the high demand for them. The Funding Council and the Committee of Vice-Chancellors and Principals have been sponsoring various conferences on "Opportunities in the Funding of Higher Education" in late 1993 and in the Spring and Summer of 1994 for potential lenders.

4.20 The Financial Memorandum between the Department for Education and the Funding Council requires that the Funding Council "make such provision as seems to them to be necessary to protect the public interest in Council funded assets, to protect the public investment in institutions and to maintain accountability for the use of Council funds". This is reflected in the Financial Memorandum between the Funding Council and each institution. The Funding Council have laid down conditions for both secured and unsecured borrowing.

4.21 For borrowing on the security of Exchequer or local authority funded assets, an institution must obtain Funding Council approval, which will be given provided that the institution has satisfied the Funding Council that:

- the project in relation to which the borrowing is proposed will realise an appropriate rate of return, equal to or exceeding the Treasury discount rate, taking account of both revenue savings and generated income;

- the institution will be able both to repay the sum borrowed and to pay the interest thereon without recourse to additional grant from the Funding Council;

- the ability of the institution to maintain financial viability will not be impaired as a result; and

- the institution's annual level of repayment and servicing costs for all loans will not exceed seven per cent of the institution's annual income. Excluded from the seven per cent rule are loans on student residences where the project is completely self-financing and loans inherited from local authorities which are reimbursed by the Funding Council (paragraph 2.6).

4.22 Where the borrowings secured on publicly funded assets are a substantial proportion of an institution's income, the Funding Council may seek independent professional advice. An institution is free to borrow against other privately owned assets but if the project involves the servicing and/or repayment of the loan with the aid of funding from the Funding Council, the institution must seek the Funding Council's prior consent which will only be given if the above criteria are satisfied.

4.23 An institution may enter into unsecured borrowing to fund capital or recurrent expenditure but the institution must inform the Funding Council in writing if the aggregate of such borrowing, after taking account of all cash balances, exceeds the lower of five per cent of total income or £2 million. If the institution proposes that the total of unsecured borrowing will exceed the lower of eight per cent of total income or £3 million, the prior consent of the Funding Council must be sought.

4.24 The National Audit Office examined eight cases of secured borrowing for academic buildings at six institutions. At the time of the examination (March 1994) there were only 15 such cases, all from the former polytechnics and colleges sector. Since then, as at September 1994, there have been six further cases of secured borrowing for academic buildings, two in the "old" universities sector and four in the former polytechnics and colleges sector. There have also been 17 cases of secured borrowing for residential building, five in the "old" universities sector and 12 in the former polytechnics and colleges sector.

4.25 The National Audit Office found that the Funding Council checked in each case for adherence to the criteria in paragraph 4.21 above. Moreover, each institution had to provide an investment appraisal for the project, an analysis of the risks and sensitivities including the sensitivity to change in Government policy, details of the other options considered, the consequences of repossession, and also how the scheme would fit into the applicant's overall estate strategy. In making their case to the Funding Council, four institutions referred to space norms or space efficiency indices formerly used by the polytechnics sector to demonstrate that existing space was used efficiently. In some of the earlier cases not all of the Funding Council's checks had been documented but on the later cases a more systematic and fully documented approach had been adopted.

Key points

4.26 The risks involved in institutions borrowing on the security of Exchequer and local authority funded assets are that, in principle, if an institution were to default on a loan, teaching and research facilities might be jeopardised and the property originally funded from the public purse might be lost to the commercial sector. As yet, no institution has been in this position.

4.27 The Funding Council are playing a crucial role in approving borrowing requests and assessing the impact on the institution's financial health. They need to continue to ensure that their controls are sufficient to identify those cases where borrowing could put the institution's health at risk.

Maintenance of the estate

4.28 The Pearce Report noted that many buildings in the sector were in a poor state of repair and expensive in terms of energy consumption. Moreover, expenditure on maintenance had been generally low, giving rise to estates which were in poor condition, and outmoded in respect of modern teaching methods. Two sector-wide surveys had earlier been carried out on the condition of institutional estates. First, the Hunter survey in 1989 covered all ex-polytechnics and colleges and in 1992 was enhanced by an electrical compliance survey. Secondly, in 1992 the KDK survey covered all "old" universities. Both these surveys were intended to give the former funding councils a global picture of the sectors' estates and indicated that £1.8 billion of work was required to bring all buildings of English higher education institutions up to standard.

4.29 The National Audit Office survey sought to assess how institutions viewed the scale of their maintenance problems in practice. Only one third of the sector thought the Hunter/KDK surveys were accurate. About half of the sector thought the problems were understated and about a fifth said they were overstated.

4.30 A backlog of maintenance work and work needed to comply with new health and safety legislation are putting pressure on the expenditure of the majority of the sector. The 1989 Hunter survey identified a total of some £626 million as being required to address the maintenance backlog of English former polytechnics and colleges, over a five year period. The survey recommended that the priority 1 work (£75 million) needed to be completed within one year, priority 2 work (£188 million) within two years, and the balance of the work after the completion of priority 2. The majority of priority 1 and 2 work has now been carried out. However, the 1992 Hunter electrical survey identified a further £115 million for priority 1 and 2 work over five years.

4.31 The KDK survey identified a maintenance backlog of £1,126 million covering English universities' residential and non-residential buildings which ought to be undertaken within seven to eight years. Of this total, priority 1 work (about £200 million) should have been undertaken within one year, priority 2 work (over £400 million) undertaken within two years, priority 3 work (over £400 million) within five years and the balance within seven to eight years.

4.32 The Funding Council have been encouraging institutions to conduct their own in-depth surveys on a three to five year rolling programme in order to keep estate maintenance under review. They are supporting priority 1 and 2 work on academic buildings identified in the Hunter electrical and KDK surveys: £81 million to support 40 per cent of priority 1 work over the three financial years to 1996-97, and a further £96 million to support 25 per cent of priority 2 work over the three financial years to 1997-98, subject to future public expenditure settlements.

4.33 In response to the question in the National Audit Office survey on whether the maintenance provision in financial projections as at July 1993 was sufficient to cover all the backlog, 58 per cent of institutions stated that it was not. Much of the priority 1 and 2 maintenance work in the former polytechnics and colleges is now reaching completion. A backlog of long term maintenance can be a contributory factor to financial problems. This is identified at Appendix 4, paragraph 5.

4.34 The Flowers Committee report in November 1993 on the Review of the Academic Year identified maintenance as one of the main factors deterring institutions from considering an extension of the academic year into the Summer period. Such an extension would increase wear and tear on buildings and equipment, result in higher maintenance costs, and make it more difficult to schedule major maintenance programmes, traditionally carried out during the Summer vacation.

Key point

4.35 Fifty-eight per cent of the sector considered that they had not put aside sufficient provision in their July 1993 financial forecasts to deal with all the maintenance backlog. Institutions could face financial difficulties if they have to undertake urgent repairs for which no provision has been made. The Funding Council will, as they recognise, need to focus on this issue in their review of institutions' accounts, forecasts, and estate strategies.

Space utilisation

4.36 Institutions are having to accommodate increased numbers in classes and need to maximise the potential of all of their space. The Pearce Report concluded that proper management of space was fundamental to improving utilisation and reducing the risk of waste. The report recommended that a substantially greater proportion of space at institutions should be subject to central timetabling and space charging schemes should be introduced by institutions where appropriate.

4.37 The National Audit Office survey found that about one third of the sector had a system for allocating the costs of space occupied to academic budget centres. There are a range of other measures for improving space utilisation, such as central timetabling, space audits, spot checks and the application of performance indicators. Institutions need to consider the costs and benefits of these various measures, or a combination of them, before determining how to improve their use of space. The Funding Council have taken forward work on space utilisation. Their guidance on estate management provides for institutions to have in their estate strategies methods for improving space utilisation.

4.38 During the National Audit Office visit to the University of Manchester, the benefits of having a space charging and central timetabling system were made clear. Previously departments had been unwilling to relinquish any accommodation held. With the introduction of space charging and a Central Timetabling Unit, lecture theatres were being used more effectively and, to make savings, academic budget centres were giving up space which was then being used by other expanding departments. For example, in response to the financial pressures, space totalling 5,000 square metres had been vacated in one building. The university accepted that there was a cost implication because rationalisation of space sometimes involved expensive adaptations.

Key points

4.39 Charging for space is one means by which improved space utilisation can be achieved. Only one third of institutions have systems for attributing the cost of space occupied. There is therefore scope for extending this practice where appropriate. This method of improving space utilisation needs to be considered by institutions alongside others, such as central timetabling, space audits, spot checks and the application of performance indicators, and the costs and benefits of each method, or a combination of methods, weighed up.

4.40 Funding Council guidance encourages institutions to include in their estate strategies methods for improving space utilisation. This should assist the Funding Council in assessing the extent to which space at institutions is being utilised efficiently and in identifying and disseminating good practice.

Mergers and collaboration

4.41 Since April 1993 there has been one merger in the English sector although others are planned in the near future. Proposals for merger are initiated by the institutions themselves. The Funding Council need to consider these proposals, not only because of the requirement to provide advice to the Secretary of State on the circumstances surrounding the dissolution of certain institutions, but also because of the impact on the financial health of the merged institution. In October 1992 the Funding Council adopted certain principles for assessing proposed mergers. These principles include the requirement that the distinctive characteristics of the institutions themselves and the diversity of the sector as a whole should be maintained. Another requirement is that the merged institution must be financially healthy and capable of delivering the teaching and research for which it is funded.

4.42 Some institutions have in the past suffered financial problems following mergers because of inherited deficits and inaccurate data being used to cost the mergers. This is identified at Appendix 4, paragraph 6. These mergers took place before the creation of the current Funding Council. Both of the former funding councils had produced checklists of the factors which needed to be considered for any merger proposal. The Funding Council will produce a revised checklist in 1994.

4.43 As at October 1994, there have been three mergers of further education colleges with higher education institutions. The Funding Council have no formal role in this area since the Department do not require that they be consulted. The Secretary of State looks to the Further Education Funding Council to ensure that their general approach to cases involving the merger of a further education corporation with a higher education institution is acceptable to the Funding Council, particularly in relation to the funding implications for further and higher education. Before advising her on individual cases, the Further Education Funding Council is also expected to consult the Funding Council on the particular case.

4.44 Collaboration between institutions can achieve academic and financial benefits. The National Audit Office visits to institutions in the Greater Manchester area showed there was already good collaboration on courses and some support services such as residence, health, sport and careers advice. These institutions were also looking to see how other complementary activities might be brought together and any duplication reduced. The Greater Manchester area lends itself well to collaboration because of the close physical proximity of institutions. However, collaboration between institutions can be constrained by institutions' differing natures, their disparate locations, and by the fact that they are increasingly in competition with one another.

4.45 There are many areas where collaboration already exists in the sector:

- professional groups on national and regional bases provide fora disseminating best practice and addressing common interests. These groupings include finance directors, building officers and senior academic administrators;

- five regional purchasing consortia in England, based on the consortia structure of the former "old" university sector, have been developed following the abolition of the binary line. (The Comptroller and Auditor General's Report on University Purchasing (HC 635) dated 12 May 1993 refers). These consortia also draw on the best practice of the former single Polytechnics Purchasing Consortium;

- the "old" universities have collaborated to form groups of software families to develop financial and administrative packages under the Management and Administrative Computing initiative. Some of the institutions of the former polytechnics sector have bought parts of these packages; and

- other areas of institutional collaboration include internal audit and value for money consortia, shared course provision and support services.

Key points

4.46 Rationalisation through mergers can achieve greater efficiency but some institutions in the past have had post merger financial problems because of inherited deficits or because of inaccurate costing data. The Funding Council stipulate that the higher education institution resulting from a merger must be financially healthy. The institutions and the Funding Council need to be satisfied that the financial case for merger has been based on sound data.

4.47 Where the merger is between a higher education institution and a further education institution, the Funding Council need to be formally consulted by the Further Education Funding Council.

4.48 There is already collaboration in the sector, for example, on purchasing and management information. Neighbouring institutions may already be collaborating by sharing support and other services, as occurs in the Manchester area. Institutions need to keep under review opportunities for collaborative initiatives. The Funding Council and institutions' representative bodies should continue to encourage good practice on collaboration.

Residences and catering

4.49 Residence and catering facilities are primarily used by the students but they also generate income from conference and vacation trade. Income from residences and catering at £461 million represented six per cent of the sector's total income in 1992-93. It is forecast to rise marginally to seven per cent of total income by 1997-98. The Funding Council cannot require it but nonetheless expect residence and catering accounts to be self-financing in the long term. They accept that in the early years of operation of a new residence, short term deficits may occur. The sector as a whole had residence and catering deficits of £15 million and £8 million for 1990-91 and 1991-92 respectively and in 1992-93 made a surplus of £3 million (Table 3).

Table 3: Sectoral residences and catering operations: income and expenditure

	Actual 1990-91 £m	Actual 1991-92 £m	Actual 1992-93 £m	Estimate 1993-94 £m	Estimate 1994-95 £m	Estimate 1995-96 £m	Estimate 1996-97 £m	Estimate 1997-98 £m
Income	337	380	461	472	528	579	609	633
Expenditure	352	388	458	465	511	552	579	596
Surplus/deficit	(15)	(8)	3	7	17	27	30	37

Source: Higher Education Funding Council for England

Table 3 shows that the sector has recorded deficits on residences and catering for 1990-91 and 1991-92. But a surplus was achieved in 1992-93 and surpluses are projected for 1993-94 and subsequent years.

4.50 For 1992-93, 58 institutions were planning residence and catering deficits totalling £17.4 million. In practice, 65 institutions actually incurred deficits totalling £17.9 million. About £5.5 million of the £17.9 million related to four institutions with residence and catering deficits of over £1 million each. Deficits on residences and catering can be a contributory factor to the financial problems at institutions. The related lesson learned is at Appendix 4, paragraph 7.

4.51 The sector is forecasting surpluses on residence and catering from 1993-94 (Table 3). The increased income should not be affected by the consolidation of student numbers since the number of bed spaces has not kept pace with the previous expansion in student numbers. In addition, some institutions believe that the local availability of alternative accommodation suitable for students is limited, and in any case many students prefer to live in halls of residence rather than isolated lodgings or flats.

Key points

4.52 The Funding Council expect residence and catering at individual institutions to be self-financing in the long term. The sector as a whole had a small surplus for 1992-93 but within the sectoral total, about half of all institutions had deficits on their residence and catering accounts though the bulk of these were planned.

4.53 Deficits on these accounts at individual institutions can be a contributory factor to financial problems. Institutions should be planning at least to balance residence and catering accounts in the long term. This is an area which the Funding Council include in their monitoring of institutions' financial health.

Commercial services

4.54 Institutions seek to increase their income from a variety of sources such as special and short courses, consultancy and information services. As for research contract work, the Funding Council expect institutions to assess and, in most cases, to recover the full costs unless particular circumstances make it inappropriate to do so. Commercial services, accounting for about five per cent of the sector's total income, have provided surpluses each year to date and are projected to continue (Table 4). The National Audit Office survey found that virtually all institutions ran special and short courses. Most of them said that they were recovering full costs. There was a similar picture for consultancy work. This contrasts with the findings on commercially supported research (paragraphs 3.57-3.58).

Table 4: Sectoral commercial services: income and expenditure

	Actual 1990-91 £m	Actual 1991-92 £m	Actual 1992-93 £m	Estimate 1993-94 £m	Estimate 1994-95 £m	Estimate 1995-96 £m	Estimate 1996-97 £m	Estimate 1997-98 £m
Income	248	282	351	354	377	401	413	433
Expenditure	209	237	290	298	318	337	343	358
Surplus	39	45	61	56	59	64	70	75

Source: Higher Education Funding Council for England

Table 4 shows that the sector is generating surpluses on commercial services.

4.55 Many institutions have a financial interest in companies set up to channel and attract work from other sources, or to further develop areas of research with commercial potential. The revised Statement of Recommended Practice requires insitutions to produce consolidated accounts to include subsidiary undertakings, such as companies. In addition the Funding Council require institutions to submit consolidated forecasts. This information enables the Funding Council to monitor the financial health of each institution as a whole, including subsidiary undertakings.

4.56 The National Audit Office survey found that 106 institutions had a financial interest in 240 companies. The operations of these companies had resulted in a net profit for the sector of £0.5 million in 1991-92. For 44 institutions there were net profits of £6 million but at another 24 there were net losses of £5.5 million, some of which may have been associated with setting up costs. The extent of the sector's liability/risk exposure for the 240 companies was estimated by the institutions to be £39 million though this is largely covered by assets which may be realisable. Risk exposure varied from none to over £8 million at some of the largest institutions.

Key points

4.57 The sector in the main say they are recovering full costs for special and short courses and consultancy work.

4.58 In view of the losses being incurred by some institutions on related companies, they need to consider whether the academic benefits outweigh the risk exposure. This is an area where the Funding Council might consider drawing out some lessons learned for the benefit of the sector as a whole.

Part 5: The strength of local management at institutions

5.1 The Committee of Public Accounts in their 4th Report 1992-93 on the Polytechnics and Colleges Funding Council emphasised the importance of the former funding council monitoring the strength of local management. Many of the key principles were set out in the Jarratt Report of 1985 on Efficiency Studies in Universities. Against this background this part of the Report considers the current position and reviews the monitoring by the Funding Council across the new combined sector.

Organisational structures

5.2 One of the key requirements of the Jarratt Report was the need for planning, resource allocation and accountability to be brought together into one corporate process linking academic, financial and physical aspects of strategic plans. The National Audit Office survey found that virtually all institutions had a single committee or senior management group, either formal or informal, responsible for integrating academic, financial and physical plans. In many cases, there was both a formal committee responsible for strategic planning and a solely executive senior management group which formulated strategic policy for approval by the formal committee.

5.3 It is important that the officer with day to day responsibility for managing the institution's finances, most commonly designated the Director of Finance, should have access to and be able to report directly to the head of the institution. The National Audit Office's survey confirmed that direct reporting was the case for half of the sector. For the remainder of the sector, the Director of Finance normally reported to another officer who then reported directly to the head of the institution.

5.4 In a few instances, organisational and management changes at institutions were identified by the Funding Council as contributory factors in bringing about financial difficulties. The related lesson learned is at Appendix 4, paragraph 8. Changes to the organisation and management of institutions, if not well managed, increase the risk that financial control is weakened. These changes are monitored by the Funding Council.

Key points

5.5 In accordance with one of the key requirements of the Jarratt Report, virtually all institutions have a single committee or senior management group, either formal or informal, responsible for integrating academic, financial and physical plans.

Continued

5.6 The Director of Finance or equivalent at institutions reports either directly to the head of the institution or to someone else who does. In the National Audit Office's view, it may be preferable for the Director of Finance to be able to report directly to the head of the institution.

5.7 The Funding Council have established that changes to the organisation and management of institutions, if not well managed, increase the risk of financial control being weakened. They include this factor in their monitoring of the financial health of institutions.

Strategic planning

5.8 In July each year, the Funding Council invite institutions to present their mission statements, five year strategic plans, their annual operating statements and other numerical data. They expect institutions' strategic plans to be set in the context of their mission statements. These documents do not receive Funding Council approval. Nonetheless, the plans are of value to the Council in:

- informing them that institutions have coherent and integrated objectives and strategies consistent with the Government's and the Funding Council's broad policy objectives;
- informing them that resources are managed efficiently and effectively and assessing the prospective financial health of institutions;
- identifying trends within the sector and the match between institutions' intentions and the Funding Council's priorities;
- assisting with the preparation of advice to the Secretary of State for Education on the funding needs of higher education institutions; and
- providing a context in which specific institutional proposals may be considered.

5.9 The Funding Council's examination of institutions' plans submitted in July 1993 revealed that almost all plans were consistent with the overall missions stated by institutions. Some institutions planned developments which might come into conflict with changes in Government policies specifically those on consolidation. These forecasts were overtaken by institutions' mid-year forecasts in April 1994 which showed that student number projections were broadly consistent with the Government's expenditure plans.

5.10 Institutions were asked in the National Audit Office survey what changes to funding they expected in the November 1993 Autumn Statement. Most institutions correctly interpreted the general trend of Government policy and envisaged what could be summed up as continuation of present policies with continued restraint on student number growth, reductions in tuition fees, and an expectation of further efficiency savings. Almost all of these institutions had included the expected changes in their financial forecasts. About one fifth chose not to speculate on the future intentions of Government.

5.11 Although most institutions had correctly interpreted the general trend of Government policy, most had not expected the severity of the measures introduced to redress over-recruitment above Government targets. Institutions' mid-year financial forecasts as at April 1994 suggest that they have been able to accommodate this shift in policy.

Key point

5.12 In July 1993 some institutions had been planning developments which might come into conflict with the Government policy on consolidation of student numbers. However, institutions' mid-year forecasts in April 1994 were broadly consistent with Government plans.

Financial forecasting

5.13 Institutions aim to balance income and expenditure taking one year with another. In their 4th Report 1992-93, the Committee of Public Accounts commented that institutions tended to make only small surpluses of income over expenditure, and there was little margin for error in their financial forecasting. Both the predecessor funding councils had institutions which experienced the sudden emergence of financial difficulties that had not been apparent in their forecasts. Paragraphs 3.12-3.20 consider the specific issue of student number forecasting and this section of the Report considers forecasting more generally.

5.14 Reliable and accurate forecasting is one indicator of the strength of local financial management, particularly the ability to anticipate and react to change. The Funding Council monitor institutions' actual results against their financial forecasts and follow up large variations with institutions. The Funding Council compared the forecast and actual surplus/deficit position for 1992-93 and found that 44 per cent of institutions had a better position than forecast; 45 per cent were accurate to within one per cent of total income; and the remaining 11 per cent achieved lower than forecast. The bulk of the sector was therefore forecasting accurately or pessimistically.

5.15 In analysing forecasting performance, the Funding Council are alert to tactical forecasting by institutions, that is, where institutions' internal forecasts are different from those provided to external bodies such as the Funding Council. This may be evident in forecasts of low surpluses which past experience suggests an institution has every intention of improving upon.

5.16 For the July 1993 forecasting exercise, the Funding Council issued general guidance on the sensitivity analysis to be undertaken by institutions. The National Audit Office found that, in the forecasts submitted to the Funding Council, half of the sector had not stated the actual pessimistic assumptions used. In the July 1994 forecasting exercise, the Funding Council have required institutions to use specific pessimistic assumptions including the financial impact of:

- a reduction of the funding for teaching;
- under-recruitment of students (paragraph 3.19);
- a failure to achieve forecast levels of external research income;
- a failure to achieve forecast recovery rates on external research income;
- an increase in the pay and non-pay inflation assumptions; and
- an increase in the rates of interest payable.

5.17 Institutions have also been required by the Funding Council to state what compensatory action they would take to lessen the financial impact in the event of these pessimistic assumptions being realised. The National Audit Office welcome this initiative and note that in their monitoring of institutions' financial health, the Funding Council should now be better placed to consider the potential threats facing institutions and the strategies being adopted to cope with them.

Key points

5.18 The Funding Council are able to make a judgement on local management's ability to get its forecasts right by looking at past performance on forecasting.

5.19 In the 1994 forecasting exercise, the Funding Council have strengthened their arrangements by issuing guidance on the specific pessimistic assumptions to be used by institutions, along with the requirement for institutions to state the financial impact and the compensatory action to be taken in the event of these scenarios being realised.

Delegated budgeting

5.20 Delegated budgets can be a means of securing the most efficient and effective use of resources by empowering those who are most directly involved in the delivery of core and support activities. But poor control and monitoring of delegated budgets can lead to over-expenditure and hence financial difficulties (Appendix 4, paragraph 10).

5.21 The National Audit Office survey found that systems of delegated budgeting existed in all but one of the institutions in the sector. Academic budget centres were normally given responsibility for consumables and equipment throughout the sector. Responsibility for academic and non-academic salaries with authority to appoint staff had also been delegated to budget centres in half of the sector. From the National Audit Office's visits to institutions, it was clear that numbers, grades, rates of pay and conditions of service of staff were subject to varying but tight central control.

5.22 In some delegated budgetary systems, academic budget centres are charged for the central resources they consume. This can bring home to users the cost of the service and encourages them to make efficient use of such resources. The National Audit Office survey showed that the costs of central administration, library, computing and other support services were not apportioned to academic budget centres in about two thirds of institutions. This may be due to the belief of some institutions that the administrative costs of managing a complex resource allocation system outweigh the advantages. Furthermore, many institutions consider that merely allocating a predetermined proportion of central costs to budget units is not as effective in encouraging efficient use of resources as making budget units responsible only for those central costs whose scale they can control, whilst delegating budget responsibility for other central costs to the relevant functional managers.

5.23 The survey found that most institutions provide appropriate incentives to academic budget centres to maximise income by allowing them to retain from 10 to 100 per cent of the additional income which they generate. It is helpful to institutional management to know which academic budget centres are in deficit and are being subsidised by others. The survey found that just over half of all institutions had identified such budget centres. However, attributing income to specific academic budget centres can be difficult for some institutions because of current changes in the way that courses are provided, giving students greater choice.

Key points

5.24 Nearly all institutions have a system of delegated budgeting. The extent of the delegation varies considerably from consumables and equipment to salaries and the ability to appoint staff.

5.25 About one third of the sector apportion the cost of central support services to users. There is scope, where appropriate, to extend this practice, which, if properly managed and monitored, could encourage more efficient usage.

5.26 Over half of the sector had identified which budget centres were in deficit and required cross-subsidy from others. Financial management is improved if such information is produced with institutions being able to make informed decisions on whether to subsidise budget centres or require them to find savings.

Financial management reporting

5.27 The head of an institution and senior management need regular financial reports so that actual performance against budget can be monitored. The survey found that financial reports usually went to the head of the institution and also to the committee responsible for financial management. For 57 per cent of the sector, such reports were submitted on at least a monthly basis but for the remainder it was quarterly or less frequently.

5.28 Most formal reports provided explanations of variations between budget and outturn and any fresh developments which might impact on outturn. But in 46 per cent of the sector, the reports did not include outstanding orders/commitments (although these will be taken into account in projected outturns), and the current and projected cash flow positions were not included in another 38 per cent. General cash flow problems can contribute to the financial difficulties of institutions. The related lesson learned is at Appendix 4, paragraph 9. The Funding Council, via their internal audit service, encourage institutions, where appropriate, to consider accounting for commitments and forecasting cash flow. A good practice framework on treasury management should be provided by the national value for money study on this subject being undertaken by the three funding councils of England, Scotland and Wales, and the Department of Education for Northern Ireland (paragraph 1.14).

5.29 An essential part of good financial management is reliable and comprehensive information. The inadequacy or inaccuracy of financial management information can contribute to financial difficulties at an institution. The related lesson learned is at Appendix 4, paragraph 9. In the late 1980s the former Universities Grants Committee recognised that a major constraint on the management arrangements within institutions was the poor availability of administrative data and the quality of management information. As a result, the Management and Administrative Computing initiative was started in 1988. The Funding Council and their predecessor councils have been providing £1 million annually to the cost of the initiative with the balance being provided by institutions. On the basis of advice from consultants, the Funding Council expect that the development of over 30 different software products will be complete by the end of 1994-95.

5.30 The aim of the initiative is the production of good management information in five areas: staff, students, finance, research, and physical resources. There are four families in the Management and Administrative Computing initiative and all but one of the "old" universities is a member of a family. Each family has its own constitution, management arrangements, development methodologies and standards.

5.31 A review of the initiative by the Audit Service of the Funding Council in July 1993 found that while there had been some slippage from causes common to computer developments, it was on course to provide a range, but not all, of planned products to all participants. Delays on average of one year were recorded in three of the families and ranged from a two month delay on the staff programme of one family to a 21 month delay on the students' admission programme of another. The Funding Council expect each institution to ensure that appropriate management information systems are in place. Accordingly they have commissioned a study on current provision across the entire sector.

Key points

5.32 The National Audit Office consider that half of the sector could improve their formal financial management reports to the heads of institutions and finance committees by including outstanding orders/commitments wherever appropriate. Over a third of the sector could improve such reports by including their current and projected cash flow positions. The Funding Council are encouraging good practice in this area.

5.33 Three of the families of the Management and Administrative Computing initiative in the "old" university sector have suffered delays in their programmes of one year on average. However, the Funding Council believe that the initiative is on course to provide a range of the planned products by the end of 1994-95. The Funding Council are conscious of the importance of management information systems and have commissioned a review across the entire sector.

Financial and accounting practice

5.34 One measure of sound financial practice is the existence of institutional financial regulations which are authorised by the Governing Body, checked for compliance by internal audit and updated regularly. The National Audit Office survey found that the bulk of the sector (over 90 per cent) comply with these criteria. However, ten institutions said they did not, at the time of the survey, have any financial regulations in place. The Funding Council have followed up this finding and found that all these institutions are in the process of finalising financial regulations.

5.35 The Chief Executive of the Funding Council is responsible for satisfying himself that institutions have appropriate arrangements for financial management and accounting. The work of the Audit Service of the Funding Council is used as a means to give him that assurance. The main activities of the Service have been to develop a new Audit Code of Practice for the combined sector and to visit institutions to assess their internal systems and audit arrangements.

5.36 The Funding Council's Audit Service have a staff of 10 and operate a three year cycle of visits to institutions in line with Treasury guidance. A programme of visits to 47 institutions was completed in the year to 31 March 1994. From these visits and from a review of the management letters produced by institutions' external auditors, the Audit Service, in their annual report dated June 1994, were able to provide assurance that institutions had appropriate arrangements for financial management and accounting. This was with the exception of one institution where improvements had been agreed but not yet implemented. The report also identified a number of areas where improvements to procedures had been agreed with individual institutions. The Funding Council intend to disseminate information on these improved procedures across the sector.

Key points

5.37 The Funding Council should continue to encourage institutions to maintain up-to-date financial regulations.

5.38 The Funding Council's Audit Service have been able to provide assurance that institutions have appropriate arrangements for financial management and accounting.

A specific cash flow problem

5.39 During the National Audit Office pilot visits a specific cash flow problem was drawn to their attention. This related to the late payment of tuition fees by local education authorities in England and Wales. This has been a persistent and sector-wide problem with the 33 London boroughs being particularly bad payers. Financial problems at institutions can be specifically related to this factor. The related lesson learned is at Appendix 4, paragraph 9. Scottish institutions do not suffer from these difficulties since the bulk of their tuition fees are paid direct to them by the Scottish Office Student Awards Agency and not through Scottish local education authorities.

5.40 The National Audit Office survey enquired into the extent of this problem. About two thirds of the sector said they had suffered cash flow problems in 1992-93 arising from late payment of tuition fees. The cost or loss of interest was estimated to be £2.5 million in 1992. Most institutions claimed to have lost up to £30,000. Thirteen institutions had each lost over £50,000, and for four of these the loss had been £100,000 or over.

5.41 The Committee of Vice-Chancellors and Principals undertake regular surveys to monitor tuition fee payments. Their survey for the first and second terms of the academic year 1993-94 showed over 50 per cent improvement in payment by local education authorities compared with the previous year. Nonetheless, in December 1993, £52 million remained outstanding to institutions for first term tuition fees; and in February 1994, £35 million remained outstanding for second term fees. For the third term, £38 million of fees was still outstanding at the beginning of May 1994. This was similar to the shortfall recorded at the same point in the previous year. These results show that the position on payment of tuition fees is still not satisfactory.

Key point

5.42 Institutions have been suffering cash flow problems because of late payment of tuition fees from local education authorities. There has been some improvement in the academic year 1993-94 but overall the position is still not satisfactory.

Financial manoeuvrability

5.43 General reserves provide flexibility and act as a cushion for institutions when financial problems arise. A lack of general reserves can compound actual or potential financial difficulties. The related lesson learned is at Appendix 4, paragraph 2. The sector as a whole is forecasting that general reserves will more than double from £0.5 billion in 1990-91 to £1.3 billion in 1997-98 (Table 1).

5.44 The National Audit Office survey found that two thirds of institutions had action plans in place in the event of unplanned deficits arising. The remainder believed that they had sufficient resources to cover any deficit. For those that had action plans the most common measures to be taken were use of contingency funds and a freeze on certain elements of expenditure.

5.45 Retention of funds by institutions for contingencies and strategic developments gives them the ability to react to and cope with change. One course is to set aside amounts from revenue budgets. The National Audit Office survey asked what percentage of the institutional revenue budget for 1992-93 had been retained to provide for these eventualities. About three quarters of the sector had made provisions of up to 10 per cent of their revenue budget for contingencies and eight per cent for strategic developments.

5.46 But 33 institutions had made no explicit provision for contingencies and 36 had not explicitly provided for strategic developments. Of these, 19 had provided for neither. Even if institutions do not make explicit provision for these factors, they may make provision in some other way, such as within their general and capital reserves. Nonetheless, in their July 1993 forecasts 13 of 33 institutions which had not explicitly provided for contingencies were either planning deficits or had general reserves of less than five per cent of their revenue budgets. The seven institutions over which the Funding Council had most serious concern in March 1994 had all made provision for contingencies (paragraph 2.21).

5.47 The sector's ability to implement change is constrained to some extent by the existence of tenured appointments, the relatively low number of part-time staff, particularly in the "old" university sector and few retirements due to the high level of premature retirements in recent years, which in consequence mean that early retirement schemes would be expensive. To assess the manoeuvrability afforded in staffing, the National Audit Office's survey enquired about the numbers of academic staff on fixed short term contracts. The survey indicated that nearly all institutions had some academic staff on these contracts varying from one per cent to, in two instances, 100 per cent of staff. The latter two institutions were specialised business and art schools. Another specialist institution also had 99 per cent of staff employed on this basis. The National Audit Office note that it is for each institution to determine the right balance between permanent and fixed short term contracts in the light of its particular circumstances.

5.48 Most institutions had under 15 per cent of staff employed on fixed short term contracts. A quarter of the sector had over 30 per cent of staff on such contracts, mainly in the "old" university sector. Few institutions (18) had set an explicit target for staff to be employed on this basis. Whilst the policy of employing staff on short term contracts provides financial manoeuvrability it may cause problems in recruiting staff of the right quality because the lack of security can deter good applicants from applying. The terms and conditions of employment of the staff of institutions are not normally within the Funding Council's locus.

5.49 Institutions have also had manoeuvrability in the use of teaching and research funds particularly in the "old" university sector. Recurrent grant is a block grant and institutions have the discretion to determine how those funds should be deployed in delivering the teaching and research for the funding provided. Therefore funds allocated by the Funding Council for teaching may be spent on research and vice versa. From 1994-95 institutions are being required to report to the Funding Council on how they have allocated their research funds (paragraphs 3.66-3.72).

Key points

5.50 Two thirds of the sector have action plans in the event of unplanned deficits arising. The most common measures to be taken are use of contingency funds and a freeze on expenditure. The remainder of the sector believe that they have sufficient reserves to cover any unplanned deficit.

5.51 About three quarters of institutions have made explicit provision for strategic developments and contingencies. The remainder might consider doing so, if they have the funds available, to give themselves additional flexibility.

5.52 The ability of some of the sector to adapt to change may be constrained by a high level of permanent staff. Many institutions are taking what steps they can to increase the proportion of staff on short term contracts. However, very few institutions have set themselves targets for the number of staff on such contracts.

Dissemination of lessons learned

5.53 Following a consultant's review of general lessons from the problems arising at the Dartington College of Arts in 1989-90, the former Polytechnics and Colleges Funding Council issued a Guide for Governors to all institutions in that former sector. This guide sought to ensure institutions were aware of their responsibilities, one of which was to inform the former funding council of any major organisational or management changes. In response to the Committee of Public Accounts' 4th Report 1992-93 the Funding Council undertook to consider, in consultation with the new higher education sector, whether the specific guidance in the Polytechnics and Colleges Funding Council's Guide for Governors could be extended to the whole sector. Accordingly the Funding Council established a Working Party under their Chairman with the remit of updating the guide for the whole of the new sector. A draft report was provided to the Association of Heads of University Administration and the Committee of Chairmen of University Councils and Boards in June 1994. Proposed revisions are due from these bodies in December 1994.

5.54 The National Audit Office's examination of the 20 cases in Appendix 4, which have been a cause of concern over the years 1990 to 1994 inclusive, are referred to in Parts 2-5 of this Report. The Funding Council have decided to disseminate the lessons learned and are holding discussions with representative bodies of the sector to develop the most effective format for this dissemination. As a means of strengthening financial management in institutions, the Funding Council are also discussing with representative bodies how to develop and promote guidance on best practice in a number of areas considered elsewhere in this Report (for example budgetary control, contingency planning, research grants and contracts, and residence and catering).

Key point

5.55 The Funding Council will disseminate the lessons learned from past cases of institutions where actual or potential financial difficulties have arisen. The Funding Council are also discussing with representative bodies the best way of developing and promoting guidance on best practice in a number of areas considered elsewhere in this Report.

Appendix 1

Financial responsibilities and accountabilities for higher education

1 A Financial Memorandum exists between the Department for Education (the Department) and the Higher Education Funding Council for England (the Funding Council) and also between the Funding Council and each of the funded higher education institutions in England. The main responsibilities and accountabilities in these memoranda are set out below.

The Department for Education

2 The Permanent Secretary of the Department is responsible and accountable to Parliament for:

- issue of grant to the Funding Council; and
- satisfying himself that:
  - a) the financial and other management controls applied by the Department are appropriate and sufficient to safeguard public funds;
  - b) the Funding Council observe the conditions of grant laid down in the Financial Memorandum between them and the Department; and
  - c) the controls applied by the Funding Council conform with the requirements of propriety and good financial management.

The Higher Education Funding Council for England

3 The Chief Executive of the Funding Council is responsible and accountable to Parliament for the administration of funds made available to the Funding Council by the Department for the provision of teaching and research for higher education. The Chief Executive's responsibilities in regard to higher education institutions include the following:

- control of recurrent and capital payments to institutions;
- satisfying himself that institutions have appropriate arrangements for financial management and accounting, and that the uses to which the Funding Council's payments are put are consistent with the purposes for which they have been given;

- promoting good value for money through grants paid to institutions and associated guidance;
- monitoring the financial health of the institutions;
- safeguarding the public investment in institutions by monitoring and control of institutional borrowing as seems necessary to protect the public investment in institutions;
- specifying accounting requirements in consultation with the Department and requiring institutions to provide audited accounts; and
- drawing up a Code or Codes of Practice governing institutions' internal and external audit.

4 The Funding Council may not borrow (Schedule 1 of the Further and Higher Education Act 1992). Moreover, without the prior written consent of the Department, the Council may not lend money from grant-in-aid received in respect of its running costs, give any guarantees, indemnities, letters of comfort nor incur any other contingent liabilities other than in the normal course of business.

The higher education institutions

5 The Financial Memorandum between the Funding Council and each higher education institution sets out the terms and conditions on which grant is made to institutions and reflects the provisions in the Memorandum between the Department and the Funding Council. It covers such matters as the requirement for good financial management including financial solvency, property acquisition and disposal, borrowing and leasing, accounting records and financial statements, the need to assess the full cost of research contracts and other services, audit arrangements, and the provision of information. The Governing Body of each institution is responsible for ensuring that conditions of grant are met. The Governing Body designates a principal officer of the institution with responsibility for satisfying the Governing Body that there has been compliance with such conditions. The holder of this office is accountable to the Funding Council and may be called to account before the House of Commons' Committee of Public Accounts for the funds paid to his institution.

6 The Govenors of institutions play a central and crucial role in ensuring sound financial control. The financial statements must be approved by them; planning and resource committees (or their equivalent) oversee the preparation of budgetary plans, and monitor progress against those plans; whilst audit committees are amongst other things responsible for the review of financial controls and processes. The Governing Body itself is also expected to take reasonable steps to:

- ensure that funds are used in accordance with the Financial Memorandum;

- ensure that there are appropriate financial and management controls in place to safeguard public funds and funds from other sources;

- safeguard the assets of the institutions and prevent and detect fraud; and

- secure the economical, efficient and effective management of the institution's resources and expenditure.

7 Higher education institutions are independent and autonomous. Many institutions have substantial private income and assets. Neither the Department nor the Funding Council have specific powers to intervene directly in the affairs of a particular institution, though the Funding Council may attach conditions to their grant. Instead the Funding Council pursue an active approach to the monitoring of institutions' financial performance and health and to the provision of support and guidance.

8 The limitations on the Department's and the Funding Council's powers of direct intervention reflect Parliament's desire to ensure institutions' autonomy which is seen as an important safeguard for academic freedom. For example, under the Further and Higher Education Act 1992, the Funding Council may not impose terms and conditions relating to the application by institutions of any sums derived otherwise than from the Funding Council. Nonetheless, the Funding Council may withhold grant from an institution if the terms and conditions on which it is made are not met. In addition, under the Further and Higher Education Act 1992, the Funding Council may require repayment by an institution of any funds received from the Funding Council if the institution fails to comply with any of the conditions to which the funds were subject.

9 In exceptional cases, if it appears to the Secretary of State that the financial affairs of any institution within the higher education sector have been or are being mismanaged, she may give directions to the Funding Council about the provision of financial support to that institution (Section 81(3) of the Further and Higher Education Act 1992). It is not the role of the Funding Council or the Secretary of State to seek to substitute their judgement for the institution's judgement in particular cases. In exceptional cases also, the Secretary of State can dissolve a higher education corporation.

Appendix 2

Funding changes in higher education 1981-1995

1981	Overseas students were charged full cost fees instead of receiving a substantial subsidy from public funds. This resulted in a loss of income for universities.
1981-82 to 1983-84	The recurrent grant to universities was cut in real terms by about 8.5 per cent.
1986	The first research assessment exercise for the "old" university sector was undertaken to align progressively the research component of recurrent grant with quality assessment ratings.
1986-87	The teaching component of the "old" universities' recurrent grant was calculated by reference to units of resource for students in subject groups. Thus, those institutions with higher student:staff ratios gained at the expense of those with lower ratios.
1989	The second research assessment exercise for the "old" university sector was undertaken.
1989 onwards	Measures were introduced to ensure that no institution received an unmanageable change year on year in the level of its recurrent funding.
1990-91	The balance in public funding was shifted from the cash-limited recurrent grant to tuition fees to encourage universities to recruit more students.
1991-92	A single tuition fee was replaced by three band levels rewarding recruitment for laboratory/workshop and clinical courses over classroom based courses.
1991-92 onwards	Annual assumptions were made about improved efficiency in relation to the allocation of teaching grant. For example, in 1991-92 an overall efficiency gain of 1.5 per cent was assumed and this rose to two per cent in 1994-95 .
1992	The third research assessment exercise was undertaken covering all institutions of the former Universities Funding Council and the former Polytechnics and Colleges Funding Council.
1992-93 to 1994-95	Funds are being transferred from the Funding Council's block recurrent grant to the Research Councils to enable them to meet more of their direct costs and to contribute to the indirect costs (overheads) of their projects.

1993-94

In the five years to 1993-94, public funding per student reduced by 26 per cent in real terms.

A new method for funding teaching was introduced to promote stability and efficiency. A new formula for distributing research funds more selectively was also introduced.

To slow down expansion, tuition fees for clinical and laboratory/workshop based courses were pegged at 1992-93 levels and those for classroom based courses reduced by 30 per cent. Funding to compensate institutions for this lost fee income was transferred to the Funding Council's recurrent grant.

Quality assessment of teaching by the Funding Council was introduced. An institution with a subject still rated unsatisfactory after two visits by the Funding Council's assessors will have the relevant part of core funding immediately or successively withdrawn.

1994-95

Tuition fees are being reduced by 45 per cent to encourage consolidation of student numbers and about £0.7 billion transferred to the Funding Council's recurrent grant to provide fee compensation to institutions.

Teaching funding is being withheld from institutions if they fail to recruit students to the funding level provided. Institutions may also be penalised if they over-recruit students receiving publicly funded tuition fees.

Appendix 3

Higher education institutions visited by the National Audit Office

Pilot study

Middlesex University

University of Warwick

Main study

University of Manchester

University of Manchester Institute of Science and Technology (UMIST)

Manchester Metropolitan University

Manchester Business School

Royal Northern College of Music

University of Salford

Salford College of Technology

Southampton Institute of Higher Education

Winchester School of Art

Appendix 4

Lessons to be learned from actual or potential financial difficulties which had arisen at 20 English higher education institutions in the period 1990-1994

The lessons which follow have each been learned as a result of one or more institutions experiencing actual or potential financial difficulties related to them.

Teaching

1 Institutions need to set realistic targets for student recruitment. The financial impact of changes to key assumptions in forecasts should be assessed and appropriate contingency plans made (paragraph 3.18).

2 Changes in Government policy, such as the move from expansion to consolidation, can affect the income of an institution, particularly those with a high rate of in-built growth. Institutions need to assess carefully the financial impact of changes in Government policy and also other changes in their external and internal environment. To cope with change effectively they need sufficient financial flexibility to respond. This flexibility can be increased by, for example, building up reserves, setting funds aside for contingencies and strategic developments, and adjusting the balance between staff on permanent contracts and those on fixed short term contracts (paragraphs 3.62 and 5.43 - 5.52).

3 Institutions heavily dependent on a narrow range of activity, such as teacher training institutions, are vulnerable to change and need to take particular care in assessing the impact of Government policy changes. Sound management is therefore important along with the need to plan for diversification of course provision consistent with their mission (paragraph 3.63).

Research

4 Institutions need to be alert to the consequences of lower research ratings, which can mean a reduction in research funding. Ratings can also affect an institution's ability to attract external research contracts. Institutions need to concentrate on their research strengths but retain sufficient flexibility in their strategies to respond to changes in funding arrangements. Institutions may wish to consider giving incentives to staff to achieve high ratings (paragraph 3.40).

Support and other activities

5 Institutions with disparate locations, those with earlier under-investment in buildings by local education authorities and those with a backlog of long term maintenance may be prone to experiencing difficulties. A sound estate strategy is essential with rationalisation measures taken where necessary. Estate strategies should be integrated with the institution's main strategic plan and financial provision made for developing and maintaining the estate. The financial priority given to the estate needs to be assessed against the major priorities of teaching and research (paragraphs 4.7 and 4.33).

6 Some institutions which have merged have experienced problems brought about by inherited deficits and inaccurate financial data on which the decision to merge was based. The financial implications of merger need to be properly assessed and evaluated. There should be a clear strategy for managing and implementing the transition (paragraph 4.42).

7 Institutions should plan to balance their residence and catering accounts in the long term unless low fees and prices are part of a policy to attract students. Significant deficits which arise on residence and catering accounts can contribute to financial problems. The benefits of subsidising residence and catering activities at the expense of others need to be carefully weighed up (paragraph 4.50).

Organisation and management

8 With sudden changes to the organisation and management of institutions, there is risk that financial control is weakened. Transitional arrangements need to be carefully planned and managed (paragraph 5.4).

9 An accurate, comprehensive, and regular flow of management information is needed for monitoring the financial position of the institution. In particular, regular reports on the institution's finances need to be made to the head of the institution and senior management so that performance against budget can be monitored and decisive action taken when problems arise. These reports should contain outstanding orders and commitments and the current and projected cash flow position including that relating to the payment of tuition fees (paragraphs 5.28, 5.29 and 5.39).

10 Proper control and monitoring of delegated budgets are essential to avoid over-spending, especially on salaries, and hence financial difficulties (paragraph 5.20).

Appendix 5

Location and identity of higher education institutions in England

University of London

Directly funded schools
- Birkbeck College
- Goldsmiths College
- Imperial College
- King's College
- London School of Economics and Political Science
- Queen Mary and Westfield College
- Royal Holloway
- University College

Centrally funded schools
- Senate Institutions

British Postgraduate Medical Federation
- BPMF Institute of Cancer Research
- BPMF Institute of Child Health
- BPMF Institute of Neurology
- BPMF Institute of Opthalmology
- BPMF Institute of Psychiatry
- BPMF National Heart and Lung Institute
- Institute of Dental Surgery

Other
- Charing Cross and Westminster Medical School
- Institute of Education
- London Hospital Medical College
- London School of Hygiene and Tropical Medicine
- Royal Free Hospital School of Medicine
- Royal Postgraduate Medical School
- Royal Veterinary College
- St Bartholomew's Hospital Medical College
- St George's Hospital Medical School
- School of Oriental and African Studies
- School of Pharmacy
- United Medical and Dental Schools of Guy's and St Thomas' Hospitals
- Wye College

Other universities
- City
- London Business School
- East London
- Greenwich
- Kingston
- London Guildhall
- Middlesex
- North London
- South Bank
- Thames Valley
- Westminster

Colleges
- Central School of Speech and Drama
- Institute of Advanced Nursing Education
- London Institute
- Ravensbourne
- Roehampton
- Rose Bruford
- Royal Academy of Music
- Royal College of Art
- Royal College of Music
- St Mary's
- Trinity College of Music
- West London
- Wimbledon

Source: National Audit Office

The map shows the 148 higher education institutions in England as at 31 July 1994. These comprised 37 "old" universities, 35 "new" universities, 48 colleges of higher education, and 28 schools of the University of London (eight funded directly by the Funding Council and 20 funded centrally by the University).

Reports by the Comptroller and Auditor General Session 1994-95

The Comptroller and Auditor General has to date, in Session 1994-95, presented to the House of Commons the following reports under Section 9 of the National Audit Act, 1983:

Treasury Management in National Health Service Trusts in England.............HC 7
The Financial Health of Higher Education Institutions in England...............HC 13

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