Module **4**

Governor Training Materials

Financial management

Further Education Funding Council

June 2000

www.fefc.ac.uk/documents/othercouncilpublications

For suggestions on how to get the most out of these self-study materials, see the section on Using the materials.

Introduction

This module explains governors' key role and responsibilities for the financial management of a college. It is aimed at all governors and assumes that the reader does not have specialist financial knowledge, or detailed knowledge of the further education sector and its accounting policies.

There are three main parts to the module. Sections 1–4 deal with governors' responsibilities, Sections 5–8 cover strategic financial management and Section 9 reviews the main source of funding for the sector. Section 10 reviews good practice and areas of weakness in financial management. The module has been divided into ten short sections to help the reader tackle the subject. It should take two to three hours to complete if you choose to work through all the sections.

Key terms

Cash days in hand – How long a college could last with its current cash balance and its normal expenditure patterns without receiving further income. This is calculated by taking total cash (including any short-term investments), dividing by total income and multiplying by 365.

Current ratio – A measure of short-term solvency, used to calculate whether a college can cover its short-term liabilities (less than one year) with its current cash and bank balances, plus other assets that can be converted to cash (e.g. stock and debtors). The calculation is current assets divided by creditors (of less than one year).

Operating surplus – This is college income minus the revenue expenditure on the operations of the college before any movements on reserves. If expenditure was more than income this would be a deficit.

General reserve – This is the ongoing balance built up or reduced from either the surplus or deficit made each year by the college.

Positive cash flow from operations – Based on all the cash movements in a college, this is the net position of all money actually received against money paid out during the year from the normal trading activities of the college. It is not the same as income and expenditure because of timing differences (e.g. the time taken to collect debts or to pay suppliers).

Capital expenditure – expenditure on assets such as computers and buildings which will provide benefits to the college over an extended period (more than one year). Each college will have set a threshold value (e.g. £1,000) below which it will not capitalise expenditure. For example, buying a new chair is likely to be charged straight to this year's revenue expenditure despite being intended for use over a number of years.

Aims

By the end of this module you should be able to:

- explain governors' role in monitoring the financial position of the college and its audit process
- identify the range and purpose of financial documents that will be presented to you as a governor
- explain the broad indicators used by the Further Education Funding Council (FEFC) to evaluate a college's financial health
- describe common areas of weakness in financial target setting, financial monitoring and financial management within the sector
- explain the use of sensitivity analysis in a college financial forecast
- identify good practice in financial management
- understand FEFC funding methodology.

Contents

Mark the sections you want to study and tick them off as you complete them.

Working on the self-study activities

These materials have been designed for flexible use, so that you can work through sections and activities in your own time and at your own pace if you would find it difficult to attend organised training sessions. Governors who have tested these materials point out how valuable it is to work on at least some of the suggested activities together with another governor or group of governors, as there is such potential to learn from each other's experience. For suggestions on how to organise this kind of support for yourself, see *Using the materials*.

What you will need

To complete activities in this module you will need to get hold of the following information or documents from the clerk:

- a copy of the college's financial memorandum with the FEFC (the document which sets out the conditions under which the FEFC funds colleges)
- the agendas for last year's meetings of the governing body
- the college's most recent set of audited financial accounts
- the college's most recent three-year financial forecast
- the most recent set of management accounts provided to governors
- the college's financial regulations.

Where you need to make notes in response to activity questions, we suggest you do this in a notebook or on separate sheets of loose-leaf paper, and store the information you compile along with the module for future reference.

Section 1 Governors' responsibilities – an overview

The governing body of a college has a number of significant responsibilities for financial matters. A summary of the responsibilities of the governing body is set out in paragraph 8 of FEFC Circular 99/48. This states that 'the role of the board is to set objectives for the college, to determine the limits on the principal's discretion to act, to monitor the performance of the college, the principal and themselves and to be accountable to the college's stakeholders'.

The Department for Education and Employment (DfEE) requires governors to have a role in ensuring 'the efficient and effective use of resources, the solvency of the institution and the governing body and for safeguarding their assets and for approving annual estimates of income and expenditure'.

Financial Monitoring: Notes for Governing Bodies

These provide a summary of specific responsibilities governors have in relation to financial matters, i.e. for:

- the solvency of the college, that is to say, that the college has sufficient cash to pay its staff and suppliers
- approving the college's annual budget
- securing value for money
- ensuring financial matters are always taken into account when making decisions
- safeguarding the college's assets
- operating an audit committee
- giving an annual account of their stewardship of the college's funds
- ensuring that there are adequate management controls in place to enable them to discharge their other responsibilities.

The FEFC establishes a financial memorandum with each college which is set out in two parts. The first part states the general terms and conditions of the agreement under which the FEFC provides funds to colleges. The second part of the financial memorandum sets out for each year the additional terms and conditions in the FEFC funding agreement with that college. This second part has to be signed by the principal and returned to the FEFC each year to confirm acceptance on behalf of the college of the terms and conditions, including the college's individual annual funding target.

In addition to the requirements set down by the FEFC, the college may well have responsibilities for reporting returns to other stakeholders, such as the

European Commission and Training and Enterprise Councils (TECs) or the bodies which replace TECs. The governing body must also be aware of its responsibilities in these areas.

Activity Review your own financial responsibilities

This section has identified key areas of responsibility for governors. List three ways in which you have discharged your responsibilities in these areas for your college.

Viewpoint

Have you carefully considered the different reports containing financial information that you have received for consideration at governing body and committee meetings over the last 12 months, or have you merely glanced at them and filed them away to be read at some future date?

Are you aware of the operational cycle and timescales within which each report was created and required? For example, can you recall when the governing body approved the college's current annual budget?

When did the governing body last receive a report from its external or internal auditors regarding the adequacy of internal controls?

Look at the calendar of key financial and funding returns to the FEFC (Appendix A) to remind yourself of the timing of key events in the financial calendar.

Section 2 Requirements of financial monitoring

In this section we look at the important role of governors in meeting the requirements of financial monitoring.

The financial memorandum

This makes 'further requirements' of colleges' accounting and financial management. It requires that:

- the college keeps proper accounts and accounting records and prepares in respect of each financial year a statement of accounts
- the college provides the FEFC with audited accounts for the financial year no later than five months after the year-end
- the accounts are signed by the principal and by the chair or one other member of the governing body as appointed for this purpose
- the college arranges for its accounts to be made publicly available
- the college notifies the FEFC in writing if at any time there is a significant deterioration in its financial position
- college governors receive at least termly a report that reviews the college's financial position.

The FEFC, after consulting colleges, specifies the information required in the accounts, the manner in which the accounts are to be presented and the methods and principles according to which they are to be prepared.

The financial memorandum further requires colleges to provide the FEFC with information on its finances, staffing, students and programmes. This normally includes:

- the college's annual financial statements, finance record, external auditor's management letter and internal audit annual report
- the college's strategic plan and strategic plan updates, together with the financial forecast which supports the plan
- where appropriate, a mid-year financial forecast update
- individualised student record data, in-year funding returns, the final funding unit claim, the external auditor's report and management letter
- staff individualised record data
- periodic information on the accommodation strategy.

Where a board fails to comply with any of these conditions of funding the FEFC may take further action, including withdrawing funds from the college.

A calendar of key financial and funding returns is attached at Appendix A.

Companies and joint ventures

Governors need to ensure that all college companies, joint ventures (both formal and informal) and overseas operations are conducted in accordance with the guidelines issued in FEFC Circular 99/14 *College Companies and Joint Ventures.*

Key responsibilities for governors

The governing body should:

- seek appropriate legal and financial advice to ensure that any proposed activities are lawful and any potential risks or liabilities are minimised
- gain governing body approval for all formations and acquisitions
- ensure that the organisation of companies and joint ventures are appropriate (including avoidance of any potential for conflicts of interest)
- thoroughly review the business plan and proposed control arrangements
- ensure that suitable arrangements are in place to enable the governing body to discharge its responsibilities. This includes governor representation on the company/joint venture board, attendance at the AGM, regular reporting on performance and future plans, appropriate audit arrangements, and a formal memorandum of understanding between the college and the company or joint venture.

Franchising

Governors need to be aware of any franchising arrangements made by the college. This is a high-risk area, so governors need to ensure that franchising arrangements are conducted in accordance with FEFC Circular 99/37 *Franchising*. In particular, governors need to ensure that the college is fully in control of provision. The control criteria required are set out in various other circulars referred to in Circular 99/37.

Franchising controls

The governing body should :

- approve franchising proposals as part of the strategic plan approval
- ensure the college is using the model contract for the provision as set out in the supplement to Circular 99/37
- ensure that a review of franchised provision is in the internal audit plan
- receive and consider regular reports on franchised activity.

College fees

The governing body has a responsibility for setting the policy by which tuition fees and other fees payable to the college are determined. It is for the management of the college to set the actual fees payable within the policy framework approved by the governors.

Register of interests

The governing body needs to maintain a register of interests to ensure probity. The register of interests should cover more than financial interests and must also include the relevant interests of senior postholders and governors' families. For more information see *Module 1 Introduction, Section 5 Integrity in working practices.*

FEFC approval

The financial memorandum specifies transactions for which colleges are required to obtain the FEFC's consent. These are:

- significant land and/or buildings transactions
- unsecured or secured borrowing arrangements.

The general consents set out in part 1 of the financial memorandum for such transactions may not apply to your college. If there is a withdrawal of a general consent for your college it will be set out in part 2 of the financial memorandum, or in correspondence from the FEFC.

Activity Review your college's recent financial statements

Obtain a copy of your college's most recent audited financial statements. What was the value of the following items? (See 'Key terms' at the front of the module for an explanation of these items.)

Item	Value
Cash days in hand	
Current ratio	
Operating surplus	
General reserve	
Positive cash flow from operations	
Capital expenditure	

Viewpoint

If you found this exercise difficult, arrange with the clerk for the college's director of finance or a qualified governor to explain these concepts to you. If you feel that your answers indicate areas where information produced by the college is not clear or adequate, make a note to discuss this with the clerk to the governing body. You could suggest specific ways in which you would like to see the information improved, or suggest that governors' views are sought on what information they want and how it should be supplied.

Section 3 The audit process – governors' responsibilities

The audit process provides an important check on the assets of the college. It enables the governors, and others, to check whether the actual financial situation of the college reflects the budgeted or planned financial situation of the college. It also provides an opportunity for identifying any financial irregularities.

The role of the audit committee and governors

The full governing body is required to approve the audited financial statements, which are then signed by the chair on behalf of the governing body and the principal. It is normal for the finance committee to review the accounts and recommend them for approval to the full governing body.

The governing body is required to establish an audit committee to advise on matters relating to the governing body's audit arrangements and systems of internal control. The audit committee should:

- take a 'step back', and be largely independent of the other committees or the college senior management team
- establish a system of financial checks and balances on behalf of the governing body
- scrutinise the financial information received by governors and the systems that generate it.

The audit committee membership should not include the principal, the chair of governors or members of the college finance committee. It should not be clerked by the clerk to the governing body if he/she has significant financial responsibilities at senior management level within the college.

A recent FEFC amendment to the financial memorandum requires at least one member of the audit committee to have relevant financial experience. This individual does not have to be an accountant but somebody with experience of organisational financial matters, and he/she need not necessarily be a governor.

The governing body must determine terms of reference for the audit committee. The FEFC has provided a model in Circular 98/15 *Audit Code of Practice*. The governing body should be careful to avoid adding terms of reference that compromise the requirement for independence and objectivity. The model terms of reference are contained in the *Audit Code of Practice* and are summarised in *Module 7 The audit committee, Section 2 What does an audit committee do?*

The audit process and the function of internal and external auditors

The governors' role in the audit process and the functions of internal and external audit are covered in *Module 7 The audit committee*. It is the responsibility of the governors to ensure that colleges have an appropriate system of internal control in order to provide assurance that public funds are safeguarded and used for appropriate purposes.

In addition it is a requirement under the financial memorandum that a governing body must establish an audit committee and appoint separate providers for the internal and external audit service to the college.

Activity Check what you know about your audit committee

Are you confident that you know enough basic information about your own audit committee? Read through the following statements, and tick the appropriate box.

	Yes	*No*	*Not sure*
I know who the members of the audit committee are and I am confident that at least one member has relevant financial experience.	☐	☐	☐
I am confident that the audit committee is independent of senior management and is objective.	☐	☐	☐
I know that the audit committee has ensured an appropriate system of internal control in the college.	☐	☐	☐
The audit committee has appointed separate external auditors and I know them to be independent.	☐	☐	☐

Viewpoint

If you ticked ‘not sure’ or ‘no’ for any of the above statements, find out the answers from the committee chair or clerk. The governing body as a whole is responsible for ensuring that the audit committee is working in line with guidance and is effective.

Section 4 Approving and monitoring the financial position of the college

Governors have specific responsibilities for their college’s budget and corporate financial statements. They also need to satisfy themselves that their college has an effective financial control system in place. This section looks at these responsibilities after considering the separate and distinct responsibilities of the college principal for financial matters.

The role of the principal as the accounting officer

The role and responsibilities of the principal as accounting officer are set out in the financial memorandum. These include:

- preparing a budget for consideration and approval by the governing body
- managing the college within the budget approved by the governing body
- ensuring that funds from the FEFC are used only for the purpose for which they are given and in line with any terms and conditions attached to them
- appearing, if required, before the committee of public accounts on matters relating to FEFC income and its use
- reporting to the FEFC any policy or proposed action of the governing body which is incompatible with the financial memorandum.

Budget approval and monitoring of performance

The governors have to approve the annual budget before the start of the new financial year, which is in August. This is a task which cannot be delegated.

The budget should form the first year of a three-year financial forecast, and therefore needs to be an integral part of the college's operating plan and strategic planning process. It should, in effect, provide a financial translation of the college's specific objectives and targets for the coming year at a 'whole-college' level. This translation of the operating plan into a consistent, viable and agreed financial plan provides the framework for protecting the solvency of the college.

A clear timetable for the budget preparation should be set out by college management and agreed by governors. All colleges have a financial year-end of 31 July. Typically, the majority of budget preparation work takes place in May and June of each year. The approved college budget should on all occasions agree with the financial forecasts submitted to the FEFC.

In most colleges, the budget would be considered by a finance committee before being approved by the full governing body. It is therefore likely there would be a finance committee meeting in June/July each year followed by a full governing body meeting shortly afterwards. The governing body will also have to approve the three-year financial forecast at the same meeting as this also has to be returned to the FEFC by 31 July.

In order to approve the budget, governors need to be aware of:

- key assumptions made in the budget preparation
- key areas of risk and how these will be addressed should they materialise (this is covered in more detail in Section 8)
- the process by which the budget has been built up.

As a minimum the governors should expect to see:

- an income and expenditure account
- a balance sheet
- a 12-month cash flow forecast
- a capital expenditure plan
- supporting commentary for each of these.

Colleges should produce monthly management accounts. It is good practice for the accounts to be sent to every member of the finance committee every month. Members of the full governing body may receive copies of these monthly accounts at their termly meeting only. Also, the DfEE and the financial memorandum have made it clear that the full governing body should receive a report at least once a term dealing with the college performance against budget.

Monthly report

The contents of the monthly report should be similar to the minimum information given below in Section 10. It should also include cumulative and monthly actual performance against budget, and a projection for the end of the year. The commentary should deal with any significant variances against budget with explanations and details of planned action.

Activity What financial information do you receive and when?

What type of financial information do you receive as governors to help monitor the financial position in your college?

How often is information presented to governors?

If your college is in financial difficulty or has recently been in this situation, has the frequency of financial reports increased (for example on a monthly basis rather than once a term)?

Viewpoint

The governing body should expect financial information to be presented in a way that can be clearly understood by all governors. For example, not everyone can understand balance sheets and income and expenditure accounts on their own. How clear is the financial commentary that accompanies the data in your financial reports? Think about your own governing body meetings. Do you think all governors are aware of the college's overall financial position in the short and long term? Are any performance indicators used to demonstrate succinctly the college's financial position? If this activity has highlighted weaknesses in the way that information is presented to governors, note down how you might follow this up.

Protecting the college's assets

The audit committee has responsibility for advising the governing body on the college's systems of internal control. These systems of control are critical to governors' assurance that they are able to meet their duty to safeguard college assets.

Financial regulations

One of the key documents in safeguarding the assets is the college's financial regulations. The financial regulations should be approved by the governing body, reviewed and, if appropriate, amended annually. It should include procedures and limits of authority for:

- committing the college to expenditure
- generating and receiving income
- handling cash
- dealing with college assets
- budget preparation, financial management and monitoring
- reporting of fraud and irregularities
- controls over capital expenditure.

The FEFC financial memorandum sets out specific requirements for land and building transactions.

❑ The governing body needs to obtain FEFC consent for land and buildings transactions where the total cost exceeds £1 million or 5% of the college's annual income, whichever is the lower. This includes disposals, as well as purchase or construction of buildings.

❑ FEFC consent is needed for secured loans to finance the construction or purchase of buildings. Again, the requirement to obtain consent is triggered by borrowings of £1 million or 5% of income, whichever is the lower. This applies on an accumulated basis, so any existing borrowings need to be taken into account. It applies where the buildings that are being purchased or constructed are offered as security. If additional buildings or land have to be offered as security, FEFC consent is required whatever the amount.

Colleges can also borrow up to 5% of their annual income as unsecured loans before needing consent from the FEFC. Any application for consent will usually be dealt with as part of an application for a capital support grant.

Activity Check your financial regulations

Obtain a copy of your college's financial regulations. Check to see that the points in the list above are covered. How does your governing body ensure the financial regulations are being observed in practice?

Viewpoint

Considering your own college's financial regulations, is it clear, for example, how much expenditure may be incurred without reference to governors? Are the procedures clear for approving the principal's and governors' expenses? Do the regulations spell out at what stage governors should become involved in the event of a possible fraud or irregularity?

Section 5 Strategic financial management – an overview

All colleges are required to share their strategic plans with the FEFC at set intervals. An integral part of the strategic plan is the three-year financial forecast. This forecast should cost the strategic plan and include all of the resource implications of its targets. The process of integrating the financial forecast is essential to ensure that the plan is both affordable and realistic.

The process of producing strategic plans and financial forecasts is normally iterative. In other words, when the effects of the first draft of the strategic plan are costed, it may be found that the plan cannot be afforded or would miss a key financial target. This is then followed by a revised strategic plan and financial forecast which provides a better fit between targets and resources available.

The role of the governors is to set the general strategic framework within which the college management and staff operate. Governors should therefore be actively involved in:

- the formation and adoption of the strategic plan, the annual operating statement and the associated financial forecast

- recording the governing body approval of the plan before dissemination throughout the college and to external stakeholders
- referring to the plan frequently during governing body discussions
- monitoring progress towards its objectives and targets on a regular basis
- reviewing the whole plan annually to assess progress
- updating it by producing a new operating statement and financial forecast for the coming year.

Colleges have to submit their three-year financial forecast to the FEFC by 31 July. This forecast is reviewed by the FEFC along with information known about the college, including its strategic plan, accommodation strategy and other returns. Using this information, the regional finance director will make a judgement about the financial health of the college and grade it as category A, B or C. The college is asked as part of its submission to self-assess its own financial health, and the FEFC will then confirm whether it concurs with the college's self-assessment. The definitions of the grades of financial health A, B and C, used by the FEFC are included in the next section.

The FEFC aggregates all the financial forecasts submitted to assess the overall financial health of the sector. This assessment contributes to advice given to the Secretary of State for Education and Employment in preparation for the annual spending review. Colleges should, therefore, present a realistic position so that an accurate view of the financial health of the sector is obtained.

Range and purpose of financial documents

Governors need to receive and approve a range of documents in order to discharge their financial duties properly. These include but are not limited to the following.

- ❑ **The college's three-year financial forecast**. This should include a commentary stating the key assumptions, financial targets, main areas of risk (the potential impact of which should be quantified) and contingency plan.
- ❑ **An annual budget plan**. This is to include an income and expenditure account, a projected balance sheet, a cash flow projection and a capital expenditure plan. This is an expression of the college's operating plan.
- ❑ **A monthly financial reporting pack**. This details actual performance against budget projections. It should include a commentary explaining any variances and providing details of proposed actions, and this should be received in a timely manner each month, certainly no later than 15 working days after the previous month-end. Monthly management accounts enable governors to monitor the financial performance of the college against the budget plan.

- ❑ **An assessment of project affordability and financial viability for planned major capital projects, plus investment appraisals**. These are necessary for informed decision-making on capital projects, taking into account all the financial implications. If the project does go ahead, regular financial progress reports should be made to governors to ensure that it remains on track.
- ❑ **The annual financial statements plus accompanying management letter from the external auditors**. The management letter identifies any issues arising out of the auditors' work and provides details of material errors and areas for improvement.
- ❑ **The audit needs assessment and internal audit plan**. This shows an assessment of the risk attached to each of the college's systems and activities, and the schedule of planned reviews for those areas. The internal auditors should provide a separate report to the audit committee for each of the areas reviewed, and an annual report advising on the adequacy of the college's systems of internal control. This is covered in more detail in Module 7 *The audit committee*.
- ❑ **The details of the annual funding allocation from the FEFC and any other major income sources**. The average college receives approximately 70–75% of its total income from the FEFC, so it is vital that governors are familiar with the details of this funding source.
- ❑ **Regular reports on student numbers and the anticipated units of funding.** The number of students generates the annual funding allocation from the FEFC. Any variation in this could have a significant financial impact on the college because it is usually such a large part of the college's income. If a college does not achieve its funding units target it will be subject to clawback of funds. If it overachieves its target, it will generally not be compensated for the extra activity.
- ❑ **Regular reports on the volume, nature and financial quality control of franchising activity**. (See Section 2.)

Activity Review the financial documents received by your governing body

Look again over the list of documents above. Which of these can you recall seeing in the past year? Tick off those you have seen and put a ? beside those you have not.

Viewpoint

If this activity has made you aware of gaps in the financial documents that your governing body receives, and you think these might be important omissions, discuss this with the clerk.

Section 6 Indicators of a college's financial health

A college's financial health depends on the overall financial strength of the college's key financial indicators for the forecast period, and their sensitivity to areas of risk. The FEFC has devised a system for grading financial health to reflect this. There are three groups: A, B, and C. The definitions of these groups are published in Supplement A to FEFC Circular 99/25 *Strategic Plans Including Financial Forecasts*. These definitions should be regarded as guidelines rather than absolute criteria. The final grading decision is made on the basis of all known information about the college. The group definitions are explained below.

Group A

'Colleges which appear to have sufficiently robust finances to implement their strategic plan and to deal with the circumstances which are most likely to occur during the planning period. These colleges will normally have:

- a positive cash flow from operations each year
- more than 25 cash days in hand
- a positive balance on their general reserve (income and expenditure (I & E) account).

These colleges will also have carried out a rigorous sensitivity analysis and modelled the issues which are most critical to their success. They will also have identified contingency plans to deal with the most likely variances.'

Group B

'Colleges that show signs of financial weakness which might limit their ability to implement their strategic plan if they encounter adverse circumstances during the planning period. Colleges in this group are likely to have weaker solvency than those in group A but still should have:

- more than 15 cash days in hand
- a positive balance on their general reserve (I & E account).

In addition, this group also covers those colleges which may appear to have features similar to those for group A but whose assumptions appear either over-ambitious or optimistic. For example, some colleges in group B are planning significant efficiency savings without having robust plans to achieve these savings. These colleges may also have included income generation without a supporting business plan. Conversely, this group also covers those colleges which are improving from a group C position.’

Group C

‘Colleges that are financially weak and which are or may become dependent on the goodwill of others. This might involve, for example, a loan from their bank for revenue purposes. Colleges in this position are likely to have an accumulated deficit on their general reserve account and net current liabilities.’

The key financial indicators used will be:

- operating surplus/deficit
- historical cost surplus/deficit
- general reserve
- cash and cash equivalents, including short-term investments and net of overdrafts
- cash days in hand
- current ratio.

The financial forecast covers a period of four years, which includes a plan for the next three financial years and an estimate of the projected position for the year about to finish. When evaluating the financial health of the college all four years are taken into account. However, in assessing the true position, a greater weighting is given to the first two years’ performance as this should be based on more realistic information. Assuming that appropriate financial reporting systems exist, the college should be able to predict the likely outcome for the existing year with a fair degree of accuracy when the forecast is prepared. In addition the first year of the three-year forecast should reflect the budget already approved by the governing body.

Similarly, a greater weighting is also given to the solvency indicators over the other financial indicators. A college’s financial objectives should concentrate on levels of solvency rather than profitability. Governors should take all of these factors into account when making their own judgements about the financial health of the college.

Activity In which group is your college?

Which financial health group does your college fall into, and why?

Viewpoint

If your college is category C, it should be clear how this position was reached and what plans are in place to improve matters. If your college is category B, is this a conscious decision made by governors to adopt this level of risk in order to meet certain obligations? If this is not a deliberate policy, it may be an issue that needs to be addressed.

Section 7 Financial target setting

The financial forecast is an integral part of the college strategic plan. Clear linkage should exist between the objectives set in the strategic plan and the financial targets set in the financial forecast. The financial targets should support the objectives set in the strategic plan and assist the college in achieving those objectives.

Measurable targets

Targets should be set which are measurable, achievable and sufficiently challenging. They need to include periodic checks so that governors can measure whether the objectives are being achieved. Targets should have a measurable, clear performance indicator, which can be benchmarked against past performance and sector performance. The target should include an identified timetable for staged implementation against which progress can be reviewed.

One of the key responsibilities of governors is to ensure the solvency of the institution. Governors should therefore require that there are financial targets which address solvency – such as requiring a minimum number of cash days in hand. Similarly, financial targets should be set to support the governors in discharging their responsibilities for financial management and monitoring; for ensuring effective management controls and reporting systems; and for safeguarding college assets.

Once targets have been set there should be regular reviews against progress towards those targets. The targets can be updated if necessary to reflect the changing priorities within the strategic plan. If targets are not on track then an action plan should be agreed with governors to bring them back in line.

It is essential that governors receive regular reports to help them monitor the financial situation. The reports should be clear, accurate and timely. Governors should question and challenge any aspects of the report that do not meet these criteria. Probably the most important financial report for governors is the monthly management accounts. Good practice for the monthly reporting pack is covered in detail in Section 10.

Common areas of weakness in financial target setting and financial monitoring

The most common areas of weakness are:

- **lack of clarity when setting financial targets** – often targets are too general or vague. For example, *'We will improve our cash days in hand'* is an inadequate target whereas *'We will have a minimum of 25 cash days in hand by 31 July 20XX'* provides governors with a measurable target and a deadline.

- **targets do not link to the strategic plan** – the financial forecast should fully reflect the financial implications of the objectives set in the strategic plan. For example, if the college has an objective to improve the accommodation through a major refurbishment of an existing building, then this should be reflected in the financial forecast. There should also be a financial target which includes the level of capital investment required, and the date by which the project should be completed.

- **targets that are not met in the financial forecast** – a common failure in monitoring financial performance is in monitoring student numbers. For example, overestimating student units by 10,000 could result in a £170,000 loss of income. Accurate recording of student data is of critical importance. Governors need to be both aware of and satisfied with the accuracy of the college's system for collecting student numbers and calculating the units generated.

- **poor-quality financial information produced for governors** – poor-quality financial information still exists in the sector. Good practice in financial reporting is covered in more detail in Section 10.

- **monthly financial reports that are produced far too late** – financial information is of little use if it is produced infrequently or very late. If there are financial issues to be tackled, governors need to be aware of them as soon as practically possible so that corrective action can be agreed before it is too late. It is good practice for colleges to publish in advance the dates by which reports should be produced – usually at the beginning of each financial year.

- **governors not challenging potential issues arising out of information received** – having received information from the college management, it is important that governors challenge any aspects that are not clear to them or give them concern. This should not be seen as distrust of the college management, rather part of a normal healthy working relationship between governors and management.

Activity What are your college's financial objectives?

What are the current financial objectives within your college's strategic plan and financial forecast? How is progress against them monitored and measured?

Viewpoint

Governors should set clear financial objectives for the college to achieve, and receive regular (at least once a term) monitoring information on performance against them. Typically this information should be a core component of the ongoing financial monitoring reports.

Section 8 Sensitivities in a college financial forecast

Sensitivity analysis involves assessing the impact that risks could have upon the financial health of an institution, if they were to happen. It is the first stage in the formulation of a risk management plan.

No matter how good a college is at forecasting and how robust the college finances are, things can still go wrong. It is therefore vital that colleges carry out suitable sensitivity analysis on the main areas of risk within the forecast and prepare adequate contingency plans.

When preparing financial forecasts, colleges make a number of assumptions. Some of these assumptions will derive from the college's strategic plan. They often relate to uncertainties in the external environment or the more challenging aspects of the strategic plan. Typical examples are:

- the college predicts a high level of grant income – will the European grant regime be maintained?

- the college has high levels of distance franchising – will the FEFC continue to finance long-distance franchising?
- the college plans large-scale growth – can the additional students be recruited?
- the college faces intense competition – can current student levels be maintained?
- the college plans large-scale building works – can the costs of the building project be contained?

It is important that all the assumptions are clearly stated so that the risks associated with each one can be properly assessed. Consideration should be given for each area of risk to:

- the likelihood of the risk occurring, i.e. high, medium or low
- an estimate of the potential financial impact.

Where there is a combination of high likelihood of a risk materialising and a significant potential financial impact, there are serious implications for the achievement of the financial forecast. Clearly, the governors should ensure that these areas are closely monitored by management, with regular reports provided to governors.

As well as considering individual risks, governors need to be aware of the possibility of more than one area of risk materialising. The combination of two or more risks occurring may have serious consequences. Governors may well want management to consider a 'worst case scenario'.

Risk management plans based on sensitivity analyses are important tools for minimising risk – something which every college should seek to do. There are still, however, some colleges that do not give adequate attention to risk management. Good practice would require governors to scrutinise and approve the sensitivity analysis and associated risk management plan as key components of the financial forecast.

A risk management plan should contain the following:

- a brief description of each area of risk together with an assessment of the likelihood of occurrence
- a quantification of the potential financial impact
- the name of the individual within the college management who will have responsibility for monitoring that particular area of risk

- contingency plans in the event of an adverse variance – these must be realistic
- a description of the monitoring process.

Activity Developing your awareness of financial risks

Has your college completed a sensitivity analysis? If so, what was the outcome in terms of significant impacts upon the college's viability?

How could the associated risk management plan be improved?

Governors have a responsibility to consider the assumptions underlying financial plans and to anticipate what might go wrong with the finances of the college. Get in the habit of asking yourself what the financial assumptions behind this document are, and whether they are realistic. This will help you to become alert to potential areas of risk in the financial information you receive.

Section 9 The FEFC funding methodology

Colleges generally receive their biggest proportion of income from the FEFC. This is typically about 75% of total college income. The FEFC operates a funding methodology which is based upon:

- the number of students enrolled on a course
- the length of the study programme
- whether or not the student completes the course
- the subject area studied
- achievement of the qualification aim.

Additional funding can be claimed through the FEFC funding methodology where:

- the student is under 19 years of age on a full-time programme
- the student is in receipt of a means-tested benefit
- a student receives additional support from the college where an assessment has identified that a student has certain needs.

The funding methodology is highly sophisticated but is based on the principle of funding each individual student's learning programme. Because of the numbers of students involved, the management of the data associated with student tracking is a significant task. It is also a significant risk because of the direct impact that errors have on funding.
It is important that governors have a basic understanding of the funding methodology because of its complexity and financial significance. Each year, usually in December, the FEFC publishes an update of any changes to the funding methodology for the following year. This takes the form of a circular and includes the funding tariff table for each of the areas listed above. The tariff consists of units, each college being paid a certain amount of money for each unit earned.

The units earned for each student are made up of three separate core elements:

- entry units
- on-programme units
- achievement units.

The entry units are dependent on the value of the basic on-programme units and are paid to reflect the advice and guidance that students are given when enrolling on a course. This will either be two, four or eight units.

Census dates

The main element of the funding is received through the on-programme element. A one-year course is generally based on 84 basic on-programme units. These are earned by a student still attending a course on a census date during each term. For the college to receive all 84 units, the student has to be attending the course until all three census dates have been passed, i.e. until after 15 May each year. The census dates each year are:

- 1 November
- 1 February
- 15 May.

Provided the student is still attending on the census date, the college claims one-third of the basic on-programme units (assuming a one-year course), i.e. 28 units. The basic on-programme units are then enhanced by a cost weighting factor depending on the course subject area. This takes account of some subject areas being more expensive to organise and deliver than others. Part-time courses have lower unit values.

The third element is achievement units, earned if the student completes the qualification aim recorded in the learning agreement for their study programme.

Unit value

The amount paid per unit currently varies, although there is a convergence process operating to bring all colleges to a standard funding level, expected to be £17.20 per unit by 2001/2002.

The standard level is known as the Average Level of Funding (ALF) and is simply calculated as the total funds divided by the total target number of units for the college.

Retention is critical for sound finances

Large sums of money can be involved. For instance a student on a one-year construction course which has a cost weighting factor of 2.0 could be worth the following units:

Entry		8
On-programme	(84 x 2.0)	168
Achievement		10
Total units		**186**

If a college were being paid at the convergence rate of £17.20 per unit, the total funding for this student in one year would be £3,199. This is without any additional funding that an individual student might attract for fee remission or additional support.

If this student enrolled in September and left the course at Christmas the college could only claim the entry units and one-third of the on-programme units as the student has only attended past one census date. The units earned would be 64, and at £17.20 this would be total funding of £1,101. This is a significant reduction on the potential total annual value of the funding calculated above.

Even worse, if this student were to leave before 1 November the college would receive nothing.

This example demonstrates how crucial it is to monitor retention rates, because if just five students drop out of the course at Christmas, the college would lose just over £10,000 of funding for the year. Taken over the number of courses typically offered by colleges, drop-out numbers can quickly accumulate.

No college can realistically expect 100% retention on all programmes, so it is important that a retention factor is taken into account at the planning stage and when making assumptions for the budget. This is an area which governors need to scrutinise carefully before approving the annual budget.

The FEFC makes payments to colleges each month throughout the academic year on the assumption that they will achieve their funding targets. If a college fails to achieve its target, then funds will be clawed back at the full funding rate for any unit shortfall. This can obviously have a significant impact on cash flows. Any clawback will normally take place in the March following the end of the previous financial year. On the other hand, if a college exceeds its target it will not receive extra funds and will have to absorb the cost of the additional provision. The calendar included in Appendix A sets out the key dates in the annual funding process.

Activity Compare your college's predicted and actual retention rates

Find out from your clerk the predicted and actual retention rates for the last financial year. What assumptions does your college make about retention rates? Does it have a standardised retention rate applied to all courses, or does it have different rates applied to different types of course?

Viewpoint

If there was a significant difference between the predicted and actual retention rates, what was the reason for this? Were budget predictions unduly optimistic and do you need to make adjustments to the assumptions about retention rates? How do your college's retention rates compare with those of the sector as a whole on course/student type comparisons? What is happening to your college's retention rates over time – are they improving or declining?

These are critical questions for governors. We can all probably think of colleges which no longer exist because the governors and managers did not get the correct answers to these questions.

Section 10 Good practice and common weaknesses

There is no prescribed format or process that colleges have to follow when monitoring their financial performance. However, there are basic principles of good practice which should be in place if governors are to meet their responsibility for solvency.

As a minimum, governors should expect the following financial information each month:

- an income and expenditure account comparing the budgeted income and expenditure with the actual results to date, and also a forecast of the expected position at the end of the financial year; the level of detail for the income and expenditure heads should relate clearly to the main headings in the published accounts
- a balance sheet showing the financial position at the end of the previous month, again comparing the budgeted position against actual results
- a rolling 12-month cash flow projection
- an accompanying commentary, which explains the main variances between actual results and budget and any action that needs to be taken
- information on student numbers and/or FEFC units of funding.

It is important that accounts are received by all governing body members and are timely, certainly no later than 15 working days after the previous month-end. Deadlines should be set and agreed at the start of the financial year for distribution of the monthly reporting pack. These could act as an early warning system about potential problems if the accounts do not arrive on time. If action is required to deal with any adverse variances the position should be made known to the governing body at the earliest possible opportunity so that effective plans can be put in place.

Actions agreed at committee meetings where management accounts are discussed must be minuted and followed up at the next appropriate meeting.

These are minimum requirements. Many colleges have now become far more sophisticated with their monthly financial management reporting. Some examples of useful financial information provided by colleges are given below.

- an executive summary (of about one side A4 in total) of the headline results with variances against issues, which provides a quick overview.

- a mix of tabular and graphical presentations of the finances to assist clarity; graphical presentation is useful in identifying trends over time
- a cash flow statement that provides the historical estimates against the actual cash balances achieved, together with a rolling 12-month projection. This is an extremely important area, where governors need to be confident that the information received is accurate and reliable. Obviously, no college can afford to run out of cash. By providing the historical trends the governors can see at a glance how accurate the officers have been in predicting cash balances. They can, therefore, gain confidence in the information being presented to them
- an enhanced income and expenditure statement with the following additional columns:

  1. budget for the full year
  2. forecast out-turn for the full year
  3. budget for the most recent month
  4. actual for the most recent month
  5. variance expressed as a % and/or amount, with those outside a pre-determined level of tolerance highlighted in bold
  6. ‘adverse’ or ‘favourable’ simply annotated by A or F (another common version is B – better or W – worse)
  7. all of the above columns repeated for the year-to-date position

- analysis of aged debtors showing large debtors and total value by age
- analysis of creditors showing large creditors and total value by age
- a capital expenditure summary showing budgeted, actual and committed expenditure; a separate statement is required for any major capital project
- a summary analysis of financial performance by cost centre/department, so that governors are aware of the contribution made by each area or subsidy
- analysis of FEFC funding units by curriculum area, showing actual against target and trends from previous years
- analysis of retention and achievement rates
- at appropriate times of the year, an analysis of applications and enrolments
- an analysis of franchising activity
- a statement showing performance of any subsidiary companies or joint ventures
- a separate analysis of the college enterprise and overseas activities, so that these can be monitored to ensure that they represent added value

- a staff analysis showing establishment against actual staff; for the academic staff, this could be extended to information about the use of contracted hours
- a statement showing current performance against each of the key financial objectives agreed by governors at the start of the year.

It is likely that governors would not wish to receive all of the above information as they would be overloaded – finance is only one aspect of a college's activities. Each college needs to determine an appropriate monthly financial reporting pack for governors, senior managers and budget managers. Each audience will have different needs, so the director of finance or equivalent should agree in advance what information should be provided to meet those needs.

Areas of weakness in financial management

The most common areas of weakness are:

- reports that are not user-friendly
- information received too late or on an ad-hoc basis
- reports that are either too brief or far too detailed
- inaccurate or unreliable financial data
- weak financial controls, or controls not being adhered to
- financial implications not being fully considered when making decisions
- weak senior management
- lack of planning.

The presentation of the report needs almost as much attention as the actual content. Information presented in a confusing way will generally not be used by the recipients. Presenters must remember that the majority of the audience are likely to be 'non-financial'. The presentation of the reports should be agreed in advance with users and appropriate training should be given. The format of the reports should be consistent for each of the target groups to which they are sent.

Reports must be sent out in a routine and timely manner. Budget managers are more likely to make use of the reports if there is a regular reporting routine. This could mean receiving their cost centre reports on a certain day each month, and having to respond on variances outside the tolerance limits with explanations and proposed action to correct the situation. Equally, the senior management team should have the monthly management accounts as a standing agenda item on one of their meetings each month – normally ahead of the reports being sent to governors – to enable a meaningful commentary to be provided on the current situation and underpinning rationale. These routines provide a useful discipline which will help the director of finance to produce the information on time.

The college assets should be safeguarded by financial controls. Clearly if these are weak or are not being followed the college assets could be at risk. (See *Module 7 The audit committee.*) Whenever important decisions are being made, the college's senior finance postholder should be advising the governors (if appropriate), the principal, and the senior management team of potential financial implications. Finances must be at the centre of the college's decision-making.

Activity Do you receive all the information you need?

Compare the list of reports mentioned above with the reports produced at your college. Which ones are missing?

Which of the missing ones would you find particularly useful to see?

Viewpoint

If this activity or others in this module have made you aware of possible weaknesses, gaps or areas for improvement in the way that financial documents are presented to and dealt with by your governing body, use the *Action planner* to note down any queries or suggestions that you would like to follow up.

Module review

This module has looked at governors' role and responsibilities for the financial management of their college. If you have worked through the whole module you should now be confident that you can:

- explain governors' role in monitoring the financial position of the college and its audit process
- identify the range and purpose of financial documents that will be presented to you as a governor
- explain the broad indicators used by the FEFC to evaluate a college's financial health
- describe common areas of weakness in financial target setting, financial monitoring and financial management within the sector

- explain the use of sensitivity analysis in a college financial forecast
- identify good practice in financial management
- explain FEFC funding methodology.

If you are not sure that you have achieved a particular goal, look back at the list of contents on page 2. You may find it useful to re-read the relevant section.

Summary of key learning points

Governors have a number of responsibilities in relation to the financial management of the college. To discharge these responsibilities governors should:

- be aware of the key requirements of the financial memorandum, and of the compliance criteria in the FEFC circulars on college companies and joint ventures (99/14) and franchising (99/37)
- establish an audit committee to provide advice on the system of internal controls operated by the college
- approve the annual financial statements
- approve the annual budget and the three-year financial forecast
- ensure procedures are in place and operate effectively to minimise the risk to college assets.

Strategic financial management is a vital part of the overall strategic planning process within a college. Governors will want to ensure that:

- the financial forecast is consistent with the college strategic plan
- appropriate financial targets have been approved by governors which support the solvency of the college
- clear reporting procedures are in place to enable effective monitoring of achievements against targets
- an adequate sensitivity analysis has been undertaken, with potential financial implications estimated and realistic contingency plans prepared.

The task of financial management must be part of the routine operation of the college. In order to fulfil their duties governors must be able to understand the information they are receiving and have confidence in it. To assist in this governors should have a basic understanding of the FEFC funding methodology, as in many colleges this constitutes the bulk of the total income.

Funding follows an individual student learning programme, and is financially sensitive to early withdrawals from courses.

Governors should receive clear financial information on a monthly basis in a format that is useful. These reports should be used to assess the financial position of the college. If necessary, the governors should challenge any information that is not clear to them or gives them cause for concern.

Governors should not accept infrequent reports or information that is confusing or meaningless. The governors have a responsibility for ensuring the solvency of the college. The monthly management accounts are a key tool to assist governors in discharging this responsibility.

Where next?

You have now completed work on *Module 4 Financial management*. If there are areas in which you need more guidance or information, they may be covered in other modules in the pack. Turn to *Check your current knowledge and skills*. This self-assessment questionnaire will help you to decide which modules or sections of modules may help to fill these gaps. Tick the useful sections for further study.

If you cannot find the information you need within these materials, turn to the *Action planner*. Note down what further information, support or guidance you would like. The *Action planner* gives advice on who may be able to help, and how.

Putting it into action

We hope that working through this module has raised useful questions, increased your awareness of issues and given you ideas for practical action that you would like to follow up. The *Action planner* contains a section where you can note down any questions or action points that you want to follow up within your own college.

APPENDIX A Annual timetable for funding and finance

February	Provisional funding allocation issued by the FEFC
	Final ISR* for previous academic year due for submission (with the inclusion of achievement data)
	Financial mid-year update (if requested by the FEFC)
April	Colleges required to respond to the FEFC provisional funding
	Budget preparation probably starts
May	Detailed budget preparation continues
	FEFC issues guidelines on financial forecasts
June	Completion of budget
	Completion of financial forecast
July	Approval and submission of financial forecast
	Approval and internal issue of budget
	End of financial year
September	External audit usually starts (late Sept/early Oct)
	ISR for previous academic year due for submission
November	Probably complete external audit
	Approval of annual accounts
December	ISR for current academic year due for submission
	Deadline for publication of annual financial statements
	Finance record due for submission to the FEFC

*The individualised student record (ISR) is the return submitted to the FEFC detailing the activity of all students at the college and is used for calculating the actual funding units earned by the college. There are three returns each year. The first follows the November census (due December), which gives an early estimate of all-year activity. The second is the position at the end of the year, i.e. 31 July (due September), and is used as the basis for external auditors to sign off the annual financial statements. At this stage everything should be included except exam achievements as most of these will not yet be known for students sitting exams in the summer. The final ISR will include exam achievements from the previous year and is used as the basis for the final payment of funds from the FEFC.

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