Financial Policy in respect of Council-controlled funds

[GEN012]

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Acronyms

CFO	Chief Financial Officer
COO	Chief Operating Officer
DVC	Deputy Vice-Chancellor
ED	Executive Director
GOB	General Operating Budget
ITIPC	IT Investment & Prioritisation Committee
MTF	Medium Term Forecast
NPV	Net Present Value
NSFAS	National Student Funding Aid Scheme
P&BWG	Planning & Budgeting Working Group
PIC	Project Implementation Committee
PYR	Prio Year Reserve
RAAG	Resource Allocation Advisory Group
REMCOM	Remuneration Committee
RMEC	Risk Management Executive Committee
UARC	University Audit and Risk Committee
UB&DC	University Building and Development Committee
UFC	University Finance Committee
UICTC	University Information Communication Technology Committee
VC	The Vice-Chancellor

1. Objective

The objectives of this financial policy are

- to provide the basis for the University's financial stability, sustainability and
- the achievement of strategic goals including the ability to invest in research and education-related initiatives consistent with the University's mission.

2. Scope

The purpose of this document is to describe the financial policy of the University Council ("Council') in respect of Council-controlled funds.

3. Applicable to

The financial management of all Council-controlled funds.

4. Basis for approach

The objectives of the financial policy are based on the following approaches:

4.1 Surpluses from recurrent operations and from investment income are to be used for building up free cash for capital expenditure and major projects, enabling new initiatives, and providing a hedge against unforeseen circumstances.

4.2 Capital expenditure is undertaken in terms of the University strategic priorities, as constrained by available cash resources, investment income and borrowing capacity. Capital expenditure on building works is viewed against strategic priorities of the University Building and Development Committee (UB&DC) multi-year plan which shall provide for estimates relating to approved projects and those under consideration, including staff and student accommodation. Other large projects follow a similar governance process, for example the University Information Communication Technology Committee (UICTC) in the case of investment in information technology.

4.3 Investment income, following deduction of all financing costs, is added to the free cash balance. If the free cash balance is within the required parameters, the net investment income may be used to seed new initiatives and other strategic choices. Investment income may not, however, be used for recurrent operations.

4.4 Debt finance is used conservatively if required and is further constrained by the ability to service the debt, in terms of both the interest and capital repayments.

4.5 Free cash is defined as financial investments that are undesignated, not encumbered and readily realisable after allowing for working capital requirements. It consists of net investment income and cash movements from the operating surplus or deficit. Free cash is to be maintained at a level intended to absorb risks, but not so unduly conservative that it will stifle operating and capital expenditures necessary in the interests of the University and its stakeholders.

5. Policy context

This policy is integral to University strategy and planning and should be understood in the context of the Overview of the Financial Governance, Structures and Processes of the University.

Three contextual factors have a significant bearing on the financial policy:

5.1 **Devolution**: The University has devolved management responsibility and accountability, including management of finances, to heads of budget units, mainly Deans and Executive Directors. Financial measurement and controls are supported by systems that encourage efficient and responsible discretion by budget-unit heads.

5.2 **Dispersed decision rights**: Substantial parts of the University's financial activities and resources (particularly for research operations and funding) are not fully controlled by University management or Council. The University and Council do however retain ultimate governance responsibilities for these activities and resources. The main risks inherent in this arrangement are, firstly, that unless the relationships are well understood, an illusion of greater financial stability than is supported by free cash and investments may be created. Secondly, the University remains responsible for any non-compliance with third-party obligations, tax and other legislation despite dispersed decision rights and dispersed control of these processes. These risks are managed through the monitoring process described in Section 7.1.2 and are regularly reviewed by the Risk Management Executive Committee (RMEC).

5.3 **The pressures on fees, state subsidy and costs**: The University is reliant on a delicate balance between state subsidy, fees and costs. Each of these elements faces different pressures e.g., State subsidy is subject to competing state priorities, and fees need to be affordable to ensure student accessibility against a background of continued drives for cost reduction. However, pressure for increased costs is inevitable in universities striving for quality in teaching and research, social responsibility, community engagement, accessibility to all, transformation, and a positive working environment for staff and students. In particular, the total value as well the annual increases in personnel costs (which represent the largest proportion of our costs at circa 67%) must be considered within the context of affordability and sustainability. The same principal of affordability and sustainability also applies to our underwriting of financial aid (based on internal funding policies), and the risks associated with the reliance on the National Student Financial Aid System (NSFAS). Responsible financial management is therefore needed for efficient use of resources, control of costs and increased income.

It is important to note that the bottom-line of the University is small in relation to income and expenditure, accordingly a small percentage change in any major variable has a large percentage effect on the surplus or deficit in a given year or a number of years, for example staff and related costs form the largest single expenditure item at well over half of total spend and any change impacts on operating leverage (the relative effect on the net surplus or deficit of changes in levels of income or expenditure). These pressures and features mean that efficient, goal-directed management is crucial. The management of these aspects at the budget-unit level needs to provide incentives (and restraints) to promote the efficient use of the University's resources.

6. Policy principles

To meet the objectives of the financial policy (and linked to the desired outcomes of the medium-term Financial Sustainability Plan) the following principles are followed:

6.1 Budgeting for a recurrent operating break-even for Teaching & Related operations and targeting an annual recurrent operating surplus of between 2% and 4% of recurrent operating income in Student Housing operations to ensure its own sustainability and ability to invest in renewal and capital expansion.

6.2 Recovering an appropriate amount of the costs associated with research and other activities (including short course offerings).

6.3 Including as income, funding (other than fees or subsidy) for specific expenditures that are expected to continue, for example:

- the income from an endowment to support a chair that is filled, or is expected to be filled will be recognised as revenue in the revenue budget for the year; or
- the income (even if not recurrent) for an externally funded programme which the University expects to fund from its own resources when the external funding ceases will be recognised as revenue (e.g. the programme to develop emerging researchers).

6.4 Allocating the annual realised recurrent operating surplus or deficit to the free cash balance.

6.5 Providing a portion of the realised net financing and investment income from the preceding year for allocation in the current year, on the Vice-Chancellor's (VC) recommendation to capital expenditure, new initiatives, and other limited period expenditure. To determine the amount to be made available to the VC, the UFC considers the balance of free cash, together with existing and anticipated commitments, and makes a recommendation to Council. Should the operating result be a deficit, the first use of the financing and investment income will be to reduce the deficit.

6.6 Evaluating the expenditure on capital items in terms of strategic priorities, informed by:

- An analysis of the Net Present Value (NPV) of the project.
- Uncertainty in projections of future costs and income.
- Available cash resources.
- Investment income.
- Donations from external sources.
- Such portions of the VC's discretionary spend as are allocated to capital expenditure.
- For major infrastructural developments, the borrowing capacity of the University.

6.7 Requiring Student Housing operations to cover their full costs and provide resources for long-term maintenance and organic growth of housing stock.

Exceptions may be contemplated in the case of a

- significant value of investment, either as individual items or collectively;
- multiple investments over a relatively short time.

This new stock may be underwritten by the University free cash (the capital budget) and is evaluated as described above for structural capital items.

6.8 Holding free cash at a level between 15% and 30% of recurrent operating expenditure.

Deviations from these parameters must be approved by Council on the recommendation of the UFC, having due consideration for the reasons and on presentation of a plan which indicates how the University will return to these levels.

7. Processes related to Council-controlled financial activities

Council-controlled financial activities comprise recurrent operations (educational, residence and related activities), net investment income, capital expenditure and other one-off expenditures. The relevant processes are as set out below.

7.1 Recurrent operations

The processes for recurrent operations are defined cyclically on an annual basis and can be grouped into three main categories: Planning & budgeting, Reporting & analysing, and Incentivising.

7.1.1 *Planning & budgeting*

The planning & budgeting process, incorporating recurrent activities and capital expenditure, follows a bottom-up approach. It is centrally steered by specific guidelines (including alignment with institutional goals) and parameters determined by management subject to affordability and sustainability. This in turn is driven by the extent of recurrent surplus and free cash. The process is fully consultative and includes all major stakeholders.

At a management level, the significant role players are:

- The VC, who is ultimately accountable for the University budget.
- Deans, EDs, CFO, Registrar and in some instances Directors of units (supported by their unit Finance Managers), who are responsible and accountable for the development and submission of their unit budgets.
- The Management Accounting Office within the Finance Department and the Planning & Budgeting Working Group (PBWG) are responsible for the facilitation, consolidation, and review of these budgets. The PBWG comprises senior staff of the Finance and the Institutional Planning departments; invitations to the review meetings are extended to the VC, the DVCs, COO and are open to members of the UFC.
- Resource Allocation Advisory Group (RAAG) (comprising the VC, the Deputy Vice-Chancellors (DVCs), the COO, the CFO, two Deans nominated by the Deans' Forum, and the Director of Institutional Planning and Director Management Accounting (as assessor members) is responsible for advising the VC who is in turn responsible for finalising the proposals for allocations for submission to Council. The

VC may co-opt additional assessor members. RAAG will advise the VC on operating and capital budget priorities.

- The Leadership Lekgotla (comprising the VC, DVCs, Registrar, COO, CFO and heads of operating units including deans, EDs and certain directors) is presented with an overview of the proposed budget and given an opportunity to provide input.
- The Vice-Chancellor's proposals for allocations are then put to the UFC.

At a governance level, the role players are:

- Council, as the ultimate approval authority.
- UFC, as final recommending authority to Council. The focus of the UFC is on the financial consequences of the budget, particularly cash flow and free cash for the current year and into the medium term. The UFC does not explicitly recommend the allocation of resources but considers the risk of the specific allocations on cash flow and free cash.
- The VC who makes recommendations for allocations (after consulting the UFC on the likely limits of the budget) for current and capital expenditures, having regard to the advice of RAAG, Remuneration Committee (RemCom), and the UB&DC (via SAC) and UICTC (via ITIPC).
- RemCom as the mandating authority for salary levels and increases.
- UB&DC, as recommending authority regarding the suitability of buildings for their intended usage, prioritisation to ensure compliance with the campus guide plan, design, and environmental issues.
- UICTC, as recommending authority regarding the suitability of the technologies for their intended usage, prioritisation to ensure alignment with resources and compatibility with existing technologies.

7.1.2 Reporting & analysing

Reporting is prepared on the variation between actual expenditure against planned/budgeted expenditure, including Capex and Strategic one-off allocations variations on actual spend against budget. Responsibility for variance analysis and interpretation rests with the budget-unit head (usually Dean, Executive Director or Director). Finance staff (decentralised and central) provides technical assistance to the budget-unit heads as well as some interpretative advice and facilitate the process and submission of the reports.

The Monthly Variance Analysis reports provided to Central Finance comprises three elements:

- **Operating variances:** These are analysed to reveal their cause and to indicate what will be done to redress or take advantage of the situation or to explain why no action is required.
- **Planning variances:** The analysis is intended to explain why misestimates might have occurred and what steps are being taken to ensure more accurate planning if appropriate.
- **Strategic insight:** Analysis of budget variances is alert to strategic messages offered by the variations from plan.

On a quarterly basis, the head of each unit provides a high-level review of the unit to Central Finance. A consolidated analysis of all units is prepared (by operating unit, by line item and by Capex & Strategic one-off allocation items) for discussion by the senior leadership and presentation to UFC and Council.

In addition, formal reviews, usually around mid-year (and more often if required) are held with the Leadership Lekgotla, in which progress against objectives (including financial) are discussed.

The quarterly analysis also provides an estimate/forecast of the annual spend and income, given what has occurred to date. This estimate informs the next cycle and provides opportunity for any actions and/or decisions required immediately or in the future. The quarterly analysis also includes an annual estimate/forecast on Capex and Strategic one-off allocations.

4.1.3 Incentive system at the unit level

Budget units retain a portion of the amount by which the difference between their actual revenue and expenditure is greater than the revenue and expenditure in their original budget, as a Prior Year Reserve (PYR), if the UFC recommends and Council agrees that the integrity of the complete financial policy is maintained. The portion retained is in accordance with a sliding scale and set of principles outlined in Attachment A to this document. The failure by a budget unit to achieve its financial target means that unit's PYR balance will decrease.

For the purposes of computing each unit's financial results, the state subsidy is credited at the budgeted amount. Where the subsidy received for general purposes differs from budget, the difference is not attributed to the unit but is treated as central income or expense and forms part of the University surplus or deficit. For all other variables the actual figures determine the faculty results.

Units may use their PYR subject to the following:

- 5% of a unit's total expenditure budget must be kept in reserve at all times. However, a motivation to allow the balance to fall below the 5% limit may be made to the CFO by the unit head (and if the unit head is the CFO, then to the VC), supported by the line manager, together with a plan indicating the return of the balance to the required level; to be reported to the UFC.
- Spending rights can be suspended by the UFC if the University's free cash is, or is expected to fall, below the required level.
- Units may use their reserves at their discretion provided:
    - The spending is in keeping with university priorities.
    - The activity does not result in recurrent expenditure for an undefined period.
    - Any spending greater than R1,000,000 in a 12-month period requires prior approval from the executive line manager and CFO (for consistency with priorities and cash flow considerations).
- Where a unit has a negative reserve a plan to redress the situation in a reasonable time must be drawn up in consultation with the line manager and the CFO for approval by the UFC. Progress is to be reviewed by the UFC annually.

Where, for behavioural reasons, certain line items in unit budgets may be approved at levels that are not expected to materialise, the difference between the unit budget and the expected result is provided for in the central budget. The main instance where this occurs is while a full staff complement is budgeted for; the actual staff cost is usually less due to delays in filling vacated or new posts (current practice is for units to plan for a percentage of churn, being the expected underspend resulting from vacancies and other staff movements - and the centre plans an additional percentage based on historical trend).

In case of unexpected circumstances, the CFO may approve requests for additional funds in keeping with Delegations of Authorities by Council (GEN002), for later ratification by the UFC.

7.2. Principles relating to net investment income

7.2.1 The net investment income (investment income after deducting financing expenditure where financing costs are to be met centrally) forms part of free cash.

7.2.2 The main components of investment income are returns on free cash and the income distribution from the undesignated endowment. Some miscellaneous income is also included.

7.2.3 The first call on net investment income is to ensure the University's free cash is within the required parameters.

7.2.4 A Medium-Term Forecast (MTF) is used by the University to provide a financial framework within which to evaluate and pursue the University's goals for a period of four to five years. It is informed by the recent operating performance of the University as well as the strategic imperatives and risks facing the University. Given the informed estimates for operating results, net investment income, capital expenditure and other limited period expenditures it indicates the free cash position for the medium term.

If the UFC regards the free cash position, as determined by the MTF to be stable, the VC in consultation with the RAAG may apply to the UFC for an annual allocation for strategic initiatives. These allocations may not be used for recurrent operating expenditure; typically they are for strategic priorities and for a limited period, which may exceed one year but would not normally exceed five years. For periods exceeding one year the UFC may recommend for future years, depending on the nature of the expenditure and assessment of the financial position.

If the UFC regards the free cash position, as determined by the MTF to be stable, the VC may apply to the UFC for an annual discretionary allocation.

7.2.5 Allocations referred to in 7.2.4 are made in two tranches. The discretionary tranche is allocated once the year-end results are known, and the first quarterly review has been held. At this point the University will have established the net investment income, the operating result for the previous year and the level of free cash. The strategic tranche is allocated after the budget allocations have been finalised. At this stage budget requests that have not received the allocations hoped for may be considered by the VC and the RAAG provided they meet the limited period criterion.

7.2.6 At each stage an updated free cash projection informs the amount to be allocated. The grant is made and recorded by Council on the recommendation of the UFC.

7.3 Principles relating to capital expenditure and major projects

7.3.1 The process relating to the acquisition of minor assets (costing up to R10 million) is as set out in Section 7.1.

7.3.2 The acquisition of capital assets costing more than R20 million, usually buildings, are recommended by the UB&DC and assessed for affordability by the UFC before consideration by Council. The principles for evaluating the expenditure on capital items are detailed in Section 6.

7.3.3 The acquisition of any capital assets costing in excess of R30 million, or any assets regardless of value that carry significant risk as assessed by the UB&DC or the UFC, require a Project Implementation Committee (PIC) to monitor progress and report to the UB&DC and UFC.

7.3.4 Major projects which may not necessarily involve substantial physical assets e.g. expansion of technological facilities but have university wide implications and carry a level of risk requiring governance outside of the initiating unit, follow the same process as for assets in excess of R30 million provided that a further recommendation from an appropriate body instead of or in addition to the UB&DC/UICTC may be required.

7.3.5 Capital and major projects are funded from various sources such as free cash, donations, and state infrastructure funding amongst others after taking into account the factors described in Section 5. If the project has not commenced within two years of the approval date it must be re-evaluated for its continued relevance, priority and affordability.

Attachment A: Prior Year Reserve (PYR) Accumulation

Principles of Application and Unit Applicability Variations

UCT Surplus/Deficit Result Brackets	Rate of PYR Accumulation
Surplus of 3.01% of Operating Income or higher	100%
Surplus between 2.00% and 3.00% of Operating Income	50%
Surplus up to 1.99% of Operating Income	25%
Deficit	0%

If a unit has a positive variance for the year under review, and its PYR balance is 5% of operating expenditure for the budget year, the bands above will apply (the existing guideline in respect of keeping a minimum balance of 5% of operating expenditure before spend may take place from PYR remains as is).

In the case of a unit which has a negative variance for the year under review, the full value of the difference to Operating Surplus/Deficit will accumulate to the PYR account, regardless of the overall UCT result and the bands in the table above. Further, should a unit have a negative PYR balance, the full 100% of any improvement against Operating Surplus/Deficit will accumulate regardless of the overall UCT result and the bands in the table above.

Further, should any unit have a PYR balance of less than 5% of operating expenditure for the year ahead, the full 100% of any improvement against Operating Surplus/Deficit will accumulate, regardless of the overall UCT result and the bands in the table above.

To restate the point - the bands in the table above will only apply when the unit has a PYR balance of 5% of operating expenditure or above and will cease applying if the PYR balance falls below 5% of operating expenditure for the year ahead.

In addition, the sliding scale and 5% minimum balance requirements will not apply to so called “university wide” budget/cost centres. The primary reason for this is that for these budget centres, an underspend is almost always due to a timing difference and not a saving on the budget allocated. The unspent budget is usually expended in the year that follows.
For example, the maintenance in the Properties and Services university wide centre is seldom fully spent in the year of allocation but is usually fully spent by the end of the following

year. It is not in our interests to hold this budget centre to the 5% minimum or the sliding accumulation scale as we want the maintenance to be done.

The current university wide budget centres are as follows:

- Financial Services;
- Human Resources university wide;
- Properties and Services university wide;
- Information and Communication Technology Services university wide;
- University Research Committee;
- Communications & Marketing Department university wide;
- Development & Alumni Department university wide;
- Registrar’s Office university wide;
- Vice Chancellor's Office university wide;
- Intellectual Property.

The example below illustrates the mechanics

Budget and Actuals for UNIT J

	Year 1			Year 2			Year 3	
	Budget	Actual	*Variance*	Budget	Actual	Variance	Budget	Actual
Income	112	120	*8*	220	230	*10*		
Expenditure	100	133	*33*	200	207	*7*	200	
OPERATING SURPLUS/-DEFICIT	12	-13	*-25*	20	23	*3*		
PYR	33		8	8		10.5	10.5	
5% of Expenditure	5			10			10	

In this year the variance is R3 - the first R2 gets the PYR balance to the 5% target (R10) and thus the accrual table applies to the difference of R1 - here the 50% rule applies to the R1 giving an addition to the PYR account of R0.50

Notes:

1) The UCT Overall Result for all above scenarios is a surplus between 2% and 3% of Operating Income.

2) So long as the unit has a PYR balance below the 5% of Expenditure Target as per the UCT Financial Plan the variance on Operating Surplus/Deficit target will accrue. Once the 5% level is reached, the percentage accrual table will apply.

Unit J has an operating expenditure of R100, Operating Surplus/Deficit target of R12 and a PYR balance of R33. In year 1 the UCT Operating Surplus/Deficit is in excess of 3% of operating income.

In year 1 the actual Operating Surplus/Deficit for J is –R13, which is a variance of –R25 to the budgeted target of R12. Thus, the PYR balance is now R33 less R25 equals R8. Assume operating expenditure is now R200 so the 5% PYR balance requirement is R10 and the unit is thus short on this by R2, while the Operating Surplus/Deficit target is R20.

In year 2 the UCT Operating Surplus/Deficit is 2,5% of operating income, while the unit J actual Operating Surplus/Deficit result is R23, beating the target by R3. Operating expenditure for year 3 is still R200, so the 5% PYR balance target is still R10.

Thus – the first R2 of the Operating Surplus/Deficit excess is applied to meet the 5% minimum balance target. The remaining R1 is now subject to the accumulation table bands – so R1 at 50% is R0.5. The PYR account balance is thus now R10.5, of which R0.5 is available for use by Unit J.

Area list and PYR basis

1.

Calculation of PYR basis: Bottom-line Variance per Management Accounts (budget-actual variance)	
Area	
Commerce	
Engineering & the Built Environment	
Humanities	
Health Sciences	
Law	
Science	
GSB - Teaching	
CHED	
Library - Operations	
ICTS - Operations	
ICTS - Uniwide	*
Properties & Services - Operations	
Properties & Services - Uniwide	*
International Academic Programmes Office	
Communications & Marketing Department - Operations	
Communications & Marketing Department - Uniwide	*
Development & Alumni Department - Operations	
Development & Alumni Department - Uniwide	*
Dept. of Student Affairs - Operations	
Human Resources Dept. - Operations	
Human Resources Dept. - Uniwide	*
Instituitonal Planning Department	
Registrar's Office - Operations	
Registrar's Office - Uniwide	*
Finance Department - Operations	
Financial Services	*
Office for Inclusivity & Change	
Vice Chancellor's Office - Operations	
Vice Chancellor's Office - Uniwide	*
Department of Research & Innovation	
1. Grants Office - Operations	
2. Research Development - Uniwide URC	*
3. Innovation Office	
4. Intellectual Property	*
5. PGFO - Operations	
NOTE: The areas marked with (*) are not part of the 5% opex budget reserve principle	

2.

Different basis PYR: Budget variances - calculated from Funds	
Budget Variances	
Library - Uniwide Acquisitions	*
PGFO - Uniwide GOB Scholarships	*
NOTE: The areas marked with (*) are not part of the 5% opex budget reserve principle	

3.

Areas not part of PYR	
Baxter	UCT Teaching & Learning supports the Baxter Theatre with an annual grant effectively underwriting the Baxter's operating deficit
Housing	Any surpluses generated are to be invested for capital expansion/major capital works
Dept. of Student Affairs - Financial Aid	Underwritten budget; It is the difference between what external parties (most notably NSFAS) funds and what we allow based on our Financial Aid policy
GSB Breakwater Lodge and Academic Conference Centre	Hotel operators have own incentive scheme to maximise returns
Commercial Development	Per agreement Jun 2019: Aligns with the principles applied to the GSB Breakwater Lodge