View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Digital Education Resource Archive

July 2010/20
Core funding/operations
Report on outcomes
This report is for information

This report gives an overview of the outcomes of the review of annual accountability returns for 2008-09.

Annual accountability returns

Outcomes for 2009

© HEFCE 2010

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND
hefce

Contents

Executive summary 2
Overview 4
Annual assurance return 5
Annual monitoring statement 5
Corporate planning statement 5
Audited financial statements and financial forecasts 6
Financial commentary 7
Audit committee annual report 8
External audit management letter 9
Internal audit annual report 10
Higher Education Students Early Statistics return and Research Activity Survey 10
Transparent Approach to Costing return 11
Annex A Financial health of the HE Sector 12
Appendix A Actual financial results for 2008-09 16
Appendix B Future financial sustainability 23

Annual accountability returns: Outcomes for 2009

To	Heads of HEFCE-funded higher education institutions Heads of universities in Northern Ireland
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning, Student data
Reference	2010/ **20**
Publication date	July 2010
Enquiries to	HEFCE assurance consultants or assurance advisers (for financial and audit accountability returns) HEFCE higher education policy advisers (on annual monitoring statements, corporate planning statements, student data and research activity returns) Contact details for HEFCE staff are at www.hefce.ac.uk/aboutus/cop/contact

Executive summary

Purpose

1. This report gives an overview of the outcomes of the review of annual accountability returns for 2008-09. The outcomes are based on information provided by higher education institutions (HEIs) in December 2009 (and January 2010 for the Transparent Approach to Costing return). In addition, the report also provides an overview of the financial health of the higher education sector in England.

Key points

2. The outcomes of our reviews of all the annual accountability returns fed into the risk assessments and risk letters to institutions as well as informing the continuing dialogue with each institution. This publication provides some general feedback points for consideration by all institutions.

3. The overall financial results for the sector in 2008-09 show a fairly sound financial position albeit a marginal deterioration on the previous year. At the end of 2008-09 the sector had strong cash balances and healthy reserve levels, which will provide some cushion for the likely risks the sector now faces.

4. There are undoubtedly going to be increased pressures on public finances which, together with significant pressures on expenditure, will create a different financial picture for the sector. In the past decade the sector has seen its overall financial position strengthen, but this has been on the back of significant income growth rather than cost reductions. The future may be different.

5. The sector continues to operate on very fine margins, so small changes can have a material impact on the financial performance of the sector. HEIs need to generate surpluses to provide the positive cash flow to fund future developments, to the extent that these are not met from capital funding. The actual level of such surplus needed will vary, depending on the

circumstances of individual HEIs. In the medium to long term, some institutions will need to generate even larger surpluses to help cover the full economic costs of their activities and to provide cover for risk/uncertainty.

6. There are some areas in which institutions could improve their reporting, including demonstrating economy, efficiency and effectiveness (value for money). In our dialogue with institutions it is clear that the pursuit of value for money is a high priority, but the reporting of the activity and achievement could become more explicit. By being more explicit in reporting areas of efficiency it becomes easier for us to identify and quantify efficiency savings across the sector. We remind institutions that there is a requirement under the Financial Memorandum with HEFCE to ensure that public funds are spent on the purposes for which they are intended, and that good value for money is obtained.

7. In 2008 we made it a condition of funding that all institutions' audit committees provided an opinion on management and quality assurance of data submitted to the Higher Education Statistics Agency and to HEFCE and other funding bodies. This was requested in the Financial Memorandum with HEIs that took effect from 1 August 2008.

8. We expect all institutions to comply with this mandatory requirement in 2009-10. We remain concerned that some data received from HEIs are not accurate or do not comply with funding rules. It is strongly recommend that all institutions undertake a formal review of existing arrangements.

Action required

9. No action is required: this report is for information.

Overview

10. Higher education institutions (HEIs) in England are required to send us their annual accountability returns, to support the process previously known as the 'single conversation'. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them.

11. We primarily use the information collected to:

- monitor the use of our funds for the purposes intended, including compliance with the Financial Memorandum
- form a basis for discussion with institutions about their progress in key areas, their priorities for strategic development and their current and future performance (including financial sustainability)
- largely determine our risk assessments of each institution
- identify trends across the sector and advise the Secretary of State for Business, Innovation and Skills on the needs and development of the higher education sector.

12. The annual accountability returns are a key element of HEFCE's institutional assurance and risk framework. They complement our cycle of assurance reviews and data audits to provide a coherent regulatory approach to HEIs. The various accountability returns submitted to HEFCE provide assurance to all investors and to the community that each institution serves. The returns submitted were:

- annual assurance return
- annual monitoring statement (AMS)
- corporate planning statement (CPS)
- audited financial statements
- 2008-09 financial results and forecast tables (2009-10 to 2012-13)
- financial commentary on past performance and future prospects
- audit committee annual report
- external audit management letter
- internal audit annual report
- Higher Education Students Early Statistics (HESES) return
- Research Activity Survey (RAS)
- Transparent Approach to Costing (TRAC) return.

13. The following sections provide feedback on the various returns submitted. This feedback is at a general sector level. Each institution has already received benchmarking data in relation to its 2008-09 financial performance and forecast position up to 2012-13.

14. The following sections provide sector-level comments on each of the accountability returns submitted by institutions.

Annual assurance return

15. The purpose of this return is to confirm that each institution has met its obligations to HEFCE under the Financial Memorandum ('Model Financial Memorandum between HEFCE and institutions', HEFCE 2008/19). In signing this return the designated officer (head of institution) is confirming that the institution has returned all the relevant accountability returns and that these are accurate, adhere to the published guidance and have been through the appropriate approval process. Institutions need to ensure that they sign the most up-to-date version of this return which is provided annually alongside the accountability returns guidance document (for the 2009 process, this is 'Annual accountability returns 2009', HEFCE 2009/35).

16. There are no issues to report at a sector level on this return, but we would remind all institutions that they should have a robust process that provides assurances to the designated officer to sign the return. It is also imperative that the designated officer (head of institution) signs the return and not someone else within the institution.

17. We remind all institutions that they have an obligation under the Financial Memorandum to raise with us at early stage 'any material adverse change in an institution's circumstances, such as a significant and immediate threat to the HEI's financial position, significant fraud or major accounting breakdown'. Institutions should not wait until the annual accountability returns process to provide this information.

Annual monitoring statement

18. The AMS monitors the use of special initiative funding outside of the main teaching and research funding allocations. As part of our commitment to ensuring that reporting remains proportionate, we generally only ask for reporting on areas where institutions have not met their planned targets. We also use this process to track institutions' work to monitor their estates strategies including carbon reduction, and we monitor progress in our requirement to promote equality and diversity.

19. Although this is an annual process, the general condition of HEFCE funding still applies: we do not fund ahead of need. If expenditure on any project has slipped substantially, we expect institutions to contact us to discuss whether it is appropriate to suspend payments temporarily. This can happen at any point in the year; there is no need to wait until the annual submission date.

20. In 2008-09 the AMS monitored the use of over £220 million of funding, across both the Higher Education Innovation Fund (£120 million) and various special initiatives for teaching and research. Reported levels of slippage against targets and levels of underspend have improved over the past three years but HEFCE institutional and policy teams will continue to monitor the progress of institutions with underspend to ensure funds are used appropriately and in a timely fashion.

Corporate planning statement

21. One of the purposes of the annual accountability returns process is to review an institution's performance and risk position as a whole. In the CPS, institutions give us a strategic update that provides the context in which to understand the other returns more fully, and to help understand the progress towards delivery of the strategic plan and aims for the year ahead.

22. In this statement we request an update on the institution's activities across the full range of its strategic priorities as identified in its corporate plan, including progress against key

performance targets. We do not analyse the statements on a sector basis due to the specific and unique nature of each institution's return. We use the CPS to feed into HEFCE institutional team engagements with institutions over the coming year, and into our risk assessments.

Audited financial statements and financial forecasts

23. Institutions were required to follow the latest version of the 'Statement of Recommended Practice: Accounting for Further and Higher Education' (SORP)[1] in preparing their financial statements this year. Institutions should have also complied with our annual Accounts Direction ('HEFCE's Accounts Direction to higher education institutions for 2008-09 financial statements', HEFCE Circular letter 16/2008).

24. As well as returning information to HEFCE, all institutions must submit financial information to the Higher Education Statistics Agency (HESA). The return to HESA (the Finance Statistics Return) is based on the annual audited financial statements and, as such, should be consistent with both the audited statements and the data returned to HEFCE.

25. A significant minority of institutions reported incorrect data to HEFCE, HESA or both relating to their 2008-09 financial outturn. In most cases this was caused by data input errors at institutions, which were corrected as necessary.

26. We remind institutions of the importance of providing accurate information to both HEFCE and HESA, which in turn will reduce the number of queries. In particular we ask institutions to ensure that they have the necessary checks in place to give HESA information that is consistent with the audited financial statements.

27. The overall financial results for the sector in 2008-09 show a fairly sound financial position albeit a marginal deterioration on the previous year. At the end of 2008-09 the sector had strong cash balances and healthy reserve levels, which will provide some cushion for the likely risks the sector now faces.

28. There are undoubtedly going to be increased pressures on public finances which, together with significant pressures on expenditure, will create a different financial picture for the sector. In the past decade the sector has seen its overall financial position strengthen, but this has been on the back of significant income growth rather than cost reductions. The future may be different.

29. It is clear from our analysis that most institutions are acting or planning to act to ensure they remain sustainable. For a small number of institutions the information provided was insufficient to make a judgement on whether further action was being planned, and we are in contact with all of these institutions both informally and formally (through the annual risk letter process).

30. The sector continues to operate on very fine margins, so small changes can have a material impact on the financial performance of the sector.

31. The uncertain conditions have made sector-wide analysis more difficult this year, because there are some wide variations in assumptions (more than usual). The forecasts were submitted before the December 2009 pre-Budget report and therefore the 2010 Budgets.

---

[1] The latest version of the SORP (2007) is available from the Universities UK web-site at http://bookshop.universitiesuk.ac.uk.

32. HEIs need to generate surpluses to provide the positive cash flow to fund future developments, to the extent that these are not met from capital funding. The actual level of such surplus needed will vary, depending on the circumstances of individual HEIs. In the medium to long term, some institutions will need to generate even larger surpluses to help cover the full economic costs of their activities and to provide cover for risk/uncertainty. The 2008-09 Transparency Review data indicate an overall full economic cost deficit of £1,267 million across the sector.

33. We ask all institutions to continue undertaking scenario planning to look at the impact of a more difficult financial climate. HEFCE institutional teams, in their regular engagement with HEIs, will continue to discuss the actions being taken by the sector to mitigate the risks from the recession.

34. Annex A provides a more detailed analysis of the financial health of the sector.

Financial commentary

35. The financial commentary is an integral part of the overall financial return, explaining the forecast financial performance in the context of the financial results. As well as aiding our understanding of each institution's specific circumstances, the commentaries, taken together, aid our understanding of the sector as a whole and facilitate our positioning of the sector for the next round of the spending review.

36. Guidance, and the specific questions to which we require a response, were provided in the Annual Accountability Returns guidance (HEFCE 2009/35, paragraphs 34-36). Not all institutions provided explicit responses to all of the questions. HEFCE reviewers followed up gaps, but it would facilitate the review process if institutions were to provide the requested information in an explicit format in the commentary itself.

37. Our reviews indicated that around half of the institutions disclosed restructuring (staff and other types, for example departmental or faculty) that was ongoing or planned. Around 60 per cent described cost reduction programmes around non-staff costs and increasing income streams while controlling costs. These programmes include actions such as:

- reviewing existing contracts and using in-house procurement expertise to reduce running costs
- focusing effort on improving cost recovery on research
- reviewing courses to deliver fewer course combinations with the same academic staffing level, thus enabling improvements in course quality with minimal impact on staff numbers
- increasing use of technology in course delivery to teach more students with the same level of resource (for example virtual classrooms, distance learning).

38. One area of particular interest is around value for money (VFM): institutions were asked what VFM initiatives had been implemented in the past 12 months and what had been achieved. Only 35 per cent of institutions explicitly answered this question in the commentary, with information sought by HEFCE reviewers from the remainder – a greater proportion provided general VFM information but did not include an indication of initiatives or specific VFM activities. Audit committee annual reports show a better picture, with many institutions providing VFM reports to their audit committees.

39. Following the advice given in the 2009 annual risk assessment letters, we requested information about what scenario planning had been undertaken, what contingencies had been modelled and what mitigating actions had been taken or were planned. About half of institutions provided information about scenario planning – although responses varied from detailed scenarios (with accompanying ongoing or planned mitigating actions to address any financial challenges arising) to a summary of work presented to the governing body with general explanations of actions to be taken in the event that a scenario crystallises. HEFCE reviewers followed up with those institutions that had provided limited information and this suggested that there is a lot of scenario planning being carried out by the sector.

40. Institutions identified a variety of key risks. Across the sector the following were considered in the top three risks for most institutions:

- further public funding cuts (53 per cent of institutions), particularly around income from HEFCE and the Training and Development Agency for Schools, and the uncertainty of the future public funding environment
- student recruitment and retention (52 per cent of institutions), particularly a reduction in income that could result from reduced recruitment of overseas students
- staff and pension costs (42 per cent of institutions); these are a significant cost for most institutions and there is concern over rising pay costs and the likelihood of rising pensions costs, particularly with the impending revaluation of the liabilities of several major pension providers in 2010-11
- non-government funding income sources (31 per cent of institutions), including concerns over potential loss of income from commercial and charitable organisations.

41. We also asked how changes to the economic environment over the last year had impacted institutions' financial strategy. Around half of the commentaries included discussion of this question, with many institutions determining that no change to the financial strategy was needed. Other institutions have increased bursary payments to help struggling students, delayed property disposals, scaled back estates development plans, and taken on more borrowing to compensate for asset sales that have not proceeded as planned. Some institutions reported a fundamental change in financial strategy from expansions and diversification to focused consolidation because growth is more difficult.

42. In summary, there were differences in the quality of the financial commentaries provided by institutions. The commentaries varied in length from one to 84 pages (12 pages on average), with no apparent correlation between length and quality.

43. The guidance notes that information produced for internal purposes by the institution may be used for the commentary in order to reduce the accountability burden; however, we do expect institutions to answer all of the questions outlined in the guidance. To assist this, we are considering providing a template for institutions to use if they wish. It would also be helpful for institutions to include their VFM reports in the commentary; in other words, to use existing institutional reports to provide the VFM information that we request in the financial commentary.

Audit committee annual report

44. As stated in the Accountability and Audit Code of Practice (Annex B to HEFCE 2008/19) the audit committee must produce an annual report for the governing body and the designated officer. The audit committee annual report should cover the relevant financial year and include

any significant issues up to the date of preparation of the report. The audit committee annual report should normally be submitted to the governing body before the annual financial statements are signed.

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

- risk management, control and governance
- economy, efficiency and effectiveness (value for money)
- management and quality assurance of data submitted to HESA, HEFCE and other funding bodies.

46. These opinions should be based on the information presented to the committee. The report should also record the work of the committee and consider the following:

- the external auditors' management letter
- the internal auditors' annual report
- any VFM work
- any HEFCE assurance service or other relevant evaluation.

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

48. A majority of audit committee annual reports for 2008-09 included the required opinions but a significant minority failed to address one or more of the elements of risk management, control, governance, VFM or the management and quality assurance of data submitted to funding bodies. The opinions should be based on the information presented to the committee and we expect these sources of information to be summarised in the report. We remind the sector that the provision of these opinions is a mandatory requirement of the Financial Memorandum.

External audit management letter

49. External audit should report to each institution by way of a management letter or audit issues memorandum that highlights any significant accounting and control issues arising from the audit. The HEI's management should provide written responses to any recommendations made or issues raised.

50. Most external auditors grade recommendations according to their relative priority. Graded recommendations are more helpful for us than ungraded recommendations because it is easier to understand the relative importance of recommendations. In 2008-09, 20 management letters featured ungraded recommendations.

51. We request external audit management letters so that we are aware of any significant accounting and control issues arising from the audit and of management responses. Given the complexity of HEIs, we were surprised to find that in 2008-09, as in 2007-08, approximately one-tenth of management letters did not refer to any significant accounting and control issues. Again a small number referred to accounting and control issues in an interim letter or other document.

52. One of the objectives of the annual accountability returns exercise is to provide us with assurance about institutional risk management control and governance using reports that HEIs produce for their own purposes. So, if the external auditor's observations about significant

accounting and control issues are not contained in the final management letter, it would be helpful if HEIs would also return the report that contains this information.

53. A small number of management letters were submitted without management responses to the significant accounting and control issues, and a few letters were submitted with management responses to some, but not all, of the significant accounting and control issues. It is a requirement of the Financial Memorandum that the final management letter (incorporating management responses) is sent to HEFCE.

54. The Accountability and Audit Code of Practice requests that the extent of reliance on internal audit should be indicated in the management letter. About 10 per cent of management letters made no reference to the extent of reliance on internal audit.

Internal audit annual report

55. The internal audit annual report must refer to the financial year and include any significant issues, up to the date of preparing the report, which affected the opinion. The internal audit annual report should include the internal auditor's opinion on the adequacy and effectiveness of the HEI's arrangements for:

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

56. These opinions should be placed into their proper context: that is, the work undertaken was based on the agreed audit strategy and on the areas reviewed in the year, as well as incorporating knowledge of areas audited in previous years (including from a previous auditor). Internal audit performance measures should be provided, including coverage achieved against the original audit plan. The annual report should also draw attention to any significant audit recommendations which the internal audit service considers have not received adequate management attention.

57. Most internal auditors gave the required opinions for 2008-09, although some 20 per cent omitted to give an opinion on one or more of the elements of risk management, control, governance or VFM.

Higher Education Students Early Statistics return and Research Activity Survey

58. All institutions submitted their annual HESES and RAS returns in December. The outcomes of these data returns fed into the grant announcements released in March.

59. We are continuing our programme of audits of data used for funding purposes (HESES and RAS). We feed back general findings to the sector each year to help institutions to make accurate returns. It is strongly recommended that all institutions undertake a formal review of existing arrangements, taking into account the advice and information given in the 'Audit issues' section of the HESES publication each year (the latest being 'HESES09: Higher Education Students Early Statistics Survey 2009-10', HEFCE 2009/36, paragraphs 29-50) and the annual guidance produced for the RAS returns (the latest being 'Research Activity Survey 2009', HEFCE 2009/33). We remain concerned that some data received from HEIs are not accurate and/or do not comply with funding rules.

60. We had a significant number of changes to data this year, following queries raised by HEFCE on the data originally submitted. Both the HESES and RAS returns have a significant

impact on the level of funding provided and institutions need to ensure that appropriate scrutiny is given to these returns before they are submitted. Under the Financial Memorandum we have a right to use our own estimates of data where we have reason to believe that institutional data are not fit for purpose.

61. Where it is found, either through reconciliations with HESA or Data Service data, or any data audit, that erroneous data have resulted in institutions receiving incorrect funding allocations, then we adjust their funding accordingly (subject, where appropriate, to an appeals process). To date, all cases of incorrect reporting of data identified through our audit processes have resulted in any overpaid grant being reclaimed. To do otherwise would be a failing of our responsibilities to ensure the proper use of public funds.

62. We remind all institutions that they have a requirement to ensure they have effective arrangements in place for the management and quality assurance of data submitted to HESA, HEFCE and other funding bodies. The head of each institution and the audit committee are now required to provide written assurances that effective arrangements are in place.

Transparent Approach to Costing return

63. The TRAC return is a continuing requirement for UK HEIs following the Government's 1998 comprehensive spending review (and subsequent spending reviews), as a condition of the enhanced funding awarded to the sector in those reviews. It was established as an approach to identifying the full economic costing of all activities to improve the accountability for the use of public funds and to inform institutional decision-making.

64. Since 2006, governance of TRAC and pricing in the sector has passed to sector organisations. It is now the responsibility of the Financial Sustainability Strategy Group (FSSG) whose membership includes officers of the UK funding councils and research councils, the Department for Business, Innovation and Skills and representatives from UK sector institutions and sector bodies. A TRAC Development Group, reporting to FSSG, started work in late 2008 on rolling out new processes and the operational development of TRAC. These developments should lead to more robust reporting and greater use of TRAC data.

65. TRAC data for 2008-09 show a slight deterioration on the previous year with a full-cost deficit across all activities of £1,267 million (6.1 per cent of total income) for HEFCE-funded HEIs. This includes the return for financing and investment and the infrastructure adjustment, which are added to reported expenditure in institutions' audited financial statements. These adjustments provide an estimate of the full economic costs of institutions' activities.

66. Annex A provides a report of the financial health of the sector, which includes further analysis of the 2008-09 TRAC data.

Annex A Financial health of the higher education sector

1. This annex provides an overview on the financial health of the higher education sector in England.

2. The data used in this annex come from two main sources. All data up to and including 2007-08 are from the Higher Education Statistics Agency's Finance Statistics Record, which is completed by all institutions each year. Information covering the period 2008-09 to 2012-13 is from HEIs' 2008 financial results and forecasts, submitted to us in December 2009[2].

Headline information

3. Table 1 provides the key headline data from the financial information submitted by higher education institutions (HEIs) in December 2009. Further detail and analysis can be found in the remainder of this annex.

Table 1 Summary of key financial indicators

	Actual		Forecast			
	2007-08	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**
Total income	£19,146M	£20,777M	£21,439M	£21,905M	£22,418M	£22,948M
Operating surplus as % of total income	£395M 2.1%	£296M 1.4%	£170M 0.8%	£249M 1.1%	£254M 1.1%	£215M 0.9%
Historical cost surplus as % of total income	£709M 3.7%	£524M 2.5%	£199M 0.9%	£390M 1.8%	£327M 1.5%	£329M 1.4%
TRAC operating deficit* as % of total income	(£1,056M) -5.5%	(£1,267M) -6.1%	n/a	n/a	n/a	n/a
Cash flow from operating activities as % of total income	6.0%	6.9%	3.6%	4.1%	4.9%	4.7%
Net liquidity as number of days' expenditure	84	83	68	57	51	49
External borrowings as % of total income	21.2%	21.2%	23.1%	24.3%	24.8%	24.0%
Discretionary reserves exc. FRS17[3], as % of total income	44.4%	44.0%	43.5%	44.8%	45.7%	46.5%

* Only actual information collected.

---

[2] The figures used in this document exclude the forecasts and previous results of two institutions to enable like-for-like comparisons to be made. This does not change the key issues arising from the analysis.

[3] FRS17 is the financial reporting standard on retirement benefits, which requires institutions' share of pension scheme surpluses or deficits to be included in their own balance sheet.

2008-09 financial performance

4. The actual result for 2008-09 shows a slightly worse financial performance compared to 2007-08, although it must be borne in mind that 2007-08 was one of the best years on record. The surplus for 2008-09 was better than the sector had forecast. At the end of the year the sector had healthy reserves that are underpinned by very strong cash balances (£4,398 million of liquidity[4]).

5. The annual Transparent Approach to Costing (TRAC) returns show that the sector had a full-cost deficit across all activities of £1,267 million (6.1 per cent of total income). This is a marginal deterioration on the previous year due to the lower operating surplus reported by the sector.

6. However, in line with previous years, the sector still has a substantial level of activity that is not fully funded. This is consistent with the Financial Sustainability Strategy Group (FSSG) report in February 2009 which concluded that there is evidence of significant deferral of necessary investment in the sector. The current financial climate is likely to put this position under further pressure.

7. The reporting framework for TRAC is under review, which should help to improve the understanding of the TRAC deficits reported.

8. Staff costs increased significantly in 2008-09: by 7.9 per cent. This continued a trend of higher than inflation increases due to a combination of factors including increased numbers of staff, the 2006 national pay agreement and rising pension contributions. Despite these increases, the proportion of total staff costs to income has actually fallen gradually over recent years and in 2008-09 the sector average was 55.3 per cent.

9. One of the elements of staff costs relates to pension contributions, which increased by over 10 per cent. In addition to this, at the end of July 2009, the sector had a FRS17 pension deficit on its balance sheet of £3,589 million (compared to £2,350 million in the previous year). The financial reporting of pension deficits does not have an immediate impact on the current cash expenditure of an institution. However it is likely to lead to increased pressure on the sector to increase employers' pension contributions, and this has been evident during the last 12 months. For example, the Universities Superannuation Scheme (USS) increased its employer contributions rates from 14 per cent to 16 per cent in October 2009. Other pension schemes are likely to follow suit.

10. It is important to note that the two main pension schemes in the sector, the USS and the Teachers' Pension Scheme, are defined benefit schemes that do not require individual institutional assets/liabilities to be disclosed. Therefore the current pension deficits included in the sector's balance sheet do not fully reflect all the pension activity within the sector.

11. Further analysis of the sector's financial performance in 2008-09 is in Appendix A.

---

[4] Net liquidity = current asset investments, bank and cash balances less bank overdrafts. The indicator is also expressed as the number of days' operating expenditure covered by the net liquidity.

Financial forecasts for 2009-10 to 2012-13

12. Institutions submitted financial forecasts (excluding TRAC adjustments) for the period up to and including 2012-13, which indicate (at a sector level) an overall financially sound position in each year. Looking at the forecast period as a whole, the level of operating surpluses indicated are broadly in line with those forecast last year. However at a historical cost level the surpluses are smaller, possibly reflecting the lower levels of returns now expected on property sales.

13. Despite the operating position appearing similar to previous forecasts, different underlying assumptions are being made about both income and expenditure movements with both being forecast to increase at much slower speeds. Given the high level of uncertainty, particularly about future public funding, there is greater variation between the underlying assumptions of HEIs. Also, forecasts were submitted before the pre-budget report in December 2009 and it is not clear that the forecasts have fully anticipated the increased level of financial risk facing the sector over the medium term. Despite these caveats it is still possible to draw some conclusions from the financial information provided by the sector. It is important to note that many HEIs indicated they had developed action plans that would be implemented should the financial climate deteriorate more than forecast.

14. The sector, as a whole, has made some relatively prudent assumptions about the levels of HEFCE funding over the forecast period. However the assumptions made across other public funding streams appear optimistic, particularly regarding the Department of Health and the Research Councils. We are talking to those institutions with the most optimistic assumptions, although it is worth noting that in 2010-11 the sector has been fairly prudent about the (now announced) level of HEFCE funding so there is some gain that mitigates any lower levels of other income streams.

15. The sector is expecting overseas fee income to rise from £1,861 million in 2008-09 to £2,434 million by 2012-13, an average annual increase of over 7 per cent. Although the expected increase is lower than the growth rate actually achieved over the last seven years, it is expected that there will be an increased level of competition (from other UK HEIs and organisations in other countries providing courses in English language). The current exchange rates are helping the sector to attract overseas students to the UK, and mitigating some of the other competition risks.

16. In addition to fee income the sector is forecasting continued growth in research income (non-funding councils) at the rate of 4.6 per cent per year. Recent history would indicate that this should be achievable, however this assumes there is no impact from the current economic climate which seems very optimistic.

17. The sector is expecting total staff costs to increase only marginally above inflation, and significantly less than the trend since 2002-03. This trend has seen staff costs increase, on average, by 5.3 per cent per year in real terms. This is not just because of the 2006 national pay agreement but due to underlying increases incurred before this agreement. The forecasts are assuming a small reduction in staff numbers in the last three years of the forecast period, indicating that HEIs are planning to act to reduce the staffing cost base.

18. We know that many institutions have plans in place that will reduce staff numbers should income projections not materialise. Institutions only formally submit one set of forecasts to HEFCE, which we use in our analysis, but alongside this they each also submit a financial commentary highlighting actions they would take should certain events materialise or not. We have told individual institutions if we believe their forecasts are overly optimistic, and provided

governing bodies benchmarking information in relation to a number of financial indicators (including staff costs).

19. Although the level of liquidity days is currently one of the highest on record, it is not expected to remain so high. The number of days that liquidity covers expenditure is forecast to fall gradually each year to a low of 49 days at the end of 2012-13, though this is a still a healthy level. One of the reasons why liquidity is reducing is that the sector is continuing to invest heavily in its infrastructure.

20. As in previous years, the sector-wide picture encompasses the wide range of results (and forecasts) between institutions. The main financial strength remains in a small number of institutions.

21. Further analysis of the sector's financial forecasts and the variation between institutions is in Appendix B.

Appendix A

Actual financial results for 2008-09

1. The overall financial results for the sector in 2008-09 show a financially sound position, although not as strong as the previous two years. However, as in previous years, the sector-wide picture encompasses a wide range of results between institutions. This appendix discusses the key messages from our analysis of the 2008-09 annual accounts. It is important to note that the position at the end of July 2009 is before any material impact of the reductions in public funding had been announced. Annex B discusses the future risks to the financial sustainability of the sector.

Income and expenditure

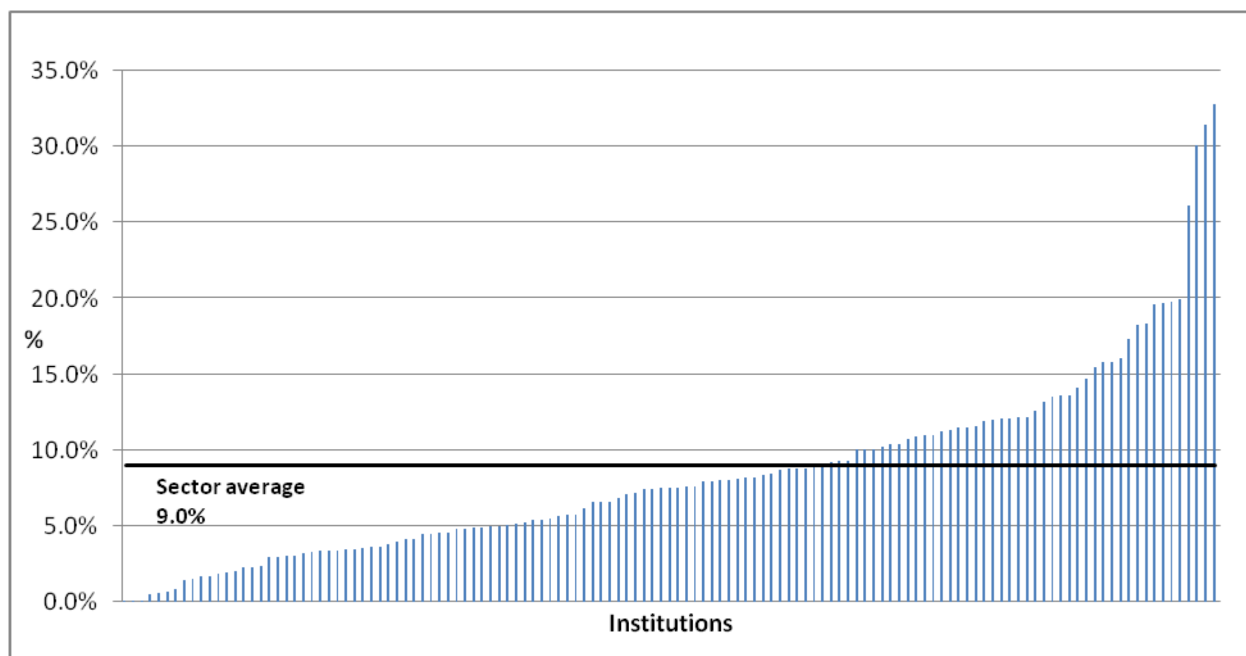
2. Total income for the sector was £20,777 million, which was an increase of 8.5 per cent on the previous year. This growth was ahead of the average increase seen by the sector in the last 10 years (7.4 per cent) but lower than the previous two years. The main reasons for the increase in 2008-09 were the continued impact of variable fees, a 14.8 per cent increase in fee income from overseas students and an 11.1 per cent increase in income from research grants.

3. Despite the large increase in income in 2008-09 across the sector, 12 HEIs recorded real-terms reductions in income. At the same time though, another 12 HEIs recorded increases in total income of over 15 per cent. This indicates the wide variation in performances across the sector.

4. Since 2003-04 total income has increased by £7,090 million (48.5 per cent), which is significantly above inflation (a 33.1 per cent real-terms increase). All income sources have grown, but the largest increases have been in tuition fees (mainly through the introduction of variable fees for home and EU students and a significant increase in fee income from overseas students) and also large increases from ‘other operating income’. Although income from public sources has increased, it has been at a lower rate than non-publicly funded income.

5. In real terms the sector has seen considerable growth in fee income from overseas students. However the dependence on this income source still varies across the sector. At the end of 2008-09 this income accounted for 9 per cent of the sector’s total income, the highest on record. The 25 institutions recording the most income from overseas fees account for 55 per cent of the sector’s total, suggesting that although all institutions receive income, the majority goes to a small group of institutions in London and the South East. However the reliance on this income source varies even more between institutions, ranging from 0.1 per cent to 32.8 per cent of total income. Figure 1 shows the distribution last year.

Figure 1 Overseas fee income as percentage of total income (2008-09)



6. Total expenditure was £20,383 million in 2008-09, an increase of 9.1 per cent on the prior year. This is slightly higher than the rate of cost increase seen in the previous year. The main percentage movement was in interest payable which increased by 29.8 per cent to £332 million. This increase is mainly to do with the accounting for finance costs relating to FRS17 and not actual cash transactions. This accounting treatment alone reduced the sector's operating surplus by £69 million (over 60 per cent of the total reduction).

7. Staff costs continued to remain the main contributor to expenditure, although as a proportion of total income the level of staff costs reduced to 55.3 per cent (55.7 per cent in 2007-08). In total, staff costs increased by 7.9 per cent during the year, which was driven by both an increase in the number of staff and the last year of the 2006 pay agreement. Pension costs also increased significantly in 2008-09, with a rise in employers' contributions of 10.3 per cent.

Surpluses

8. The sector had an operating surplus (that is, total income less total expenditure before any exceptional items) of £296 million (1.4 per cent of total income). This is lower than the 2.1 per cent achieved in 2007-08 but better than it had forecast for 2008-09 (0.6 per cent).

9. On a historical cost basis[5] the sector recorded a surplus of £524 million (2.5 per cent of total income), which is slightly ahead of the average over the last decade (2.4 per cent). The large difference between the operating and historical position in 2008-09 is partly accounted for by exceptional items (for example profit or loss from the sale of properties) of £106 million.

[5] Historical cost surplus/(deficit) is after adjustment for the difference between historical cost depreciation and the actual depreciation charged on revalued assets, and net gains realised on the disposal of revalued assets. Institutions may use either historical cost or revaluation to value their assets and the different bases of valuation will alter the operating results, so the historical cost surplus/(deficit) provides greater consistency for comparison of results between institutions.

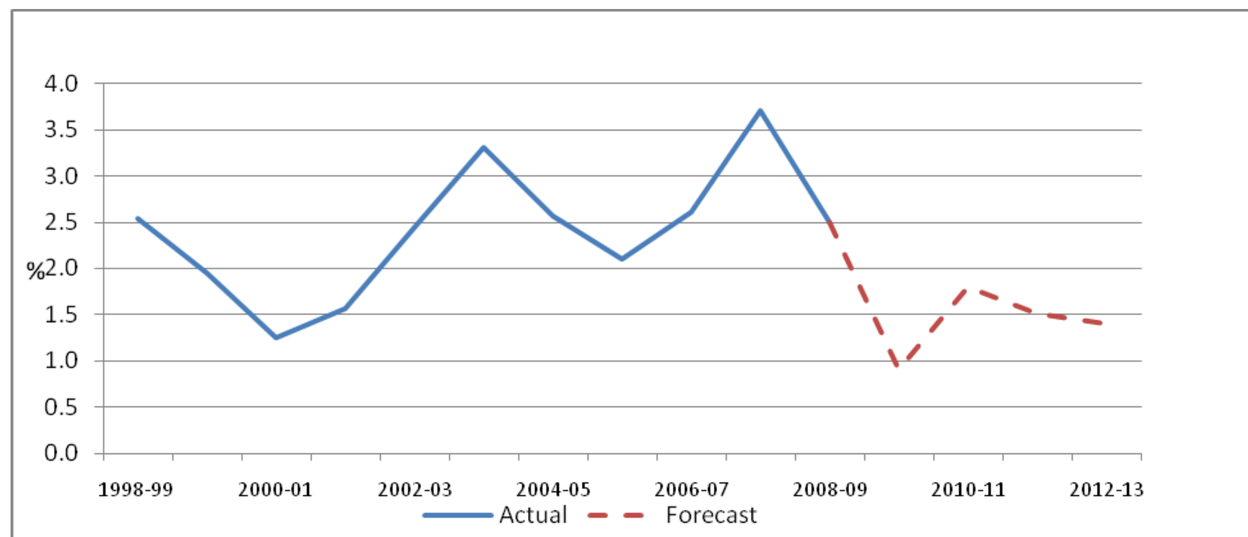
Although the exceptional items do not substantially distort the analysis of the sector's financial performance, of the £106 million, £70 million was accounted for by two institutions seeing substantial profits from the sale of properties.

10. The forecasts show the sector's level of surpluses reducing in 2009-10 and thereafter remaining below the levels achieved in the last seven years. This is commented on further in Annex B.

11. The sector has generally been very prudent in its forecasting of historical cost surpluses. Over the last five years the sector has outperformed its forecast surplus position by an average of 0.7 per cent of total income (the actual surplus has averaged 2.7 per cent of total income compared to the forecast of 2.0 per cent). In line with this trend the 2.5 per cent surplus in 2008-09 was significantly greater than the 1.9 per cent forecast, and again indicated that the assumptions made by the sector turned out to be very cautious. In a time of income growth this is not concerning, but it may be unlikely that this prudence will continue.

12. Figure 2 shows the level of historical cost surpluses since 1998-99 and the forecast level of surpluses up to 2012-13.

Figure 2 Historical cost surplus as percentage of total income



Liquidity and borrowings

13. At the end of 2008-09 the sector had net liquidity of £4,398 million, equivalent to a healthy 83 days' expenditure and consistent with the previous year. This is also above the forecast level (71 days), which probably reflects the better than forecast operating performance but could also indicate changes in the timing of capital projects and asset disposals.

14. As in the previous two years the improved liquidity happened at the same time as an increase in borrowings. At 31 July 2009 total borrowing amounted to £4,395 million, which was £334 million (8.2 per cent) more than the previous year. The annual increase was lower than recent years, which is unsurprising given the economic climate at the time. However at the end of July the sector also had £1,131 million of financing agreed with lenders but not drawn down. Between August and October the sector drew down £159 million of this borrowing.

15. Borrowing still represents 21.2 per cent of income, in line with the previous year. However in the last year interest payments on borrowings increased significantly (29.8 per cent). This was caused by changes in actuarial assumptions relating to the FRS17 pension reporting. The

underlying interest payments on borrowings have reduced slightly (in proportionate terms), mainly due to the lower interest rates available during the year. The sector's annualised servicing costs have also remained fairly constant, being 2.14 per cent of income in 2008-09 (compared with 2.22 per cent in 2007-08). The sector still continues to benefit from competitive interest rates; an increase in interest rates of 1 per cent could lead to an additional cost of over £100 million, albeit most institutions will have hedged this potential increase.

Reserves

16. Discretionary reserves[6] at the end of 2008-09 totalled £5,554 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS17). This reporting standard, which requires pension scheme surpluses or deficits to be included in the balance sheet, makes comparisons with previous years more difficult. Without FRS17 the sector would have reserves of £9,143 million, equivalent to 44.0 per cent of total income. Total pension scheme deficits of £3,589 million reduced reserves to 26.7 per cent of income. The level of pension scheme deficits increased by £1,239 million (52.7 per cent) this year, mainly due to changes in actuarial assumptions.

17. It is important to note that the two main pension schemes in the sector, the Universities Superannuation Scheme (USS) and the Teachers' Pension Scheme, are defined-benefit schemes that do not require individual institutional assets/liabilities to be disclosed. Therefore the current £3,589 million pension deficits included in the sector's balance sheet do not fully reflect all the pension activity within the sector.

18. The financial reporting of pension deficits does not have an immediate impact on the current expenditure (therefore cash) of any institution. However it is likely to lead to increased pressure on the sector to increase employers' pension contributions, and this has been evident during the last 12 months. For example the employer's contributions to USS increased in October 2009 from 14 to 16 per cent, and increases in future years are seen as a significant risk unless the scheme is reformed. The 2 per cent increase in 2009 will add approximately £130 million to the sector's USS pension contributions (which from October 2009 will total £723 million annually[7]).

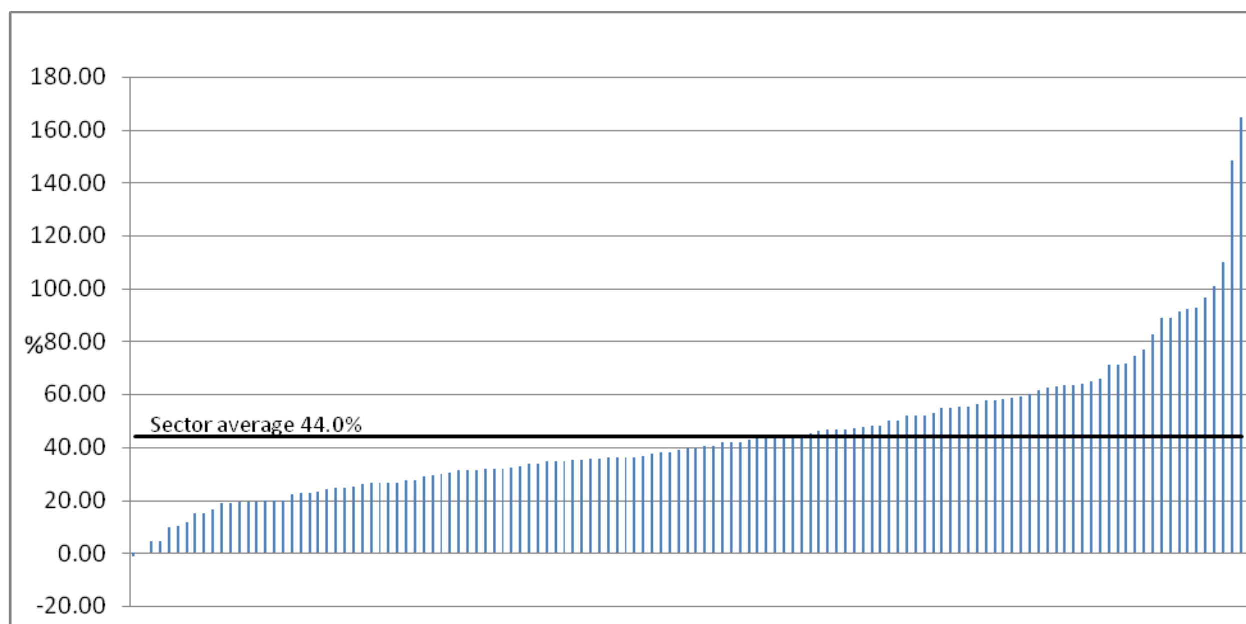
19. As reported in previous years, the aggregate sector financial position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities. Figure 3 shows this spread of reserves, as a percentage of total income, as reported at 31 July 2009. The 18 institutions with the most discretionary reserves (in cash terms) account for over half of the sector's total.

---

[6] Expendable endowments plus general reserves from the balance sheet.

[7] Source: UCEA input to the 'USS Review: Employers Paper on the costs of contribution rates', 20 March 2009. Figures are approximate and could vary by ±£10 million, and are included for illustrative purposes.

Figure 3 Discretionary reserves as percentage of total income (2008-09)



Cash flow

20. Cash flow from operating activities totalled £1,426 million in 2008-09, which compares favourably with the level forecast (£588 million) and the cash flow in 2007-08 of £1,157 million. The level of cash flow in 2008-09 was equivalent to 6.9 per cent of total income, an improvement on the 6.0 per cent in 2007-08. The sector has increased its cash flow gradually each year since 2004, which is a positive indicator of solvency.

TRAC data 2008-09

21. The TRAC data for 2008-09 show a slight deterioration on the previous year with a full-cost deficit across all activities of £1,267 million (6.1 per cent of total income) as can be seen in Table 2. The 'TRAC adjusted' surplus/deficit position of institutions is different from the headline surplus/deficit reported in the audited accounts because: some institutions understate current asset values; there can be inadequate investment in physical infrastructure; and there needs to be an allowance (or margin) for risk, financing and development. The 'TRAC adjusted' figure is thus arguably a more reliable guide to an institution's medium-term financial sustainability.

Table 2 HEFCE sector summary

£M	Total	As a % of total expenditure
Total income	20,697*	
Total expenditure	20,399	
Infrastructure	644	3.2%
Return for financing and investment	921	4.5%
Total costs (full economic costs per TRAC)	21,963	
Surplus/(deficit) per TRAC	**(1,266)**	

* This figure is marginally different to the total income reported in the annual financial statements due to the exclusion of joint venture income in TRAC returns.

22. In terms of the individual reporting areas, there have been only slight changes in the levels of surpluses/deficits recorded. Table 3 shows the breakdown over the last three years.

Table 3 Breakdown over 2006-07 to 2008-09

£M	2006-07	2007-08	2008-09
Publicly funded teaching surplus/(deficit)	(£213)	(£226)	(£191)
as % of total income	-2.8%	-2.7%	-2.1%
Non-publicly funded teaching surplus/(deficit)	£389	£413	£460
as % of total income	23.6%	22.8%	20.8%
Research surplus/(deficit)	(£1,645)	(£1,710)	(£1,848)
as % of total income	-34.2%	-32.9%	-32.8%
Other activities surplus/(deficit)	£298	£466	£312
as % of total income	8.9%	12.5%	8.1%
TOTAL surplus/(deficit)	(£1,171)	(£1,056)	(£1,267)
as % of total income	-6.8%	-5.5%	-6.1%

23. Table 3 shows that despite only a slight deterioration in the financial performance of the sector in 2008-09 there are underlying issues that could be cause for concern. These include:

- a proportionately reduced return from non-regulated publicly funded teaching
- continued subsidising of research from independent income to a significant level (despite an improvement in the recovery of full economic costs from the Research Councils)
- a reduced return on other activities.

24. Tables 4 and 5 summarise the TRAC data for HEFCE-funded institutions. Table 4 shows the level of income and costs by activity. Table 5 shows the breakdown of research income and costs. These are provided for information because the sector’s TRAC Development Group has already considered this information in detail.

Table 4 TRAC income and costs by activity

£M	Teaching				Research	Other	Total
	Publicly funded – regulated provision	Publicly funded – non-regulated provision	Total publicly funded	Non-publicly funded			
Income	6,992	2,021	9,014	2,213	5,628	3,843	20,697
TRAC full economic costs	7,179	2,025	9,204	1,753	7,476	3,530	21,963
Surplus/(deficit)	**(187)**	**(4)**	**(191)**	**460**	**(1,848)**	**312**	**(1,267)**
Surplus/(deficit) as % of income	-2.7%	-0.2%	-2.1%	20.8%	-32.8%	8.1%	-6.1%
Surplus/(deficit) as % of costs	-2.6%	-0.2%	-2.1%	26.2%	-24.7%	8.9%	-5.8%

Table 5 Research income and costs by sponsor type

£M	HEI own funded	Postgraduate research	Research Councils	Other government departments	EU*	UK charities	Industry§	Total research
Income	1,631	508	1,284	564	271	787	585	5,628
TRAC full economic costs	1,535	960	1,734	744	448	1,279	776	7,476
Surplus/(deficit)	**95**	**(452)**	**(450)**	**(180)**	**(177)**	**(493)**	**(191)**	**(1,848)**
Surplus/(deficit) as % of costs	6.2%	-47.1%	-26.0%	-24.2%	-39.4%	-38.5%	-24.7%	-24.7%
FEC recovery (income as % of costs)	106.2%	52.9%	74.0%	75.8%	60.6%	61.5%	75.3%	75.3%

* EU (European Union) covers EU government bodies including the Commission. This is the same as that defined under 3(e) in Table 6b of the HESA Finance Statistics Return.

§ Industry should include all other organisations such as UK industry, commerce and public corporations, EU non-government organisations (that is, EU-based charities, EU industry and EU other), overseas charities, overseas industry and other sources.

Appendix B

Future financial sustainability

1. The 2009 forecasts cover the period up to and including 2012-13. Institutions tend to forecast cautiously, and this is evidenced by consistently better outturns compared to forecasts. However, it is still possible to make some observations about the financial sustainability of the sector, and this appendix comments on this in detail.

2. Overall, the sector is likely to maintain a financially sustainable position up to the end of the forecast period, though some institutions will need to generate better financial results to remain sustainable in the medium term.

Income and expenditure

3. Total income is forecast to increase to £22,948 million in 2012-13, which equates to an average increase of just 2.6 per cent per year. This is significantly below the level of increase achieved in the last five years (8.7 per cent). The sector is forecasting income growth to reduce each year which, given the current economic climate, and the end of the introduction of variable fees, seems reasonable. Compared to previous forecasts the income growth projections this time are considerably more pessimistic. Table 6 provides a breakdown of the income levels forecast.

Table 6 Breakdown of forecast income levels

£M	2008-09	2009-10	2010-11	2011-12	2012-13
Funding council grants	6,992	7,124	6,927	6,788	6,733
Overseas fee income	1,773	1,951	2,123	2,293	2,434
Other academic fees and support grants	4,398	4,708	4,915	5,075	5,217
Research grants and contracts	3,328	3,493	3,636	3,793	3,937
Other operating income	3,994	3,968	4,098	4,248	4,398
Endowment income and interest	293	197	206	221	229
TOTAL	**20,777**	**21,439**	**21,905**	**22,418**	**22,948**

4. Some areas of income that have seen growth in the past five years (for example fees from overseas students) may become more competitive and HEIs may find it difficult to maintain growth rates. After 2008-09, when the main impact of variable fees has been felt, growth in income will become more difficult to sustain, and this is reflected to some degree in the sector's forecasts. Overall financial sustainability is not determined by just income growth, but it is a major factor. Those HEIs that are unable to increase their income will need to consider restructuring their cost base to protect surpluses and cash flow.

5. The sector, as a whole, has made some relatively prudent assumptions about the levels of HEFCE funding over the forecast period. For example in 2010-11 the forecast level of reduction (in cash terms) was -2.9 per cent whereas the recent grant announcement (excluding capital) was -1.0 per cent.

6. However the assumptions made across other public funding streams appear optimistic, particularly from the Department of Health (DH) and the Research Councils.

7. Table 7 shows the breakdown of public funding assumptions.

Table 7 Percentage change in public funding (cash terms) from financial forecasts submitted in December 2009

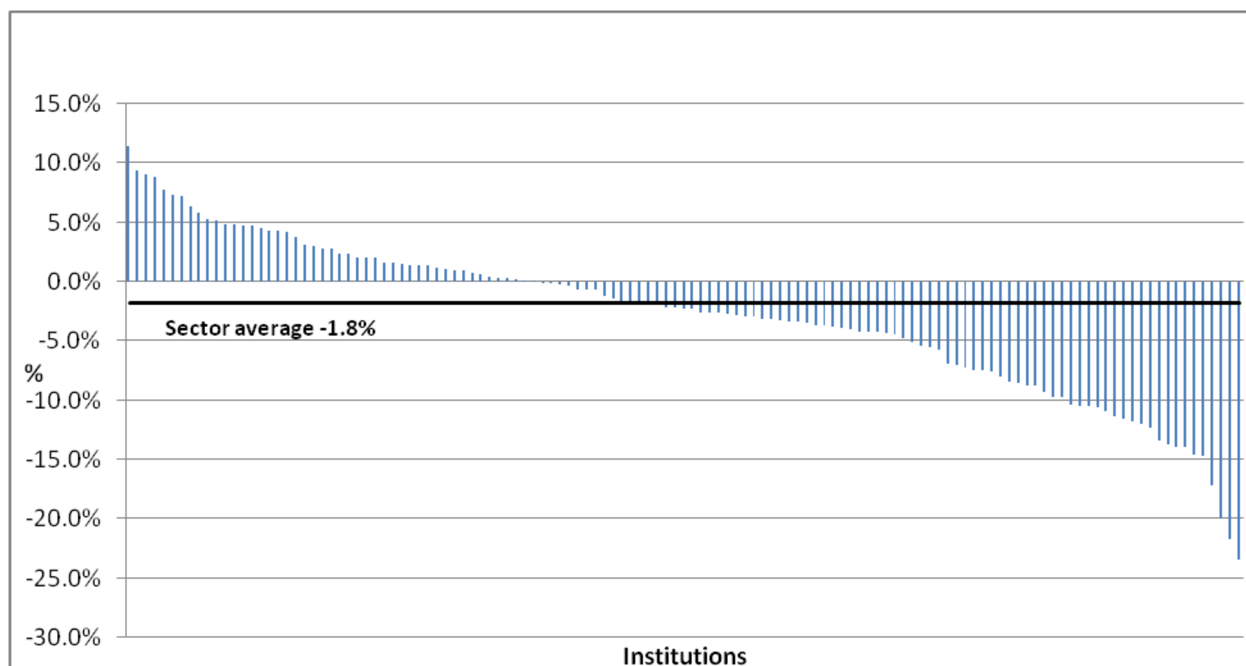
	2010-11	2011-12	2012-13	Cumulative
HEFCE	-2.9%	-2.3%	-0.9%	-6.0%
DH	+2.0%	+1.7%	+1.4%	+5.2%
Research Councils	+4.6%	+3.6%	+3.1%	+11.7%
Training and Development Agency for Schools	-0.4%	-0.4%	+0.6%	-0.2%
Learning and Skills Council§	-2.6%	-2.1%	+0.1%	-4.6%
TOTAL *	**-1.0%**	**-0.8%**	**+0.0%**	**-1.8%**

* Includes deferred capital grants which are excluded from the other rows.

§ Excludes Thames Valley University's planned divestment from further education in Reading. As of 1 April 2010 the Learning and Skills Council became the Skills Funding Agency.

8. Table 7 does hide the variation in assumptions made by individual institutions. Across the sector, 47 institutions are forecasting a cumulative increase in public sector funding, and of these seven forecast a real-terms increase (that is, an increase of over 6.5 per cent). We are already talking to these institutions about their assumptions and what other scenarios they are modelling. It is important to note that some of the variations can be explained by changes to research funding following the Research Assessment Exercise, and to funding for additional student numbers. Figure 4 shows the variability in assumptions being made.

Figure 4 Forecast changes in public spending (2009-10 to 2012-13)



9. As the Board discussed in March the Institute of Fiscal Studies (IFS) has indicated a number of scenarios in relation to future public sector funding. In its best case scenario, where all public services are treated equally, the necessary real-terms reduction in public funding is 11 per cent over four years. The current forecasts show a reduction of 1.8 per cent in cash terms which is equivalent to 8.3 per cent in real terms, broadly in line with the IFS projection.

10. However, if some areas of the public sector are protected (notably health and schools) then the reduction in non-protected public services could be 20 per cent over four years. If this scenario does materialise the sector's financial position at the end of 2012-13 could be significantly different to what is currently being forecast.

11. The sector is forecasting income from academic fees to increase by over 14 per cent in real terms after 2008-09. This increase is linked to the forecast growth in overseas student numbers, which may be aspirational.

12. In addition to fee income the sector is forecasting continued growth in research income (non-funding councils) at the rate of 4.6 per cent per year. Recent history would indicate that this should be achievable, however this assumes there is no impact from the current economic climate which seems very optimistic. We know from our reviews that institutions are also forecasting increases in expenditure that would not materialise if research contracts were not awarded.

13. As noted the sector is continuing to expect overseas (non-EC) student numbers to increase over the forecast period. The financial contribution these students make is significant and the sector has been very successful over the last decade in attracting international students. On average there has been an increase in fee income from overseas students of 14 per cent per year over the last seven years. The forecasts show the growth rate slowing down slightly, but this still averages 7.7 per cent per year. In cash terms the sector is expecting overseas fee income to rise from £1,861 million in 2008-09 to £2,434 million by 2012-13.

14. Across the sector 11 institutions are forecasting a real-terms reduction in overseas fee income, however these are clearly in the minority. At the other end of the scale 13 institutions are expecting fee income to double in real terms over the period, albeit some of these are starting from a low base. The increased level of competition, both from other UK HEIs and from organisations in other countries providing courses taught in English, does imply that the current growth forecasts are optimistic. However the current exchange rates are helping the sector to attract overseas students to the UK.

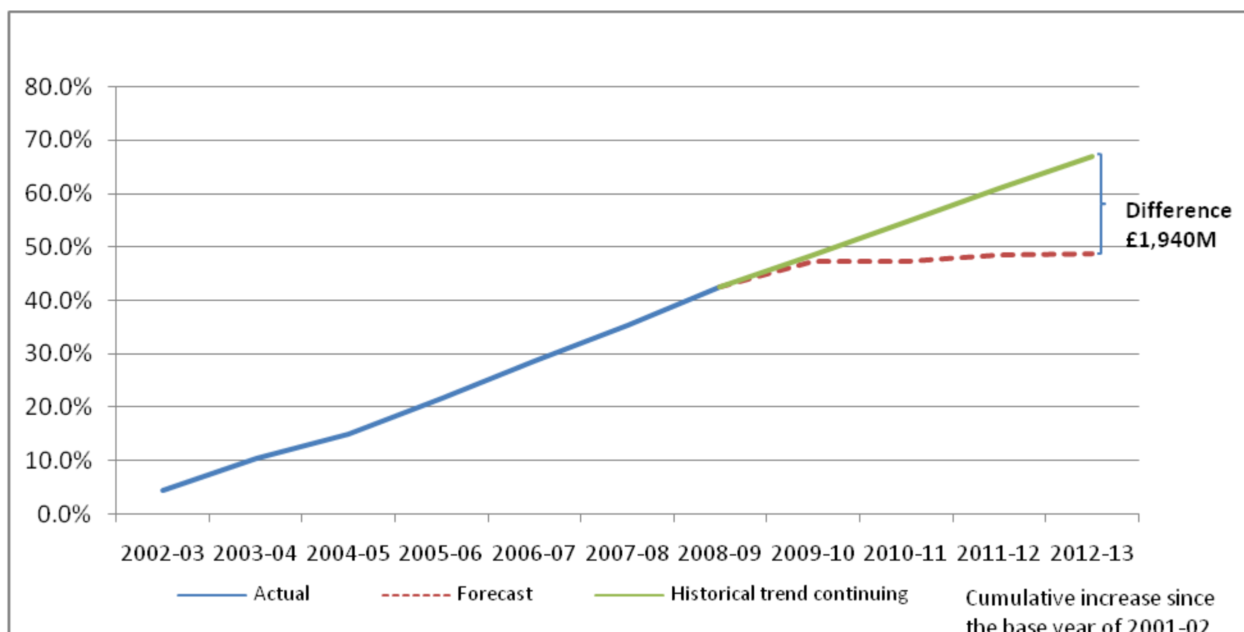
15. Given that a large proportion of the sector's income depends upon the number of students recruited, we collect information from institutions on the forecast number of students. This shows that total student numbers are forecast to increase on average by 2.1 per cent each year. Within these figures institutions are expecting the number of overseas students to increase on average by 5.4 per cent each year. The increases in student numbers over the next two years seem ambitious.

16. Some institutions are expecting home and EU students to increase significantly over the forecast period. Twelve HEIs are forecasting full-time undergraduate student numbers to increase by over 20 per cent from 2009-10 to 2012-13. Whether this increase is achievable will depend on government policies relating to student support arrangements and any control on student numbers.

17. In addition to income growth the sector is forecasting a slower growth in expenditure. Most of the assumptions appear reasonable although given the low surplus margins forecast it would only take a small increase in expenditure to have a material impact on the financial performance of the sector. The sector's biggest expenditure continues to be staff costs, which in 2008-09 totalled £11,495 million (equivalent to 55.3 per cent of total income). Since 2001-02 the average annual increase in staff costs has been 8 per cent, with a further increase of 5.4 per cent forecast in 2009-10. However in future years the forecast increases are no more than 2.7 per cent per year, which seems low.

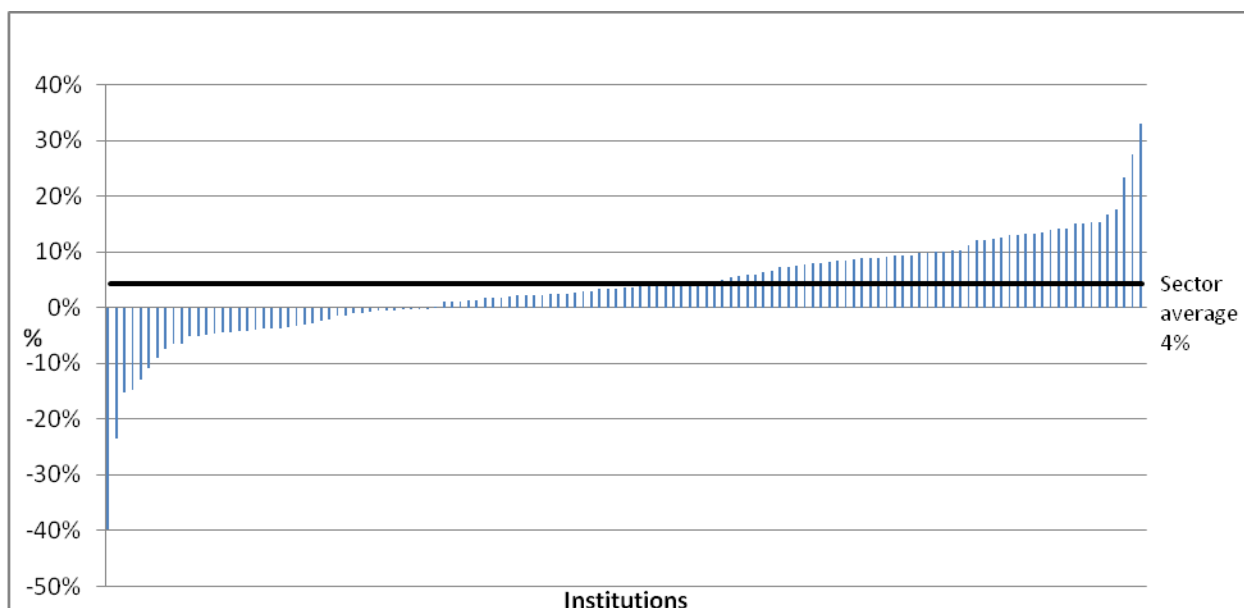
18. Figure 5 shows the level of real-terms increases over the last seven years, plus what the sector is currently forecasting to happen in the next four years. As can be seen from this, the sector is expecting the increase in total staff costs to be only marginally above inflation, and significantly less than the trend since 2002-03. This trend has seen staff costs increase, on average, by 5.3 per cent per year in real terms. This is not just because of the 2006 national pay agreement but due to underlying increases incurred before this agreement. If the 5.3 per cent rate of increase continued then by 2012-13 total staff costs would be £1,940 million (15.5 per cent) higher than currently forecast.

Figure 5 Real-terms increases in staff costs



19. At individual institutional level the forecast increases in staff costs varies (as Figure 6 shows) although most are broadly in line with the sector average. In real terms the sector is expecting a 4 per cent increase over the whole forecast period although the individual institutions assumptions vary from -40 per cent to +33 per cent.

Figure 6 Real-terms changes to staff costs (2008-09 to 2012-13)



20. It is clear that the forecast increases in staff costs look challenging given the trend in recent years. However it is worth noting that despite the large increases in staff costs over the last decade, as a proportion of income the level of staff costs has actually fallen gradually over

the period. In 2008-09 the proportion had fallen to an average of 55.3 per cent, although there was considerable variation across the sector. A large proportion of the increase in recent years has been volume (that is, number of staff) and this is not forecast to continue. In recent years we have found a strong correlation with those HEIs 'at higher risk' and those with high staff costs.

21. For this year's annual accountability returns we requested more data to enable us to understand the movements in certain income and expenditure areas. In relation to staff costs we collected more information about pensions, National Insurance contributions and the expected number of staff. Table 8 shows the breakdown of this.

Table 8 Annual percentage changes in staff costs (cash terms)

	2008-09	2009-10	2010-11	2011-12	2012-13
Salaries and wages	7.9%	4.8%	2.1%	2.4%	2.7%
National Insurance	6.5%	7.4%	2.5%	3.4%	3.0%
Pension costs	10.3%	9.3%	3.1%	3.9%	3.5%
Other staff-related costs	-11.3%	-2.6%	-21.1%	1.6%	-8.9%
Total staff costs	**7.9%**	**5.4%**	**2.1%**	**2.6%**	**2.7%**
Total staff numbers (full-time equivalent)	**1.6%**	**0.5%**	**-0.8%**	**-0.4%**	**-0.1%**

22. Table 8 shows that the forecast increases in salaries after 2010 is just above inflation, whereas the increases in National Insurance and pension contributions are higher. Because National Insurance contributions are due to increase by 1 per cent in April 2011, the increases forecast seem appropriate. The current pressure on pension schemes will lead to increased contributions, which may be greater than the levels forecast.

23. Sector bodies have established an Employers' Pension Forum (EPF) to consider the pension needs of the sector. This group and USS have committed to a review of USS this year and a feasibility study on the options for self-administered schemes. HEFCE has provided Leadership, Governance and Management Fund funding to the EPF to support it in developing a new higher education pension strategy.

24. Within Table 8 it is clear that institutions are expecting the total number of staff to reduce in each of the last three years of the forecasts. This means that the total pay cost per employee is forecast to rise marginally higher than the initial figures might suggest. A number of institutions are known to be exploring restructuring programmes to ensure they maintain their long-term sustainability. Should the income position be worse than forecast, more HEIs will need to look at restructuring their cost bases.

Surpluses

25. The forecasts indicate at an operating level (that is, total income less total expenditure, before any exceptional items) the sector will see a reduction in 2009-10 to 0.8 per cent of total income. Future years then show gradual improvements fluctuating around the 1 per cent level. The forecast deterioration in 2009-10 is partly due to large increases in pay costs (linked to increased pension contributions) and the lower growth in public funding. On a historical cost basis the level of surpluses forecast average 1.4 per cent, which is significantly below the levels

achieved over the last five years. In fact only once since HESA records began in 1994-95 has the sector's historical cost surplus been less than 1.6 per cent (1.2 per cent in 2000-01).

26. One significant impact on the historical cost surplus forecast in 2009-10 is the net exceptional cost of £61 million. In recent years the sector has been returning net exceptional benefits (mainly through the sale of properties). In 2009-10, 14 HEIs expect significant exceptional costs (totalling £98 million) primarily relating to restructuring. The difference in the changes in exceptional items in 2009-10, compared to the actual position in 2008-09, equates to £166 million. This explains about half of the reduction in the historical cost surplus movement in the next year. Looking at the forecast period as a whole, the surpluses predicted are more pessimistic than last year's forecasts, although there are still elements of optimism within the assumptions made by the sector.

27. HEIs need to generate surpluses to provide the positive cash flow to fund future developments, to the extent that these are not met from capital funding. Sustainability in the short term for the sector as a whole looks reasonable, but in the longer term some HEIs will need to generate larger surpluses.

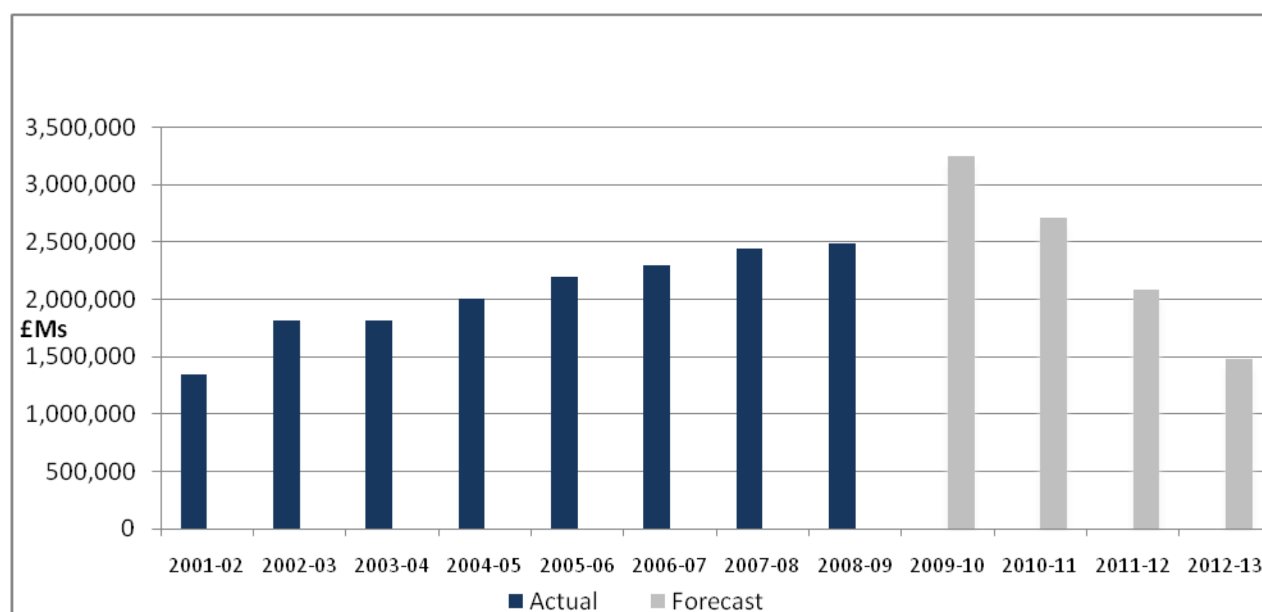
Liquidity and borrowings

28. Although the level of liquidity days is the one of the highest on record, it is not expected to remain so high. The number of days that liquidity covers expenditure is forecast to fall gradually each year to a low of 49 days at the end of 2012-13, though this is a still a healthy level.

29. One of the reasons why liquidity is reducing is that the sector is continuing to invest in its infrastructure at significant levels. One indicator of this is the level of capital expenditure in 2008-09 which totalled £2,488 million (a 2.0 per cent increase on the previous year). The sector is forecasting a further significant increase in capital expenditure during 2009-10, which means total capital expenditure is expected to be £3,258 million. Given that most of this expenditure is likely to be under way, or to have been finished, it is reasonable to expect the actual level to be in line with the forecasts. The level of expenditure after 2009-10 is forecast to reduce significantly to just £1,485 million in 2012-13. Over the whole forecast period the sector expects to spend £9,547 million.

30. Since 2001 the sector has spent £16,398 million on improving its physical infrastructure, and this figure excludes general day-to-day maintenance. Figure 7 shows the actual levels of investment over the period, together with the forecast changes now projected by the sector.

Figure 7 Capital expenditure



31. When comparing information from previous years' forecasts with the actual expenditure, it is clear that the financial forecasts tend to understate future capital expenditure. However this has been during a period of strong income growth, which is unlikely to materialise in the short to medium term. To avoid a return to an era of significant under-investment, many HEIs will need to generate increased surpluses in order to help finance future capital expenditure requirements. The projected reduction in investment presents a risk to the long-term sustainability of the sector and would add to the £3.5 billion backlog investment highlighted by the FSSG report 'The sustainability of learning and teaching in English higher education' (December 2008)[8].

32. To help finance these investments in infrastructure the sector continues to increase its borrowings substantially, although the current rate of growth cannot continue indefinitely. The sector forecasts borrowings to rise to £5,561 million at the end of 2011-12 (24.8 per cent of total income), which is £1,166 million more than at 31 July 2009. Given that the sector already has access to over £1,131 million of additional financing agreed with lenders but not yet all drawn down, the availability of financing should be less of an issue compared to other sectors.

33. Compared to total income, the level of borrowing has remained relatively stable, fluctuating between 18.4 and 20.0 per cent since 2001 (although the general trend being an increase). The increase in 2007-08 saw the level of borrowings rise to 21.2 per cent of total income and this is projected to increase to an all-time high of 24.8 per cent at the end of 2011-12. The increase in payments to service these borrowings (interest and capital payments) will be affordable as long as income (and cash) projections are as forecast. However, this rise in 'fixed costs' could put pressure on some institutions that fail to constrain other costs and/or increase income.

34. Some HEIs will have taken out borrowings with front-loaded holiday periods so there could be increased payments to be made in the coming years from existing borrowings. The sector is

---

[8] This report may be read at www.hefce.ac.uk/finance/fundinghe/trac/fssg

forecasting an increase in interest payments from 2010-11, with the average increase over the forecast period at 2.2 per cent per year. Given that total borrowings are forecast to increase faster than this, either the interest payments are understated and/or the sector is expecting low interest payments to continue.

Reserves

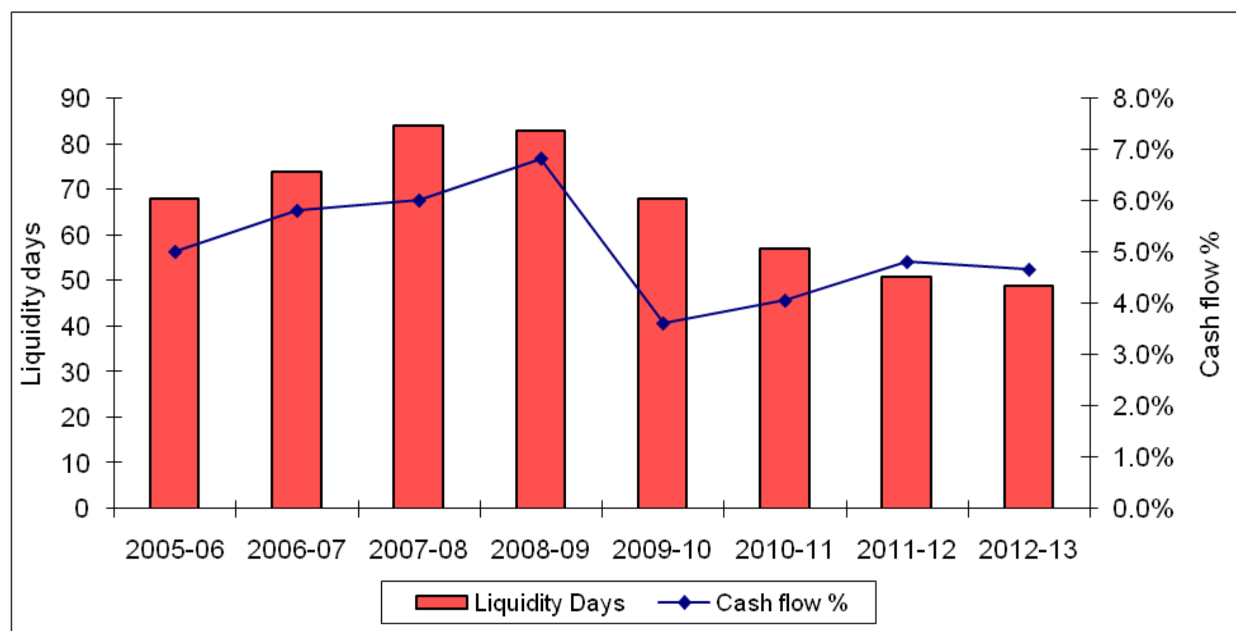
35. Discretionary reserves are forecast to increase each year of the forecast period. However uncertainty over pension deficits, depending on the assumptions made by actuaries, could significantly affect this. The aggregate sector financial position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities. This concentration is forecast to continue.

Cash flow

36. The sector continues to forecast cash inflows from operating activities over the whole period, which are sufficient to finance any expenditure plans not financed by capital grants or borrowings. The large capital expenditure forecast in the next year will require close cash flow management, but the pressures should ease as capital expenditure reduces after 2010.

37. Figure 8 shows the forecast levels of net liquidity (expresses as expenditure days cover) and the expected cash flow from operating activities (as percentage of total income). This shows that over the period the level of liquidity is forecast to reduce annually whereas the cash flow from operating activities increases after a sharp fall in 2009-10. The important factor is that the sector is still forecasting cash generation, which is critical for solvency. Across the sector 13 institutions are forecasting negative cash flow by 2012-13, which is consistent with the actual performance in 2008-09.

Figure 8 Net liquidity and cash flow



How realistic are the sector's forecasts?

38. Historically the sector has been pessimistic in its short-term (one-year) forecasting, with the actual results always better than expected. However, this has been at a time of significant income growth and it is not clear whether this pessimism will continue in the face of constraints on income growth. Taking the current forecasts we have attempted to highlight the limited margins in which the sector operates. Looking at the first three areas of risk (public funding, overseas fee income and pay costs) we have modelled the impact of a small (1 per cent) cash change in what HEIs are forecasting for each of the last three years. Table 9 shows the level of operating surpluses in each year (as a percentage of total income) under the various scenarios.

Table 9 Operating surpluses as percentage of total income

	2010-11	**2011-12**	**2012-13**
Current forecasts	1.1%	1.1%	0.9%
Public funding 1% per year less than forecast	0.7%	0.3%	-0.3%
Overseas fee income 1% per year less than forecast	1.0%	0.9%	0.6%
Pay costs 1% per year more than forecast	0.6%	0.1%	-0.7%
Combination of above three events	**0.1%**	**-1.0%**	**-2.3%**

39. The above scenarios assume no mitigating action is taken by institutions, which is unlikely. However Table 9 does highlight the fine margins with which the sector operates, and how quickly small changes can have a material impact on the financial performance of the sector. In the event of all three changes happening, the sector would be in deficit by 2011-12 and by 2012-13 over 50 institutions would be recording operating deficits.

40. HEIs need to generate surpluses to provide the positive cash flow to fund future developments, to the extent that these are not met from capital funding. The actual level of such surplus needed will vary, depending on the circumstances of individual HEIs. Overall the sector is in a financially sustainable position in the short term. However in the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities and maintaining sustainability. This is particularly important given the present and future economic conditions. The above analysis highlights the tight margins within which some institutions are operating.

List of abbreviations

AMS	Annual monitoring statement
CPS	Corporate planning statement
DH	Department of Health
EPF	Employers' Pension Forum
FSSG	Financial Sustainability Strategy Group
HEI	Higher education institution
HESA	Higher Education Statistics Agency
HESES	Higher Education Students Early Statistics
IFS	Institute of Fiscal Studies
RAS	Research Activity Survey
SORP	Statement of Recommended (Accounting) Practice
TRAC	Transparent Approach to Costing
USS	Universities Superannuation Scheme
VFM	Value for money