July 2011/23

Core funding/operations

Report on outcomes

This report is for information

This report provides an overview on the current and future financial health of the higher education sector in England. It also gives an overview of the outcomes of the review of annual accountability returns for 2009-10.

Financial health of the higher education sector

Including overview of 2009-10 annual accountability returns

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND hefce

Contents

Financial health of the higher education sector including overview of 2009-10 annual accountability returns

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2011/**23**
Publication date	July 2011
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 provides an overview on the financial health of the higher education sector in England. The analysis covers the financial forecasts for the period 2010-11 to 2013-14, as submitted to HEFCE in December 2010 and April 2011.

2. The report is being published to provide universities and higher education colleges with feedback on their projected financial performance. The analysis also provides stakeholders with information about the sector's current and future financial health and supersedes our previous analysis published in March 2011 ('Financial health of the higher education sector: 2009-10 financial results and 2010-11 forecasts', HEFCE 2011/06[1]).

3. In addition to the financial health analysis the report provides an overview of the outcomes of our review of the annual accountability returns for 2009-10.The outcomes of our reviews of all the annual accountability returns feed 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.

Key points

4. Higher education institutions (HEIs) in England are required to send us their annual accountability returns in December each year. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them. The accountability returns enable HEFCE to reassess HEIs' overall risk assessments and to ensure that HEIs are meeting their accountability responsibilities.

---

[1] All HEFCE publications are available at www.hefce.ac.uk/pubs.

5. Due to the uncertainty over the future funding climate, we gave institutions an option to defer forecast information for the period 2011-12 to 2013-14 until April 2011 (see 'Update to our requirement for the 2010 accountability returns in relation to financial forecasts', HEFCE Circular letter 27/2010). Eighty-five institutions decided to defer submission until that time. A further 28 institutions revised their original forecasts in April. The White Paper on Higher Education, published in July 2011 introduced further reforms, for example in relation to student number allocations. These are subject to consultation at this present time, and as a result will not have been included in HEIs financial forecasts, and are therefore outside of the scope of this report.

6. The overall financial results for the sector in 2009-10 showed a stronger financial position than previous years. At the end of 2009-10 the sector had strong cash balances and healthy reserve levels, which will provide some cushioning for the likely risks the sector now faces.

7. The projected performance in 2010-11 is sound overall, albeit not as strong as 2009-10. Cash levels are expected to remain strong, which is important as the sector enters a potentially challenging year in 2011-12. The performance in 2010-11 is now expected to be better than HEIs estimated in December 2010. This may be due to prudent forecasting earlier in the year.

8. Over the past 10 years 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 is likely to be less predictable for some institutions and they will need to respond decisively to the new funding and policy priorities.

9. Based on the financial forecasts there are no institutions that are presently close to risk of insolvency. This is supported by independent going-concern opinions of institutions' external auditors and the projected continuation of positive cash in-flows and healthy cash-backed reserves.

10. The key risk to the sector's forecasts not materialising is a significant fall in student participation from 2012. The sector is forecasting a small reduction, but there is no certainty over the likely level of student numbers in the future. We are aware that institutions have developed contingency plans to deal with changes in income if recruitment levels are not as forecast from 2012.

11. This report includes feedback to the sector on all of the annual accountability returns submitted in December 2010. For the first time in 2009-10 most HEIs were required to include additional information in their financial statements, relating to their status as exempt charities. The quality of reporting in this area was variable and we are preparing updated guidance, particularly on public benefit reporting, that will be available during August this year at www.hefce.ac.uk/pubs. There were also a small number of instances of other non-compliance with the requirements of the Financial Memorandum (as distinct from weak performance) and we have drawn these to the attention of the individual institutions concerned.

Action required

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

Overview

13. Higher education institutions (HEIs) in England are required to send us their annual accountability returns. These returns form a significant part of the way in which HEIs can demonstrate accountability for the public funds distributed to them.

14. We primarily use the information collected to:

- monitor the use of our funds for the purposes intended, including compliance with the Financial Memorandum[2]
- 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
- to monitor HEIs' reporting of information relating to their charitable status. This is the first time we have used the returns for this purpose, and follows our appointment on 1 June 2010 as a principal regulator under the terms of the Charities Act 2006.

15. 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
- corporate planning statement
- audited financial statements
- 2009-10 financial results and forecast tables (2010-11 to 2013-14)
- 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 return
- Research Activity Survey
- Transparent Approach to Costing (TRAC) return.

[2] For further information see 'Model Financial Memorandum between HEFCE and institutions: Terms and conditions for payment of HEFCE grants to higher education institutions' (HEFCE 2010/19). All HEFCE publications are available at www.hefce.ac.uk/pubs.

16. This report provides analysis of the financial health of the higher education sector. Annex A provides sector-level comments on each of the accountability returns submitted by institutions. This feedback is at a general sector level although each institution has already received benchmarking data in relation to its 2009-10 financial performance and forecast position up to 2013-14.

17. The data used in this paper come from two main sources. All data up to and including 2008-09 are from the Higher Education Statistics Agency's Finance Statistics Record, which is completed by all institutions each year. Information covering the period 2009-10 to 2013-14 is from HEIs' 2010 financial results and forecasts submitted to HEFCE. For references to real-terms changes in performance we have used HM Treasury's gross domestic product deflator announced in December 2010[3].

Summary and headline information

18. The overall financial results for the sector in 2009-10 showed a stronger financial position than previous years. At the end of 2009-10 the sector had strong cash balances and healthy reserve levels, which will provide some cushion for the likely risks the sector now faces. There is also evidence that many institutions have taken the opportunity to restructure their cost bases ahead of the pressures on public funding.

19. The projected performance in 2010-11 is sound overall, albeit not as strong as 2009-10. Cash levels are expected to remain strong, which is important as the sector enters a potentially difficult year in 2011-12. The performance in 2010-11 is now expected to be better than HEIs estimated in December 2010. This may be due to prudent forecasting earlier in the year.

20. The sector is forecasting continued pressure on public finances which, together with significant pressures on expenditure, will create a different financial picture for the sector to the recent past. Over the last 10 years 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 is likely to be different.

21. The sector continues to operate on very fine margins which mean that small changes can have a material impact on the sector's financial performance. But despite the small margins, the viability of institutions is not a concern at this time. Continued positive cash in-flows and healthy cash-backed reserves mean that institutions are unlikely to face solvency concerns in the short term.

22. The key risk to the sector's forecasts not materialising is a significant fall in student participation from 2012. The sector is forecasting a small reduction but there is no certainty over the likely level of student numbers in the future. We are aware that institutions have developed contingency plans to deal with changes in income if recruitment levels are not as forecast from 2012.

23. Table 1 provides the key headline data from the financial information submitted by HEIs in April 2011. Further detail and analysis of the sector's financial performance in 2009-10 can be

[3] See www.hm-treasury.gov.uk/data_gdp_index.htm

found in ‘Financial health of the higher education sector: 2009-10 financial results and 2010-11 forecasts’ (HEFCE 2011/06). Analysis of the financial forecasts for the period 2010-11 to 2013-14 can be found in the remainder of this report.

Table 1 Summary of key financial indicators

	Actual		Forecast			
	2008-09	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Total income	£21,015M	£22,223M	£22,721M	£22,639M	£23,362M	£24,100M
Operating surplus as % of total income	£275M 1.3%	£706M 3.2%	£600M 2.6%	£215M 1.0%	£443M 1.9%	£551M 2.3%
Historical cost surplus as % of total income	£522M 2.5%	£805M 3.6%	£789M 3.5%	£344M 1.5%	£569M 2.4%	£773M 3.2%
TRAC operating deficit* as % of total income	(£1,267M) -6.1%	(£926M) -4.2%	n/a	n/a	n/a	n/a
Cash flow from operating activities as % of total income	6.8%	8.3%	5.4%	4.7%	6.0%	6.5%
Net liquidity as number of days’ expenditure	83	98	84	75	71	71
External borrowings as % of total income	20.9%	21.1%	22.3%	24.1%	24.3%	23.4%
Discretionary reserves exc. FRS17†, as % of total income	43.7%	46.1%	49%	51.2%	52.5%	54.6%

* Only actual information collected.

† FRS17 is the financial reporting standard on retirement benefits.

Assessing future financial sustainability

24. The financial forecasts cover the period up to and including 2013-14. Institutions tend to forecast cautiously (this is evidenced by consistently better outturns compared to forecasts). Nonetheless, it is still possible to make some observations about the sector’s financial sustainability.

25. As in previous years, the sector-wide picture encompasses a wide range of results (and forecasts) between institutions. The main financial strength of the sector remains in a small number of institutions. Overall, the sector is likely to remain financially sustainable 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.

26. As in all years, the accuracy of forecasts depends on the assumptions being made by HEIs. For this year the level of uncertainty in the sector was (and still is) significantly higher than

previous years. In preparing their financial forecasts, institutions have identified a number of key risks to the forecasts' accuracy and their financial performance.

Key risks

27. HEIs have identified the following key risks to the sector's financial sustainability:

- fall in student recruitment and retention in an increasingly competitive market
- further unanticipated public spending cuts
- failure to effectively manage changes to the timing of cash payments from public funding bodies (including payments from the Student Loans Company)
- failure to effectively manage major capital investment programmes and their financial impacts
- rise in the cost of future borrowing
- failure to achieve overseas fee income growth
- a rise in staff and pension costs above forecast levels.

28. There are also risks to the accuracy and reliability of the financial forecasts, arising as a result of the current level of uncertainty, such as:

- fee levels used in forecast assumptions for 2012-13 and beyond may differ from those contained in Access Agreements submitted to the Office for Fair Access (OFFA) after the HEFCE financial forecast deadline
- unrealistic assumptions may be used in developing forecasts around future public funding, student demand, and cost reductions and efficiencies.

29. It is important to note that HEIs have undertaken their own scenario planning and sensitivity analysis to assist them in developing their financial forecasts and developing ongoing or planned mitigating actions to address any financial challenges arising. 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.

Forecast performance in 2010-11

30. Due to the uncertainty over the future funding climate, we gave institutions an option to defer forecast information for the period 2011-12 to 2013-14 until April 2011 (see 'Update to our requirement for the 2010 accountability returns in relation to financial forecasts', HEFCE Circular letter 27/2010). Eighty-five institutions decided to defer submission until that time. A further 28 institutions revised their original forecasts in April.

31. The vast majority of institutions submitting forecast data to us in April 2011 also provided revised forecast information for 2010-11. This was because the earlier forecasts were made before further reductions to HEFCE funding were announced in February 2011 (see 'Funding for universities and colleges in 2010-11 and 2011-12', HEFCE Circular letter 05/2011). Therefore the second submission date for forecasts gave HEIs a further opportunity to update their forecasts to reflect the latest funding announcements.

32. Table 2 summarises the key financial indicators for 2010-11 derived from the forecasts submitted in December 2010 and April 2011, and shows the variance between these.

Table 2 Summary of 2010-11 forecast key financial indicators December 2010 and April 2011

	2010-11		
	Forecast December 2010	**Forecast April 2011**	**Variance**
Total income	£22,736M	£22,721M	-0.1%
Operating surplus	£402M	£600M	49.1%
Historical cost surplus	£542M	£789M	45.5%
Cash flow from operating activities as % of total income	4.4%	5.4%	1.0%
Net liquidity as number of days' expenditure	80	84	5.0%
External borrowings as % of total income	22.4%	22.3%	-0.1%
Discretionary reserves exc. FRS17*, as % of total income	48.1%	49.0%	0.9%

* This is the financial reporting standard on retirement benefits.

33. Income levels are expected to fall marginally in 2010-11 compared to the December forecasts, but significant cost savings mean a much improved bottom line compared to the earlier forecasts. The most significant savings come from staff costs, which are expected to be £176 million (1.4 per cent) less than forecast in December 2010. This fall in staff costs may be due to HEIs having more confidence that their cost reduction programmes for the current year will produce better results than previously forecast.

Forecast performance in 2011-12 to 2013-14

34. The first year of transition to the new funding environment will be 2011-12, and the financial forecasts show that this year will be more difficult than previous ones. The main reason is that public funding reductions will start to bite before HEIs are able to charge higher fees for home and EU undergraduates.

35. The forecasts for 2011-12 show that surplus levels are expected to be significantly lower than in recent years, with an operating surplus of just 1 per cent. The main cause of this is a 3 per cent real-terms reduction in total income compared to 2010-11. Despite this, cash (liquidity) levels remain sound, and it appears that all institutions have made sufficient plans to manage the transition in 2011-12.

36. The following sections look at different aspects of the financial forecasts in more detail, for the whole period to 2013-14.

Income

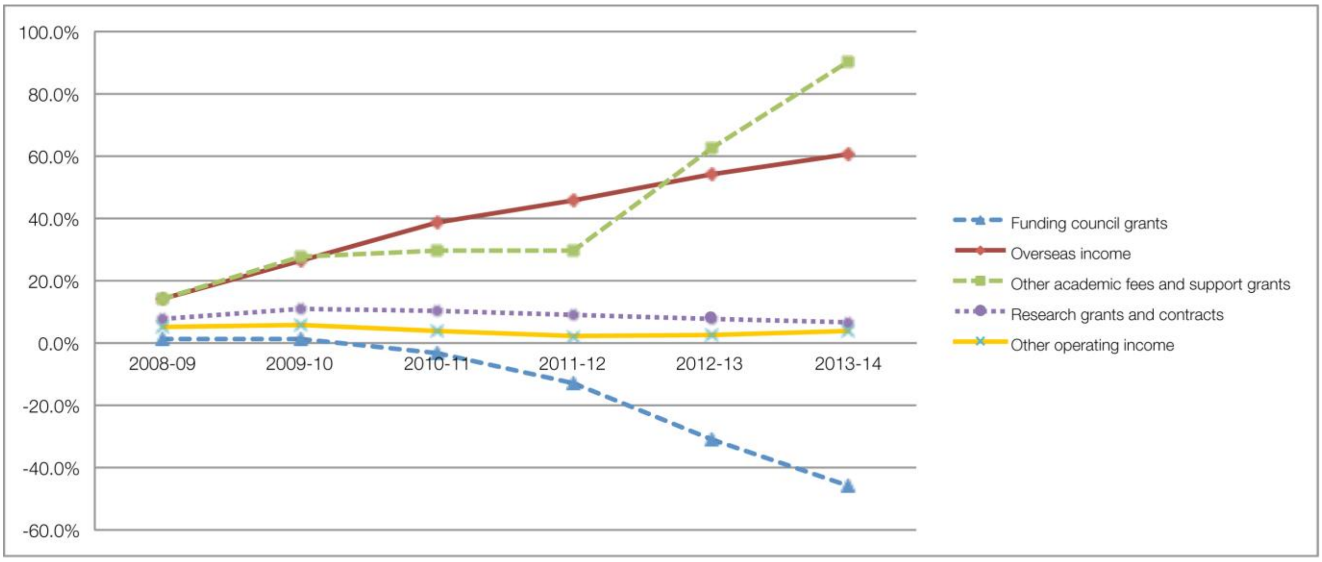
37. At sector level, total income is forecast to fall marginally by 0.4 per cent (cash terms) in 2011-12 due to reductions in public funding, but is expected to rise by on average by 3.2 per cent in the following two years, reaching £24,100 million in 2013-14. Table 3 provides a breakdown of the income levels forecast.

Table 3 Breakdown of forecast income levels

£M	2009-10 actual	2010-11	2011-12	2012-13	2013-14
Funding council grants	7,282	7,153	6,609	5,388	4,325
Overseas fee income	2,133	2,409	2,607	2,819	3,018
Other academic fees and support grants	5,007	5,231	5,392	6,927	8,314
Research grants and contracts	3,500	3,582	3,632	3,691	3,742
Other operating income	4,121	4,165	4,215	4,346	4,501
Endowment income and interest	180	182	184	191	199
Total income	**22,223**	**22,721**	**22,639**	**23,362**	**24,100**

38. While the above table shows future changes in cash terms, Figure 1 shows the cumulative real-terms changes in income since 2007-08 (excluding endowment income). This illustrates the sharp fall in funding council grants over the period, which is countered by significant growth in fee income from both home and overseas students.

Figure 1 Cumulative real-terms changes in income since 2007-08



39. In 2012-13 fee income from full-time home and EU undergraduates is expected to increase by £1.35 billion with a further increase in 2013-14 of £1.22 billion. Part-time and postgraduate fees are also forecast to increase in real terms over the forecast period, by 28 per

cent and 16 per cent respectively. HEIs forecast that in 2012-13 HEFCE teaching funding will reduce by £1.11 billion with a further reduction of £1 billion in 2013-14. Table 5 shows the breakdown of public funding assumptions in cash terms.

Table 5 Percentage change in public funding from financial forecasts submitted in April 2011

	2011-12	2012-13	2013-14	Cumulative
HEFCE	-7.8%	-19.7%	-21.6%	-41.9%
Department of Health	-3.2%	-1.8%	-0.4%	-5.3%
Research Councils	-0.4%	+0.5%	+0.3%	+0.4%
Training and Development Agency for Schools	-8.7%	-14.9%	-10.1%	-30.1%
Skills Funding Agency	-12.3%	-4.6%	-3.0%	-18.8%
Total*	-6.1%	-13.8%	-13.8%	-30.3%

*Total includes changes in deferred capital grants

40. We reported last year[4] that the sector, as a whole, had made some relatively prudent assumptions about the levels of HEFCE funding for the forecast period. For 2011-12 this appears to be the case again, though the prudence of future assumptions is more difficult to ascertain until HEFCE receives its grant letter from the Department for Business, Innovation and Skills in January 2012.

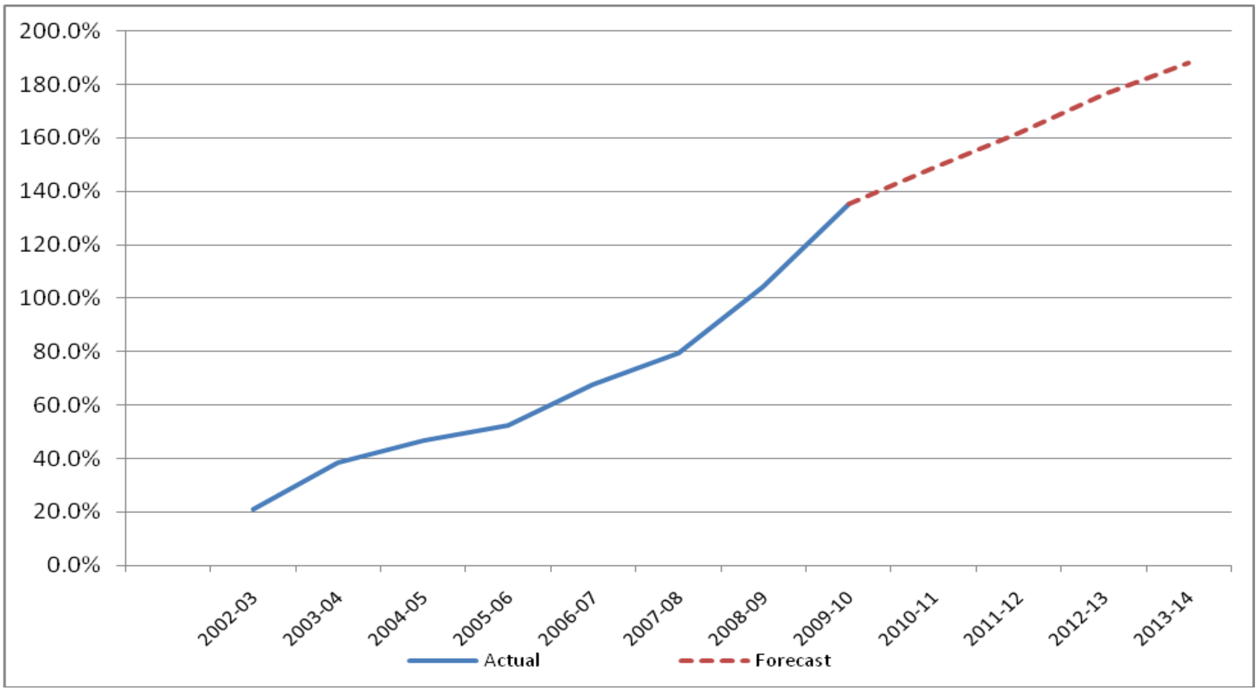
41. Table 5 does hide the variation in assumptions made by individual institutions. Across the sector, 46 institutions are forecasting a cumulative decrease in public sector funding of over 50 per cent over the forecast period; 53 forecast a decrease of over 20 per cent; 28 forecast reductions under 20 per cent; and two anticipate small increases. These data suggest that there is continued uncertainty within the sector about the levels of future public sector funding and that this has resulted in different assumptions and approaches being used to forecast future public income.

Overseas income

42. As in previous years, the sector is expecting overseas (non-EU) student numbers to increase over the forecast period. On average there has been an increase in fee income from overseas students of 10.8 per cent (real terms) per year over the last eight years. In cash terms the sector is expecting overseas fee income to rise 41.5 per cent from £2,133 million in 2009-10 to £3,018 million by 2013-14. Figure 2 shows the real-terms percentage change in overseas fee income reported by the sector since 2001-02, together with the projected overseas fee income for the forecast period. As can be seen from Figure 2, real-terms increases in overseas income are expected to continue over the forecast period.

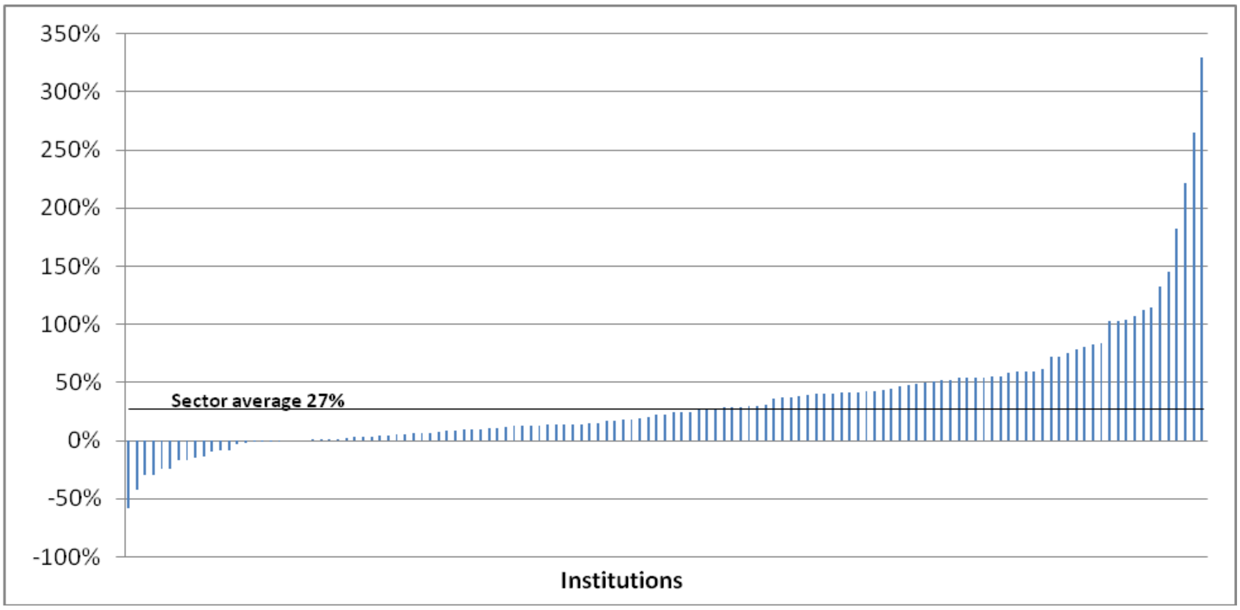
[4] 'Annual accountability returns: Outcomes for 2009' (HEFCE 2010/20).

Figure 2 Real-terms change in overseas income



43. Over the whole sector the average increase in fee income for international students is 27 per cent in real terms (2013-14 compared to 2009-10). However this disguises the significant differences in individual institutions assumptions. Figure 3 shows the variation between different institutions.

Figure 3 Real-terms change in overseas fee income (2013-14 compared to 2009-10)



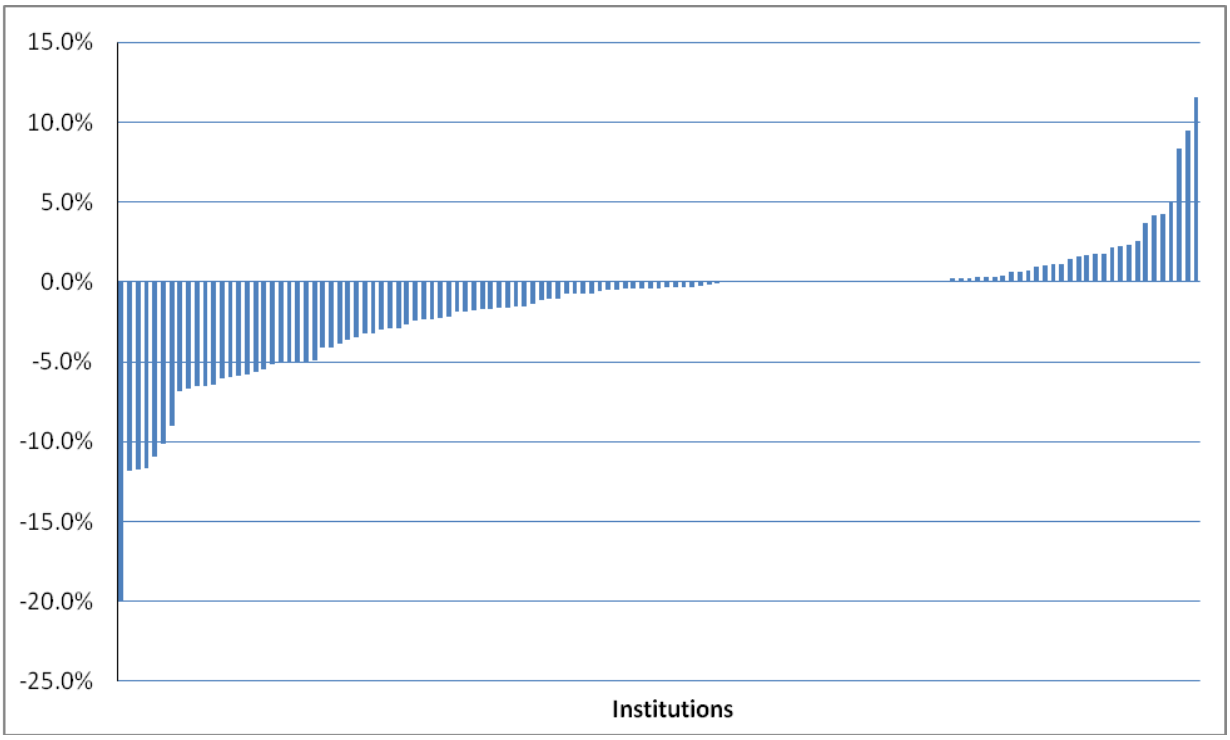
Student participation

44. 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. As

already noted this information was collected prior to the Higher Education White Paper, and thus will exclude institutions assumptions on the impact of proposed changes to student number allocations. The information submitted in April shows that the majority of institutions, 56 per cent, are expecting home and EU full-time undergraduate students to decrease in 2012-13, the first year of the new fee arrangements. A further 20 per cent of institutions are forecasting no change in student numbers over this period; and 24 per cent of HEIs forecast small increases.

45. At sector level, full-time home and EU undergraduate student numbers are forecast to decrease by an average of 1.9 per cent in 2012-13. Figure 4 shows the forecast changes in these student numbers between 2011-12 and 2012-13 for all institutions.

Figure 4 Forecast changes in home and EU undergraduate numbers (2011-12 to 2012-13)



46. Home and EU postgraduate taught student numbers are expected to marginally increase over the forecast period, increasing by between 0.6 per cent and 1.5 per cent per year, whereas all overseas student numbers are expected to rise by between 3 per cent and 6 per cent each year.

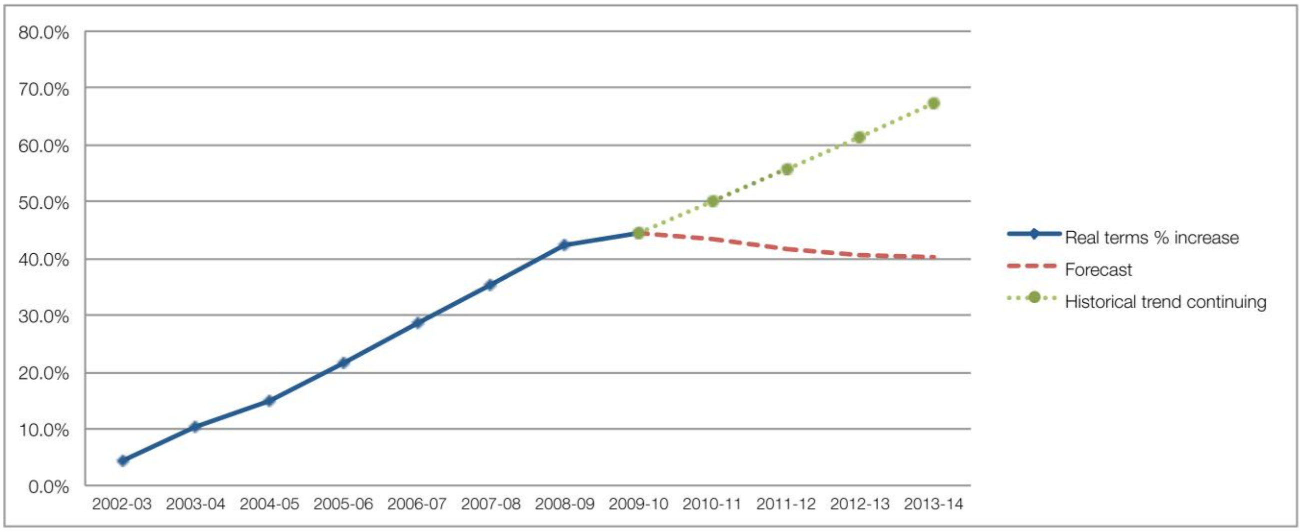
47. Part-time undergraduate numbers are forecast to rise in 2011-12 by 2.1 per cent but then to fall back slightly in the following two years.

Expenditure

48. In addition to income growth the sector is continuing to forecast slower growth in expenditure. The sector's biggest expenditure is staff costs, which in 2009-10 totalled £12,070 million, equivalent to 54.3 per cent of total income. This is 3.6 per cent (cash terms) more than the previous year, lower than the average annual increase since 2001-02 of 7.4 per cent (cash terms). Forecast increases for future years remain low, at no more than 2.5 per cent per year, which may be challenging to achieve.

49. Figure 5 shows the level of real-terms increases over the past seven years, plus what the sector is forecasting to happen over the next four years. It shows that the sector is expecting much lower increases in staff costs than the historical trend, which is an average of 4.6 per cent in real terms.

Figure 5 Real-terms increases in staff costs (cumulative increase since base year of 2001-02)



50. Figure 5 shows that the forecast change in total staff costs (including pensions) is actually a real-terms reduction over the period until 2013-14. This partly due to smaller pay rises compared to recent years and also a marginal reduction in staff numbers.

51. In addition to the much smaller increases in staff costs the sector is forecasting below-inflation rises in other operating expenditure. Depreciation and interest payable are expected to increase at a faster rate than previously, partly due to recent large expenditure on capital projects and a rise in external borrowings.

Surpluses

52. The forecasts indicate that, at an operating level (that is, total income less total expenditure, before any exceptional items), the sector expects a reduction in operating surpluses in the years 2010-11 and 2011-12 as public funding cuts take effect. Thereafter surpluses are expected to rise as fee income increases at a greater rate than reductions in HEFCE teaching grants (as forecast by HEIs). On a historical cost basis the average level of surpluses expected over the forecast period is 2.7 per cent. Historical cost surpluses are expected to follow a similar pattern to operating surpluses, falling in 2010-11 and 2011-12 but then recovering in 2012-13.

53. Figure 6 shows the actual and expected operating and historical cost surpluses for the forecast period. The large difference between the operating and historical position forecast in 2013-14 is partly accounted for by exceptional items (for example profit or loss from the sale of properties) of £118 million. Although the exceptional items do not substantially distort the analysis of the sector’s financial performance, £100 million of the £118 million was accounted for by one institution expecting substantial profits from the sale of properties.

Figure 6 Operating and historical cost surpluses

54. Looking at the forecast period as a whole, the surpluses predicted are more optimistic than predicted in last year's forecasts. This may be because, at the time of submitting the previous forecasts in December 2009, there was a high level of uncertainty about the future of higher education funding and HEIs were generally pessimistic in their assumptions. Also, programmes to reduce costs and increase efficiencies within the sector are now starting to take effect, and the outcomes of these are reflected within the new forecasts.

Liquidity and borrowings

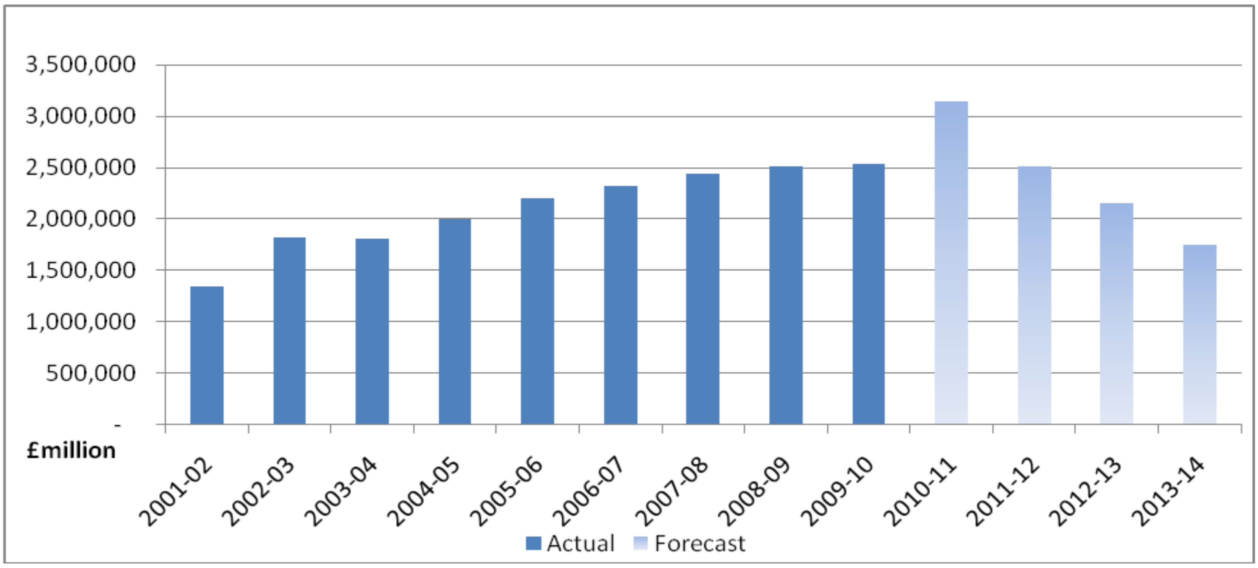
55. The level of liquidity days (that is, the number of days that liquidity covers expenditure) reported for 2009-10 is strong. This is expected to fall gradually over the next three years to 71 days (which is still a healthy level) at the end of 2012-13, and to remain stable in 2013-14.

56. One of the reasons for liquidity reducing is that the sector is continuing to invest in its infrastructure at substantial levels; an indicator of this is the level of capital expenditure. In its December 2009 forecasts, the sector had expected capital expenditure to increase in 2009-10 by 31 per cent to £3,258 million. However, actual expenditure reported was much lower at £2,535 million (a decrease of 1.1 per cent on the previous year). Capital expenditure is now expected to rise in 2010-11 to £3,146 million (24.1 per cent rise) and is then expected to fall to current levels (between £2 million and £2.5 million) before falling further from 2013-14.

57. The delay in the forecast increase in expenditure to 2010-11 is not unusual: large capital programmes are commonly subject to delay. However, given that most of this expenditure is likely to have been finished during summer 2010, or to be under way, it is reasonable to expect the actual level to be in line with the forecasts. Over the whole forecast period the sector expects to spend £9,569 million.

58. Since 2001 the sector has spent £19,116 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 (payments to acquire tangible assets), together with the forecast changes now projected by the sector.

Figure 7 Capital expenditure



59. As a result of the reductions in HEFCE capital funding, the sector expects to increase its borrowings to help finance these investments in infrastructure. The sector forecasts borrowings to rise to £5,665 million at the end of 2012-13 (24.3 per cent of total income), which is £1,982 million more than at 31 July 2010. Given that the sector already has access to over £1,347 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.

60. Compared to total income, the level of borrowing has remained relatively stable, fluctuating between 18.4 and 21.1 per cent since 2001 (although the trend is an increase). In 2009-10, the level of borrowing increased to 21.1 per cent of total income and this is projected to rise further over the next three years to a high of 24.3 per cent by the end of 2012-13. 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, as stated in previous reports, this rise in 'fixed costs' could put pressure on institutions that fail to constrain other costs and/or increase income.

61. The sector has seen a decrease in its interest payments from £398 million in 2009-10 to £328 million in 2010-11, but forecasts that interest payments will steadily increase to reach £398 million by 2013-14.

Reserves

62. Discretionary reserves are forecast to increase each year of the forecast period as the sector continues to generate surpluses. However, uncertainty over pension deficits, depending on the assumptions made by actuaries, could significantly affect this.

63. 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.

64. At the end of 2009-10 reserves totalled £6,888 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 (but not those of multi-employer schemes such as the Universities Superannuation Scheme), makes comparisons with previous years more difficult. Without FRS17 the sector would have reserves of £10,256 million, equivalent to 46.1 per cent of total income. Total pension scheme deficits of £3,367 million reduced reserves to 31.0 per cent of income. The level of pension scheme deficits decreased by £321 million this year, mainly due to changes in the inflation assumptions from Retail Price Index to Consumer Price Index.

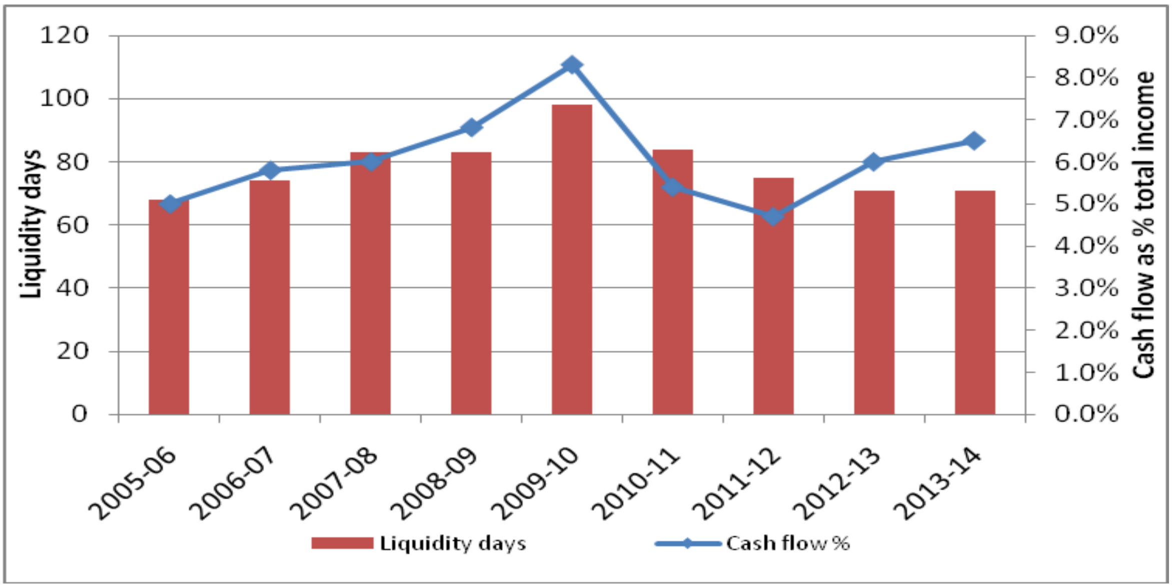
65. As in previous years the sector is not forecasting any material changes in the pension liabilities on its balance sheets. This is an understandable position, due to the inherent difficulty in forecasting pension assets and liabilities, but there is a risk that the sector reserves could come under further pressure if pension liabilities increase.

Cash flow

66. The sector continues to forecast cash inflows from operating activities over the whole period, sufficient to finance any expenditure plans not financed by capital grants or borrowings. The large capital expenditure forecast for 2010-11 will require close cash flow management, but the pressures should ease as capital expenditure reduces after 2011-12. As mentioned earlier in this report one of the key risks facing the sector relates to the differences in the timing of payments from HEFCE and those of tuition fees through the Student Loans Company from 2012-13. This may raise additional in-year cash flow pressures, though arrangements are being put in place to mitigate most of this risk. The sector is aware of this and seems to be preparing for the changes appropriately.

67. Figure 8 shows the forecast levels of net liquidity (expressed as expenditure days cover) and the expected cash flow from operating activities (as percentage of total income). This shows that the level of liquidity is forecast to reduce over the next three years to 2012-13, before levelling out by the end of 2013-14. Cash flow from operating activities is expected to fall over the next two years as government funding cuts take effect, before rising again in the 2012-13 and 2013-14 as a result of increases in fee income.

Figure 8 Net liquidity and cash flow



68. The number of institutions forecasting negative cash flows is expected to fall over the forecast period with only seven institutions forecasting negative cash flows in 2013-14. Together with the already sound levels of cash held by institutions, the risk of solvency problems is very low.

Annex A Annual accountability returns feedback

1. This annex provides sector-level comments on each of the accountability returns submitted by institutions for the academic year 2009-10.

Annual assurance return

2. 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 2010/19). In signing this return the accountable officer (normally the head of institution) confirms 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.

3. There are no issues to report at a sector level on this return, but we remind all institutions that they should have a robust process that provides assurances to the accountable officer to sign Part 1 of the return. It is also imperative that the accountable officer signs this part of the return and not someone else within the institution. We also remind all institutions that are exempt charities that Part 2 of the annual assurance return should be signed by a trustee to confirm that the institution has conducted its affairs in accordance with its status as a charity.

4. 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. Details of the requirements on reporting these events are described in paragraphs 13-17 of Annex B in HEFCE 2010/19.

Annual monitoring statement

5. The annual monitoring statement (AMS) monitors the use of special initiative funding outside 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.

6. 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.

7. In 2009-10 the AMS monitored the use of some £150 million of funding, mainly for the fourth round of the Higher Education Innovation Fund. In 2009-10, 25 institutions reported non-trivial underspend of Higher Education Innovation Fund monies. 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

8. 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 corporate planning statement (CPS), institutions have provided a strategic update to 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.

9. In this statement we requested 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 have not analysed the statements on a sector basis due to the specific and unique nature of each institution's return. We have used the CPS to feed into HEFCE institutional team engagements with institutions over the coming year, and into our risk assessments.

10. Please note that we will no longer require submission of the CPS for the 2011 annual accountability return. This decision follows our review of the returns requested and the need to ensure an appropriate balance with respect to the accountability burden that we place on institutions.

Audited financial statements and financial forecasts

11. Institutions were required to follow the latest version of the 'Statement of Recommended Practice: Accounting for Further and Higher Education' (SORP)[5] 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 2009-10 financial statements', HEFCE Circular letter 14/2009).

12. 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.

13. A number of institutions reported incorrect data to HEFCE, HESA or both relating to their 2009-10 financial outturn. This was caused by data input errors at institutions, which were corrected as necessary.

14. 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.

15. We required HEIs to include in the notes to their 2009-10 audited financial statements information about payments to trustees (or a statement that no such payments were made) and, in the narrative section of the financial statements, a report on how they delivered public benefit during the year.

---

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

16. Most HEIs complied with the requirement to report payments to trustees as trustees and payments of expenses to or on behalf of trustees. But we are concerned that many HEIs do not report ‘related party transactions’ with their trustees.

17. In the first year of reporting some HEIs reported their public benefit activities in an interesting, informative way and also complied with the minimum requirements. Some did not manage to meet required standards and need to improve. We are preparing updated guidance about reporting public benefit and look to institutions to significantly improve their reports in future.

Financial commentary

18. 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.

19. Guidance, and the specific questions to which we require a response, were provided in the annual accountability returns guidance (‘Annual accountability returns 2010’, HEFCE 2010/25, paragraphs 37-39). As in the previous years, not all institutions provided explicit responses to all of the questions although this was improved relative to the commentaries submitted as part of previous year’s return. 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.

20. 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, and were encouraged to submit their own VFM reports in support of this question. In contrast to the low response rate in 2009 (35 per cent), 82 per cent of institutions explicitly answered this question in the commentary this year. Audit committee annual reports show a similar picture, with many institutions providing VFM reports to their audit committees. Given the increased interest in VFM we will be requesting that institutions submit their VFM reports as part of next year’s return.

21. Following the advice given in the 2009 and 2010 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. The majority 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. This suggests that the sector is undertaking a lot of scenario planning.

22. We ask all institutions to continue 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.

23. Institutions identified a variety of key risks, although only half of those identifying their key risks also described in the commentary mitigating actions that they had identified with respect to

these risks. Across the sector the following were considered in the top three risks for most institutions:

- further public funding cuts (49 per cent of institutions), particularly around income from HEFCE and the Training and Development Agency for Schools, but also including knock-on effects of local government cuts and the more general uncertainty of the future public funding environment
- student recruitment and retention (39 per cent of institutions), around all types of students
- student demand (33 per cent of institutions), particularly around the uncertain impact on demand of the introduction of higher fees from 2012-13
- fee level (30 per cent of institutions), particularly around whether they would be allowed to charge their desired fee and the uncertainty of the market's response to this fee level
- staff and pension costs (24 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 revaluation of the liabilities of several major pension providers in 2010-11.

24. In summary, there were differences in the quality of the financial commentaries provided by institutions. Our guidance indicates that information produced for internal purposes by the institution may be used for the commentary in order to reduce the accountability burden; as long as the information answers all of the questions outlined in the guidance. To assist this process, we have provided a template for institutions to use if they wish.

Audit committee annual report

25. As stated in the Audit Code of Practice (Annex B to HEFCE 2010/19) the audit committee must produce an annual report for the governing body and the accountable officer. The audit committee annual report must 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 members' responsibility statement in the annual financial statements is signed.

26. The audit committee annual report must include the committee's conclusions 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.

27. 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.

28. A majority of audit committee annual reports for 2009-10 included the required opinions but a significant minority failed to clearly report 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. Omission of the required opinions from the audit committee annual report has been notified to institutions through the risk assessment letters issued in June and July.

External audit management letter

29. External audit should issue a report to those charged with governance – normally referred to as a ‘management letter’ – which highlights accounting issues and control deficiencies arising from the audit. The HEI’s management should provide written responses to any recommendations made or issues raised.

30. 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 2009-10, a large minority of management letters featured ungraded recommendations.

31. 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 2009-10, as in 2007-08 and 2008-09, approximately one-tenth of management letters did not refer to any significant accounting and control issues. A small number referred to accounting and control issues in an interim letter or other document which was not submitted to HEFCE.

32. 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.

33. Two 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. In these cases we requested the necessary information from the institutions. We remind all HEIs that it is a requirement of the Financial Memorandum that the final management letter (incorporating management responses) is sent to HEFCE.

34. The Accountability and Audit Code of Practice requests that the extent of reliance on internal audit should be indicated in the management letter. About 20 per cent of management letters made no reference to the extent of reliance on internal audit.

Internal audit annual report

35. The internal audit annual report must relate to the financial year and include any significant issues, up to the date of preparing the report, which affect 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.

36. These opinions should be placed into their proper context: that is, the work undertaken has been 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.

37. Most internal auditors gave the required opinions for 2009-10, although a small minority omitted to report 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

38. All institutions submitted their annual Higher Education Early Statistics (HESES) and Research Activity Survey (RAS) returns in December. The outcomes of these data returns fed into the grant announcements released in March[6].

39. We are continuing our programme of audits of data used for funding purposes (HESES, RAS and HESA returns). 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 HESES publication each year and, as necessary, the annual guidance produced for the RAS returns (the latest being 'Research Activity Survey 2010', HEFCE 2010/28).

40. We had a large number of changes to data this year, following queries raised by HEFCE on the data originally submitted. The HESES and RAS returns both 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 reserve the right to use our own estimates of data where we have reason to believe that institutional data are not fit for purpose.

41. 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.

42. 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 required to provide written assurances that effective arrangements are in place.

---

[6] For more information see 'Recurrent grants for 2011-12' (HEFCE 2011/07).

Transparent Approach to Costing return

43. 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.

44. 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 the 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.

45. We continue to remind institutions that a Board committee (a committee with lay governor majority) must confirm compliance with section A.5.2 of the statement of requirements which can be seen at www.jcpsg.ac.uk/guidance/require/. It is important that a Board committee specifically reviews the results of the TRAC tests for reasonableness and either confirms compliance with the statement of requirements or draws up an action plan for any areas where the institution is not fully compliant.

46. Institutions provided commentaries where data fell outside the parameters shown in the commentary section of the return, but commentaries on any material movements when comparing data with the previous year's return could be improved in a few cases. Institutions should therefore refer to the TRAC summary sheet to point them to areas where additional comments could be provided to explain material movements.

47. TRAC data for 2009-10 show a short-run operating position (includes infrastructure adjustment only) at break-even with a full-cost deficit across all activities of £926 million (4.2 per cent of total income) for HEFCE-funded institutions. This is a significant improvement on the previous year's position. The full-cost deficit includes both the infrastructure adjustment and the return for financing and investment, which are added to reported expenditure in institutions' audited financial statements. These adjustments provide an estimate of the full economic costs of institutions' activities.

48. 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 A1 provides a summary of the English sector for 2009-10.

Table A1 HEFCE sector summary

	Total (£M)	As % of total expenditure
Total income	22,159*	
Total expenditure	21,416*	
Infrastructure adjustment	667	3.1%
Short-run operating surplus/(deficit) per TRAC	76	
Return for financing and investment adjustment	1,002	4.7%
Total costs (full economic costs per TRAC)	23,085	
Surplus/(deficit) per TRAC	**(926)**	

* This figure is marginally different to the total income reported in the annual financial statements due adjustments in respect of joint ventures, minority interests and endowments in the TRAC returns.

49. In terms of the individual reporting areas, there have been only slight changes in the levels of surpluses/deficits recorded. Table A2 shows the breakdown over the last three years.

Table A2 Breakdown over 2007-08 to 2009-10

		2007-08	2008-09 *	2009-10
Publicly funded teaching surplus/(deficit) as % of total income		(£249M) -2.9%	(£197M) -2.2%	(£2M) 0.0%
Non-publicly funded teaching surplus/(deficit) as % of total income		£414M 22.5%	£451M 20.1%	£538M 21.3%
Research surplus/(deficit) as % of total income		(£1,720M) -33.0%	(£1,858M) -33.0%	(£1,718M) -28.6%
Other activities surplus/(deficit) as % of total income		£460M 12.2%	£309M 8.0%	£255M 6.5%
Total surplus/(deficit) as % of total income		(£1,095M) -5.7%	(£1,294M) -6.2%	(£926M) -4.2%

* Excludes data from one institution.

50. Table A2 shows that financial performance in all areas except other activities improved in 2009-10 because of the improved operating position in the sector

51. Tables A3 and A4 summarise the TRAC data for HEFCE-funded institutions. Table A3 shows the level of income and costs by activity. Table A4 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 A3 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	7,524	2,172	9,697	2,530	6,010	3,923	22,159
TRAC full economic costs	7,547	2,152	9,698	1,991	7,728	3,667	23,085
Surplus/(deficit)	**(22)**	**21**	**(2)**	**538**	**(1,718)**	**255**	**(926)**
Surplus/(deficit) as % of income	-0.3%	0.9%	0.0%	21.3%	-28.6%	6.5%	-4.2%
Surplus/(deficit) as % of costs	-0.3%	1.0%	0.0%	27.0%	-22.2%	7.0%	-4.0%

Table A4 Research income and costs by sponsor type

£M	Recurrent research funding from the funding councils[7]	Institution-own funded	Postgraduate research	Research Councils	Other government departments	EU*	UK charities	Industry[§]	Total research
Income	1,637	182	597	1,296	627	313	779	578	6,010
TRAC full economic costs		1,508	1,153	1,718	811	488	1,266	783	7,728
Surplus/(deficit)		**(1,325)**	**(556)**	**(422)**	**(184)**	**(176)**	**(487)**	**(206)**	**(1,718)**
Surplus/(deficit) as % of costs		-87.9%	-48.2%	-24.5%	-22.7%	-36.0%	-38.5%	-26.3%	-22.2%
FEC recovery (income as % of costs)		12.1%	51.8%	75.5%	77.3%	64.0%	61.5%	73.7%	77.8%

* 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.

[7] For the first time in 2009-10, HEIs were required to report recurrent research funding from the funding councils in a separate column. Only income is recorded against this column.

List of abbreviations

AMS	Annual monitoring statement
CPS	Corporate planning statement
FRS	Financial Reporting Standard
FSSG	Financial Sustainability Strategy Group
HEI	Higher education institution
HESA	Higher Education Statistics Agency
HESES	Higher Education Students Early Statistics
OFFA	Office for Fair Access
RAS	Research Activity Survey
SORP	Statement of Recommended (Accounting) Practice
TRAC	Transparent Approach to Costing
VFM	Value for money