January 2005/06

Core funding/operations

Report on outcomes and consultation

This report is for information. Comments on the AMS are invited by Wednesday 30 March.

This document gives financial projections for the higher education sector covering 2003-04 to 2007-08, and summarises the sector's annual monitoring statements and corporate planning statements for 2003-04. It also includes information on our plans for a revised approach to monitoring strategic special funding in 2004-05.

Financial forecasts, annual monitoring and corporate planning statements

Outcomes for 2004 and changes to annual monitoring statements in 2005

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Financial forecasts, annual monitoring and corporate planning statements

Outcomes for 2004 and changes to annual monitoring statements in 2005

To	Heads of HEFCE-funded higher education institutions Heads of universities in Northern Ireland
Of interest to those responsible for	Finance, Planning, Management
Reference	2005/**06**
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Executive summary

Purpose

1. This report gives financial projections for the higher education sector covering 2003-04 to 2007-08, summarises the sector's annual reporting statements for 2003-04, and invites comments on proposed changes to the process for submitting annual monitoring statements. The outcomes are based on information provided by higher education institutions (HEIs) in July 2004.

Key points

Financial forecasts

2. The analysis in this publication concentrates on the financial position of the sector excluding the impact of variable fees.

3. The operating position, before exceptional items, is forecast to remain relatively constant from 2004-05, with surpluses at approximately 0.5 per cent of total income per annum. This is in line with the actual surpluses achieved in 2000-01 and 2001-02, but lower than the outturns achieved in 2002-03 and 2003-04.

4. Total student numbers (headcount) are forecast to increase by 9.6 per cent over the period 2003-04 to 2007-08. Within this total, overseas student numbers are forecast to increase by 26.7 per cent. This will see forecast overseas student fee income increase by 44.1 per cent from £1,125 million in 2003-04 to £1,621 million in 2007-08. The sector has previously exceeded ambitious plans for overseas growth: there was a 66 per cent increase in income between 1999-2000 and 2002-03.

5. Income from research grants and contracts is forecast to increase by 30 per cent from 2003-04 onwards, averaging an increase of 6 per cent per annum. These annual increases are lower than those actually achieved over the period 1998-99 to 2002-03, which averaged 9 per cent per annum. The 2004 forecast figures include the additional £120 million being made available by Research Councils from 2005-06 to increase contributions to the full economic costs of research projects.

6. The sector's dependence on income from public sources is forecast to decline marginally from 60.9 per cent of total income in 2002-03 to 59.9 per cent in 2007-08.

7. Staff costs are forecast to increase well above the rate of general inflation, while staff numbers increase by 6.3 per cent over the period, leading to a reduction in staff:student ratios. The sector may be exposed to risk that pay inflation (including additional pension costs) may be higher than forecast in the later periods. The additional costs relating to job evaluation and movement to the new single pay spine will mean additional pressures on costs in the next few years.

8. Net liquidity is forecast to increase to £2,219 million by 31 July 2004, before fluctuating around £2,100 million for the remainder of the forecast period, which is equivalent to over 50 days' expenditure (higher than forecast in previous years). Borrowings are forecast to increase by £1,159 million to £3,591 million by July 2008, which represents a substantial investment for the sector.

9. Total capital expenditure during the period 2003-04 to 2007-08 totals £7,896 million across the whole sector, of which £4,056 million will be financed by capital grants.

10. The major risk identified by institutions remains the under-recruitment of students (both home and overseas students). Other major risks include salary increases above inflation and the management of capital programmes.

11. Generally the forecasts appear to have been prepared on broadly reasonable assumptions, although for some institutions these may be challenging or unduly optimistic. The financial strength of the sector is satisfactory when viewed in aggregate, but a small number of HEIs are facing significant financial constraints.

12. While recognising that the forecasts provided are confidential, we have produced schedules for individual institutions so that they can compare their position against financial health indicators for the sector. Institutions can download their own schedules through the HEFCE extranet, https://extranet.hefce.ac.uk.

13. We are continuing to look at ways of reducing the accountability burden on the sector in producing financial forecasts. We will consult with the sector later in the year about specific proposals.

Annual monitoring and corporate planning statements

14. Our analysis of the 2003-04 annual monitoring statements (AMSs) focused on five key areas of HEFCE strategic funding: widening participation, learning and teaching, business and the community, rewarding and developing staff, and research capability (monitored for the first time this year through the AMS). Race equality monitoring was introduced last year, and continues to be monitored as part of our obligations under the Race Relations (Amendment) Act 2000.

15. Institutions were also asked to submit a corporate planning statement (CPS). The CPS is a general update of the institution's progress during 2003-04 against its corporate plan and strategic priorities.

16. Our analysis of the 2003-04 AMSs and CPSs shows that nearly all institutions are making good progress with their plans in each of the areas of strategic special funding, and against their own strategic priorities.

17. Where the AMS indicates that an HEI has fallen behind with its plans, we will investigate the matter further to determine what action is appropriate. In extreme cases we may re-profile funds or take back funding.

Changes to the annual monitoring statement

18. We are continuing to develop the AMS framework, seeking to identify the minimum range of information that we need for monitoring, and collecting as much of it as possible through the AMS.

19. In order to lessen the burden on institutions, we will be changing the AMS process in 2005. The final section of this report illustrates these changes. We would welcome comments on the revised approach to monitoring strategic special funding.

Action required

20. Institutions are invited to comment on the proposed changes to the AMS. Comments should be e-mailed to d.whyte@hefce.ac.uk by **Wednesday 30 March**.

2004 Financial forecasts

Income and expenditure

21. In HEFCE 2004/20 we asked HEIs to provide us with financial forecasts covering the period 2003-04 to 2007-08. These forecasts, as in previous years, were prepared on assumptions reflecting the current funding announcements and the prevailing economic climate. They take into account the Department for Education and Skills (DfES) announcements in January 2003 and January 2004 on the funding to be provided for higher education for the financial years 2003-04 to 2005-06.

22. At the time of preparing the forecasts (June/July 2004) legislation on the Government’s policy of variable fees had still to be passed through Parliament. Therefore, after discussions with the DfES and relevant sector bodies, it was agreed that institutions should assume that student fees (for full-time undergraduates) would only be maintained in real terms over the forecast period. The analysis in this publication concentrates on the financial position of the sector excluding the impact of variable fees.

23. The sector outturn for 2002-03 was a historical cost surplus of £309.9 million (2.4 per cent of total income), which was the largest surplus since 1997-98. The financial forecasts show that outturns for 2003-04 and 2004-05 are better than forecast in 2003 but there is a small deterioration in 2005-06. The results forecast for subsequent years show a small improvement on previous forecasts. A time series from 1996-97 of forecast and actual historical cost surpluses is at Annex A.

24. The forecast income and expenditure account for the sector as a whole is at Annex B, and summarised in Table 1. This shows that total income for the sector is forecast to grow by 19.9 per cent over the five-year period 2003-04 to 2007-08, with the greatest growth forecast in 2003-04 and 2004-05. Historical cost surpluses are forecast of between 1 per cent and 1.4 per cent of total income, except in 2003-04 when exceptional items are expected to improve the surplus position to 2.7 per cent of total income. The surpluses forecast are on average £19.5 million per annum above the surpluses forecast in 2003.

25. Exceptional items affect the projected level of surpluses, especially in 2003-04. Although a number of institutions are forecasting negative exceptional items (such as restructuring or losses on property transactions), the sector as a whole is expecting gains from exceptional items. These mainly arise from gains on property transactions, with some from the sale of intellectual property rights or of spin-out companies. In 2003-04, eight institutions are each expecting the sale of properties to provide exceptional gains in excess of £10 million. These eight institutions account for half of the sector’s total exceptional items in that year.

26. Operating surpluses before exceptional items are expected to remain relatively constant from 2004-05, at approximately 0.5 per cent of total income per annum. This is in line with the actual surpluses achieved in 2000-01 and 2001-02, but may be prudent given the outturns in the last two years. The operating surpluses in 2002-03 and 2003-04 are higher than the recent average (by at least an additional 1 per cent each year). This appears to be because of improved operating positions across the sector, with income rising faster than expenditure in the last two years. This implies that a greater contribution is being obtained from new income, and that HEIs are attempting to be more cost effective.

Table 1 Income and expenditure

	Actual 2001-02 £M	Actual 2002-03 £M	Forecast 2003-04 £M	Forecast 2004-05 £M	Forecast 2005-06 £M	Forecast 2006-07 £M	Forecast 2007-08 £M
Total income	11,834	12,721	13,604	14,410	15,082	15,697	16,316
% increase on previous year		7.5%	6.9%	5.9%	4.7%	4.1%	3.9%
Total expenditure	11,777	12,545	13,474	14,381	15,023	15,627	16,221
% increase on previous year		6.5%	7.4%	6.7%	4.5%	4.0%	3.8%
Exceptional items	35	43	132	33	5	46	57
Surplus after depreciation of assets at valuation and tax	90	218	261	59	62	113	148
Surplus as % of total income	0.8%	1.7%	1.9%	0.4%	0.4%	0.7%	0.9%
Historical cost surplus	185	310	365	205	145	181	207
Historical cost surplus as % of total income	1.6%	2.4%	2.7%	1.4%	1.0%	1.2%	1.3%

27. In 2002-03 and 2003-04 the main increases in income arise from funding council grants and particularly tuition fees. Fee income from overseas, NHS, and postgraduate students is increasing at a faster rate than experienced in previous years. The forecasts indicate a slowing down of the main increases in income (especially funding council grants), while increased levels of pay inflation add pressure to expenditure during the period.

28. The sector-wide analysis disguises the range of results and forecasts between institutions. The number of universities and colleges forecasting deficits each year is shown in Table 2.

Table 2 Operating and historical cost deficits

	Number of HEIs with operating deficits (% of total HEIs)	Number of HEIs with historical cost deficits (% of total HEIs)
2001-02 Actual	47 (36%)	33 (25%)
2002-03 Actual	36 (27%)	22 (17%)
2003-04 Forecast	31 (24%)	18 (14%)
2004-05 Forecast	39 (30%)	18 (14%)
2005-06 Forecast	38 (29%)	22 (17%)
2006-07 Forecast	41 (32%)	25 (19%)
2007-08 Forecast	39 (30%)	29 (22%)

29. The forecasts show that there is a short-term improvement in the number of institutions recording deficits, but from 2005-06 the numbers start to increase again. Despite this, the median surplus level for the sector remains at around 1 per cent of total income. This means that the levels of deficits forecast reduce over the period. The graph at Annex C shows the trend in sector surplus and deficit levels over the forecast period (excluding variable fees).

30. HEIs need to generate surpluses to provide the positive cash flow for reinvestment and to fund future developments, to the extent that these are not met from capital funding. The actual level of such surpluses will vary, depending on the circumstances of individual institutions, but should be sufficient to demonstrate that full economic costs are being recovered, across all activities in aggregate, taking one year with another. The actual level required may reduce through the continuation of additional capital funding and actions taken to reduce costs.

Analysis of income trends

31. Total income and expenditure are forecast to increase broadly in line over the forecast period, although in 2003-04 and 2004-05 expenditure increases at a faster rate. This appears to be due to cost pressures on pay and the significant increase in depreciation charges. Over the five-year forecast period, the level of income increases by 19.9 per cent and total expenditure increases by 20.4 per cent.

32. Grants from the funding councils (HEFCE, the Teacher Training Agency and the Learning and Skills Council) are forecast to increase by 12.6 per cent over the period, with the main increases being in 2003-04 and 2004-05. The forecast increases take account of uplifts for inflation, and additional funding for medical intakes, additional foundation degrees awarded and other HEFCE grants already announced.

33. The forecast increase in all higher and further education (HE and FE) student numbers (headcount) over the period 2003-04 to 2007-08 is 174,945 (9.6 per cent), of which home and EC undergraduates account for 82,142. Table 3 shows a breakdown of the forecast increases in student numbers over the period.

34. The projections in Table 3 include both the student places already awarded through the annual exercise to allocate additional student numbers, and the additional numbers that HEIs hope to obtain. The income assumptions reflected in the forecasts for growth in HEFCE-funded student numbers, over and above those already awarded, imply growth of approximately 30,000 student places across the sector from 2005-06 to 2007-08.

35. There are significant variations in the growth plans of institutions across the sector. Twenty-seven institutions are forecasting growth of over 20 per cent in total student numbers over the period 2003-04 to 2007-08, contributing 29 per cent of the forecast growth in the sector. Within this group much of the growth relates to existing developments, such as new medical schools, and general growth in student numbers already allocated. Almost all institutions identify under-recruitment or lack of demand for student places as a major risk.

36. Total fee income is forecast to increase by 29 per cent over the period 2003-04 to 2007-08, with annual increases reducing from 8.5 per cent in 2003-04 to 5.2 per cent in 2007-08. The forecast increases show the same trend levels as forecast last year. The main

increases in fee income arise from postgraduate, part-time, overseas and NHS contract students. The sector is expecting fee income from full-time postgraduate students to increase by 36.3 per cent over the period, with student numbers forecast to increase by 19.5 per cent, which implies increases in postgraduate fees that are above inflation. The increases projected are greater than previous forecasts.

Table 3 Student number projections (headcounts)

	2003-04	2004-05	2005-06	2006-07	2007-08	Percentage increase over period
Home & EC full-time undergraduate	776,794	800,556	817,662	826,951	834,756	7.5%
Home & EC full-time postgraduate	81,082	86,981	91,149	94,446	96,877	19.5%
Home & EC part-time	599,672	597,315	611,346	625,222	639,576	6.7%
Overseas students	166,369	175,971	189,451	201,250	210,865	26.7%
NHS students	127,498	133,380	137,727	139,709	140,369	10.1%
Total HE students	**1,751,415**	**1,794,203**	**1,847,335**	**1,887,578**	**1,922,443**	**9.8%**
FE students	80,213	80,012	81,474	82,455	84,130	4.9%

37. Overseas fee income is forecast to increase by 44.1 per cent over the forecast period, from £1,125 million in 2003-04 to £1,621 million in 2007-08. This follows on from significant increases already seen in the sector: overseas fee income has already risen by 66 per cent, from £583 million in 1999-2000 to £966 million in 2002-03. During the period 2003-04 to 2007-08 overseas student numbers are forecast to increase by 26.7 per cent, with only relatively modest increases in fee rates being forecast.

38. Income from research grants and contracts is forecast to increase by 30 per cent from 2003-04 onwards. The average annual increase is 6 per cent, which is lower than actually achieved over the period 1998-99 to 2002-03, when the average was 9 per cent per annum. Many institutions have also included assumptions following the announcement of an extra £120 million from the Research Councils to contribute towards the full economic costs of the research projects they commission from 2005-06. Therefore the increase in income from research grants and contracts is greater towards the end of the period than at the beginning, which is the only income stream with this trend.

39. Following the 2002 and 2004 Spending Review announcements, institutions can now expect to receive an additional £120 million from 2005-06 rising to £200 million 2007-08, as increased contributions towards the full economic costs of the existing volume of Research Council projects. No assumptions of this additional £80 million increase have been made in the forecasts.

40. Other operating income (including income from residences and catering plus other services rendered) is forecast to increase by an average 3.6 per cent per annum. The forecast levels are lower than the actual increases achieved in 2001-02 and 2002-03, when increases in income averaged above 6 per cent each year.

41. Income from non-public sources is forecast to increase by 31.7 per cent between 2002-03 and 2007-08 (from £4,970 million to £6,545 million). By comparison, the forecast rate of increase for publicly funded activity is 26.0 per cent. Consequently, the dependence of HEIs on public funding is forecast to reduce slightly from 60.9 per cent to 59.9 per cent over the period for the sector as a whole.

42. The most significant movements in relation to diversity of income relate to funding council grants and overseas fee income. Over the period 2003-04 to 2007-08 the income from funding council grants is forecast to reduce from 38.7 per cent of total income to 36.3 per cent, despite a forecast increase in funding above inflation. At the same time, overseas fee income increases from 8.3 per cent of total income to 9.9 per cent. Other areas of income show relatively small changes over the period, and overall there are no material changes.

Analysis of expenditure trends

43. Staff costs are forecast to increase by 23.8 per cent over the period 2003-04 to 2007-08 (from £7,880 million to £9,757 million). In 2003-04 the sector is expecting staff costs to have increased by 7.2 per cent and in 2004-05 a rise of 7.3 per cent is forecast. The increases in future years are smaller and diminish each year, with a forecast rise of 4.4 per cent in 2007-08. These increases include pay awards, incremental drift, higher pension contributions and changes in staff numbers. The movement to a new single pay spine will add to the cost pressures at institutions over the next few years.

44. On average, pay inflation (including incremental drift) is forecast to be 4.4 per cent in 2003-04, reducing to 4 per cent per annum for the remainder of the period. The sector is thus exposed to the risk that pay inflation may be higher than forecast in future years. Staff numbers are forecast to increase by 6.3 per cent over the period (from 228,635 to 243,046) which, given the larger increase in student numbers, indicates that reductions in staff:student ratios are planned. Staff costs were equivalent to 57.6 per cent of total income in 2002-03, and over the forecast period the level will increase annually to 59.8 per cent by 2007-08.

45. Non-pay expenditure (other operating expenses) is forecast to increase by 13.7 per cent over the period, which averages at an annual increase of 3.6 per cent. As the increase in 2003-04 is expected to be 7 per cent, the increases in future years, and particularly 2005-06, seem relatively low and imply that institutions are expecting to continue to improve efficiency. The sector-wide analysis disguises the range of forecasts between institutions. Over the period, 34 HEIs are forecasting a real-terms reduction in non-pay expenditure, with nine of these expecting an actual reduction (before inflation) in expenditure. Improving efficiency to this extent, given the increases in income forecast, may prove challenging.

46. Depreciation charges are expected to increase from £581 million in 2002-03 to £787 million in 2007-08. The large increase is linked to the increase in fixed assets owned by institutions and the extensive capital investment plans across the sector (see paragraph 56).

The increased depreciation levels put pressure on the surplus positions across the sector, but this is in line with previous forecast levels.

47. In 2002-03 the sector was receiving more income from endowments and interest than it was paying out in interest charges. However from 2004-05 the sector is expecting to pay out more interest than it receives, due to the increase in borrowings (see paragraph 52) and the relatively low rates of return from investments.

Variable fees

48. When we sent out the request for financial forecasts (April 2004), the legislation on variable fees had yet to be passed. Following guidance from the DfES, we asked institutions to assume that student fees would only be maintained in real terms over the forecast period. However, we also asked institutions to indicate separately the additional income and associated expenditure relating to the introduction of variable fees in 2006.

49. Most institutions stressed that they had yet to come to a final decision on their fees policy, but most included an estimate of the financial impact. As already noted, this publication concentrates on the financial position of the sector excluding variable fees. At present, one of the main risks surrounding variable fees is that some institutions may not implement their fees policy effectively, and will then see a reduction in recruitment levels.

Balance sheet

50. The balance sheet for the sector as a whole is at Annex D. In aggregate, the sector is forecasting significant increases in the value of tangible fixed assets from £12,888 million (2002-03) to £16,612 million (2007-08). This is to be financed by cash generated from operations, increased capital grants and increases in borrowings. The availability of capital grants has increased the amount of capital expenditure being forecast by institutions, and in turn this sees the value of fixed assets held by HEIs increasing significantly over the period.

51. Net liquidity[1] has increased annually since 2001-02, and at the end of the 2002-03 financial year totalled a healthy £2,081 million. The sector is expecting a further increase in liquidity to £2,219 million by 31 July 2004, before fluctuating around £2,100 million for the remainder of the forecast period. The number of days that liquidity covers expenditure remains above 50 for the whole period, which is higher than forecast in previous years. The trend in liquidity is also reflected in the net current asset position.

52. At the end of July 2003 the sector had external borrowings totalling £2,432 million, and this is forecast to increase significantly to £3,591 million by 31 July 2008. This represents a substantial investment for the sector, the majority of which appears to be supporting capital infrastructure investment. In comparison to previous forecasts the sector is now projecting higher levels of borrowings, but given the current low interest rates the increased borrowings are affordable. The trends in borrowings and net liquidity are represented graphically at Annex E. The rise in the level of borrowings represents an increase from 18.9 per cent of total income at 31 July 2003 to 22.0 per cent by the end of the period.

[1] Current asset investments plus cash in hand/bank less bank overdrafts.

53. Since 1998-99 the level of external borrowings has been greater than that of net liquidity; however in 2004-05 the difference between the two will be over £1,000 million for the first time. By the end of the period, the level of borrowings is expected to be £1,500 million more than net liquidity. In spite of this, interest payable as a percentage of total income remains relatively constant. Therefore, unless interest rates rise significantly and for a sustained period, the increase in borrowings appears to be affordable.

54. As reported in previous years, the aggregate sector financial position masks a significant spread of financial strength, with a concentration of financial strength in a small number of mainly old universities. Similarly, borrowing is concentrated in a relatively few institutions (for example, at 31 July 2003, 49 per cent of borrowings by the sector were held by just 20 institutions). Thus, some institutions may be at or near the practicable limit of their borrowing capacity, while others could comfortably borrow more.

Cash flow

55. The cash flow forecasts for the sector are shown at Annex F.

56. Table 4 shows forecast levels of capital expenditure and how this is expected to be financed.

Table 4 Capital expenditure and financing

	Capital expenditure	**Asset sales**	**Capital grants**	**New borrowings**	**Net capital to be financed**	**Available funds from operating cash flow**
	£M	£M	£M	£M	£M	£M
2002-03 [2]	1,843	146	759	345	593	739
2003-04	1,941	302	986	526	127	522
2004-05	2,332	298	1,097	565	372	340
2005-06	1,648	131	650	572	295	493
2006-07	1,105	129	332	335	309	590
2007-08	870	128	232	282	228	614

57. Total capital expenditure during the period 2003-04 to 2007-08 totals £7,896 million across the whole sector. The forecast capital expenditure peaks during 2004-05 and then reduces significantly by 2007-08, reflecting the known availability of grants such as project capital. This shows that the availability of capital grants leads to an increase in capital expenditure rather than a substitution for other sources of finance.

58. The amount of capital expenditure forecast over the period 2002-03 to 2006-07 is £1,603 million more than forecast for the same period in 2003. This in turn was higher than the forecast in 2002, which implies that the sector is continuing to increase investment in its infrastructure in order to remain viable in the long term. Some institutions are also planning investment before the introduction of variable fees, as they see enhanced facilities as one area where they can achieve competitive advantage.

[2] Actual values for 2002-03.

Statement of financial strategy

59. We require institutions to provide a statement of financial strategy to accompany their forecasts, with supporting notes. These include a statement of the strategic context and the institution's financial strategy, as agreed by the governing body, that underpins the corporate plan, focusing on high-level financial objectives. The corporate planning statements have been reviewed alongside the financial forecasts to ensure consistency between corporate objectives and the HEIs' financial strategies. Comments on the corporate planning statements can be found in paragraphs 121 to 126.

Key risks

60. Institutions are required to provide an analysis of key risks faced during the planning period, and the specific actions likely to be taken to ensure continued financial viability. An analysis of these risks and mitigating actions identified by institutions shows that many are the same as in the previous two years.

61. This analysis shows that student recruitment and retention are overwhelmingly the major risks for the sector. As the forecast level of income from overseas students increases each year, there will be added risks. Under-recruitment of overseas students is now being highlighted as one of the main risks facing institutions across the sector. Although recruitment of home students remains a critical area for institutions, many are now highlighting changes in HEFCE funding methodology as a potential risk.

62. The other major risks relate to the pressure to make pay awards above the level of inflation, and failure to manage capital programmes. In the case of high salary increases, the onus is on institutions to manage this through their arrangements for recruiting and rewarding staff, and through balancing this against the requirement for efficiencies, or increasing revenues through recovery of full costs. Nevertheless, there is inevitably some trade off between managing the risk of high salary increases and the risk of not being able to recruit and retain well-qualified staff. The additional costs associated with the new single pay spine will only add to the risks faced by the sector. The third major area of risk (management of capital programmes) reinforces the need for good management practice in capital investment and project management.

63. The impact of variable fees has not, at present, been identified as a major risk for the sector, but the implementation of HEIs' policies on fees and bursaries could have detrimental consequences for their future viability. Most institutions are expecting a positive outcome from the introduction of variable fees, but some HEIs may not reap the same benefits as the majority of the sector. A potential fall in recruitment in 2006-07 is not expected by the sector overall, although some institutions feel more vulnerable than others.

Actions to ensure continued viability

64. We analysed HEIs' commentaries to identify the actions they have put in place, or intend to put in place, to ensure continued sustainability. The main actions, listed below, are in line with those highlighted by HEIs last year:

- control of staff costs
- control of non-pay costs

- growth in overseas student numbers
- growth in other operating income
- improvement in pricing/contributions to costs
- growth in student numbers
- estates developments/improved facilities
- implementation/consideration of collaborative opportunities.

65. The relatively narrow operating margins increase the impact of any changes in the key assumptions that underpin the forecasts. As in previous years, even a 1 per cent adverse change in assumed pay costs, non-pay inflation, or funding levels would have significant financial consequences for many universities and colleges. For example, a 1 per cent increase per annum in pay costs amounts to an additional £78 million in 2004-05, rising to a cumulative £379 million by 2007-08. A 1 per cent real-terms reduction in forecast HEFCE teaching grants per annum (from 2005-06) would see the sector's projected income fall by £111 million by 2007-08. Such changes would reduce (or even eliminate) the sector's forecast operating surpluses, though the impact would be reduced by any mitigating action. The introduction of variable fees is likely to increase the sustainability of the sector, at least in the short-term, although there is a risk that costs may start to rise quickly to match any additional income.

2004 annual monitoring and corporate planning statements

Overview

66. Until 2003, we requested annual operating statements from the HEIs we fund, which both reported on the use of special funding and gave us an update on overall strategic planning. Feedback from the sector suggested the need for greater clarity between the two sections. Consequently, from 2003 we requested, in parallel with the financial forecasts, two documents from each HEI:

a. Annual monitoring statement (AMS) – institutions are asked to report specifically on the use of HEFCE's strategic special funding initiatives and on race equality work.

b. Corporate planning statement (CPS) – institutions are asked to provide a general update on their progress against their corporate plan and strategic priorities.

67. These changes were driven by our need to strike a balance between our responsibility to secure accountability for the use of special funds, and our interest in the wider strategic planning of institutions in order to understand national trends and inform our advice to the Secretary of State. We aimed to be clearer about the purposes of requesting this information, particularly in relation to the special or discretionary funding distributed to institutions that is monitored through the AMS. We were also mindful of the need to avoid placing unnecessary burdens on institutions.

68. In April 2004, we issued HEFCE 2004/20 which asked institutions to provide their AMS and CPS along with their financial forecast by the end of July 2004. This year, for the first time, we provided an electronic template for each HEI on the HEFCE extranet, preloaded with the activities and targets they had submitted in last year's AMS return. This reduced the need for institutions to submit the same information more than once.

69. We compared the evidence in the AMS, in which institutions described the activities they intended to undertake in 2003-04, with the strategic funding we had allocated for those activities. We focused on the following key HEFCE strategic initiatives:

a. Widening participation – including allocations for widening access and improving retention, aspiration funding[3] and mainstream funding for students with disabilities.

b. Institutional funding under the Teaching Quality Enhancement Fund, for learning and teaching strategies.

c. Funding to support third stream initiatives – including the HE Reach Out to Business and the Community fund, the HE Innovation Fund, the HE Active Community Fund, and Business Fellowships.

d. Rewarding and Developing Staff in HE.

e. Research Capability Fund – this was the first year of monitoring for this fund.

[3] Aspiration funding was allocated to institutions with fewer than 80 per cent of their students from state schools, to help them do more to encourage applications from such students.

70. In addition, we requested information to enable us to monitor institutions' progress against their obligations under the Race Relations (Amendment) Act 2000. These are to eliminate unlawful racial discrimination, and to promote equality of opportunity and good relations between people of different racial groups. We have a statutory duty to monitor the impact of the Act on the HE sector.

71. We compared the evidence in the AMS with the activities that institutions said they would undertake in 2003-04, and with the strategic funding we allocated. For this part of the analysis we classified institutions' progress as 'good', 'satisfactory', or 'unsatisfactory'.

72. The analysis does reflect an element of judgement, because of the variation in institutions' reporting practices and the amount of evidence provided. To get as much consistency as possible, a cross-region 'benchmarking' exercise was carried out.

73. Where the AMS showed that institutions had not undertaken their intended activities, we told them that we might re-profile funds, or provide no further money under the relevant programme, or in extreme cases, might take back funding. We will follow up the very small number of cases where we have identified problems, to clarify the position with the institution and decide what action is appropriate.

74. We also asked institutions to use the AMS to update us about any changes to their plans for activities and targets for 2003-04 and 2004-05. Where institutions are proposing changes, we will check that their revised plans are reasonable.

75. Our analysis of the CPS covers the fit between the CPS and the institution's most recent corporate plan, an assessment of progress against previously identified strategic priorities during 2003-04, and an outline of strategic priorities for 2004-05.

Targets and accountability

76. Targets within this year's AMS have been concerned with undertaking specified activities supported by the funds allocated. It will continue to be for each HEI to determine its own targets within the context of information we disseminate about good practice.

77. Increasingly we need institutions to produce specific and measurable targets, and to provide evidence of the outcomes of projects, rather than simply describing activities and processes. In our discussions with institutions about their strategic planning, we will continue to emphasise the need for them to set targets linked to outcomes, and will encourage them to report against these targets in future AMSs.

78. The AMS is an important tool for us to monitor the performance and activities of HEIs in areas for which they receive special initiative funding. By asking HEIs to report across all strategic priorities in the same submission and only once a year, the AMS is intended to minimise the burden of accountability. As new funding streams have been developed, for example to improve research capability, where possible we have arranged for them to be monitored through the AMS.

79. We continue to evolve the framework for reporting, seeking to identify the minimum range of information that we need for monitoring and accountability, and collecting as much as possible through the AMS and CPS. Although much has been done to improve the AMS process, we believe that there is room for further improvement. In paragraphs 127 to 133 below, we outline our new approach to monitoring strategic funding in 2004-05.

Widening participation

80. The purpose of student-related additional funding for widening participation is to support the additional costs of provision for the students concerned; to support proven success in widening participation; and to provide an incentive for institutions to develop widening participation activity.

81. In October 2001, institutions submitted revised widening participation strategies, showing how they proposed to use the formula-based widening participation funding during the three-year period from 2001-02 to 2003-04. They were asked to include a three-year action plan, defining organisational and numerical targets as a basis for tracking progress.

82. In 2003 we said that we would issue a call for revised widening participation strategies and action plans from HEIs in autumn 2003 for submission in July 2004. However, this was put on hold while the proposals for the Office for Fair Access were being finalised. Therefore, institutions were asked to provide us with action plans for 2004-05 within the AMS template, which updated the information provided in 2003-04.

83. Formula-based funds include the widening participation allocation (formerly referred to as the 'postcode premium') and aspiration funding, which for 2003-04 amounted to £255 million and £6 million respectively.

84. We also provide funds to institutions to help them recruit and support students with disabilities (£10 million).

85. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 activities and targets** Institutions' achievement in 2003-04 (in terms of activities supported by the widening participation allocation and the achievement of targets) was judged to be either 'satisfactory' or 'good'. There were no cases where activities and progress were judged to be 'unsatisfactory'. However, there were a small number of cases (8 per cent) where we had specific concerns about progress (for example, slippage in plans or under-spend).

b. **2004-05 activities and targets** In most cases (92 per cent), the targets shown for 2004-05 reflected those previously set by the institution. In 83 per cent of cases we did not have specific concerns (such as about how SMART the targets were).

c. **Aspiration funding** All 23 institutions in receipt of the aspiration funding provided specific information about activities and targets for 2003-04. In all cases, institutions' achievements were judged to be either 'satisfactory' or 'good'. The majority (78 per cent) gave information on embedding the activity once the aspiration funding ends, and 61 per cent mentioned contributions of matched funding.

d. **Mainstream funding for disabled students** In most cases (96 per cent) institutions mentioned their work to improve provision for disabled students, and 80 per cent specifically mentioned use of mainstream funds for this purpose.

Learning and teaching

86. We provided £17 million in 2003-04 to promote the development and implementation of institutional learning and teaching (L&T) strategies. Funds are used to extend existing activities or to generate new ones, and to encourage other institutional resources to be directed at delivering L&T strategies. We also encouraged institutions to address a number of national priorities such as improving student employability and staff development.

87. Institutions were asked to submit new strategies and action plans during July 2002 for the three-year period 2002-03 to 2004-05.

88. We encouraged institutions to be specific in their L&T strategies and action plans about proposed activities, and to include both intermediate and final targets so that achievement could be objectively demonstrated. Each HEI was asked to set out in the AMS its progress against the targets and activities described in the L&T strategy submitted in 2002.When reviewing AMSs, therefore, we had specific information against which to monitor progress. Institutions were asked to highlight where plans had changed in the light of experience and the embedding of good practice.

89. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 activities and targets** In most cases (96 per cent), activities and targets reported for 2003-04 reflected proposals set out in institutions' 2002 L&T strategies. All institutions were judged to have made either 'satisfactory' or 'good' progress. In 95 per cent of cases we had no specific concerns.

b. **2004-05 targets and activities** In most cases (93 per cent), institutions' targets and activities for 2004-05 reflected those set out in the 2002 L&T strategy.

Business and the community

90. Ensuring that higher education is responsive to the needs of business and the wider community is an important strand of our aims and objectives. We are concerned to encourage and reward partnerships between HEIs and businesses; the transfer of knowledge and expertise; the development of employment skills; and a variety of interactions at local, regional and national levels in promoting the social economy.

Higher Education Reach-out to Business and the Community fund (HEROBC)

91. Institutions were asked to draw up a strategy for improving their interaction with business and the community, reflecting their mission, track record, and regional and national needs of business. They were asked to identify measurable outcomes from the activities supported through additional funding.

92. Our approach to HEROBC had a stronger competitive element than for other initiatives such as L&T and widening participation. Following the first round of bidding we made 87 awards, ranging from £25,000 to £1.1 million (including five collaborative projects). Over £60 million was made available between January 2000 and July 2003. HEROBC transitional

funding was allocated to these institutions from August 2003 to support activity up to July 2004. For the second round of HEROBC, over £22 million was made available between August 2000 and July 2004. HEIs are only required to report on single-institution HEROBC awards in the AMS. Collaborative awards are monitored outside the AMS process.

93. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 activities and targets** In most cases (94 per cent) the activities and targets described in the AMS reflected what was agreed for 2003-04. All HEIs were judged to be making either 'good' or 'satisfactory' progress. In 96 per cent of cases we did not have specific concerns (for example, about slippage in plans or under-spend).

b. **Impact of HEROBC funding** As HEROBC funding ended for the majority of institutions in summer 2004, there will shortly be a review of its overall impact and effectiveness. To inform this review, we asked institutions to provide a brief assessment in the AMS of the impact of HEROBC funding on the institution. Two-thirds provided this information.

Business Fellowships

94. Institutions who receive funding for Business Fellowships were asked to report on progress. The aim of this funding is to highlight the key role played by individuals within HEIs in promoting knowledge transfer and closer working with business. Mainstream academics are identified as Business Fellows who work to raise the academic credibility of the institution's interactions with business and catalyse further reach-out activities.

95. Eleven HEIs were successful in bidding for fellowships and receive £25,000 per year for four years from September 2001.

96. We monitor the activities of individual Business Fellows outside of the AMS process through reports at the outset and end of the four-year period of funding. Therefore, monitoring through the AMS is relatively light touch.

97. Our analysis of the AMSs shows the following:

a. All 11 institutions that have a Business Fellow reported in the AMS on their activities.

b. In all cases, the progress of the Business Fellow reflected broadly what was agreed for 2003-04.

c. In eight institutions, the funded activities listed for 2004-05 reflected those set out in the agreed business plan.

Higher Education Innovation Fund (HEIF) – round one

98. HEIF is the successor to HEROBC. Institutions were asked to draw up a strategy to support activities which will increase their capability to respond to the needs of business (including companies of all sizes and sectors and a range of bodies within the wider community), where this will lead to economic benefit. We encouraged them to specify

milestones, targets for delivery of specific services, and the management structures and other internal arrangements to be introduced to ensure the necessary action.

99. As with HEROBC, HEIF has a stronger competitive element than for other HEFCE initiatives. Strategies and details of activities cover the three-year period 2001-04. The total allocation for the three years is over £77 million, allocated to 73 institutions (excluding collaborative projects).

100. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 activities and targets** Most institutions (96 per cent) described targets and activities in their AMS which reflected what had been accepted for 2003-04. Nearly all (99 per cent) were judged to be making 'good' or 'satisfactory' progress. The number of cases where we had specific concerns (for example about slippage in plans or under-spend) was substantially lower this year (3 per cent) than last year (24 per cent).

b. **2004-05 activities and targets** In most cases (83 per cent), activities listed for 2004-05 reflected those set out in the business plan. In 78 per cent of cases it was felt that the target outcomes and activities listed were sufficiently specific to allow evaluation of progress against them next year.

Higher Education Active Community Fund (HEACF)

101. The HEACF is intended to enhance the role played by HEIs in the local community. It is part of the Government's wider Active Community initiative which aims to involve more people in voluntary activity in their local communities. HEACF is an entitlement fund, with allocations calculated for each HEI by formula.

102. Institutions were asked to draw up plans to encourage greater involvement in voluntary and community activities, covering the period February 2002 to August 2004. The total allocation for the period is almost £27 million.

103. In their plans, we asked HEIs to be specific about how they would use funding to generate new opportunities for volunteering and community involvement, and to include both the target number and type of volunteering opportunities. When reviewing AMSs, therefore, we had specific information against which to monitor progress.

104. Because of the relatively low levels of funding under the HEACF, monitoring through the AMS is comparatively light touch and concentrated on qualitative elements. Quantitative information (numbers of volunteering opportunities) is reported annually outside of the AMS process.

105. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 activities and targets** Most institutions (94 per cent) reported on activities and targets in the AMS that reflected what had been accepted for 2003-04. In 96 per cent of cases they were judged to be making either 'satisfactory' or 'good' progress, and in 93 per cent of cases we did not have specific concerns (for example about slippage in plans or under-spend).

b. **2004-05 activities and targets** In 84 per cent of cases, activities listed for 2004-05 reflected those set out in the original business plan.

Rewarding and developing staff

106. We provide special funding to support the development of human resources management within the sector. Funding amounted to £330 million over the three years 2001-02 to 2003-04. Funds were allocated formulaically to all HEIs, on receipt of an HR strategy that identified objectives, described how the money would be spent, and set specific targets.

107. Strategies were submitted in June 2001, and the majority were fully approved by the end of January 2003.

108. In recognition of the diversity of needs across the sector, we encouraged institutions to determine their own priorities and state how these would be tackled, although we did expect strategies to cover six specific priority areas.

109. Further funding of £167 million has been made available over two years from 2004-05, and the existing funds will be consolidated into the block teaching grant from that date. To release the new funds, HEIs were asked to revise their strategies, to demonstrate how they would meet the HR challenges set out by the Government in its White Paper, while continuing to address existing priority areas.

110. We requested information in the AMS on activities and expected outcomes for 2004-05 relating to the new funds for rewarding and developing staff, which would tie in with the revisions to the HR strategy, or the extended action plan submitted by HEIs in May 2004.

111. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 targets and activities** Most institutions (95 per cent) reported on activities and targets that reflected proposals in their HR strategy. All institutions were judged to be making either ’satisfactory’ or ’good’ progress. In 94 per cent of cases we did not have any specific concerns (for example about slippage in plans or under-spend).

b. **2004-05 targets and activities** In most cases (89 per cent), activities listed for 2004-05 reflected those set out in the HR strategy.

Race equality and diversity

112. The Race Relations (Amendment) Act 2000 (RRAA) places a statutory duty on us to monitor the impact of the Act on the HE sector. As part of this monitoring we said we would build the race equality and diversity dimension into the AMS through:

a. Asking HEIs to identify the race equality and diversity dimension of their strategic objectives, including widening access and participation, learning and teaching, and projects to reach out to minority groups and organisations.

b. Analysing the race equality and diversity dimension of operating statements and using the results to inform ongoing discussions between HEFCE regional consultants and HEIs.

113. In October 2002 we asked HEIs to send us their race equality policies and associated action plans for meeting their obligations. The Equality Challenge Unit issued confidential feedback on these to each HEI, and there was an expectation that every institution would meet the requirements of the RRAA by 31 July 2003. In May 2004 we carried out a selective review of the implementation of the RRAA with 70 HEIs, 75 per cent of whom were judged as progressing well. Institutions were reviewed against the legal and good practice standards which all public bodies are under.

114. In the AMS, institutions were asked to set out their strategic objectives for race equality and diversity, the outcomes of these objectives during 2003-04, and planned activity for the following year. We asked them to present this information as a brief statement of race equality and diversity outcomes in four sections of the AMS (widening participation, learning and teaching, business and the community, and rewarding and developing staff).

115. We reminded institutions that they should, as part of implementing the Act's requirements, be able to demonstrate some additional work or actions they have carried out as a response to the RRAA, to improve and promote race equality in their organisation. In our analysis of the AMS, we were looking for evidence of outcomes (what the institution had actually achieved or was working towards) rather than purely aspirational statements.

116. Our analysis of the AMSs shows the following:

a. Most institutions provided a summary of race equality and diversity priorities related to the work within each of their strategic objectives, as follows:

Widening participation	93 per cent
Learning and teaching	95 per cent
Business and the community	90 per cent
Rewarding and developing staff	96 per cent.

b. In 91 per cent of cases, evidence of progress in race equality and diversity was provided, and we did not have any specific concerns about reporting of actions against institutions' own targets.

Research Capability Fund

117. The Research Capability Fund was established to support research in emerging subject areas where the research base is currently not as strong as in more established subjects. Seven subject areas[4] were identified as eligible for this funding, on the basis that they had low proportions of staff in departments rated 4, 5 or 5* in the 2001 Research Assessment Exercise, and in 2002-03 had relatively high proportions of quality-related research funding attributable to 3a or 3b rated departments.

[4] The seven subjects are: art and design; communication, cultural and media studies; dance, drama and performing arts; nursing; other studies and professions allied to medicine; social work; and sports-related studies.

118. Funding was conditional on the submission of an acceptable strategy showing how the funds would be used over the three-year period 2003-04 to 2005-06, for each of the subjects for which funding was allocated.

119. We asked institutions to provide information in the AMS on the status of progress indicators and milestones for the period 2003-04 for each subject where capability funding was allocated (including where an institution had made multiple submissions for the same subject).

120. Our analysis of the AMSs shows the following:

a. **Progress against 2003-04 activities and targets** In 88 per cent of cases it was judged that milestones and progress indicators, specified for 2003-04, had been met. Achievement in 2003-04, in terms of progress against the original strategy submitted for each subject, was judged to be either ’satisfactory’ or ’good’ for 95 per cent of HEIs. In most cases (91 per cent) we did not have any specific concerns about progress (such as slippage in plans or under-spend).

b. **2004-05 activities and targets** In 47 cases (42 per cent), institutions had adapted milestones and progress indicators for 2004-05. However, in most of these cases (89 per cent) a satisfactory explanation was provided for how these changes will continue to develop research capability in the subject area.

Corporate planning statements

121. This was the second year that institutions were asked to submit a corporate planning statement (CPS).

122. The CPS is a general update of the institution's progress against its corporate plan and strategic priorities. We did not prescribe a format for the CPS. We said that we would accept documents that had already been produced for the institution's own purposes, and that the statement could be relatively brief (approximately four sides of A4).

123. We requested information on:

a. The institution's mission and strategic objectives.

b. An assessment of progress against previously identified strategic priorities during 2003-04 and an outline of strategic priorities and areas of activity for 2004-05.

124. We advised institutions that the CPS should cover broader issues than the AMS, and that we would welcome an update on activities across the full range of their strategic priorities as identified in their corporate plans. Information did not have to be limited to activities supported by HEFCE special or recurrent funding, but could include any area of strategic importance to the institution.

125. Information provided through the CPS is used:

a. As a basis for discussions with institutions about their priorities for strategic development and their financial position, and the support we may be able to give.

b. To supplement the financial forecast commentary, in order to monitor consistency and provide the context within which we assess institutions' financial forecasts.

c. To identify trends across the sector and so advise the Secretary of State for Education and Skills on the needs and development of HE.

126. Our analysis of the CPSs shows the following:

a. Most institutions (89 per cent) provided a mission and strategic objectives which corresponded with their most recent full corporate plan.

b. Institutions were asked to provide an assessment of progress during 2003-04 against their previously identified strategic priorities. We took a view of HEIs' progress against their activities and their own performance indicators. In 94 per cent of cases, institutions were judged to be making either 'satisfactory' or 'good' progress.

c. Most institutions (90 per cent) reported on significant activities across the full range of strategic priorities identified in their most recent full corporate plan. Similarly, in 87 per cent of cases the strategic priorities and areas of activity for 2004-05 reflected the strategic objectives set out in their plan.

d. In 95 per cent of cases the past progress and future priorities described in the CPS corresponded with related information in the AMS and the financial forecast commentary.

Revised approach to the AMS process for 2005

127. As noted in paragraph 79 above, we continue to evolve the framework for reporting, to identify the minimum range of information that we need for monitoring and accountability, and collecting as much as possible through the AMS and CPS. While much has been done to improve the AMS process, we believe that there is room for further improvement, particularly in relation to reducing the regulatory burden. We also want to take advantage of the increased assurance that we will receive for those HEIs that adopt the CUC code of governance (HEFCE 2004/40a).

128. Analysis of the information provided through the AMS over the past three years shows that in virtually all cases institutions are delivering the targets and outcomes that they agreed with us in their bids or strategies. Based on this evidence, coupled with more detailed discussions we have held with institutions, we feel that the risk that institutions are failing to meet their agreed targets and outcomes is generally low. Given this, we have revised our approach to the amount and nature of information that we will gather through the AMS.

129. Three principles underpin the new approach:

a. Reporting by exception.

b. Proportionality.

c. Focus on outcomes and the impact of funding.

130. Under the new approach for those HEIs that adopt the CUC code of governance (or intend to do so in the next 12 months) we will no longer require a report against individual activities and targets. Instead, institutions will be asked to provide assurance that they are delivering against the targets as originally outlined in their strategy or proposal documents. Institutions will only be required to report in more detail where there are problems with delivery or achievement of outcomes.

131. The new AMS should be formally signed off by the head of institution. This will act as an assurance that all funds reported on have been used for the intended purposes and that targets and outcomes are being delivered in accordance with agreed plans or strategies. We will also reserve the right to audit, and will do so on a sample basis or where we have concerns.

132. In our view, the new approach will make the monitoring process much lighter touch, minimising the reporting required from institutions and yet providing us with an assurance about institutions' use of public funding sufficient to fulfil our accountability role.

133. Further details on the new process will be provided in April. In the meantime, we invite comments on the new approach, which should be e-mailed to Davina Whyte (d.whyte@hefce.ac.uk), by 30 March.

List of abbreviations

AMS	Annual monitoring statement
CPS	Corporate planning statement
FE	Further education
HE	Higher education
HEACF	Higher Education Active Community Fund
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
HEIF	Higher Education Innovation Fund
HEROBC	Higher Education Reach-out to Business and the Community
HR	Human resources
L&T	Learning and teaching