January 2003/**02**

Core funding/operations

Report on outcomes

This report is for information

This report provides a summary of the higher education sector's annual operating statements (AOSs) for 2001-02, and gives financial projections for the sector covering 2001-02 to 2005-06. It is based on information provided by higher education institutions in July 2002. The AOS information relates to HEFCE special initiative funding in four areas: widening participation; learning and teaching; business and the community; rewarding and developing staff.

Outcomes of 2002 financial forecasts and annual operating statements

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

Outcomes of 2002 financial forecasts and annual operating statements

To	Heads of HEFCE-funded higher education institutions Heads of universities in Northern Ireland
Of interest to those responsible for	Finance, Planning, Management
Reference	2003/02
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Executive summary

Purpose

1. This report provides a summary of the higher education sector's annual operating statements for 2001-02, and gives financial projections for the sector covering 2001-02 to 2005-06. It is based on information provided by higher education institutions (HEIs) in July 2002.

Key points

Annual operating statements

2. This is the fourth year in which we have sought annual operating statements (AOSs) from institutions. Our analysis of the 2001-02 AOSs focused on four key areas of HEFCE strategic funding: widening participation; learning and teaching; business and the community; and rewarding and developing staff.

3. Our analysis of the 2001-02 AOSs shows that the great majority of institutions have demonstrated that they are making good progress with their plans in each of the areas of strategic special funding. Where the AOS 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.

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

Financial forecasts

5. The operating position is forecast to be at break-even for 2001-02 and 2002-03, with slight improvements in later periods but with operating surpluses remaining well below 1 per cent of total income after excluding exceptional items. (These forecasts do not take account of the infrastructure and cost of capital adjustments included by HEIs when they report under the Transparency Review to reflect the full cost of activities.)

6. Overall the forecasts appear to have been prepared on broadly reasonable assumptions, albeit for some institutions these may be challenging or unduly optimistic.

7. Universities and colleges are forecasting to keep income and expenditure in balance, but this is at a cost of, among other things, reducing staff:student ratios. Increases in income generation are forecast, and income from research grants and contract activity is forecast to increase by 6 to 7 per cent per year, but contribution rates (to indirect costs) are forecast to remain static at current levels. This is despite many institutions targeting this area for improvement, and indicates that this is likely to be a difficult area in which to secure financial benefits.

8. Institutions face a wide range of financial risks, which need to be managed. Those most often identified by institutions are:

a. Under-recruitment of UK and EU students, or failure to achieve recruitment targets.
b. Failure to achieve overseas recruitment targets.
c. Increases in salaries above inflationary uplifts.
d. Failure to manage capital programmes – delivery and funding.

9. Actions which institutions have identified to address the projected financial situation include:

a. Strategic change (including restructuring, reduction in size, merger or strategic alliance).
b. Change in academic provision and delivery.
c. Changes in resources and use of assets (including estate rationalisation).
d. Improvements in management information and management processes.
e. New strategies for costing, pricing and marketing.

10. The financial strength of the sector is satisfactory when viewed in aggregate, but a small number of HEIs are facing significant financial constraints.

11. The level of capital expenditure is forecast to be considerably higher than in previous periods, peaking in 2002-03. This strongly reflects the availability of capital grants such as the Joint Infrastructure Fund (JIF), the Science Research Investment Fund (SRIF) and project

capital, and is forecast to decline from 2004-05 onwards as these programmes come to an end.

12. These forecasts do not incorporate the additional capital grants for research announced following the 2002 Spending Review, which will enable the capital investment programme in support of research activity to continue. Continuation of capital funding streams for teaching will also be necessary if the required levels of investment are to be sustained.

Action required

13. None, this report is for information.

Annual operating statements

Overview

14. In April 2002 we asked higher education institutions to provide their AOS and financial forecast by the end of July 2002 (HEFCE 02/19). This is the fourth year in which we have sought AOSs. Our request asked HEIs to provide summary statements indicating their strategic direction and priorities for action in 2001-02, and their own assessment of their progress against strategic initiatives.

15. We expect institutions to produce annual operating statements for their own purposes. AOSs have also become the main way in which we monitor the outcomes of our major strategic funding programmes. Our request for the 2002 AOS gave institutions the option to either report through their own operating statements or complete a standard template. The majority of institutions filled out the template directly, while most of the remainder cross-referred to an AOS prepared for the institution's own purposes.

16. We compared the evidence in the AOS, in which the institutions described the activities they intended to undertake in 2001-02, with the strategic funding we allocated. For the purpose of this analysis we classified institutional responses under the key initiatives as satisfactory or unsatisfactory. Our analysis of the 2001-02 AOSs focused on the following key HEFCE strategic initiatives:

a. Widening participation (including the postcode premium, aspiration funding, administration costs funding and mainstream disability funding).

b. The institutional Teaching Quality Enhancement Fund (TQEF) funding for learning and teaching strategies.

c. Funding to support work with business and the community (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.

17. The proportions given in this analysis necessarily 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, HEFCE regional consultants held moderation meetings within their teams, and the AOS project team had a cross-regional benchmarking role.

18. In a small minority of cases institutions did not provide any evidence – or only provided limited information – about their progress in 2001-02, which may not actually reflect their performance. We are contacting these institutions to clarify the position.

19. Where the AOS shows that an institution has not undertaken its intended activities, we warned that we may re-profile funds or provide no further funding under the relevant funding programme, or in extreme cases take back funding.

Targets

20. Targets within this year's AOS have been concerned with the undertaking of specified activities supported by the funds allocated. Our presumption is that it will continue to be for each HEI to determine its own targets within the context of information we disseminate about good practice.

21. Increasingly we need institutions to produce specific and measurable targets, and to provide evidence of the ultimate outcomes of projects, rather than the achievement of activities and processes. In our ongoing discussions with institutions about their strategic planning we will continue to emphasise the need for institutions to set targets linked to ultimate outcomes, and to encourage them to report against these targets in future AOSs. As we introduce new initiatives, we are strengthening the expectation that clear and measurable targets must be set, and that they should include outcomes as well as processes.

Accountability

22. The AOS is an important tool to allow us to monitor the performance and activities of HEIs in areas where they receive special initiative funding. By asking HEIs to report across all strategic priorities in the same submission and only once per year, the AOS is intended to minimise the burden of accountability on HEIs. As new funding streams have been developed, for example for rewarding and developing staff in HE, we have, where possible, arranged for them to be monitored through the AOS. Although we welcome annual updates in the AOS on HEIs' strategic planning more generally, we only require them to report on the areas of activity where they receive HEFCE special initiative funding.

23. We intend to evaluate our use of the AOS in 2003-04 to ensure that it meets the recommendations of the Better Regulation Task Force report 'Higher Education: Easing the Burden', published July 2002.

Widening participation

24. The purposes of student-related additional funding for widening participation were to support the extra 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.

25. In October 1999 institutions provided initial three-year statements on their strategies for widening participation, including: plans for the additional formula funding allocated to widening participation; recruitment targets for under-represented groups; and targets for improvements in their retention. The format of the initial statement was not tightly prescribed. In 2001 we published HEFCE 01/36, 'Strategies for widening participation in higher education'. This report drew out examples of good practice in setting and implementing institutional widening participation strategies.

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

27. In 2001-02 formula-based widening participation funding consisted of the ‘postcode premium’ and the ‘aspiration funding’. The postcode premium is intended to recognise the extra costs to institutions of enabling students from disadvantaged backgrounds to succeed. Aspiration funding was made available for three years from 2001-02 to 2003-04 only to those institutions that have low proportions of students from state schools, in order that they can actively encourage more applications from those schools. Aspiration funding will be discontinued after this three-year period. A condition of funding is that institutions match aspiration funding from their own finances, and that they extend and embed the activities to encourage state school applications, beyond the funding period.

28. For the second year in 2001-02, we asked institutions to explain in their AOS how they had used mainstream funding for disability and additional funding for administration of various funds for student support.

29. Our analysis of progress in the widening participation area, as reported in the AOS, suggests:

a. Most institutions (90 per cent) are either fully or mostly achieving the activities and targets that they set for themselves in their revised strategies to deal with the postcode premium.

b. In a small minority (7 per cent) of cases, the AOS gave insufficient information to enable us to make a judgement about progress in widening participation in 2001-02. HEFCE regional teams are pursuing all cases where further information is required.

c. The reports of a very small minority of institutions (3 per cent) suggested a lack of progress against their widening participation plans. HEFCE regional teams will investigate the position further and determine what action is appropriate.

d. Of the 23 institutions in receipt of aspiration funding, 18 institutions are either fully or mostly achieving the activities and targets that they set for themselves in their revised widening participation statements.

e. In a few cases (five HEIs) the AOS either gave insufficient information to enable us to make a judgement about progress in using the aspiration funding in the year 2001-02, or indicated a lack of progress against their plans. HEFCE regional teams are pursuing all cases where further information is required, and institutions have been notified that aspiration funding for 2002-03 will not be released until we receive a satisfactory report on the first year’s funding.

f. As institutions' widening participation strategies span three years, in most cases we already held details of proposed activities for 2002-03. Most institutions were following the plan for which they bid, with minor refinements. In 9 per cent of cases, the activities and targets described for 2002-03 differed significantly from the bid. HEFCE regional teams will explore these cases to determine whether the proposed changes are acceptable or whether they are cause for concern.

g. In the small number of cases where information on proposed activities for 2002-03 had not previously been included in the institutions' strategy, they were asked to include it as part of their AOS. The majority (74 per cent) of institutions concerned included this information as requested. HEFCE regional teams are pursuing all cases where we still do not have a plan for 2002-03 widening participation activities.

h. The majority of institutions provided information on their mainstream disability funding and their administration costs funding in their AOS. Eighty-six per cent of HEIs reported on disability funding and 78 per cent reported on administration costs funding.

Learning and teaching – institutional funding

30. The purpose of our special funding in this area is to promote the development and implementation of institutional learning and teaching strategies. Funds are to support extending existing activities or generating new activities, and to encourage other institutional resources to be directed at delivering learning and teaching strategies. We also encouraged institutions to address a number of national priorities, such as employability and staff development (see HEFCE 99/48). In 2001 we published HEFCE 01/37, 'Strategies for learning and teaching in higher education', which is a guide to good practice in setting and implementing institutional learning and teaching strategies.

31. Strategies and details of activities cover the three-year period 1999-2000 to 2001-02. The total allocation is £48 million.

32. In their learning and teaching strategies and action plans, institutions were encouraged to be specific about proposed activities, and to include both intermediate and final targets whose achievement could be objectively demonstrated. When reviewing AOSs, therefore, we had specific information against which to monitor institutional progress.

33. Institutions were asked to submit new strategies and action plans during July 2002 for the three-year period 2002-03 to 2004-05. The total allocation is £50 million.

34. Our analysis of progress on learning and teaching strategies shows:

a. Most institutions (89 per cent) are fully or mostly achieving the activities and targets they had set for themselves for 2001-02. Only a small number (10 per cent) provided insufficient information to enable us to form a view on progress.

b. A few institutions (1 per cent) had fallen behind in their plans and we will have discussions with them.

c. As this is the final year of the first cycle of learning and teaching funding we did not expect institutions to provide details of activities in 2002-03. This is because the information has already been included in the revised strategies and action plans we received during July 2002.

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

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

36. Our approach to HEROBC had a stronger competitive element than for other special initiatives such as widening participation. Following the first round of bidding, we made 87 awards ranging from £25,000 to £1,100,000, including five collaborative projects; over £60 million was made available between January 2000 and July 2003. In the second round of HEROBC funding, we made 50 awards ranging from £100,000 to £1,100,000, including 10 collaborative projects. For the second round over £22 million was made available between August 2000 and July 2004. Institutions are only required to report on single-institution HEROBC bids in the AOS. Collaborative awards are monitored outside of the AOS process.

37. Our analysis of the AOSs shows:

a. Most institutions (90 per cent) provided sufficient information for us to form a view about their performance. The majority of institutions (80 per cent) have fully or mostly achieved the activities and targets that they had set for themselves for 2001-02.

b. A small minority of institutions (4 per cent) had fallen behind in their plans and we will have discussions with them.

c. HEFCE regional teams will follow up cases where there is insufficient information, and will have detailed discussions with all institutions that have fallen behind in their plans to determine what action is appropriate.

d. As institutions' plans span four years, we already held details of proposed activities for 2002-03. Most institutions were following the plan for which they bid, with minor refinements. In 13 per cent of cases, the activities and targets described for 2002-03 differed significantly from the bid, and HEFCE regional teams will explore these cases to determine whether the proposed changes are acceptable or whether they are cause for concern.

Business Fellowships

38. The purpose of our special funding of Business Fellowships 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 will raise the academic credibility of the institution's interactions with business, and catalyse further reach-

out activities. As with the HEROBC initiative, Business Fellowships have a stronger competitive element than initiatives for widening participation, learning and teaching, and rewarding and developing staff.

39. Institutions were asked to draw up plans, which nominated one individual per institution for a fellowship. Twelve HEIs were successful in bidding for Business Fellowships, and are receiving £25,000 per year for four years, from September 2001.

40. Our analysis of progress shows:

a. A majority of institutions (73 per cent) were fully or mostly achieving the activities and targets they had set for themselves from September 2001 to July 2002. Only two institutions provided insufficient information to enable us to form a view on progress.

b. As institutions' plans covered a four-year period we already held details of proposed activities for 2002-03. Most institutions were following the plan for which they bid.

c. HEFCE regional teams will follow up these cases where there is insufficient information, and will have detailed discussions with the institutions to ensure we receive further information to enable us to form a view on progress.

Higher Education Innovation Fund (HEIF)

41. 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 in the wider community), where this will lead to identifiable economic benefit. The strategies were encouraged to specify milestones, targets for delivery of specified services, and the management structures and other internal arrangements to be introduced to ensure the necessary action.

42. The 73[1] institutions funded in 2001-02 started to receive funding between December 2001 and April 2002. When making judgements on performance, we therefore took into account the institutions' different starting points.

43. As with the HEROBC initiative, HEIF has a stronger competitive element than the widening participation, learning and teaching, and rewarding and developing staff initiatives. Strategies and details of activities cover the three-year period 2001-04. The total allocation is over £77 million.

44. Our analysis shows:

a. The majority of institutions (76 per cent) have fully or mostly achieved the activities and targets that they had set for themselves for 2001-02. This is particularly impressive given that it is a new initiative.

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[1] This figure excludes collaborative bids which are monitored outside the AOS process.

b. Most institutions had provided sufficient information for us to form a view about their performance (85 per cent).

c. HEFCE regional teams will follow up cases where there is insufficient information, and will have detailed discussions with all institutions who have fallen behind in their plans to determine what action is appropriate.

d. Institutions' plans span three years, so we already have details of proposed activities for 2002-03. Most institutions were following the plan for which they bid. In 7 per cent of cases, the activities and targets described for 2002-03 differed significantly from the bid, and HEFCE regional teams will explore these cases to determine whether the proposed changes are acceptable or whether they are cause for concern.

Higher Education Active Community Fund (HEACF)

45. Institutions were asked to draw up plans to encourage greater involvement in voluntary and community activities. Funds are to support the development of links between HEI staff and students and the wider community. We encouraged institutions to specify targets for the number and type of volunteer opportunities.

46. Plans cover the period February 2002 to July 2004. The total allocation for the period is almost £27 million.

47. In their plans, institutions were encouraged to be specific about how funding will be used to generate new opportunities for volunteering and community involvement, and to include both the target number and type of volunteer opportunities. When reviewing AOSs, therefore, we had specific information against which to monitor institutional progress.

48. Our analysis shows:

a. The majority of institutions (70 per cent) have fully or mostly achieved the targets and activities described in their business plan up to July 2002.

b. In some cases (27 per cent), the AOS gave insufficient information to enable us to make a judgement about progress up to July 2002. HEFCE regional teams will follow up these cases, and will have detailed discussions with all institutions that have fallen behind in their plans to determine what action is appropriate.

Rewarding and developing staff

49. We are providing special funding to support the development of human resources (HR) 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.

50. Strategies were submitted in June 2001, and were assessed as either fully developed ('full') or 'emerging'. Those institutions that submitted strategies which were assessed as emerging were asked to submit full strategies by June 2002. HEFCE 02/14, 'Rewarding and

developing staff in higher education', described examples of good practice in setting HR strategies.

51. In the AOS 2002, institutions were asked to report their progress in undertaking the activities and achieving the targets identified in the spending plans for the first year of their HR funding.

52. Our analysis of the AOSs shows:

a. Most institutions (81 per cent) are either fully or mostly achieving the activities and targets that they set for themselves in their plans for 2001-02. This is a good result, considering the fact that this is the first year of our special HR funding, and that many institutions are implementing an HR strategy in this form for the first time.

b. In a minority (16 per cent) of cases, the AOS gave insufficient information to enable us to make a judgement about progress. HEFCE regional teams are pursuing all cases where further information is required.

c. The reports of a small minority of institutions (3 per cent) suggested a lack of progress against their plans for HR. HEFCE regional teams will investigate the position further and determine what action is appropriate.

d. As institutions' strategies span three years, we already held details of proposed activities for 2002-03. Most institutions were following their original plan, with minor refinements. In 5 per cent of cases, the activities and targets described for 2002-03 differed significantly from the strategy, and HEFCE regional teams will explore these cases to determine whether the proposed changes are sensible or whether they are cause for concern.

Other areas of activity

53. For the first time in 2002, we did not invite institutions to include information in their AOS on other areas of institutional activity such as governance, research, estates, and regional and international activities. As the number of special funding initiatives monitored through the AOS has grown, we feel that the burden on HEIs of including information on these other areas of activity would be too great to justify the request of such information. Nevertheless, where institutions have continued to provide information in their AOS on activities and targets outside those funded by our strategic funding initiatives, HEFCE regional teams have studied the information, and will use it to update and supplement their understanding of the HEI's strategic planning.

Financial forecasts

Income and expenditure

54. These forecasts, as in previous years, were prepared on assumptions reflecting the current funding announcements and the prevailing general economic climate. This can lead to changes in forecasts between years. The 2002 forecasts take account of the outcome of the year 2000 Spending Review. They do not take account of announcements made to date regarding funding of research activity following the 2002 Spending Review, since these announcements were made too late to be reflected in these forecasts and much of the detail will not be known until January 2003. Nevertheless, institutions will have been aware of the Government's target for 50 per cent participation by those aged under 30 by 2010, and some HEIs may have built in modest assumptions about the extent to which they can contribute to this target. However, most institutions will be awaiting clarification of the funding to support the growth in participation rate before determining their medium-term plans for growth in student numbers.

55. The forecasts show that the outturn for 2001-02 is now forecast to be slightly better than forecast in July 2001, but that there is a deterioration in the forecast outturn for 2002-03 compared with the forecast provided in July 2001. This reflects the increased financial pressure expected this year. Forecasts for subsequent years show a small improvement on previous forecasts. A time series from 1994-95 of forecasts and actual results is at Annex A.

56. The forecast income and expenditure position for the sector as a whole is at Annex B, and is summarised in Table 1. This shows that total income for the sector is forecast to grow by 26 per cent over the five-year period 2001-02 to 2005-06. Forecast historical cost surpluses fluctuate around 1 per cent of income per year over the forecast period.

Table 1: **Actual and forecast income and expenditure**

	Actual 1999-2000	**Actual 2000-01**	**Forecast 2001-02**	**Forecast 2002-03**	**Forecast 2003-04**	**Forecast 2004-05**	**Forecast 2005-06**
	£M	£M	£M	£M	£M	£M	£M
Total income	10,465	11,069	11,585	12,237	12,796	13,280	13,799
% increase		5.8%	5.5%	5.6%	4.6%	3.8%	3.9%
Total expenditure	10,370	11,100	11,598	12,250	12,754	13,213	13,711
% increase		7.0%	5.9%	5.6%	4.1%	3.6%	3.8%
Surplus after depreciation of assets at valuation and tax	125	44	13	(10)	143	109	94
Surplus as % of total income	1.19%	0.04%	0.10%	(0.09)%	1.10%	0.81%	0.67%
Historical cost surplus/deficit	204	138	106	63	271	182	141
Historical cost surplus as % of total income	1.95%	1.25%	0.92%	0.51%	2.11%	1.37%	1.02%
Exceptional items		77	26	3	101	41	6

57. These projected levels of surplus are significantly affected by exceptional items – mainly gains or losses on property transactions. These show that the underlying operating position is forecast to continue to be weak, with the sector as a whole operating at no better than break-even. The impact of exceptional items on operating and historical cost results is particularly significant in 2003-04, and comprises significant sums arising from five institutions almost entirely relating to gains on property transactions resulting from major estate rationalisation – usually campus disposals. The other significant items relate to the sale of intellectual property rights and sale of a 'spin-out' company.

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

59. Universities and colleges 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 a surplus will vary, depending on the circumstances of individual universities or colleges. Across the sector we have previously assessed this as being in the region of 3 per cent to 4 per cent of total income. It should be possible to operate on tighter margins, provided capital funding continues at levels sufficient to meet reinvestment requirements.

Table 2: **Actual and forecast surpluses and deficits**

	Number of HEIs forecasting operating deficits	**Number of HEIs forecasting historical cost deficits**
2000-01	47 (35%)	35 (26%)
2001-02	55 (41%)	35 (26%)
2002-03	60 (45%)	35 (26%)
2003-04	44 (33%)	24 (18%)
2004-05	39 (29%)	21 (16%)
2005-06	33 (25%)	22 (16%)

60. These figures show a small reduction in the numbers of institutions forecasting operating deficits in 2000-01 to 2002-03 compared with last year's forecasts. The graph at Annex C shows the trends in sector surplus levels over the forecast period.

Analysis of income trends

61. Total income and total expenditure are forecast to increase broadly in line over the forecast period, with increases of 5.6 per cent in 2002-03 reducing to 3.8 per cent and 3.6 per cent respectively by 2005-06. Both income and expenditure increase by around 19 per cent over the five-year forecast period.

62. Forecast increases in Funding Council grants are 5.3 per cent in 2002-03 reducing to 1.2 per cent in 2004-05, before increasing to 2.6 per cent in 2005-06 or 12.5 per cent over the

five-year period. These take account of inflation growth, and reflect more conservative forecasting for the period beyond 2003-04 for which details of funding levels are still to be announced.

63. The forecast increase in home and EU undergraduate student numbers (headcount) over the five-year forecast period is 137,500 (11.1 per cent), while the forecast increase in all student numbers (including overseas students and all levels of study) is 174,000 (12 per cent). These projections of student numbers include the student places already allocated for future years through the annual exercise to allocate additional student numbers, and include Teacher Training Agency (TTA) student numbers. The income assumptions reflected in the forecasts for growth in HEFCE-funded student numbers, over and above those already allocated, imply projected growth of 74,500 student places across the sector from 2003-04 to 2005-06. This appears conservative given the Government's 50 per cent participation target by 2010, but reflects the fact that most institutions are unlikely to have determined their plans for expansion of student numbers at this stage, and will be awaiting the Government's confirmation of the funding to support the expansion.

64. Fee income is forecast to increase by 28 per cent over the period 2001-02 to 2005-06, with annual increases reducing over that period from 7.7 per cent in 2002-03 to 4.9 per cent in 2005-06. Overseas fee income is forecast to increase by 40 per cent over the forecast period (from £750 million to £1,052 million). Overseas student numbers are forecast to increase from 124,600 to 155,900 (25 per cent) over the same period but with relatively modest increases in fee rates. This is likely to continue to be a competitive market, and these increases may be difficult to secure.

65. Income from research grants and contract activity is forecast to increase by 28 per cent from 2001-02 onwards, or between 6 and 7 per cent per year. The contribution rates (to indirect costs) are forecast to remain static at current, relatively low levels, throughout the forecast period. This indicates that institutions are continuing to expand the volume of activity but without apparently securing the benefits of improved costing and pricing strategies to move towards full cost recovery. This is despite the fact that many institutions are targeting costing and pricing as an area for improvement. This suggests that while institutions may be focusing effort to improve contribution levels, it is a difficult area to secure financial benefits. Nevertheless, the contribution rates on Research Council sponsored activity should improve following the announcement in the 2002 Spending Review of additional funding to be available from 2005-06 to increase Research Council contributions in respect of existing levels of research.

<u>Analysis of expenditure trends</u>

66. Staff costs are forecast to increase by 20 per cent over the period 2001-02 to 2005-06 (from £6,698 million to £8,074 million), with increases of 5.7 per cent in 2001-02 and 6.2 per cent in 2002-03 reducing to 4.4 per cent in 2005-06. (This includes pay awards, incremental drift, increases in National Insurance and changes in staff numbers.) On average, pay inflation is forecast to be 3.5 per cent in the early years of the forecast period, but forecast to reduce to 3 per cent for the later years. This implies that the sector is exposed to the risk that actual pay inflation may be higher than forecast in the later period. Staff numbers are forecast to increase by 3 per cent over the period (from 218,000 to 224,800). Given the increases in

student numbers, this indicates that further reductions in staff:student ratios are planned. Staff costs represent 57.8 per cent of total expenditure and are forecast to increase marginally over the forecast period.

67. Non-pay expenditure is forecast to increase by 4.2 per cent in 2002-03, but by only 2.6 per cent in the two subsequent years – broadly in line with expected inflation. Again, this indicates that universities and colleges are expecting to have to continue to deliver efficiencies despite the increases in activity levels.

68. Overall, the forecasts appear to have been prepared on broadly reasonable assumptions, albeit for some institutions assumptions may be challenging and unduly optimistic.

Transparency Review

69. These forecasts reflect expected income and expenditure over the forecast period. They do not take account of the infrastructure and costs of capital adjustments included by HEIs when they report under the Transparency Review. Those data take the financial accounts as their start point, and then add the infrastructure and costs of capital adjustments to reflect the full costs of activities.

Statement of financial strategy

70. We ask institutions to provide a statement of financial strategy to accompany their forecasts, together with supporting notes. These include a statement of strategic context and the institution's financial strategy, as agreed by the governing body, which underpins the corporate plan, focusing on key high-level financial objectives. In addition, institutions are required to provide an analysis of the key risks faced during the planning period, and an assessment of the specific actions taken to ensure continued financial viability.

Key risks

71. In this year's return the information requested on risk assessment was a more explicit requirement.

72. Key risks identified by institutions and the typical actions to mitigate them are summarised in Table 3.

Table 3: **Key risks and examples of actions to mitigate risks**

Risk	% of HEIs	Typical mitigating actions
Under-recruitment of UK/EU students or failure to achieve recruitment targets	70%	New marketing strategy New approach to managing recruitment through Clearing Cautious forecasting of student numbers Improved management information or early warning systems
Increases in salaries above inflationary increases	51%	Process reviews to improve efficiency Redundancy/ early retirement schemes Vacancy control processes
Failure to manage capital programmes – delivery and funding	48%	Review of estates and facilities strategies Project management enhancements Improved project appraisal and investment appraisal Reporting and oversight by senior management Rigorous tendering and contracting processes
Failure to achieve overseas recruitment targets	47%	As for UK/ EU recruitment Targeting certain markets Managing spread of overseas markets
Failure to achieve research income targets	30%	Actions to address pricing of contracts and recovery of full costs Focus on applied or consultancy-type research Planning for next RAE
Failure to recruit well-qualified staff	22%	Research opportunities and incentives Relocation packages

73. Table 3 shows that student recruitment and retention is by far the most prevalent risk for the sector. This is particularly pertinent in the context of the targets for widening participation.

74. The other major risks relate to the pressure to make pay awards above the level of inflationary increases, and failure to manage capital programmes. In the case of high salary increases, the onus is on institutions to manage the issue through their arrangements for recruiting and rewarding staff, and through balancing salary costs against the requirement for efficiencies, or increasing revenues through recovery of full costs. Nevertheless, there is inevitable conflict between the management of the risk of high salary increases and the actions necessary to manage the risk of not being able to recruit and retain well-qualified staff.

Actions to ensure continued viability

75. HEIs' commentaries on the actions they have taken, or intend to take to ensure continued viability, have been analysed to identify the main areas of action. A summary of the actions most commonly identified by institutions is shown in Table 4.

Table 4: **Analysis of actions to ensure continued viability**

Actions identified	Percentage of institutions
Growth in student numbers	45%
Growth in research income/activity	31%
Growth in other income streams	46%
Improved pricing/contributions	28%
Reductions in staff numbers	40%
Control of staff costs	54%
Control non-pay costs	56%

76. Further analysis of information on the main actions to ensure continued viability cited by institutions in their commentaries provides the following examples, which are summarised under five headings.

a. Strategic change:
   - strategic review and restructuring
   - significant reduction in size
   - merger or strategic alliance – including with further education (FE) providers to create new access routes for progression from FE to HE.

b. Changes in academic provision and delivery:
   - review of academic portfolio against a set of indicators, including financial viability
   - review of subjects/courses with low demand; closure of non-viable programmes
   - curriculum re-design to focus on demand-led niche markets
   - restructuring of academic departments
   - develop innovative learning and teaching strategies to preserve student experience
   - growth of FE franchise activity
   - improved standards through learning and teaching strategy.

c. Changes in resources and use of assets:
   - reductions in staff numbers, early retirement schemes, increases in staff:student ratios, internal restructuring
   - estate rationalisation, campus closure or consolidation, site disposals
   - outsourcing of student residences or catering services
   - improved asset utilisation, space efficiency and occupancy
   - exploitation of intellectual property
   - reduce or postpone maintenance and/or capital expenditure.

d. Changes in management information and management processes:

- improvement of cost/spending controls and budgeting
- improved financial modelling
- activity-based budgeting and reporting, improved responsibility for and ownership of budgets
- changes to resource allocation models
- new finance and student systems, with improved controls and reporting
- improved working capital management
- improve procurement processes
- review and restructuring of loan portfolio
- benchmarking – internally, and with peer group institutions.

e. New strategies for costing, pricing and marketing:

- development of costing and pricing policies and use of Transparency Review data to inform financial strategy
- renegotiation of contract terms and improved contributions on NHS contracts
- target minimum overhead rates set for research contract activity
- student residences charges increased above the rate of inflation
- increases in overseas student fees
- refined and enhanced marketing strategies.

77. The relatively low level of operating margins increases the impact of changes in the key assumptions that underpin the forecasts. As in previous years, even 1 per cent adverse changes in pay increases, non-pay inflation, or funding levels from those assumed in the forecasts, would have significant financial consequences for many universities and colleges. Any such adverse changes would just about eliminate the sector's forecast operating surpluses, although their impact could be reduced to the extent that compensatory action is both possible and is taken.

Balance sheet

78. 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 fixed assets (from £10.7 billion to £13.9 billion) over the period. This is to be financed by cash generated from operations, increased capital grants (such as SRIF) and increases in borrowings.

79. Net liquidity is forecast to reduce by £300 million from around £1.4 billion at July 2002 to £1.1 billion at July 2003, then to remain at this level until 2005-06 when an increase is forecast. This trend is reflected in the net current asset position, and is equivalent to a decline in the number of liquidity days from 47 to 33 over the same period. By contrast, external borrowings are forecast to increase significantly – from £2.2 billion at July 2002 to £2.9 billion at July 2004. This represents an increase from 19 per cent of income at July 2001 to 22.5 per cent of income at July 2004. Combined with the reduction in liquidity during the same period, this represents a substantial investment for the sector, the majority of which appears to be supporting capital infrastructure investment. These trends are represented graphically at Annex E.

80. As reported in previous years, the aggregate sector financial position masks a significant spread of financial strength, with concentration of the financial strength in a small number of mainly old universities. Similarly, borrowing is concentrated in a relatively few institutions, while many institutions have no borrowings. Nevertheless, some universities and colleges are operating within severe financial constraints.

Cash flow

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

82. Table 5 shows the forecast levels of capital expenditure and how these are forecast to be financed.

Table 5: **Actual and forecast capital expenditure and financing**

	Capital expenditure	**Asset sales**	**Capital grants**	**New borrowing**	**Net expenditure to be internally financed**	**Available funds from operating cash flow**
	£M	**£M**	**£M**	**£M**	**£M**	**£M**
2000-01[2]	1,195	161	460	248	326	386
2001-02	1,294	20	584	269	421	426
2002-03	2,192	132	1,074	496	490	215
2003-04	1,457	215	627	367	248	376
2004-05	742	95	318	132	197	453
2005-06	510	57	197	81	175	510

83. The capital expenditure forecasts peak during 2002-03 then reduce more significantly from 2004-05 onwards, strongly reflecting the availability of capital grants such as JIF, SRIF and project capital. This shows that the availability of capital grants leads to an increase in capital expenditure rather than substituting for other sources of finance. The additional capital grants for research announced following the 2002 Spending Review are not reflected in these forecasts, but will enable the sector's capital programme in support of research activity to continue beyond 2003. However, without equivalent continuation capital funding streams for teaching, the sector will continue to be under significant pressure to sustain the necessary investment levels.

84. The only alternative sources of finance are additional borrowings, asset sales or increased cash generation from operations. However, as indicated above, external borrowings are already forecast to increase significantly in the period. With only limited surpluses forecast, there is unlikely to be capacity to service further increases in borrowings without an improvement in the recurrent position.

[2] Actual values for 2000-01

List of abbreviations

AOS	Annual operating statement
EU	European Union
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
JIF	Joint Infrastructure Fund
SRIF	Science Research Investment Fund