March 2016/04

**Issues paper**

This report is for information

This report provides an overview of the financial health of the HEFCE-funded higher education sector in England. The analysis covers financial results for the academic year 2014-15, as submitted to HEFCE in December 2015.

# Financial health of the higher education sector

## Financial results and TRAC outcomes 2014-15



HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

# Financial health of the higher education sector: Financial results and TRAC outcomes 2014-15

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|---|---|
| To | Heads of HEFCE-funded higher education institutions |
| Of interest to those responsible for: | Audit, Estates, Finance, Governance, Management, Planning |
| Reference | 2016/04 |
| Publication date | March 2016 |
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## Executive summary

### Purpose

1. This report provides an overview of the current financial health of the HEFCE-funded higher education sector in England. This does not include directly funded further education or other colleges, or alternative providers of higher education. The analysis covers financial results for the academic year 2014-15, as submitted to HEFCE in December 2015, as well as the outcomes from the sector's Transparent Approach to Costing (TRAC) reporting for 2014-15, as submitted to HEFCE in January 2016.

2. The report is being published to provide universities and higher education colleges with feedback on their financial performance in 2014-15. It also provides other stakeholders with information about the current financial health of the HEFCE-funded sector. This report focuses on the financial results for 2014-15. For a more detailed assessment of the future financial sustainability of the sector, please see our November 2015 report 'Financial health of the higher education sector: 2014-15 to 2017-18 forecasts' (HEFCE 2015/29).

### Key points

#### Financial results

3. The sector's financial results for 2014-15 show a sound financial position overall. At sector level, the financial outturn improved on the results reported in 2013-14 and those projected by HEIs in July 2015. However, there is an increasingly significant variation in the financial performance of individual institutions across the sector.

4. In 2014-15, the sector reported operating surpluses of £1.6 billion, equivalent to 5.8 per cent of income. These were £608 million higher than surpluses reported in 2013-14 (which were equivalent to 3.9 per cent of income), and 50.7 per cent higher than the levels projected by the sector in July 2015. This improvement is largely attributable to a number of HEIs recognising one-off Research and Development Expenditure Credits (RDEC) from HM Revenue and Customs (HMRC) in their financial accounts increasing their surpluses for this year.

5. The RDEC scheme was established by Government in 2013 to offer tax incentives to large companies to encourage greater investment in research and development. While this measure

has since been amended so that universities and charities are unable to claim RDEC in respect of expenditure incurred on or after 1 August 2015, a number of institutions have made claims to HMRC for eligible expenditure incurred in the period 2012-13 to 2014-15.

6. Following an analysis of the latest financial accounts, submitted as part of the annual accountability process, we estimate that £436 million of the increased operating surpluses reported in 2014-15 is attributable to RDEC claims. Additional claims for eligible expenditure in the qualifying period are also likely in 2015-16 and we expect to see these reflected in the next set of financial forecasts due to be submitted to us in July 2016. This scheme is not likely to be recurring in future years so this is a one-off financial benefit to the sector reflecting its significant investment in research and development.

7. Excluding RDEC, operating surpluses were £172 million higher than reported in 2013-14. The improvement in the underlying financial outturn was partially attributable to higher levels of fee income from overseas students, which at £3,583 million were £267 million higher than reported in the previous year and £79 million more than forecast in July 2015. There was also a higher level of income from the sector's other income streams, such as residences, catering and other operating income.

### Transparent Approach to Costing (TRAC)

8. Although the sector reported higher surpluses in 2014-15, the latest TRAC submissions from higher education institutions (HEIs) show that, in the medium to long term, the sector needs to generate larger surpluses to make progress towards covering the full economic costs of all its activities and remain financially sustainable. This includes the replacement of buildings and equipment as necessary to sustain high-quality provision.

9. Our analysis of provisional TRAC data for 2014-15 shows that the sector's surpluses on non-publicly funded teaching and other activities are insufficient to support the shortfall in the recovery of the full economic costs of the sector's research activity. Excluding exceptional RDEC income, this shortfall came to £2.8 billion. Across all activities, the sector reported a sustainability gap (the difference between the level of surplus achieved by the sector and the level required to cover its full economic costs) of £522 million. This is an improvement on the previous year when the gap was £883 million (3.5 per cent of income), but has been assisted by the injection of RDEC income. Without RDEC, the gap is £860 million, equivalent to 3.2 per cent of income.

10. Without increased surpluses and continued government support, there is a risk that the sector will be unable to deliver the scale of investment required to meet rising student expectations, build capacity for growth and ensure that the sector can remain internationally competitive. Government support also fosters confidence among others to continue to invest in the sector, including banks' willingness to lend money, although the sector's capacity to lever in funding from other sources, including additional borrowing, is limited and may not be sufficient to meet the sector's long-term investment needs.

### Value for money

11. We continue to assess how the sector is securing value for money from public funds, and for the benefit of students from tuition fees, through our analysis of the value for money reports submitted to us by institutions. Our analysis of these reports indicates that the sector made an estimated saving of £1.4 billion over the period 2011 to 2015. However, under the current system of reporting, the volume of savings is likely to be understated. HEFCE is developing the

mechanisms by which the sector collects and reports value for money information in a more systematic way, to demonstrate and report the scale of sector efficiency. It will be important for the sector to maintain this efficiency drive, to support long-term sustainability in the future.

### Capital investment

12. With rising student expectations comes the need for the sector to invest more in its infrastructure (buildings, equipment, and digital technology), and in 2014-15, the sector reported capital expenditure of £3,564 million, an increase of 9.4 per cent compared with 2013-14. While this is a significant investment overall, financial results show that a large proportion of HEIs (nearly 40 per cent of the sector) actually reduced their expenditure on capital projects in the period 2012-13 to 2014-15 compared with the period 2011-12 to 2013-14.

13. Despite the overall increase in capital investment over recent years, the latest data available from the Estate Management Record shows that, at the end of July 2014, the cost to the sector of restoring its estate was £3.5 billion (compared with £3.3 billion in 2012-13). This cost reflects the investment required to restore the estate to a sound baseline condition and is not the same as the investment required to bring the estate up to the standard required to satisfy rising student expectations. A reduction in capital investment could lead to significant under-investment in the sector, with institutions that fail to invest sufficiently in infrastructure finding themselves in a weaker market position and at higher risk of financial instability.

### Liquidity and borrowing

14. In the current climate of lower public capital funding, institutions are increasingly reliant on generating increased cash reserves or increasing borrowing to deliver their capital investment programmes. In 2014-15, the sector reported that it used £1.1 billion from its own cash reserves (equivalent to 3.9 per cent of total income) and borrowed an additional £1.4 billion to help fund capital expenditure during the year. This caused total sector borrowing to rise to £7.8 billion at the end of July 2015 (equivalent to 28.1 per cent of income).

15. While the sector's liquid funds (cash) at 31 July 2015 were higher than the level reported at 31 July 2014 (£8.3 billion compared with £7.7 billion), when compared to the external borrowing level, the sector reported a net cash position of £0.5 billion at 31 July 2015. This is relatively small compared with an overall income of £27.7 billion, and represents a fall from the levels reported at 31 July 2014 and 31 July 2013, which were £1.0 billion and £1.1 billion respectively.

16. The level of financial commitments reported by the sector is expected to increase as a result of a new financial reporting standard (FRS102), which, from 2015-16, introduces new criteria for an institution to account for financial commitments relating to its service concession arrangements (such as contracts with private operators to maintain an institution's student accommodation). Although not new borrowing, this may impact on the perceived indebtedness of the sector.

17. The impact of these changes will not be seen until July 2016, when the sector's next set of financial forecasts are due to be submitted to HEFCE. As well as requiring institutions to recognise additional financial commitments, FRS102 requires HEIs to implement other significant financial reporting changes, including the recognition of additional pension liabilities and changes to revenue recognition and asset valuations. These changes may present comparability challenges when assessing the future financial health of the sector, and we are working with the sector on how to present financial information consistently in the future.

18. When reporting on liquidity levels it is important to take into account that liquidity data is taken as a snapshot of bank and investment balances at 31 July and that most institutions' main period of capital spending happens in the months after the academic year ends. The available cash not committed to capital spend is thus likely to be much lower.

19. As charities, HEIs are obligated to ensure that they remain sustainable and do not expose themselves to undue risk. Strong liquidity is particularly important given the current levels of uncertainty and risk in the sector, and we continue to monitor liquidity levels to assess whether HEIs are able to maintain sufficient cash levels to manage their risks effectively.

### Reserves and pension deficits

20. Reserves are an HEI's total assets less its liabilities and, in very broad terms, can be used as a proxy of the overall value of an institution. The main indicator used to assess reserves is the amount of 'discretionary reserves' held on an institution's balance sheet. These are the accumulated surpluses of an institution over its lifetime and are not the same as cash, although an institution could dispose of an asset if it was surplus to operational requirements (thereby converting it to cash).

21. Discretionary reserves, after taking into account projections for pension deficits, increased by 10.7 per cent in 2014-15, to reach £13.6 billion at 31 July 2015, equivalent to 49.2 per cent of total income. However, the sector position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities.

22. While sector reserves appear strong overall, from 2015-16 reported reserve levels are likely to be substantially lower following the introduction of FRS102, which requires institutions to recognise liabilities relating to deficit recovery plans for multi-employer pension schemes (such as the Universities Superannuation Scheme (USS)) in their balance sheets. While not a new liability, this will increase the transparency of the underlying deficits in the relevant pension schemes, which may impact on confidence levels in the financial strength of the sector.

23. The USS is the largest multi-employer pension scheme operating in the sector. The latest actuarial valuation for this scheme (as at March 2014) confirms that, after taking into account the revised benefit structure effective from 1 April 2016, the actuarial deficit stood at £5.3 billion.

### Financial outlook

24. The sector has shown itself to be adaptable to a more competitive and uncertain environment, but there are some significant challenges ahead. The financial outturn for 2014-15 may have been stronger overall than anticipated by the sector in July 2015, but the financial results for individual institutions show the gap between the lowest- and highest-performing institutions has widened in 2014-15, compared with the previous year.

25. One of the key challenges for the sector will be whether it can achieve plans for growth in the overseas student market, which is a significant source of income for many institutions. While income from this source grew in 2014-15, overseas student numbers were lower than forecast by the sector in July 2015, and data from the Higher Education Students Early Statistics Survey shows a 1.7 per cent drop in international new entrants in 2015-16. If this pattern were to continue, HEIs would find it difficult to achieve their income and surplus projections.

26. HEIs are due to submit their next set of financial forecasts in July 2016, covering the period from 2015-16 to 2018-19. We plan to publish an overview and analysis of these forecasts

in autumn 2016, which will focus on the expected future financial health and sustainability of the higher education sector. Until then, our view is that the sector's financial position is currently stable overall. However, financial projections for the period ending 31 July 2018 (submitted by HEIs in July 2015) indicated an expected general weakening of financial performance, with lower surpluses, a fall in cash levels and a rise in projected borrowing.

27. Evidence attained as part of our annual accountability process indicates that the short-term viability of institutions is not a concern presently, and no institutions are forecast to be close to the risk of insolvency. This is supported by independent institutional audits and the sector's own projected continuation of positive cash in-flows and healthy cash-backed reserves – though these are reliant on institutions achieving their home and overseas student recruitment targets, and on the level of public funding not deteriorating.

## Action required

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

## Background information

29. This report provides an overview of the financial health of the HEFCE-funded higher education sector in England, comprising an analysis of the sector's financial results and Transparent Approach to Costing (TRAC) reporting for 2014-15. This does not include further education colleges or alternative providers of higher education[1].

30. The data used in this paper comes from the following sources:

a. Where available, all data up to and including 2013-14 is from the Higher Education Statistics Agency (HESA) Finance Statistics Record, which is completed by higher education institutions (HEIs) each year and is derived from audited financial statements.

b. Financial data for the year 2014-15 is from HEIs' financial returns, submitted to HEFCE in December 2015.

c. TRAC data is from HEIs' TRAC returns submitted to HEFCE in January 2016.

31. All financial information is presented in academic years (ending 31 July). For references to changes in performance in real terms we have used HM Treasury's gross domestic product deflator, announced in January 2016[2].

32. Analysis of HEIs' financial forecasts submitted in July 2015 can be found in 'Financial health of the higher education sector: 2014-15 to 2017-18 forecasts' (HEFCE 2015/29)[3].

## 2014-15 financial results

33. The financial results for the higher education sector in 2014-15 show a financially sound position overall. The financial outturn was stronger than both that projected by institutions in July 2015 and that reported by the sector in 2013-14. It should be noted, however, that significant variations continue in the financial performances of individual institutions across the sector, with the sector's main financial strength remaining in a small number of institutions. Results for 2014-15 showed that the gap between the lowest- and highest-performing institutions has continued to grow.

34. Table 1 provides a summary of the key financial results for 2014-15, alongside the sector's results for 2012-13 and 2013-14.

[1] These are providers of higher education which are not funded by regular government grants.
[2] See www.hm-treasury.gov.uk/data_gdp_index.htm.
[3] Available online at www.hefce.ac.uk/pubs/year/2015/201529/.

**Table 1: Summary of key financial indicators**

| | Actual | | |
|---|---|---|---|
| | **2012-13** | **2013-14** | **2014-15** |
| Total income<br>Excluding RDEC* | £24,320M | £25,591M | £27,684M<br>£27,248M |
| Operating surplus<br>Excluding RDEC | £943M | £992M | £1,600M<br>£1,164M |
| Operating surplus as % of total income<br>Excluding RDEC | 3.9% | 3.9% | 5.8%<br>4.3% |
| Historical cost surplus<br>Excluding RDEC | £1,208M | £1,273M | £1,839M<br>£1,502M |
| Historical cost surplus as % of total income<br>Excluding RDEC | 5.0% | 5.0% | 6.6%<br>5.5% |
| Earnings before interest, taxation, depreciation and amortisation<br>Excluding RDEC | £2,186M | £2,330M | £3,043M<br>£2,706M |
| TRAC sustainability gap<br>Excluding RDEC | (£870M) | (£883M) | (£522M)<br>(£860M) |
| TRAC sustainability gap as a % of total income<br>Excluding RDEC | (3.6%) | (3.5%) | (1.9%)<br>(3.2%) |
| Cash flow from operating activities as % of total income | 8.3% | 8.4% | 8.4% |
| Net liquidity as number of days' expenditure | 123 | 122 | 126 |
| External borrowings as % of total income | 25.8% | 26.3% | 28.1% |
| Discretionary reserves excluding FRS17** as % of total income | 61.8% | 64.4% | 67.0% |
| Discretionary reserves including FRS17as % of total income | 47.4% | 48.0% | 49.2% |

* Estimated Research and Development Expenditure Credit (RDEC) values based on a review of 2014-15 HEI financial statements

** FRS17 is the financial reporting standard on retirement benefits.

35. The key messages from the analysis of the 2014-15 annual financial accounts are included in the following section and the outcomes from the sector's TRAC reporting for 2014-15 are summarised in paragraphs 78 to 91 of this report.

## Income

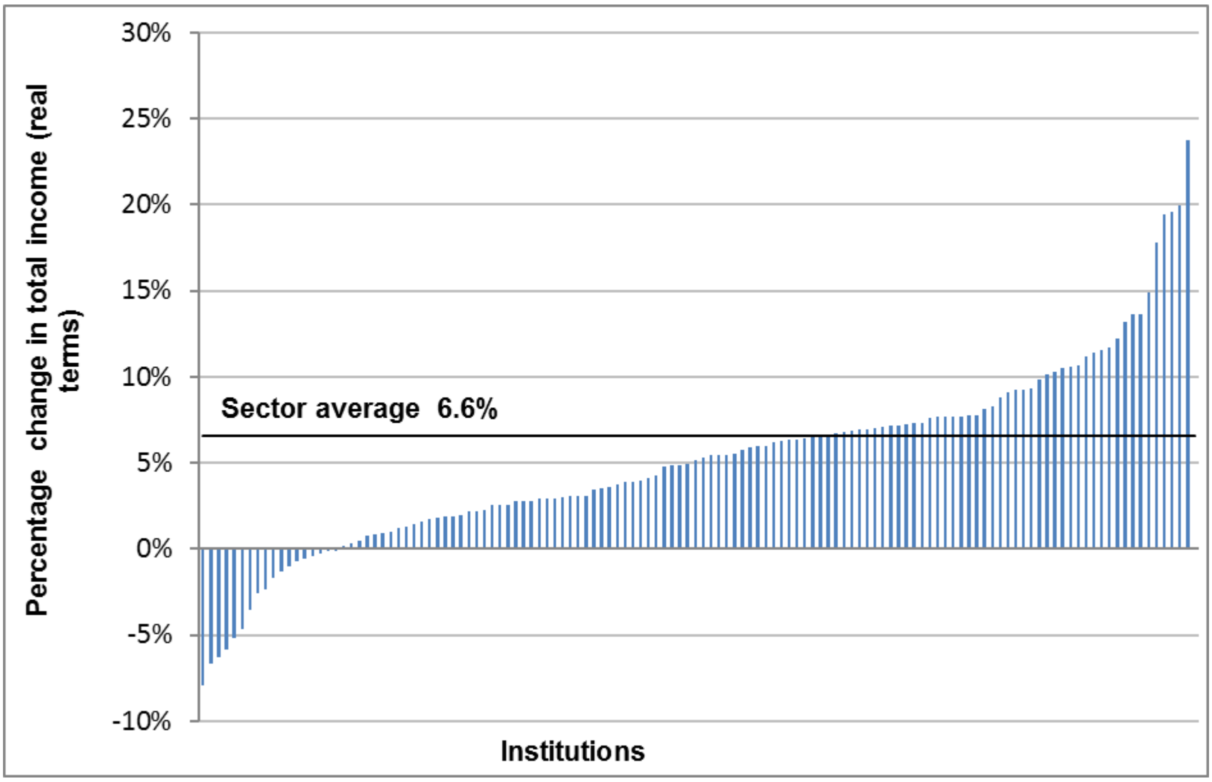
36. Total income rose by £2,093 million to £27,684 million during 2014-15, an increase of 8.2 per cent compared with 2013-14, and 2.2 per cent higher than the income projected in July 2015, although this was assisted by the one-off income injection from Research and Development Expenditure Credit (RDEC). Table 2 provides a breakdown of sector income for the last two years.

**Table 2: Breakdown of total income**

| | **Actual** | | **Change** | |
|---|---|---|---|---|
| | **2013-14** | **2014-15** | **£M** | **%** |
| Funding council grants | £4,524M | £3,760M | -£764M | -16.9% |
| Overseas fee income | £3,316M | £3,583M | £267M | 8.1% |
| Tuition fees and education contracts (Home and European Union) | £8,672M | £10,119M | £1,446M | 16.7% |
| Research grants and contracts | £4,124M | £4,819M | £695M | 16.9% |
| Research grants and contracts (excluding RDEC) | | £4,383M | £259M | 6.3% |
| Other operating income | £4,679M | £5,113M | £435M | 9.3% |
| Endowment income and interest | £277M | £290M | £13M | 4.8% |
| **Total income** | **£25,591M** | **£27,684M** | **£2,093M** | **8.2%** |

37. While income increased overall, 18 HEIs recorded real-terms reductions in income in 2014-15, compared with 25 HEIs in 2013-14 and 46 in 2012-13. The reasons for these income reductions were varied, including lower levels of research grant funding, overseas tuition fee income and 'other operating income'. Figure 1 shows the distribution of real-terms changes to total income across the sector between 2013-14 and 2014-15.

**Figure 1: Real-terms percentage changes in total income (2013-14 to 2014-15)**




38. In cash terms, total tuition fee income (including fees from international students) increased by £1,713 million in 2014-15, equivalent to a 14.3 per cent increase upon 2013-14 levels. This was driven mainly by a rise in tuition fee income from full-time undergraduate home and EU students, reflecting the switch from grant funding to tuition fees in the third year of higher fees. Table 3 provides a breakdown of tuition fee income received in 2014-15 compared with 2013-14.

**Table 3: Breakdown of tuition fee income**

| | 2013-14 | 2014-15 | % change | % change |
|---|---|---|---|---|
| FT UG (home and EU) | £5,792M | £6,972M | £1,180M | 20.4% |
| FT PG (home and EU) | £717M | £667M | -£50M | -7.0% |
| PT (home and EU) | £653M | £701M | £48M | 7.4% |
| Health (home and EU) | £787M | £768M | -£19M | -2.4% |
| Overseas | £3,316M | £3,583M | £267M | 8.1% |
| Other | £723M | £1,011M | £287M | 39.7% |
| **Total fee income** | **£11,988M** | **£13,702M** | **£1,713M** | **14.3%** |

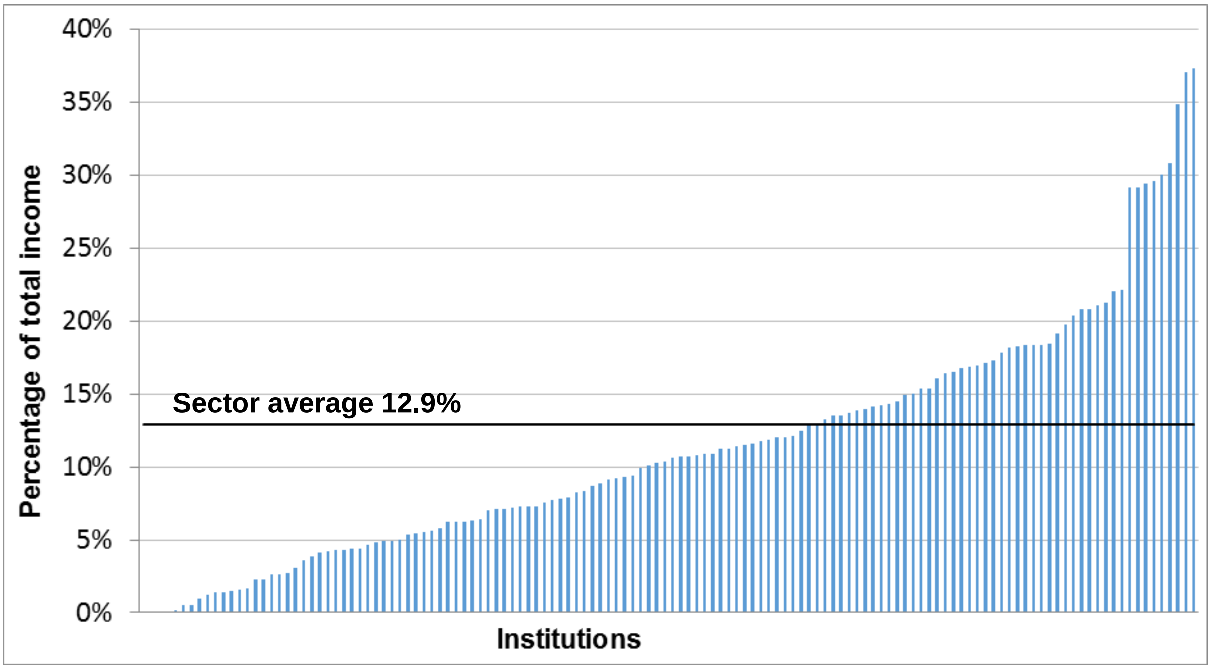
Note: ‘FT’ = ‘full-time’; ‘PT’ = ‘part-time’; ‘UG’ = ‘undergraduate’; ‘PG’ = ‘postgraduate’; ‘EU’ = ‘European Union’.

39. In 2014-15, the sector reported an increase in fee income from overseas students of £267 million, equivalent to a rise of 8.1 per cent compared with 2013-14. Overseas student numbers (across all years of study) also grew in 2014-15, rising 1.9 per cent compared with 2013-14. This indicates that the majority of income growth was due to the effect of higher fees as opposed to growth in the overseas student population (a pattern we have seen following the introduction of higher home and European Union (EU) fees).

40. While overseas fee income grew in 2014-15, overseas student numbers were 2.2 per cent lower than projected by the sector in July 2015, indicating that institutions failed to meet their expectations in overseas recruitment. Our initial analysis of the Higher Education Students Early Statistics data in December 2015 also shows a 1.7 per cent drop in international new entrants in 2015-16.

41. One of the sector’s most significant risks is a fall in overseas recruitment causing fee income to fall. Dependence on overseas fee income varies between institutions (ranging from 0 per cent to 37.0 per cent of total income) but has grown in recent years. In 2014-15, 16 institutions reported overseas fee income of over 20 per cent of their total income and 20 institutions accounted for nearly 53 per cent of the sector’s total income from this source. Figure 2 shows how the varied distribution of overseas fee income levels in 2014-15 (expressed as a percentage of income) varies across the sector.

**Figure 2: Overseas fee income as percentage of total income (2014-15)**




42. Income from research grants and contracts increased by £695 million in 2014-15, equivalent to a 16.9 per cent increase compared with 2013-14. Table 4 provides a breakdown of such income received in 2014-15 compared with 2013-14.

**Table 4: Research grants and contracts income**

| Source | 2013-14 | 2014-15 | £M change | % change |
|---|---|---|---|---|
| Research Council grant | £1,340M | £1,445M | £105M | 8.9% |
| UK-based charity grants and contracts | £826M | £860M | £34M | 3.7% |
| Other research grants and contracts | £1,958M | £2,514M | £556M | 28.7% |
| Other research grants and contracts (excluding RDEC) | | £2,078M | £120M | 6.1% |
| **Total research grants and contracts** | **£4,124M** | **£4,819M** | **£695M** | **16.9%** |

43. The increase in income from other research grants and contracts is largely attributable to a number of HEIs recognising income from the RDEC scheme from HM Revenue and Customs (HMRC) in their 2014-15 financial accounts.

44. These RDEC credits relate to a scheme introduced by Government via the Finance Act 2013, to offer tax incentives to large companies to encourage greater investment in research and

development. This scheme has since been amended through legislation so that universities and charities are unable to claim RDEC in respect of expenditure incurred on or after 1 August 2015.

45. Our analysis of the latest financial accounts, submitted as part of the annual accountability process, indicates that just over 25 per cent of institutions have recognised RDEC income in their 2014-15 accounts in respect of R&D expenditure claims for the period 2012-13 to 2014-15.

46. Gross RDEC income recognised by HEIs as a result of these claims ranges from £131,000 to £85 million, with an estimated gross sector income from this source of £436 million, although after taxation (deducted from operating surpluses) this reduces to an estimated £337 million.

47. Additional claims for eligible expenditure in the eligible period are also likely in 2015-16, and so we expect to see these reflected in the next set of financial forecasts due to be submitted to us in July 2016.

## Expenditure

48. In 2014-15 the sector reported total expenditure of £25,917 million, an increase of 6.0 per cent in cash terms compared with 2013-14, and marginally higher than the level projected by the sector in July 2015 (£25,891 million). Table 5 shows a breakdown of the sector's expenditure in 2013-14 and 2014-15.

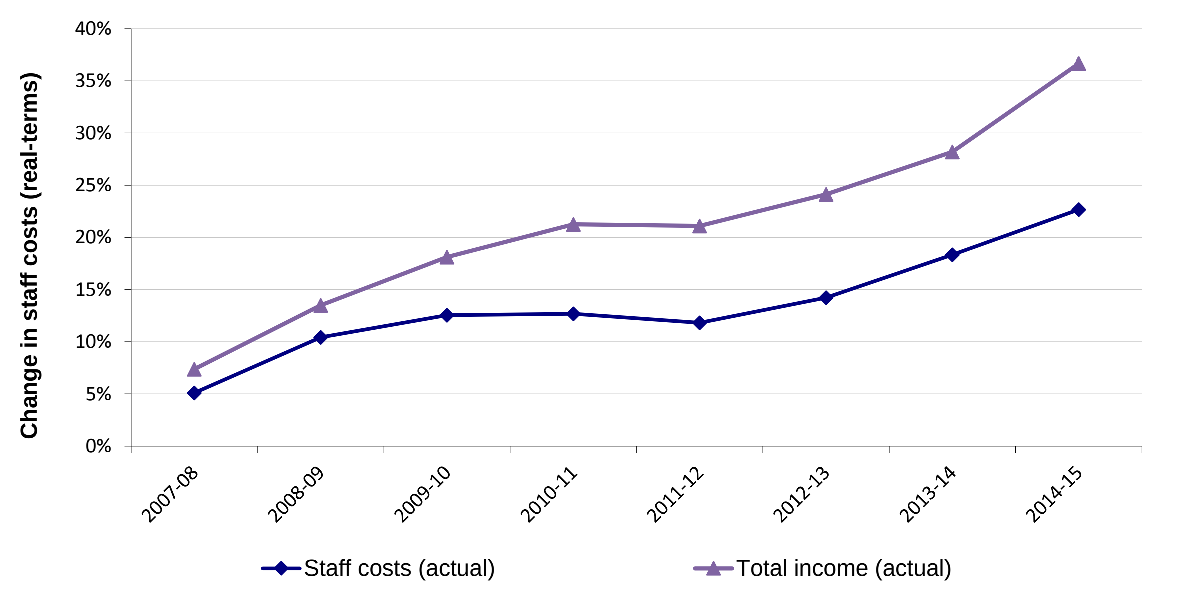
**Table 5: Breakdown of expenditure**

| | **2013-14** | **2014-15** | **% change** |
|---|---|---|---|
| Staff costs<br>as a % of total income | £13,461M<br>52.6% | £14,159M<br>51.1% | 5.2% |
| Other operating expenses<br>as a % of total income | £9,153M<br>35.8% | £9,741M<br>35.2% | 6.4% |
| Depreciation<br>as a % of total income | £1,472M<br>5.8% | £1,657M<br>6.0% | 12.6% |
| Interest payable<br>as a % of total income | £359M<br>1.4% | £358M<br>1.3% | -0.2% |
| **Total expenditure** | **£24,446M** | **£25,917M** | **6.0%** |

49. The sector's biggest expenditure relates to staff costs, which totalled £14,159 million in 2014-15, equivalent to 51.1 per cent of total income.

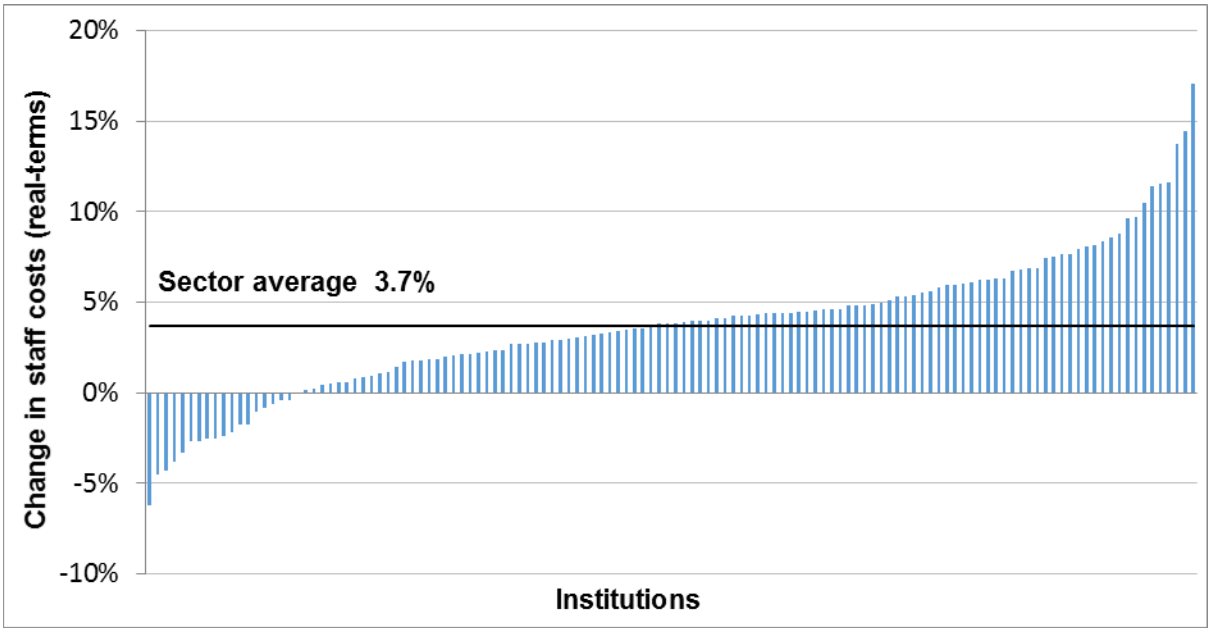
50. In real terms, total staff costs increased by 3.7 per cent, and average staff costs per employee rose by 0.2 per cent, between 2013-14 and 2014-15. This compares with a rise of 3.6 per cent and a fall of 0.2 per cent respectively in real terms between 2012-13 and 2013-14. Figure 3 shows the cumulative real-terms change in staff costs over the last nine years, compared with the real-terms change in total income over the same period.

**Figure 3: Cumulative real-terms change in total income and staff costs from base year 2006-07 to 2014-15**




51. As in previous years, there was considerable variation in the changes to staff costs reported by institutions. Figure 4 shows the distribution of changes in staff costs across the sector from 2013-14 to 2014-15.

**Figure 4: Real-terms percentage changes in staff costs (2013-14 to 2014-15)**




## Surpluses

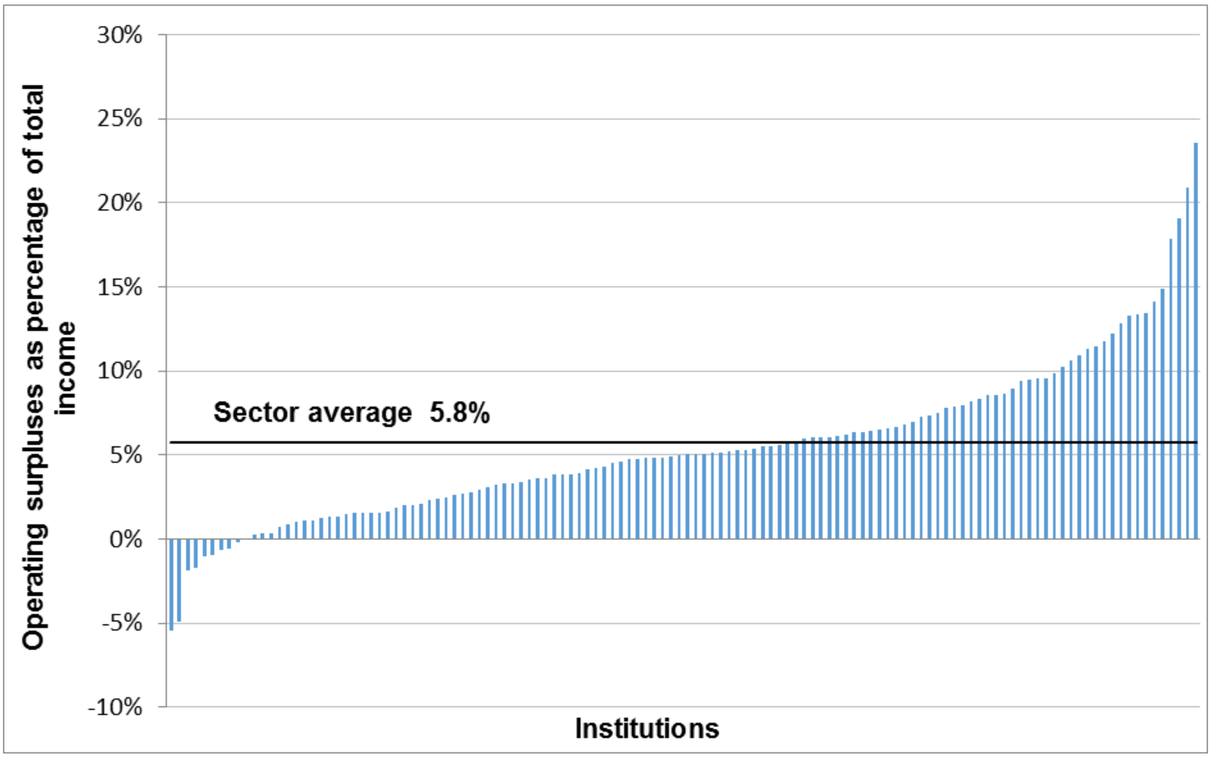
52. The sector's operating surplus (that is, its total income less its total expenditure before any exceptional items) increased by 61.3 per cent from £992 million in 2013-14 to £1.6 billion in

2014-15. This was equivalent to a sector average of 5.8 per cent of total income, an increase from 2013-14 when a sector average of 3.9 per cent was reported.

53. Much of this increase is attributable to the recognition of exceptional RDEC income, as referred to in paragraphs 43 to 47 of this report. The additional income arising from the RDEC scheme has materially increased the surpluses of the HEIs concerned and makes a significant contribution to the increased overall surpluses reported by the sector in 2014-15.

54. Although a surplus was made overall, nine institutions reported operating deficits in 2014-15, compared with 13 in 2013-14. Figure 5 shows the level of operating surpluses as a percentage of total income reported by institutions in 2014-15.

**Figure 5: Operating surpluses as a percentage of total income (2014-15)**



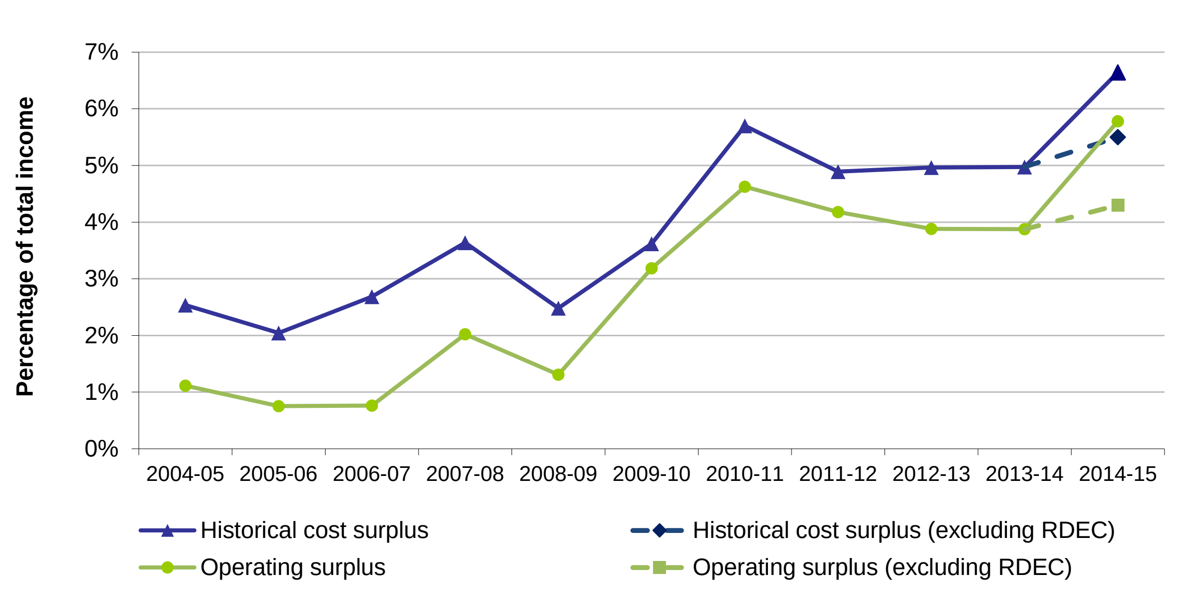

55. While nearly three-quarters of institutions produced better financial outturns in 2014-15 compared with the July 2015 forecasts, 33 reported a decline in their operating performance compared with their earlier predictions.

56. On a historical cost basis the sector recorded a surplus of £1,839 million (6.6 per cent of total income), which again is significantly better than the average over the past 10 years (which was 3.9 per cent)[4]. This falls to £1,502 million (5.5 per cent of total income) when RDEC income is removed. The large difference between the operating and historical position in 2014-15 is

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

partly accounted for by exceptional items (for example profit or loss from the sale of properties, or exceptional restructuring) totalling £120 million. Figure 6 shows the level of operating and historical cost surpluses as percentage of total income since 2004-05.

**Figure 6: Operating and historical cost surpluses as percentage of total income 2004-05 to 2014-15**




## Liquidity and cash flow

57. At the end of 2014-15 the sector had net liquidity of £8,344 million, equivalent to 126 days' expenditure. This is higher than the level forecast in July 2015 which was 113 days, and the level reported at the end of 2013-14, which was 122 days. Five institutions had liquidity of less than 20 days, the same number reported in 2013-14.

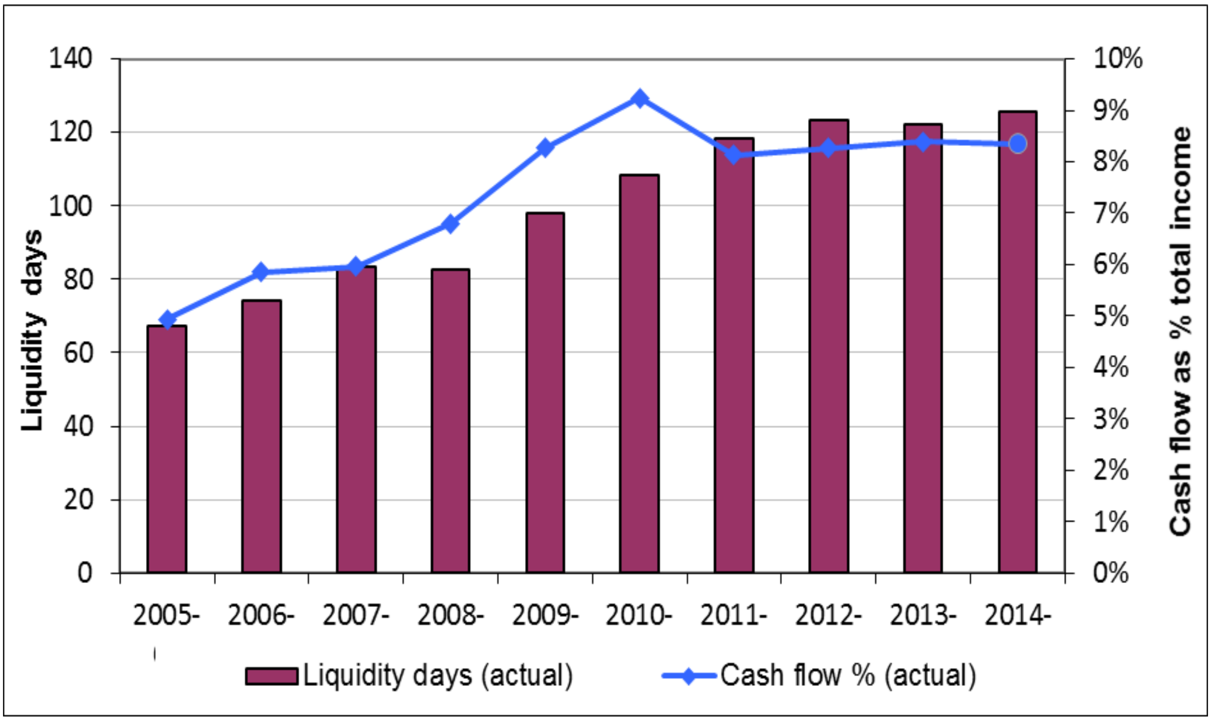
58. When reporting on liquidity levels in the sector, it is important to take into account that liquidity data is taken as a snapshot of bank and investment balances at 31 July, and the main period of capital spending for most institutions happens in the months after the academic year ends. As a result, the available cash not committed to capital spend is likely to be much lower.

59. As charities, HEIs are obligated to ensure that they remain sustainable and do not expose themselves to undue risk. Strong liquidity is particularly important given current levels of uncertainty and risk in the sector, and as part of our accountability process, we continue to monitor liquidity levels to assess whether HEIs are able to maintain sufficient cash levels to manage their risks effectively.

60. Cash flow from operating activities rose from £2,148 million in 2013-14 to £2,312 million in 2014-15, equivalent to 8.4 per cent of total income. This is higher than the level forecast in July 2014, which was 8.1 per cent. This is a positive indicator of solvency.

61. Figure 7 shows the level of net liquidity (expressed as liquidity days) and cash flow from operating activities (as percentage of total income) for the period 2005-06 to 2014-15.

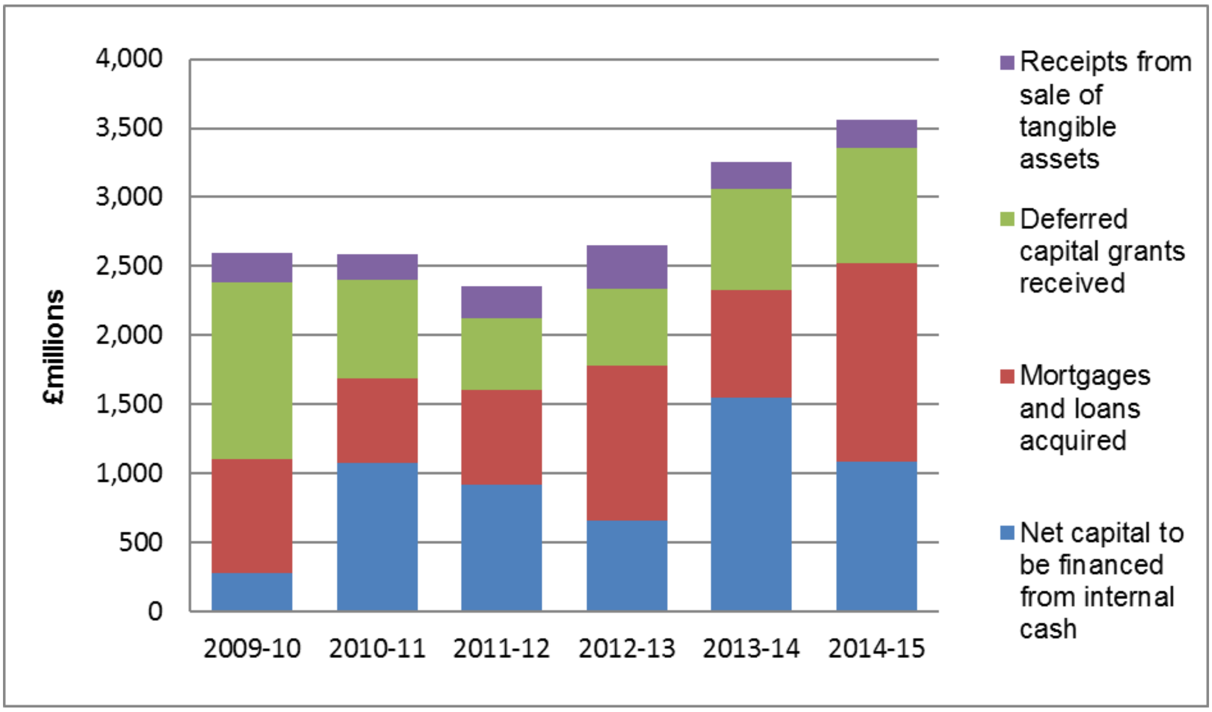
**Figure 7: Liquidity days and cash flow 2005-06 to 2014-15**




## Capital expenditure

62. The sector invested significantly in infrastructure (buildings, equipment, and digital technology) in 2014-15, with expenditure totalling £3,564 million, an increase of 9.4 per cent compared with 2013-14. Figure 8 provides a breakdown of how capital expenditure was funded in the period from 2009-10 to 2014-15.

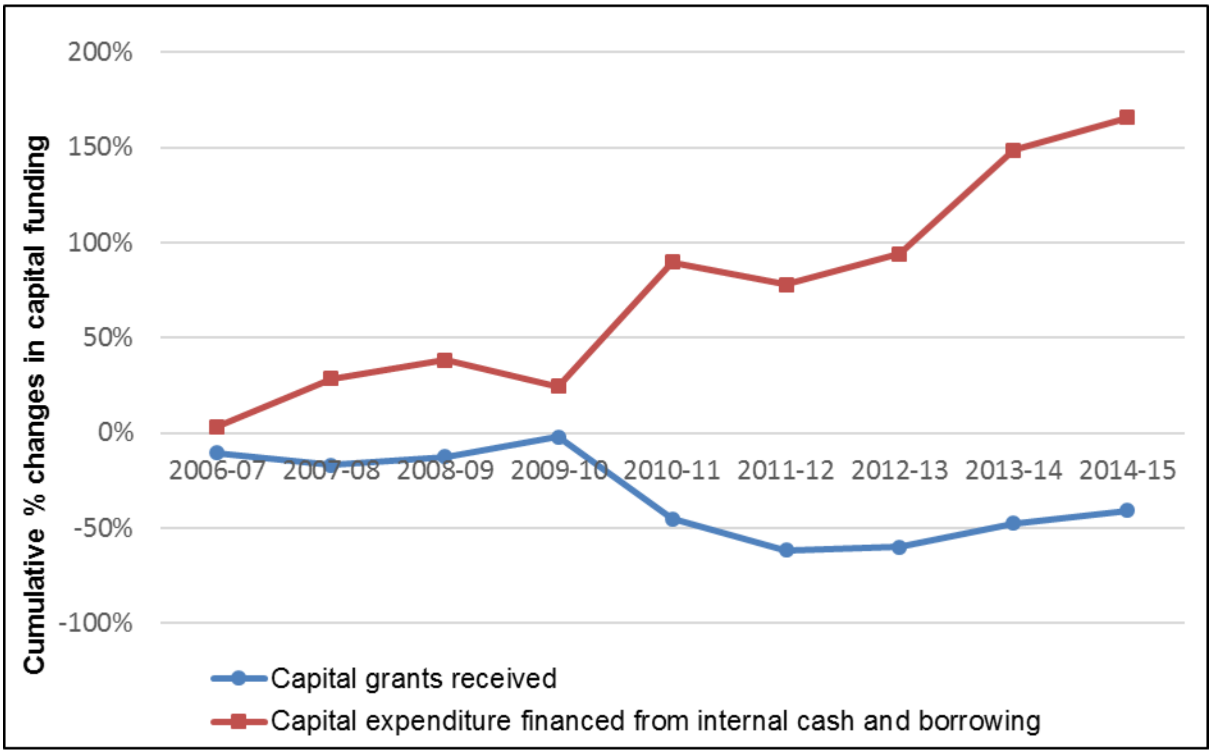
**Figure 8: Funding breakdown of capital expenditure 2009-10 to 2014-15**



63. In an era where capital funding from Government was high there was less need for institutions to generate cash to re-invest in their infrastructure. The more government funding for capital reduces, the more institutions need to generate themselves, either through increased surpluses or by levering additional funding from other sources, including borrowing (where there is capacity to do so). This places greater pressure on HEIs to generate higher surpluses to provide the positive cash flow needed to fund future investment and meet finance costs.

64. Figure 9 shows the cumulative real-terms changes in the level of deferred capital grants received by the sector since 2005-06, alongside the level of capital expenditure financed by additional borrowing and internal cash[5].

**Figure 9: Cumulative real-terms changes in capital expenditure funding from base year 2005-06 to 2014-15**




65. Although the sector has invested significantly in infrastructure over recent years, the latest data available from the Estate Management Record showed that on 31 July 2014 the sector still needed to invest £3,447 million to restore its non-residential estate to a sound and operationally safe condition (an increase of 3.6 per cent compared with the backlog on 31 July 2013)[6]. However, even more investment is needed to bring the estate up to the standard required to meet rising student expectations resulting from higher fees.

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[5] Deferred capital grants are the cash sums received by institutions in the year, although the income will be reported in institutions' income and expenditure accounts spread over the estimated useful life of the related capital assets.

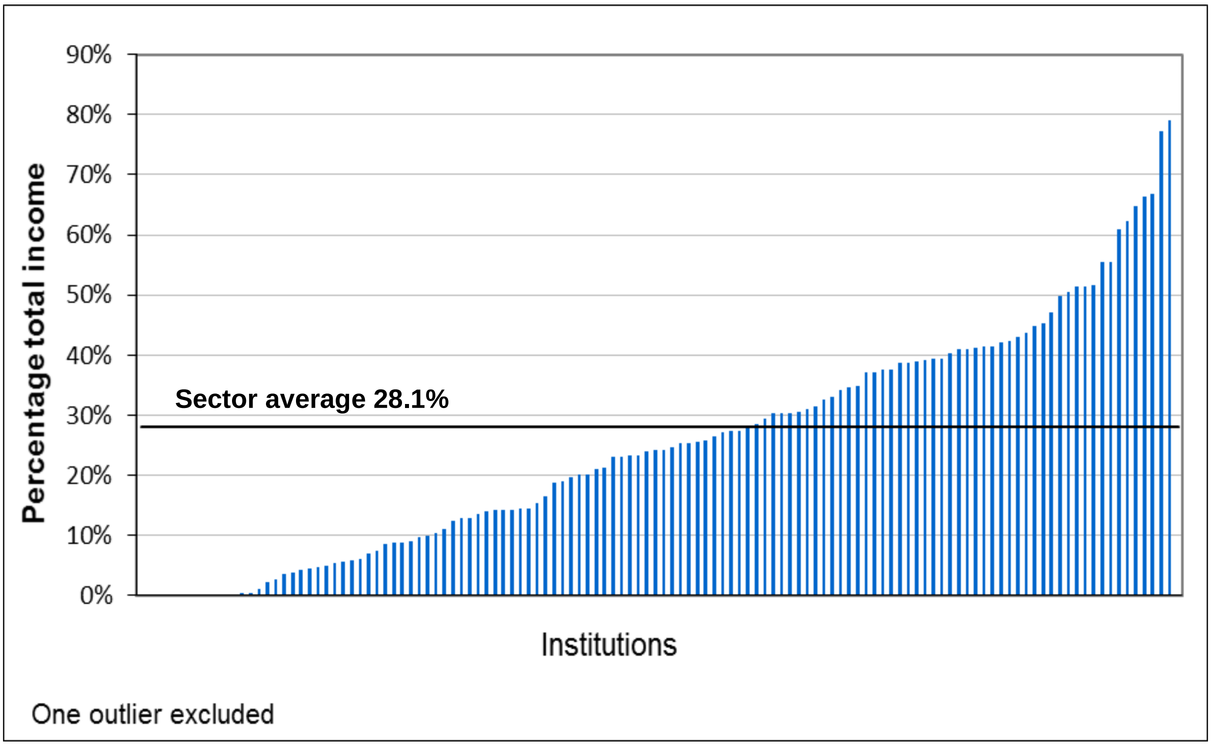
[6] This data is sourced from the Estates Management Record for 2013-14 (collected by HESA) and represents the maintenance costs required to upgrade non-residential buildings to a condition that is sound, operationally safe and exhibiting only minor deterioration.

66. With increasing competition in the home and international markets, it is important that the sector continues to increase its investment in infrastructure, to deliver world-class teaching and research, and to attract the best and brightest students, lecturers and researchers.

## Borrowing

67. At the end of July 2015, the sector reported borrowing of £7,789 million (equivalent to 28.1 per cent of income). This is £1,058 million higher than the level reported at the end of 2013-14, which was £6,730 million (26.3 per cent of income), and was aligned with the level forecast in July 2015. Figure 10 shows the wide variation in the level of borrowing across the sector at 31 July 2014.

**Figure 10: External borrowing as a percentage of total income (2014-15)**




68. Reported borrowing levels are expected to increase as a result of a new financial reporting standard (FRS102), which, from 2015-16, introduces new criteria for an institution to assess and recognise financial commitments relating to its service concession arrangements (in which an institution contracts with a private operator to develop, operate and maintain its infrastructure assets, such as student accommodation). This is likely to result in additional financial commitments being recognised on an institution's balance sheet, which might previously have been treated 'off balance sheet'. Although not new borrowing, this may impact on the perceived indebtedness of the sector.

69. As important as the absolute level of borrowing is the ability of the borrower to service the cost of borrowing. Despite increasing borrowing levels, the sector reported a marginal fall in interest payments from £359 million in 2013-14 to £358 million in 2014-15.

70. The cost of increased borrowing has to date largely been mitigated by the exceptionally low interest rates available to the sector. However, a rise in interest rates could add significant

costs to the sector, placing increasing financial burden on individual institutions' sustainability if not well managed.

## Reserves

71. Reserves are an HEI's total assets less its liabilities and, in very broad terms, can be used as a proxy of the overall value of an institution.

72. The main indicator used to assess reserves is the amount of discretionary reserves held on an institution's balance sheet[7]. These are the accumulated surpluses of an institution over its lifetime. They are not the same as cash, as in order to convert all reserves to cash an institution would have to sell all its assets.

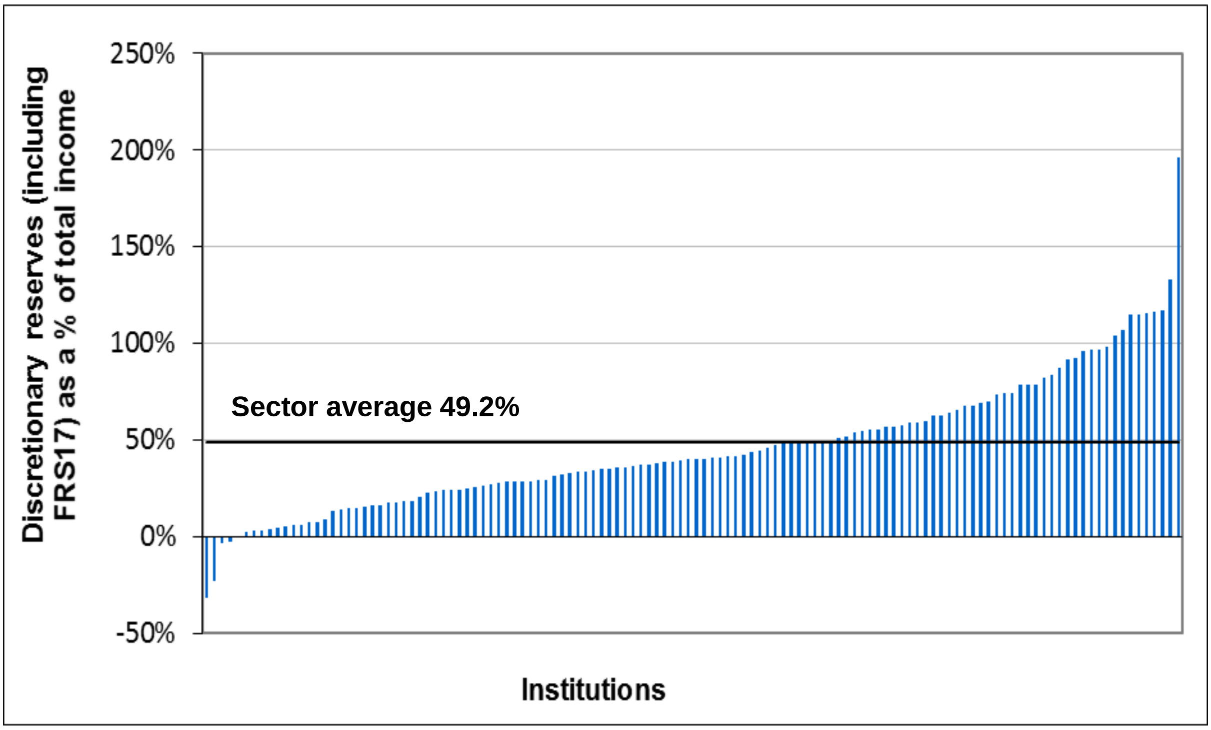
73. At the end of 2014-15, the sector's discretionary reserves totalled £13,607 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS17). This reporting standard, which requires pension scheme surpluses or deficits to be included in the balance sheet (but not yet those of multi-employer schemes such as the Universities Superannuation Scheme (USS)), makes comparison with previous years more difficult. If FRS17 is ignored, reserves totalled £18,543 million, equivalent to 67.0 per cent of total income.

74. Total reported pension scheme deficits (excluding those relating to multi-employer schemes) increased by £755 million to £4,935 million in 2014-15, reducing reserves to 49.2 per cent of income.

75. As reported in previous years, the aggregate sector financial position masks a significant spread of financial strength, with a concentration of large discretionary reserves in a small number of universities. Figure 11 shows the distribution of discretionary reserves (taking FRS17 into account) as a percentage of total income for all institutions as at 31 July 2015.

[7] Discretionary reserves are equal to expendable endowments plus general reserves from the balance sheet.

**Figure 11: Comparison of discretionary reserves including FRS17 as a percentage of total income 2014-15**




76. While sector reserves may appear strong overall, from the academic year 2015-16 reserve levels and pension deficits will change following the implementation of the new financial reporting standard, FRS102. This requires institutions to recognise liabilities relating to deficit recovery plans for multi-employer pension schemes such as the USS in their balance sheets. This does not represent a new liability, but will increase the transparency of the underlying deficits in the pension schemes, which based on the latest indications from the most recent triennial valuation are likely to be significant. Confidence levels in the financial strength of the sector may be impacted by the inclusion of USS deficits on institutions' balance sheets. The impact of these changes will not be seen until July 2016, when the sector's next set of financial forecasts are due to be submitted to HEFCE.

77. The USS is the largest multi-employer pension scheme operating in the sector. The latest actuarial valuation for this scheme (as at March 2014) confirms that, after taking into account the revised benefit structure effective from 1 April 2016, the actuarial deficit stood at £5.3 billion (equivalent to nearly 40 per cent of the sector's current reserve levels).

## Transparent Approach to Costing return 2014-15

78. The TRAC return has been a continuing requirement for UK HEIs since the Government's 1998 Comprehensive Spending Review, and is now a condition of the funding awarded to the sector in each such review. It was established as an approach to identifying the full economic costing of all activities, to improve accountability for the use of public funds and to inform institutional decision-making.

79. The full economic costs include: direct costs (such as staff costs and equipment); support costs (for services and facilities such as libraries, information and communications technology,

business systems and registry); adjustments to reflect the replacement cost of the institution's infrastructure[8]; and the full costs of sustaining activities including investment in infrastructure and future productive capacity, innovation and human capital.

80. Our data verification process for the 2014-15 TRAC return is currently in progress, but provisional TRAC data from HEFCE-funded HEIs for 2014-15 indicates that the sector reported a sustainability gap (the difference between the level of surplus achieved by the sector and the level required to cover the full economic costs of its activities) of £522 million. This is an improvement on the previous year when the gap was £883 million, but has been assisted by the additional one-off income injection from RDEC. Without RDEC, the gap is £860 million.

81. Table 6 shows a summary of the provisional TRAC results for 2014-15, alongside the results reported for 2012-13 and 2013-14. This shows the level of surplus achieved by the sector against the level required to cover the long-run costs or full economic costs of its activities. For 2014-15, the adjusted operating surplus reported in the sector's annual financial statements was £1,560 million, equivalent to 5.7 per cent of total income. While large by historical standards, this fell short of the surplus required to cover the long-run costs, which were £2,082 million, or 7.6 per cent of total income in 2014-15 – the same percentage as the previous year.

**Table 6: TRAC summary 2012-13 to 2014-15**

| | **2012-13** | **2013-14** | **2014-15** | **2014-15 excluding RDEC** |
|---|---|---|---|---|
| Target sustainability surplus to cover long run costs (full economic costs) | £1, 876M | £1, 947M | £2,082M | £2,082M |
| as % of total income | 7.7% | 7.6% | 7.6% | 7.7% |
| Actual surplus* | £1,007M | £1,064M | £1,560M | £1,223M |
| as % of total income | 4.1% | 4.2% | 5.7% | 4.5% |
| **Sustainability gap (deficit)** | **(£870M)** | **(£883M)** | **(£522M)** | **(£860M)** |
| **as % of total income** | **(3.6%)** | **(3.5%)** | **(1.9%)** | **(3.2%)** |

***** This figure is different from the surplus reported in the annual financial statements because of adjustments in respect of joint ventures, minority interests and endowments in the TRAC returns.

82. While Table 6 shows the total sustainability gap (deficit) reported by the sector, Table 7 shows the 2014-15 data across 'teaching, research and other activities' for HEFCE-funded HEIs[9].

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[8] The replacement cost is the current value of fixed assets, as opposed to the historical cost that may be held in an institution's financial accounts.
[9] Sector TRAC results exclude data for three HEIs designated as HEFCE-fundable in 2013-14 and 2014-15, currently exempt from submitting TRAC data.

**Table 7: TRAC income and full economic costs by activity 2014-15**

| | Teaching | | | | | | |
|---|---|---|---|---|---|---|---|
| | Publicly funded | Non-publicly funded | Research | Research excluding RDEC | Other | Total | Total excluding RDEC |
| Income | £11,127M | £3,941M | £7,466M | £7,129M | £4,868M | £27,402M | £27,065M |
| Full economic costs | £10,847M | £2,837M | £9,935M | £9,935M | £4,306M | £27,924M | £27,924M |
| Surplus (deficit) | £281M | £1,104M | (£2,469M) | (£2,806M) | £562M | (£522M) | (£860M) |
| Surplus (deficit) as % of income | 2.5% | 28.0% | (33.1%) | (39.4%) | 11.5% | (1.9%) | (3.2%) |
| **Cost recovery % 2014-15** | **102.6%** | **138.9%** | **75.2%** | **71.8%** | **113.1%** | **98.1%** | **96.9%** |
| **Cost recovery % 2013-14** | **102.1%** | **136.6%** | | **73.9%** | **108.1%** | | **96.6%** |

83. These figures show a pattern which has been broadly constant for some years, the main features being that:

- publicly funded teaching shows a position just slightly above break-even
- non-publicly funded teaching makes a significant surplus
- research is significantly in deficit and this deficit is growing.

84. When comparing income with costs, the TRAC data for 2014-15 shows that the sector recovered 98.1 per cent of the full costs across all of its activities: an increase from the recovery rate reported in 2013-14, which was 96.6 per cent. However, the TRAC results for 2014-15 show that the sector's research activities continue to report a significant deficit across all sponsor categories, with the sector's total research deficit totalling £2,469 million (equivalent to a deficit of 33.1 per cent when compared with research income). This increases to £2,806 million when the one-off benefit of RDEC income is removed.

85. Further analysis of the sector's research activities by research sponsor-type categories is shown in Table 8.

**Table 8: Research income and costs by research sponsor type 2014-15**

| | **Income** | **Full economic costs** | **Surplus/ (deficit)** | **Surplus/ (deficit) as % income 2014-15** | **Cost recovery % 2014-15** | **Cost recovery % 2013-14** |
|---|---|---|---|---|---|---|
| Recurrent research: Funding councils | £1,551M | | | | | |
| Institution-own funded | £209M | £1,787M | (£1,579M) | (756.7%) | **11.7%** | **12.1%** |
| Postgraduate research[10] | £906M | £1,660M | (£755M) | (83.3%) | **54.6%** | **55.3%** |
| Research Councils | £1,486M | £2,078M | (£591M) | (39.8%) | **71.5%** | **73.5%** |
| Other govt departments | £1,088M | £954M | £134M | (12.3%) | **114.0%** | |
| Other govt departments (excluding RDEC) | £751M | £954M | (£203M) | (27.1%) | **78.7%** | **78.3%** |
| European Union[11] | £608M | £936M | (£328M) | (53.9%) | **65.0%** | **67.0%** |
| UK Charities | £872M | £1,483M | (£611M) | (70.1%) | **58.8%** | **62.7%** |
| Industry[12] | £746M | £1,036M | (£290M) | (38.8%) | **72.0%** | **72.2%** |
| **Total Research 2014-15** | **£7,466M** | **£9,935M** | **(£2,469M)** | **(33.1%)** | **75.2%** | |
| **Total Research 2014-15 (excluding RDEC)** | **£7,129M** | **£9,935M** | **(£2,806M)** | **(39.4%)** | **71.8%** | **73.9%** |

[10] Supervision and training of postgraduate researchers.
[11] European Union covers EU government bodies including the Commission.
[12] Industry includes all other organisations such as UK industry, commerce and public corporations, EU non-government organisations (EU-based charities, EU industry, EU other), overseas charities, overseas industry and other sources.

86. The 2014-15 TRAC results show that overall, the sector recovered 75.2 per cent of the full economic costs of research across all sponsor categories, although this reduces to 71.8 per cent when excluding the one-off benefit from RDEC. This is after including the £1.5 billion recurrent (quality-related) research funding from funding councils, which is provided within the dual support arrangements to support all 'public good' research (but not research commissioned by UK industry, commercial organisations or overseas industry or government bodies).

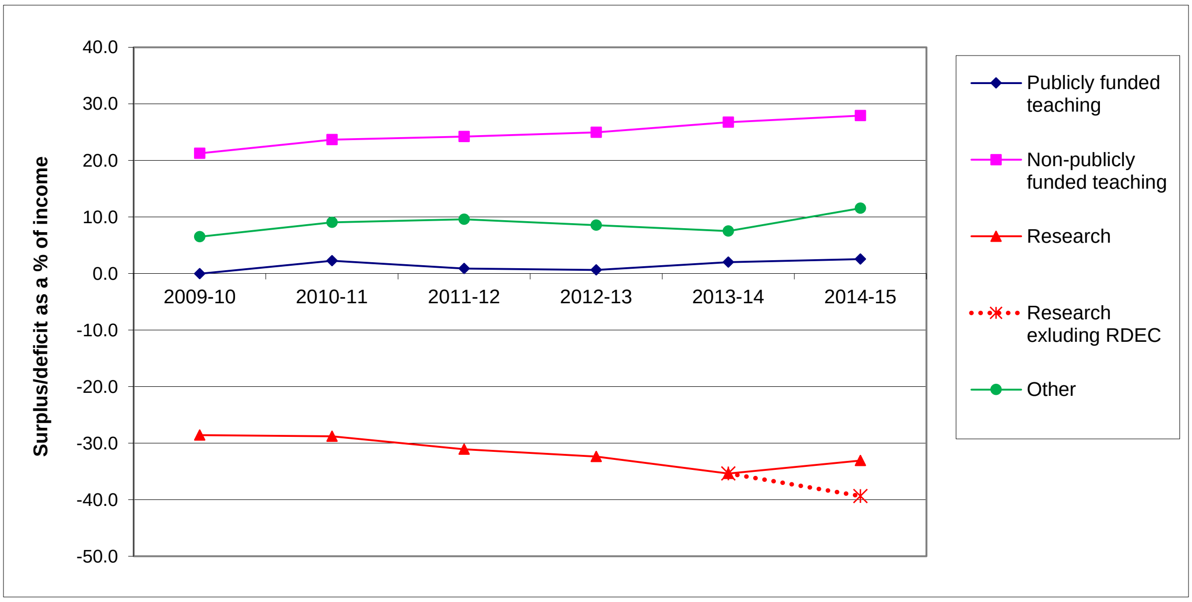
87. Research Councils collectively are the largest research sponsor, for which funding of research projects is based on 80 per cent of the forecast full economic costs. However, the reported recovery rate of 71.5 per cent of the full economic costs represents a reduction from 73.5 per cent in the previous year. This reflects the continuing impact of the application of the 'efficiency factors' (due to the capping of indexation at 0 per cent for three years) to reduce funding on Research Council funded projects since April 2011, and unfunded cost pressures. The costs of training postgraduate research students continue substantially to exceed income, with a recovery of only 54.6 per cent, a reduction from 55.3 per cent in 2013-14.

88. The full impact of the RDEC income injection is reflected in the reported recovery rate for research relating to 'Other Government Departments' (114.0 per cent). However, after excluding the effect of RDEC this falls to 78.7 per cent of full economic costs, and is thus much lower than the 100 per cent which would be expected to be funded.

89. Recovery of costs for EU-funded research and research funded by UK charities also deteriorated in 2014-15, with a recovery of 65.0 per cent (2013-14: 67.0 per cent) and 58.8 per cent (2013-14: 62.7 per cent) respectively. The recovery rate for industry and overseas-funded research remained at around 72 per cent, representing a deficit of £290 million compared with the full economic costs of the associated research activity.

90. Figure 12 shows the level of surplus or deficit reported by the sector for each of its core activities, as a percentage of the income received from those activities for the period from 2009-10 to 2014-15. This shows that the underlying research deficit (excluding the one-off RDEC effect) has continued to grow in 2014-15.

**Figure 12: Surplus/deficit as a percentage of income 2009-10 to 2014-15**



91. Overall, the data shows that surpluses on non-publicly funded teaching and other activities are insufficient to support the shortfall on research, and the continuing sustainability gap for 2014-15 reflects the fact that the sector is not generating enough income to finance all of its activities and investment. In a single year this might not matter, but over the medium term this means that in the absence of some other source of income that can be used at their discretion, some institutions are likely to face difficult decisions about their capacity to invest in and sustain their current portfolio of activities.

## Conclusion

92. The financial outturn for the sector in 2014-15 is stronger than the financial results reported in 2013-14 and those projected by the sector in July 2015, although there is an increasingly significant variation in the financial performances of individual institutions across the sector.

93. Overall, the TRAC results for 2014-15 show that in the medium to long term, institutions will need to increase surpluses to cover the full economic costs of their activities and ensure their sustainability.

94. The sector is increasingly dependent on its capacity to generate sufficient surpluses on teaching and other income streams to support research and invest adequately in infrastructure, to enhance the performance and reputation of teaching and research and address previous under-investment. Maintaining levels of investment in infrastructure will be vital to HEIs in ensuring their long-term sustainability in a market which is becoming increasingly competitive in terms of attractiveness to domestic and overseas students.

95. Institutions failing to invest sufficiently in infrastructure could find themselves in a weaker market position and at higher risk of financial instability. The reductions in public capital funding over the last few years have made the funding environment more challenging for universities. In the short to medium term the risk continues that public funding of higher education could be constrained if the overall economic climate does not improve.

96. A key challenge for the sector will be its ability to achieve plans for growth in the overseas student market, which is a significant source of income for many institutions. A downturn in overseas student recruitment increases the risk of financial instability in the sector.

97. HEIs are due to submit their next set of financial forecasts for the period 2015-16 to 2018-19 in July 2016, and we plan to publish an overview and analysis of these forecasts in autumn 2016. Until then, our view is that the sector’s financial position is currently stable overall. However, financial projections for the period ending 31 July 2018 (submitted by HEIs in July 2015) predicted lower surpluses, a fall in cash levels and a rise in borrowing, signalling a trajectory that is not sustainable in the long term. With the sector operating under such narrow margins, even small changes in income or costs could have a material impact on the financial performance of institutions and the sector as a whole.

## Disclaimer

98. This report, which is based on information provided by higher education institutions, has been prepared for the benefit of institutions and their stakeholders in general terms. HEFCE cannot reasonably foresee the various specific uses that may be made of this report, and therefore no responsibility is accepted for any reliance any third party may place upon it.

# List of abbreviations

| | |
|---|---|
| **EU** | European Union |
| **FRS** | Financial Reporting Standard |
| **FT** | Full-time |
| **HEFCE** | Higher Education Funding Council for England |
| **HEI** | Higher education institution |
| **HESA** | Higher Education Statistics Agency |
| **HMRC** | HM Revenue and Customs |
| **PG** | Postgraduate |
| **PT** | Part-time |
| **RDEC** | Research and Development Expenditure Credits |
| **TRAC** | Transparent Approach to Costing |
| **UG** | Undergraduate |
| **USS** | Universities Superannuation Scheme |