Data analysis

March 2017/02

Financial health of the higher education sector

2015-16 financial results

This report provides an overview of the financial health of the HEFCE-funded higher education sector in England. The analysis covers the financial results for 2015-16. This does not include further education or sixth-form colleges, or alternative providers of higher education.

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Financial health of the higher education sector: 2015-16 financial results

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2017/02
Publication date	March 2017
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Executive summary

Purpose

1. This report provides an overview of the financial health of the HEFCE-funded higher education sector in England. The analysis covers the financial results for 2015-16. This does not include further education or sixth-form colleges, or alternative providers of higher education.

Background

2. Financial Reporting Standard (FRS) 102 is the new financial reporting framework for higher and further education providers for reporting periods starting on or after 1 January 2015, and introduces some significant changes in the way financial performance is reported.

3. Financial results for 2015-16 are consistent with the new standard and are presented alongside 2014-15 financial data restated under FRS102. The new reporting framework poses some difficulties in comparing financial results between institutions and against historical trends. Transitional changes reflected in the restated 2014-15 results also make this an atypical year.

Financial results

4. The financial results for the higher education sector in 2015-16 show a financially sound position overall. However, as reported last year, significant variations continue to increase in the financial performances of individual institutions across the sector, with the main financial strength remaining in a small number of institutions.

5. The sector reported a surplus of £1,519 million (5.2 per cent of total income), compared with £833 million (3.0 per cent) in 2014-15.

6. Although the increase in 2015-16 appears high, it should be noted that some significant transitional accounting changes were introduced as a result of FRS102, such as the increase in pension provisions for the sector's multi-employer pension schemes that reduced sector surpluses in 2014-15. If these transitional changes were excluded, the underlying increase in 2015-16 surpluses would be much lower.

7. At an institutional level, results range from a deficit of 7.2 per cent to a surplus of 32.1 per cent. This gap, between the lowest- and highest-performing institutions, grew by 26.0 per cent in 2015-16.

8. Three institutions reported surpluses of over 20 per cent in 2015-16, compared with one institution in 2014-15. The high surpluses recorded by two of these institutions were due to one-off income injections from donations and royalties.

9. Cash flow from operating activities increased from 9.2 per cent in 2014-15 to 10.3 per cent of total income in 2015-16. But unrestricted reserves fell from £24.1 billion (86.1 per cent of income) to £23.9 billion (82.2 per cent of total income).

10. While income increased overall between 2014-15 and 2015-16, 27 higher education institutions (HEIs) recorded real-terms reductions in income in 2015-16. The reasons for these income reductions were varied, but were primarily falls in funding body grants, overseas fee income and other income.

11. Sector income from research grants and contracts fell 1.6 per cent in 2015-16 compared with 2014-15. However, 2014-15 income was boosted by an estimated £431 million from Research and Development Expenditure Credits from HM Revenue and Customs, which fell to £82 million in 2015-16. Excluding this, the data shows that overall research income increased by £272 million in 2015-16 (a rise of 6.1 per cent).

12. The sector reported total fee income from overseas (non-European Union (EU)) students of £3.8 billion in 2015-16; this was 6.3 per cent higher than the level reported in 2014-15.

13. Forecast data from July 2016 shows that the sector is projecting a significant rise in overseas income, to reach £4.8 billion by 2018-19, although increasing competition from other countries and proposed changes to student immigration rules suggest these projections may be difficult to achieve. This would have a significant adverse impact on the sector’s surplus projections and ability to borrow.

Student recruitment 2016-17 and 2017-18

14. Data from the Higher Education Students Early Statistics Survey (HESES) for the 2016-17 academic year indicates a 0.6 per cent decrease in the number of undergraduate entrants (Home, EU and non-EU). However, this masks considerable variation across the sector, with an average decline of 7 per cent for those 58 institutions where recruitment has reduced compared with the previous year. 2016-17 HESES data also indicates a continuing decline in part-time undergraduate entrants.

15. For the 2017-18 cycle, the latest UCAS application data highlights a 5 per cent decline in UK applications and a 7 per cent decline in EU applications, relative to the same point in the previous year.

16. In terms of overseas recruitment data, early student numbers for 2016-17 show no increase in overseas undergraduate entrants compared with 2015-16. Although this pattern only relates to a small proportion of overseas applications, it is echoed by UCAS application data for 2017-18 entry, which indicates that overseas applications remain at the same level as at the same point in the previous year’s cycle.

17. In July 2016 the sector forecast an increase in overseas students (expressed as full-time equivalents (FTEs)) of 3.1 per cent between 2015-16 and 2016-17. However, the data and indicators taken together suggest an overconfidence by the sector in student number forecasts.

Capital investment

18. Capital investment in 2015-16 totalled £3.8 billion, an increase of 14.5 per cent compared with 2014-15. However, it should be noted that this level of investment is being driven by a small number of institutions, with 18 higher education institutions (HEIs) contributing 50 per cent of the sector's capital expenditure total in 2015-16. A total of 53 institutions reported a decline in capital expenditure over the period.

19. Capital expenditure as a percentage of total income varied considerably at an institutional level, ranging from 0 to 70.3 per cent.

20. While there was significant capital investment overall, the sector's latest estimate is that it still needs to invest £3.6 billion in its non-residential estate to restore it to a sound baseline condition. Inflationary pressures on the cost of construction are likely to push this figure higher. This estimate does not reflect the cost of improving the estate to a standard required to meet rising student expectations and enable HEIs fully to compete in the increasingly competitive global market.

21. To help fund capital expenditure during the year, the sector used £1.6 billion from its own cash reserves (equivalent to 5.6 per cent of total income) and committed to new borrowing of £1.1 billion. Capital grant receipts of £843 million were also reported in 2015-16.

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

Liquidity and borrowing

23. Total sector borrowing increased by 8.8 per cent; from £8.3 billion at 31 July 2015 to £9.1 billion at 31 July 2016 (equivalent to 31.2 per cent of income). This was greater than the rise in liquidity, which was 7.7 per cent, from £8.9 billion (127 days of expenditure) to £9.6 billion (135 days) over the same period. This caused the sector's net cash position (liquid funds less borrowing) to fall from £548 million at 31 July 2015 to £495 million at 31 July 2016.

24. The liquidity data is taken as a snapshot of bank and investment balances, as at 31 July. The main period of capital spending at most institutions happens during the summer months, after 31 July; therefore the available cash, not committed to future capital spending, is likely to be much lower.

Reserves and pension deficits

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

26. Under the new financial reporting framework, reserves are categorised as either restricted or unrestricted. Unrestricted income and expenditure reserves represent the value of the

institution's accumulated funds through surpluses reported in an HEI's income statement, where there are no restrictions on the use of funds.

27. After taking into account pension liabilities, the sector reported unrestricted reserves of £23.9 billion, equivalent to 82.2 per cent of total income. This represents a fall from the previous year, where reported reserves were £24.1 billion (86.1 per cent of total income). The aggregate sector position masks a significant spread of financial strength and a concentration of large unrestricted reserves in a small number of institutions, with just 10 institutions reporting half of the sector's total reserves.

28. Under FRS102, reported pension deficits are much higher, with liabilities relating to the deficit recovery plans for the sector's multi-employer pension schemes now reflected in institutional balance sheets. As a result of the transition to FRS102, pension liabilities reported by the sector rose from £4.9 billion (under the previous financial reporting standards) to £7.1 billion (under FRS102) at 31 July 2015.

29. Reported pension liabilities increased significantly again in 2015-16 to reach £9.5 billion at 31 July 2016 (equivalent to a rise of 33.1 per cent). These were also 31.5 per cent higher than pension liabilities forecast by the sector last year, indicating that earlier projections underestimated the scale of increased pension deficits.

30. The sector's largest multi-employer pension scheme is the Universities Superannuation Scheme (USS), with the great majority of current staff working in HEIs that existed before 1992 being members of this scheme. Overall, 90 HEIs contribute to the USS with employer contributions representing approximately 60 per cent of total contributions to the sector's pension schemes.

31. A complex mix of factors is contributing to the growing pension deficits across the sector, not least the prevailing economic conditions and the performance of asset investments. The latest interim valuation of the USS scheme shows that the scheme ended the year with a net deficit of £10.0 billion (as at March 2016), compared with the previous year, where the deficit was valued at £8.2 billion (as at March 2015), demonstrating the significant level of volatility in these valuations. The next full triennial valuation is due in 2017.

32. The results of the revaluation of Local Government Pension Schemes (LGPS) as at 31 March 2016, are also expected to show an increase in the LGPS deficit. With nearly 20 per cent of the sector's employer contributions paid to these LGPS schemes, an increase in the deficit will inevitably lead to increases in employer costs, placing significant financial pressures on HEIs participating in these schemes too.

Financial outlook

33. The sector has shown itself to be adaptable to a more competitive and uncertain environment, but as we reported in November 2016, there are some significant challenges ahead.

34. The growing uncertainties faced by the sector will inevitably lead to a greater focus from investors on the underlying financial strength of individual HEIs. Consequently, any fall in confidence levels could restrict the availability of finance in the sector and put significant elements of the investment programme at risk. Falling confidence levels are also likely to lead to a rise in the costs of borrowing.

35. HEIs are due to submit their next set of financial forecasts in July 2017, covering the period from 2016-17 to 2019-20. We plan to publish an overview and analysis of these forecasts in autumn 2017, 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 sound overall but with increasing variability in the performance of individual HEIs.

36. However, risks are growing in relation to EU, international and home recruitment and in relation to inflationary cost pressures such as rising construction costs. Pension liabilities also look set to rise across the sector following outcomes of triennial reviews of two of the sector's major pension schemes: USS and LGPS. The sector faces some significant uncertainties arising from Britain's forthcoming exit from the European Union, the full impact of which is not yet known. In this context we regard the financial projections from some institutions in July 2016 as over-confident.

Action required

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

Detailed analysis of financial results 2015-16

38. This annex provides an overview and analysis of the financial health of the HEFCE-funded higher education sector in England. This does not include further education colleges or alternative providers of higher education[1].

Data sources and financial reporting standards

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

a. Unless stated otherwise, all financial data up to and including 2015-16 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. Student number data is from the HESA Student Record.

40. 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 2017[2].

41. Analysis of HEIs' financial forecasts submitted in July 2016 can be found in 'Financial health of the higher education sector: 2015-16 to 2018-19 forecasts' (HEFCE 2016/34)[3].

42. Financial Reporting Standard (FRS) 102 is the new financial reporting framework for higher and further education providers for reporting periods starting on or after 1 January 2015. All 2014-15 data quoted in this report is restated under FRS102.

43. These new standards present difficulties in comparing 2015-16 results between institutions and against historical trends, because the new rules have introduced significant changes in the way financial performance is reported. Some transitional changes reflected in the restated 2014-15 results mean this is also an atypical year.

2015-16 financial results

44. The financial results for the higher education sector in 2015-16 show a financially sound position overall. It should be noted, however, that significant variations continue in the financial performances of individual institutions across the sector, with the main financial strength remaining in a small number of institutions.

45. Results for 2015-16 show that the gap between the lowest- and highest-performing institutions continues to grow.

46. Table 1 provides the key headline data from the financial information for 2014-15 (restated under FRS102) and 2015-16.

[1] These are providers of higher education that 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/2016/201634/.

Table 1: Summary of key financial indicators

	Actual	
	2014-15 (restated)	**2015-16**
Total income	£28,016M	£29,076M
Surplus[4]	£833M	£1,519M
Surplus as % of total income	3.0%	5.2%
Cash flow from operating activities	£2,588M	£2,990M
Cash flow from operating activities as % of total income	9.2%	10.3%
Net liquidity as number of days' expenditure	127	135
Net assets/net liabilities ratio	2.3	2.1
External borrowings as % of total income	29.8%	31.2%
Unrestricted reserves[5] as % of total income	86.1%	82.2%

47. The Transparent Approach to Costing (TRAC) return has been a continuing requirement for UK HEIs since the Government's 1998 comprehensive spending review, and is now a condition of 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.

48. For the last two years we have reported the key findings from the sector's TRAC reporting in our financial results publication. However, because of the change in accounting standards, our analysis of the 2015-16 TRAC data and of how results have been impacted by FRS102 is still under way.

49. 2014-15 TRAC data showed a sustainability gap (deficit) of £522 million, equivalent to 1.9 per cent of total income.

50. The remainder of the report looks at different aspects of the financial results reported by institutions in 2015-16.

[4] This is the surplus reported in the 'Statement of comprehensive income', before other gains and losses and the share of surplus or deficit in joint ventures and associates.
[5] This is the unrestricted income and expenditure reserve reported in the Consolidated and Institution Balance Sheet.

Income

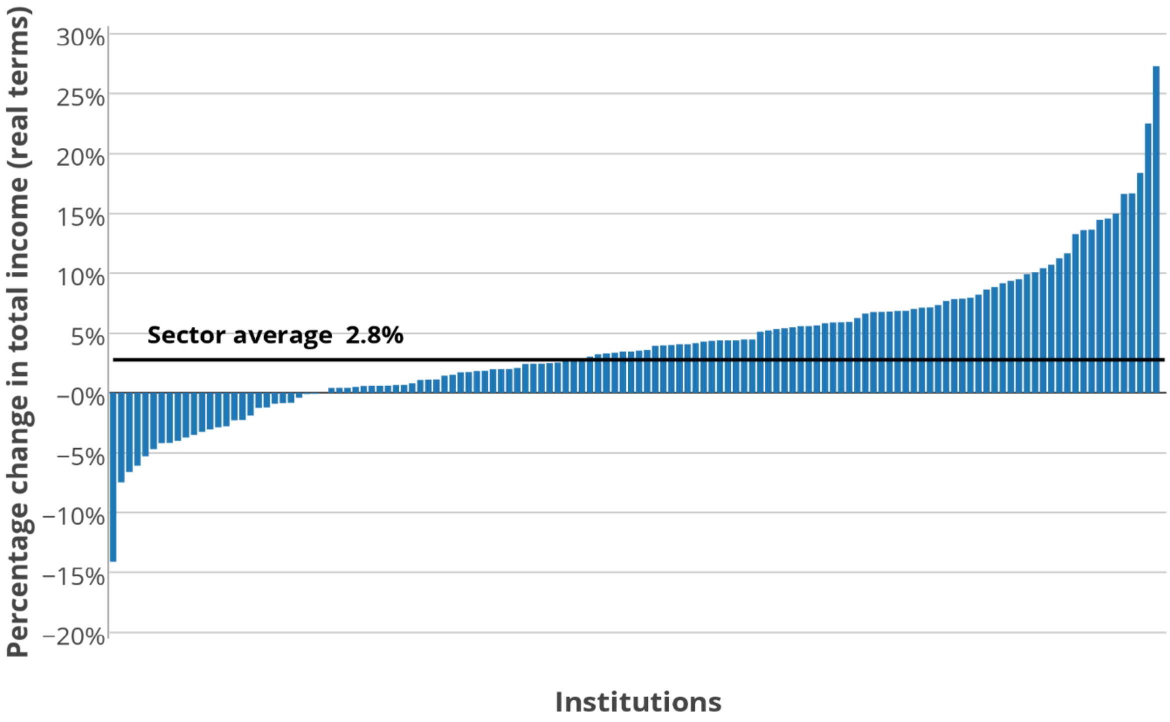
51. Total income reported by the sector in 2015-16 was £29,076 million, an increase of 3.8 per cent in cash terms compared with 2014-15, and 1.8 per cent higher than the income previously projected. Table 2 provides a breakdown of sector income for the last two years.

Table 2: Breakdown of total income

	Actual		**Change**	
	2014-15 (restated)	**2015-16**	**£M**	**%**
Funding council grants	£3,805M	£3,660M	-£145M	-3.8%
Tuition fees and education contracts (home and European Union)	£10,127M	£11,027M	£900M	8.9%
Research grants and contracts	£4,870M	£4,793M	-£77M	-1.6%
Overseas fee income	£3,556M	£3,778M	£222M	6.3%
Other income	£4,995M	£5,076M	£80M	1.6%
Investment income	£184M	£216M	£32M	17.2%
Donations and endowments	£478M	£525M	£48M	10.0%
Total income	**£28,016M**	**£29,076M**	**£1,060M**	**3.8%**

52. While income increased overall, 27 HEIs recorded real-terms reductions in income in 2015-16. The reasons for these were varied, but were primarily falls in funding body grants, overseas fee income and other income. Figure 1 shows the distribution of real-terms changes to total income across the sector between 2014-15 and 2015-16, which shows an average change of 2.8 per cent.

Figure 1: Real-terms percentage changes in total income (2014-15 to 2015-16)



53. In cash terms, tuition fee income from Home and European Union (EU) students increased by £913 million in 2015-16, equivalent to 8.9 per cent increase upon 2014-15 levels.

54. Table 3 provides a breakdown of tuition fee income received in 2015-16 compared with 2014-15.

Table 3: Breakdown of home and EU tuition fee income 2014-15 and 2015-16

£M	Actual		% increase
	2014-15	2015-16	
Full-time undergraduate	7,110	7,939	11.7%
Full-time postgraduate	714	734	2.9%
Part-time undergraduate and postgraduate	696	719	3.3%
Health	788	844	7.2%
Other fees and support grants	805	790	-1.9%
Total home and EU fee income	**10,113**	**11,027**	**9.0%**

Source: 2014-15 data - Financial return to HEFCE (July 2016), 2015-16: HESA Financial Statistics Return

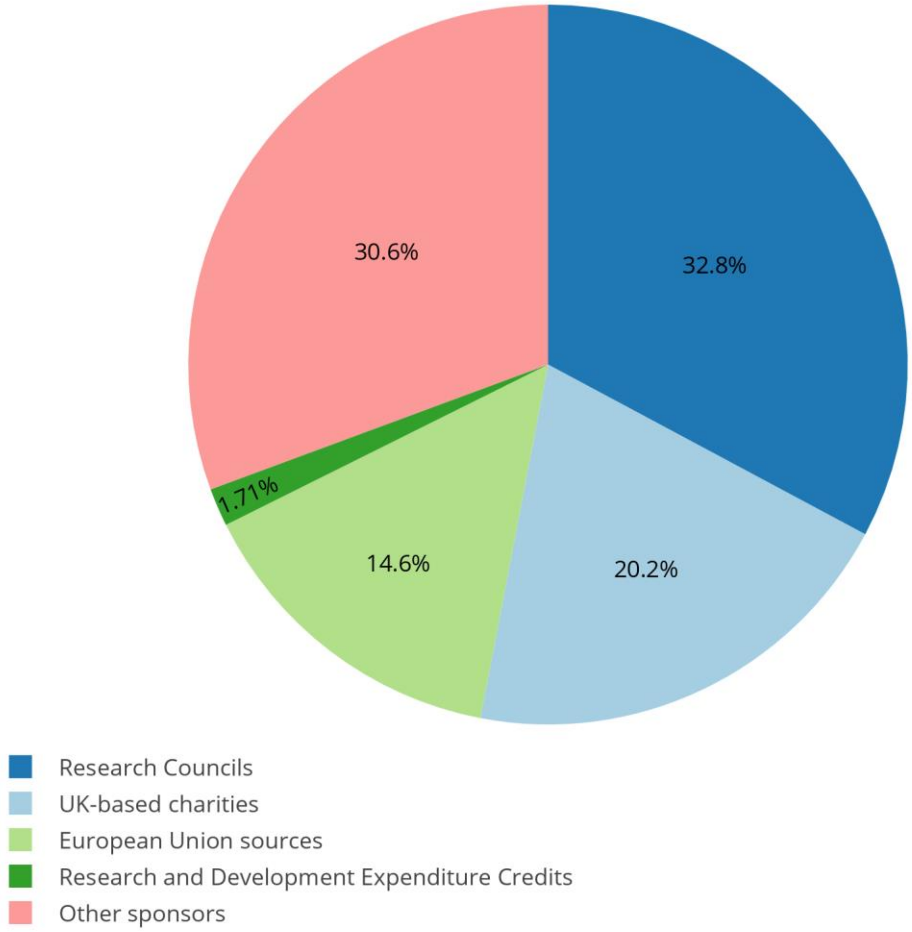
55. In 2015-16, data from the HESA student record indicates that there was an increase of 3.4 per cent in home and EU full-time undergraduate students (expressed as full-time equivalents (FTEs)) from 991,842 to 1,025,079. This indicates that much of the corresponding increase in income is due to the increase in student fees from 2012-13 replacing the reduced government funding as opposed to increased student numbers.

56. Income from research grants and contracts fell by £77 million to £4,793 million in 2015-16, equivalent to a 1.6 per cent decrease compared with 2014-15. However, 2014-15 income from research grants and contracts was boosted by £431 million from Research and Development Expenditure Credits (RDEC) from HM Revenue and Customs, which fell to £82 million in 2015-16. Without RDEC, research income would have increased by £272 million, equivalent to a rise of 6.1 per cent compared with 2014-15.

57. RDEC credits related 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 will be unable to claim RDEC in future.

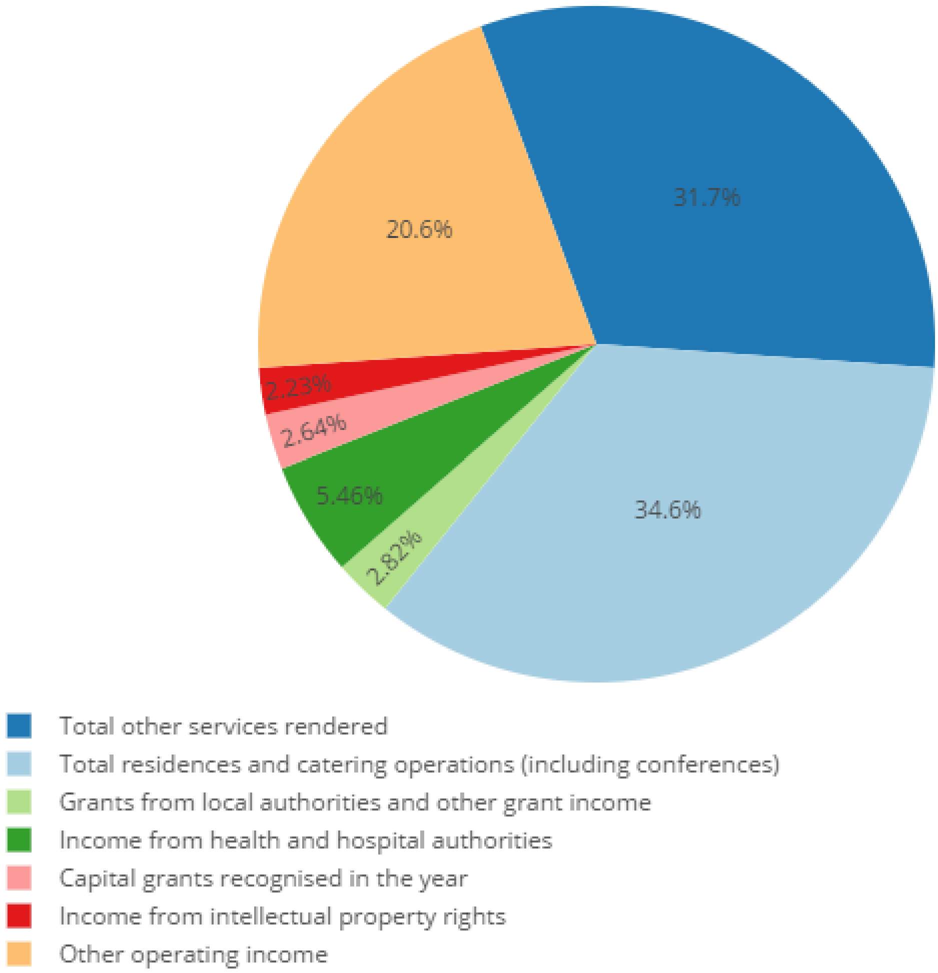
58. Figure 2 shows a breakdown of income from research grants and contracts received in 2015-16.

Figure 2: Breakdown of research and contracts income (2015-16)



59. The sector reported an increase in 'other income' over the year; from £4,995 million (17.8 per cent of total income) in 2014-15 to £5,076 million (17.5 per cent) in 2015-16. The largest income receipts in 2015-16 were from residences and catering operations (34.6 per cent of 'other income'), other services rendered (31.7 per cent) and other operating income (20.6 per cent). A breakdown of the 'other income' received is shown in Figure 3.

Figure 3: Breakdown of other income (2015-16)

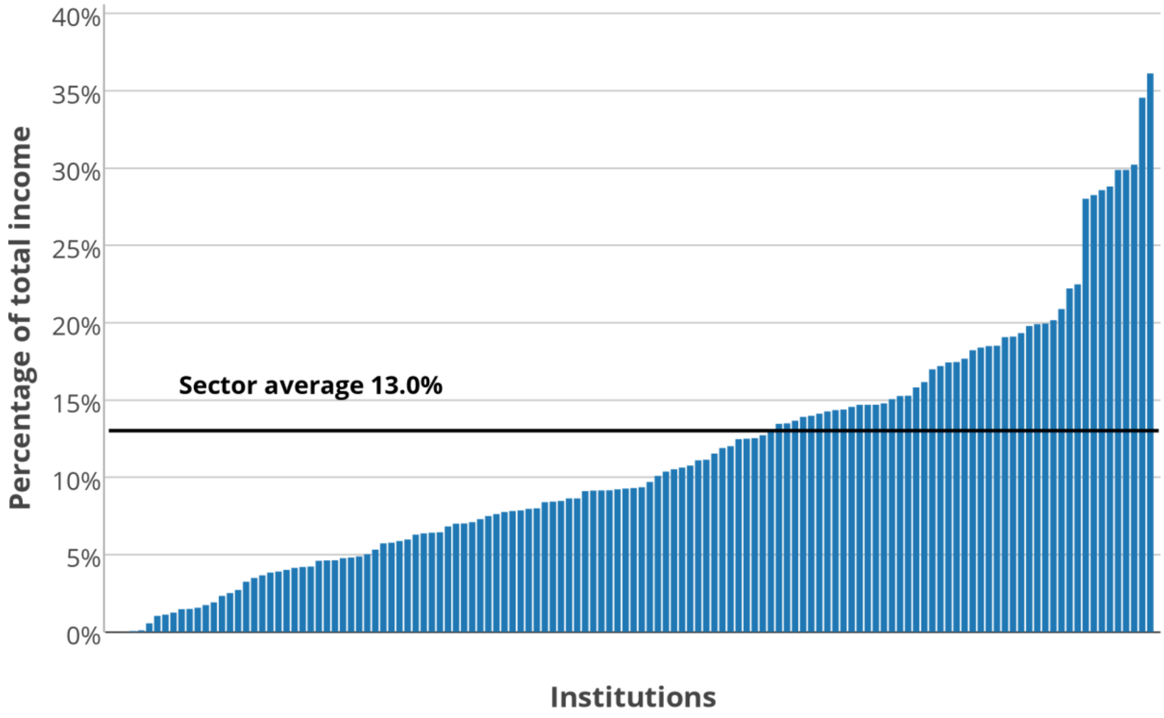


Overseas (non-EU)

60. In 2015-16 the sector reported fee income from overseas students of £3,778 million, an increase of £222 million and equivalent to a rise of 6.3 per cent compared with 2014-15. In 2015-16 this made up 13.0 per cent of total income across the sector, representing a slight increase from 2014-15 when overseas fee income made up 12.7 per cent of total income. However, as a percentage of tuition fee income, overseas fee income has declined from 26.3 per cent of total fee income in 2014-15 to 25.5 per cent in 2015-16.

61. Figure 4 shows how the distribution of overseas fee income levels in 2015-16 (expressed as a percentage of income) varies across the sector.

Figure 4: Overseas fee income as percentage of total income (2015-16)

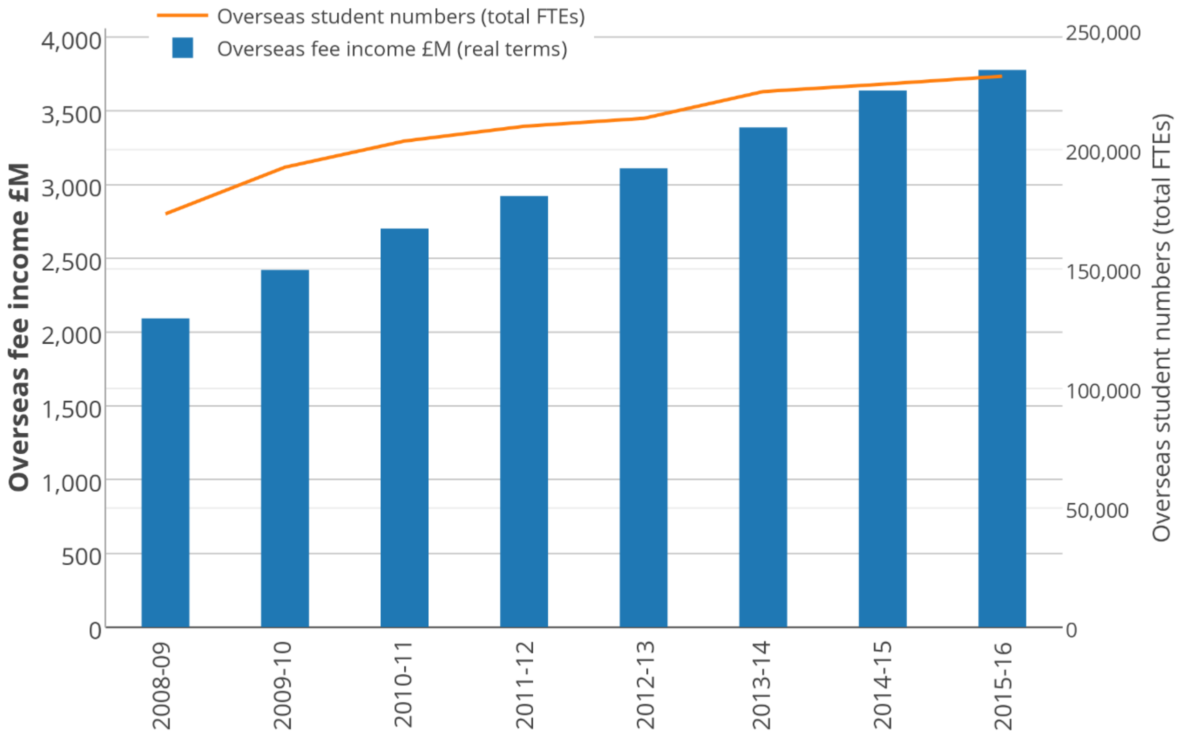


62. The HESA student record data shows that, in 2015-16, total overseas (non-EU) student numbers (FTEs) increased 1.4 per cent compared with 2014-15, increasing from 230,419 to 233,742 FTEs.

63. Figure 5 highlights that since 2008-09, although both overseas student numbers and overseas income have increased, the increase in overseas fee income is greater, indicating that the rise in overseas income is largely due to an increase in fees charged.

64. Price sensitivity is a key factor in a competitive global market and there may be a limit to the extent to which fees can be raised further, even with the current weakening in sterling.

Figure 5: Overseas fee income (real terms) and overseas student numbers (total FTEs) (2008-09 to 2015-16)



65. Table 4 shows the change in overseas students broken down by mode and level of study between 2014-15 and 2015-16.

Table 4: Breakdown of overseas student FTEs by mode and level of study.

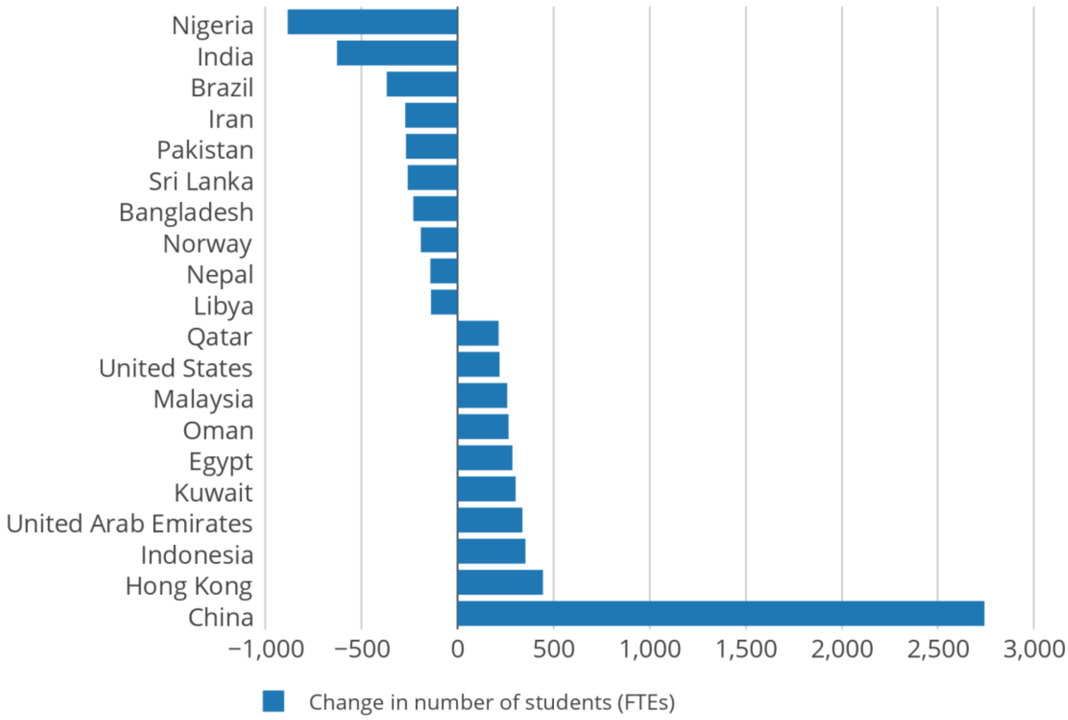
	FT UG	FT PGR	FT PGT	PT UG	PT PGR	PT PGT	Total FTEs
2014/15	121,911	22,888	76,919	3,530	1,246	3,925	230,419
2015/16	125,105	23,506	77,860	2,791	1,199	3,281	233,742
% change	2.6%	2.7%	1.2%	-20.9%	-3.8%	-16.4%	1.4%

Note: ‘FT’ = ‘full-time’; ‘PT’ = ‘part–time’; ‘UG’ = ‘undergraduate’; ‘PGR’ = ‘postgraduate research’; ‘PGT’ = ‘postgraduate taught’.

66. Total non-EU part-time student numbers have decreased by 16.6 per cent between 2014-15 and 2015-16. Indications from the 2016-17 HESES return are that overseas part-time numbers will remain constant between 2015-16 and 2016-17.

67. Figure 6 highlights the 10 countries with the largest decline of outwardly mobile students to the HEFCE-funded sector, and the 10 with largest increase between 2014-15 and 2015-16.

Figure 6: Change in total overseas students (FTEs) (2014-15 to 2015-16)



68. Chinese-domiciled students continue to make up the largest proportion of the overseas student population (30.3 per cent) and student record data shows that the number of Chinese student FTEs increased further in 2015-16, from 67,802 in 2014-15 to 70,545.

69. A significant risk to the sector is the impact a decline in overseas students would have on associated fee income and the longer-term financial sustainability of institutions. Areas of potential risk currently facing the sector include the tightening of UK immigration policy, a downturn in the global economy, including that of the UK, and increasing competition from worldwide markets for outwardly mobile students.

70. The HE sector is particularly vulnerable to changes in the Chinese student market.

Student recruitment 2016-17 and 2017-18

71. Data from the Higher Education Students Early Statistics Survey (HESES) for the 2016-17 academic year indicates a 0.6 per cent decrease in the number of undergraduate entrants compared with 2015-16. This however masks considerable variation across the sector with an average decline of 7 per cent for those 58 institutions where recruitment declined this year.

72. At tariff group level, high and low tariff grouped institutions have reported an increase in entrants, whereas specialist and medium tariff institutions have experienced a decline.

73. 2016-17 HESES data also indicates a continuing decline in part-time undergraduate entrants and flat recruitment of overseas (non-EU) entrants. This is despite many institutions forecasting growth in overseas entrants.

74. Latest UCAS data[6] indicates a 5 per cent decline in applications for 2017-18 entry. This includes a 5 per cent decline in UK applications and 7 per cent decline in EU applications. Overseas applications remain at the same level as last year.

75. This data also highlights a growing disparity between institutions in relation to student recruitment. Low tariff group institutions have so far experienced a decline in applicant numbers of 10 per cent overall, and medium tariff institutions a decline of 5 per cent, while higher tariff applications have increased by 1 per cent.

76. Certain subject areas have also experienced a decline in applications, such as nursing, where applications have declined by 20 per cent compared with the same date in 2016. The decline in nursing is assumed to be linked to funding reforms for these courses taking effect from 1 August 2017, in which the funding model for these courses will be through standard student loans provided by the Student Loan Company rather than through NHS bursaries.

77. A multitude of factors (including changing student behaviours and differential recruitment practice across providers over time) mean that it is not possible to make a fair comparison between the growth rate observed in UCAS applications data and that subsequently shown by HESES data. A crude comparison shows that since 2010-11 there have been variations for home students such that UCAS growth has been between 1.8 percentage points lower than HESES and 5.7 percentage points higher. It is therefore not possible accurately to gauge the scale or direction of any changes in 2017-18 student recruitment until the 2017 HESES data becomes available in late 2017.

78. The changes in student recruitment highlighted by the latest data raise questions over the sector's ability to achieve the ambitious growth targets in the July 2016 forecasts and potentially brings into focus the significant uncertainty facing the sector, as highlighted in 'Financial health of the higher education sector: Financial results and TRAC outcomes 2014-15' (HEFCE 2016/04). The impact of these risks is still fully to play out across the sector and it is anticipated that Britain's forthcoming exit from the European Union, increasing global competition in the higher education market, changes to funding arrangements and a volatile economy both in the UK and internationally will continue to impact the financial stability of HEIs across the sector.

Expenditure

79. In 2015-16, the sector reported total expenditure of £27,557 million, an increase of 1.4 per cent in cash terms compared with 2014-15 and equivalent to 94.8 per cent of total income. Table 5 shows a breakdown of the sector's expenditure in 2014-15 and 2015-16.

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[6] See https://www.ucas.com/corporate/data-and-analysis/ucas-undergraduate-releases/2017-cycle-applicant-figures-%E2%80%93-january-deadline.

Table 5: Breakdown of expenditure

	2014-15	2015-16	% change
Staff costs as a % of total income	£15,057M 53.7%	£14,981M 51.5%	-0.5%
Other operating expenses as a % of total income	£9,852M 35.2%	£10,166M 35.0%	3.2%
Depreciation as a % of total income	£1,668M 6.0%	£1,717M 5.9%	3.0%
Fundamental restructuring costs as a % of total income	£29M 0.1%	£41M 0.1%	44.1%
Interest and other finance costs as a % of total income	£577M 2.1%	£651M 2.2%	12.8%
Total expenditure **as a % of total income**	**£27,183M** **97.0%**	**£27,557M** **94.8%**	**1.4%**

80. The sector's largest expenditure relates to staff costs, which totalled £14,981 million in 2015-16, equivalent to 51.5 per cent of total income. While this represents a decrease of £75 million on the level reported in the previous year, 2014-15 staff costs were higher because of transitional changes introduced as a result of FRS102. In particular, the requirement for HEIs to recognise provisions for liabilities relating to the deficit recovery plans for the sector's multi-employer pension schemes increased staff costs by £883 million in the transitional year (2014-15).

81. Table 6 provides a breakdown of staff costs in 2014-15 under both the old and new financial accounting standards, alongside staff costs for 2015-16. This information is based on data submitted by institutions in July 2016 and shows the effect of the transitional change to pension provisions under FRS102.

Table 6: Breakdown of staff costs

	2014-15	2014-15 (FRS102)	2015-16 (FRS102)	2015-16 change	
Salaries and wages	£11,410M	£11,403M	£11,849M	£447M	3.9%
Social security costs	£925M	£927M	£1,038M	£111M	12.0%
Employer pension costs	£1,754M	£1,778M	£1,849M	£71M	4.0%
Changes to pension provisions	£15M	£892M	£15M	-£877M	-98.3%
Other staff related costs	£55M	£42M	£32M	-£10M	-22.9%
Total staff costs	**£14,159M**	**£15,041M**	**£14,783M**	**-£258M**	**-1.7%**

Surpluses

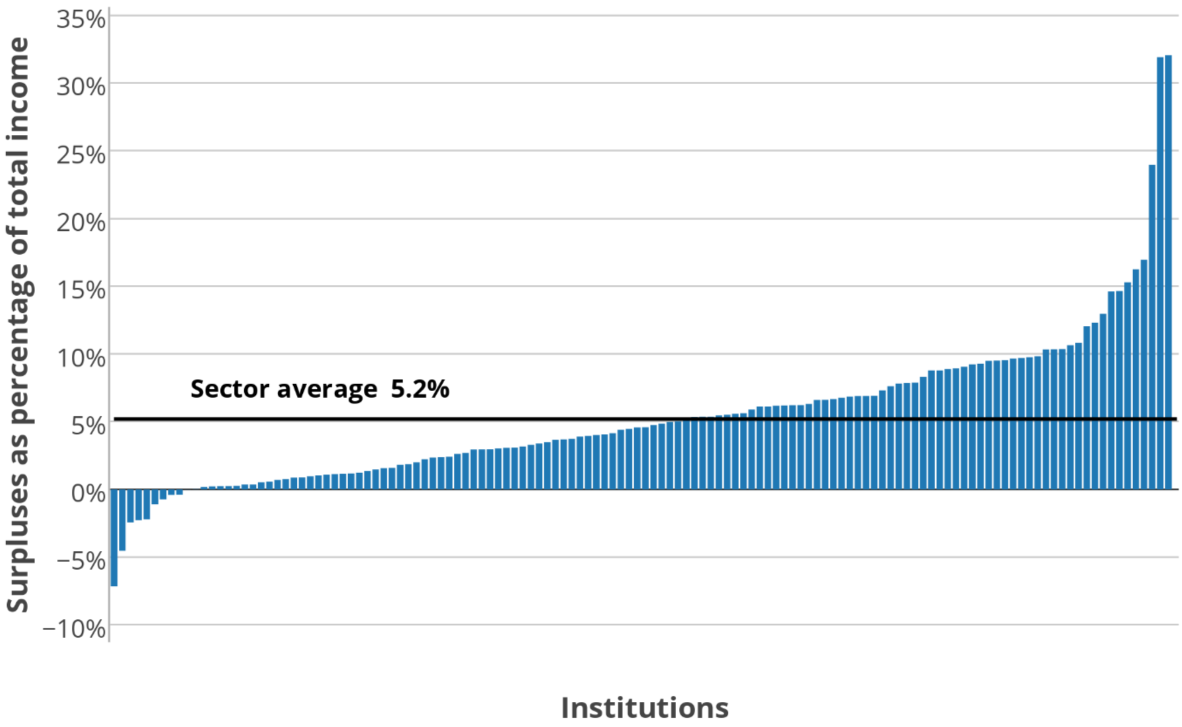
82. The sector's surplus[7] increased by 82.2 per cent from £833 million in 2014-15 to £1,519 million in 2015-16. This was equivalent to a sector average of 5.2 per cent of total income, compared with an average of 3.0 per cent in 2014-15.

83. Although the increase in 2015-16 appears high, it should be noted that some significant transitional accounting changes were introduced as a result of FRS102, such as the increase in pension provisions for the sector's multi-employer pension schemes which reduced sector surpluses in 2014-15. The underlying increase in 2015-16 surpluses (excluding these transitional changes) is much lower.

84. Figure 7 shows the level of surpluses as a percentage of total income reported by institutions in 2015-16.

[7] Total income less total expenditure, excluding other gains or losses (from investments and fixed asset disposals) and the share of surplus or deficit in joint ventures and associates.

Figure 7: Surpluses as a percentage of total income (2015-16)



85. At institutional level, results range from a deficit of 7.2 per cent to a surplus of 32.1 per cent, equivalent to a range of 39.2 per cent. This is higher than the range reported for 2014-15, which was 31.1 per cent, and demonstrates the significant level of variation in financial performances of individual institutions across the sector.

86. Three institutions reported surpluses of over 20 per cent in 2015-16, compared with one institution in 2014-15. The high surpluses recorded by two of these institutions were due to one-off income injections from donations and royalties.

Liquidity and cash flow

87. At the end of 2015-16 the sector had net liquidity of £9,577 million, equivalent to 135 days' expenditure (that is, the number of days' expenditure that the liquidity covers). This is higher than the level reported at the end of 2014-15, which was £8,896 million (127 days). Three institutions had liquidity of less than 20 days, compared with two institutions in 2014-15.

88. The liquidity data is taken as a snapshot of projected bank and investment balances, as at 31 July. The main period of capital spending at most institutions happens during the summer months, after 31 July; therefore the available cash, not committed to capital spending, is likely to be much lower.

89. As charities, HEIs are obliged 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

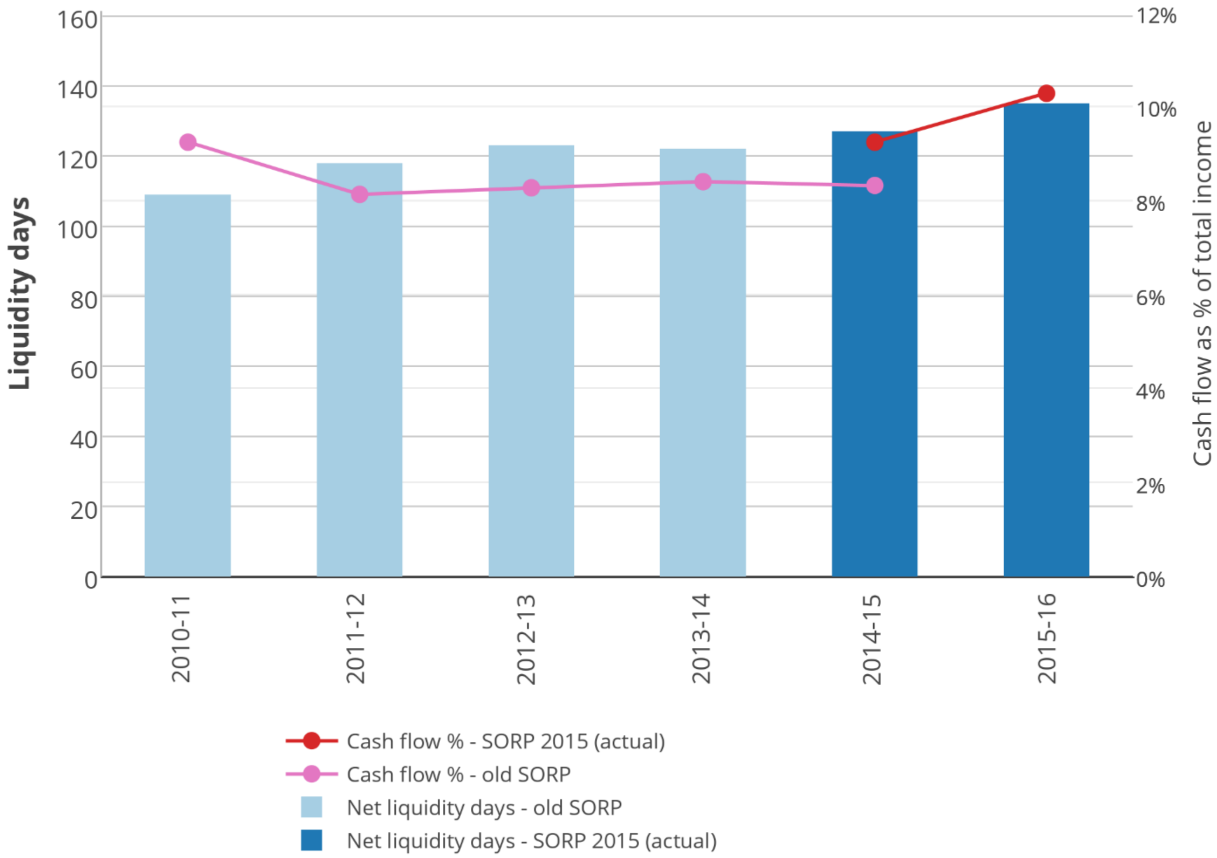
monitor liquidity levels, to assess whether HEIs are able to maintain sufficient cash levels to manage their risks effectively.

90. Cash flow from operating activities rose from £2,588 million in 2014-15 to £2,990 million in 2015-16, equivalent to 10.3 per cent of total income.

91. Seven institutions reported negative cash flows in 2015-16 (compared with nine HEIs in 2014-15).

92. Figure 8 shows the level of net liquidity (expressed in days) and cash flow from operating activities (as a percentage of total income) for the period 2010-11 to 2015-16.

Figure 8: Net liquidity (days) and cash flow from operating activities as a percentage of total income (2010-11 to 2015-16)



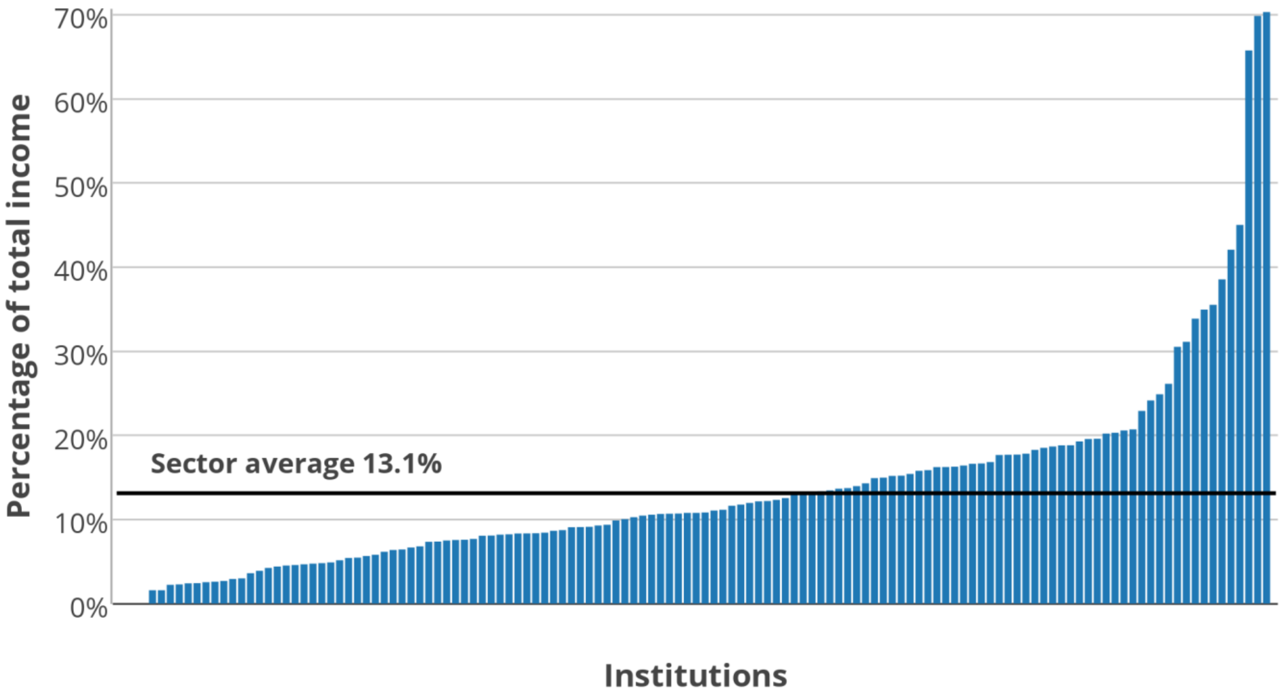
Note: ‘SORP’ = ‘Statement of Recommended Practice’ (for accounting).

Capital expenditure and borrowing

93. The sector continues to make a substantial investment in infrastructure to maintain and enhance the academic and student facilities. In 2015-16, capital expenditure totalled £3,801 million, an increase of 14.5 per cent compared with 2014-15. There is, however, significant variation between institutions, with 53 reporting a decline in capital expenditure between 2014-15 and 2015-16.

94. Figure 9 highlights capital expenditure as a percentage of total income in 2015-16, at an institutional level. While the sector's overall investment was equivalent to 13.1 per cent of total income, at institutional level this ranged from 0 to 70 per cent.

Figure 9: Total capital expenditure as a percentage of total income (2015-16)



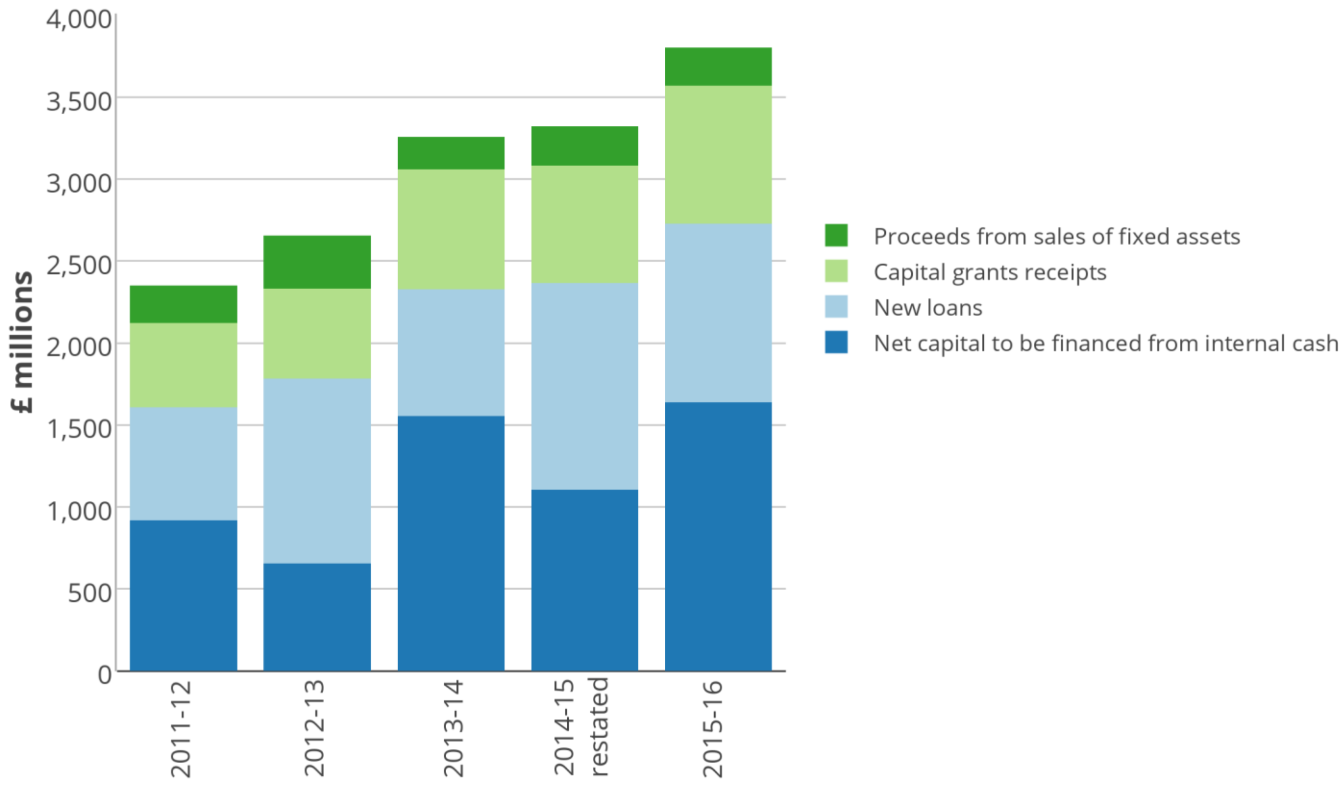
NB. Removal of the largest three values from the sector average reduces the average to 12.7 per cent.

95. Over the last 10 years, the sector has spent nearly £28 billion on improving its physical infrastructure, excluding expenditure on general day-to-day maintenance.

96. Despite this, Estate Management Statistics data, as at 31 July 2015, showed that the sector still needed to invest £3.6 billion to bring its non-residential estate up to a sound and operationally safe condition. This cost reflects the investment required to restore the estate to a sound baseline condition not to achieve the standard required to satisfy rising student expectations. This latter investment is essential for enabling HEIs to compete in the increasingly competitive domestic and global market.

97. Figure 10 provides a breakdown of how capital expenditure was funded in the period from 2010-11 to 2015-16.

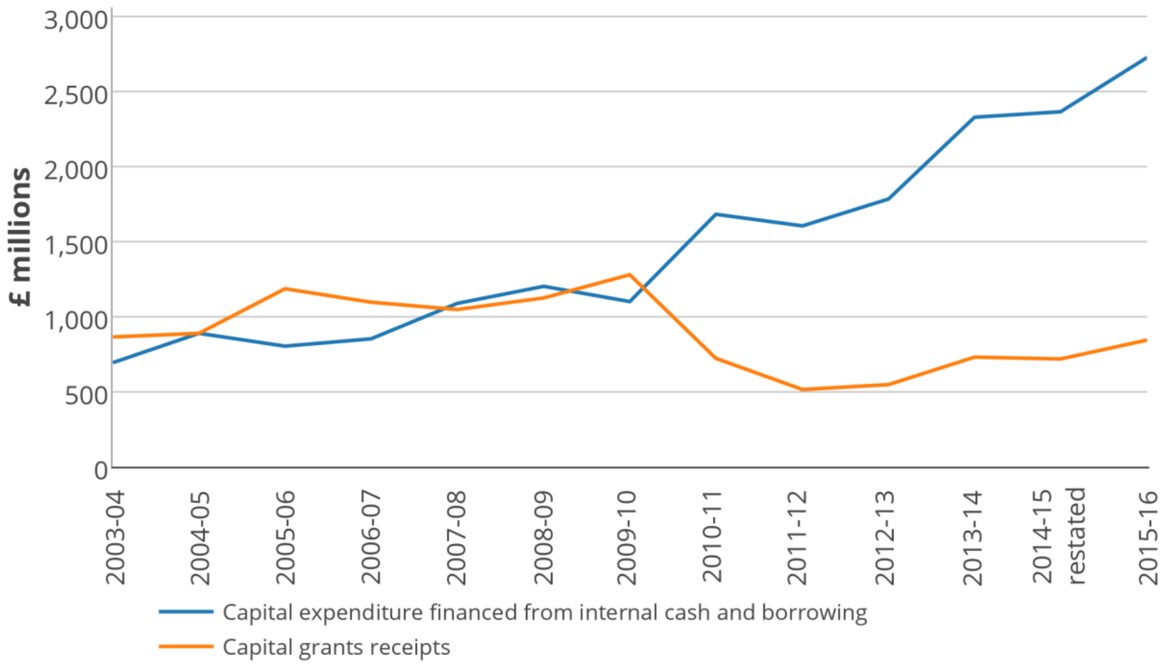
Figure 10: Funding breakdown of capital expenditure (2011-12 to 2015-16)



98. With significantly reduced levels of publicly funded capital grants, HEIs will need to generate surpluses and operating cash inflows to sustain the level of capital investment needed to attract students and staff, and ensure their long-term sustainability. Increased surpluses provide the positive cash flow needed to fund future investment and meet finance costs.

99. Figure 11 shows capital grants received by the sector since 2003-04, alongside the level of capital expenditure financed by additional borrowing and internal cash.

Figure 11: Real-terms capital expenditure funding (from base year 2003-04 to 2015-16)



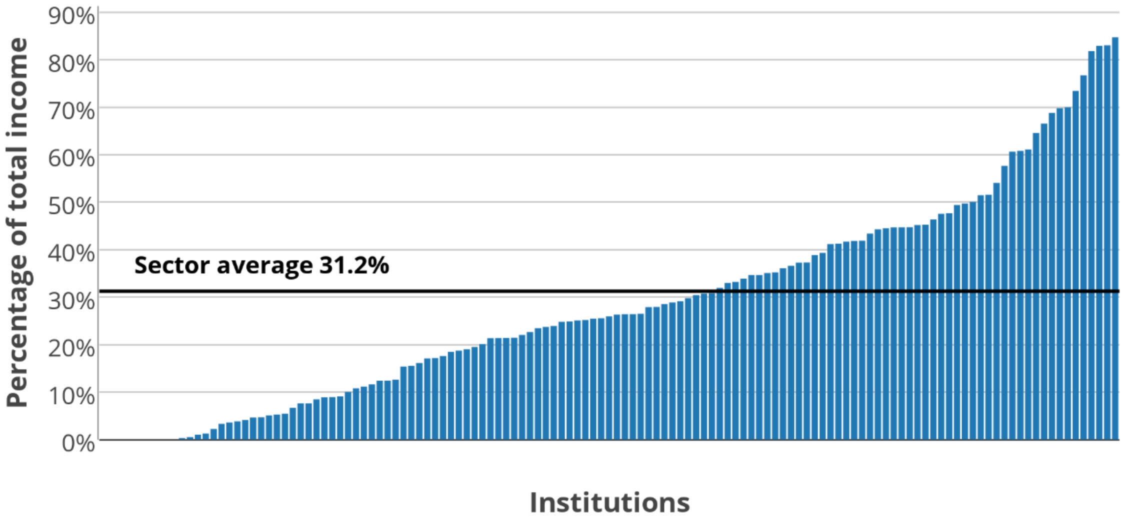
100. HEFCE 2016/34 reported the latest sector forecast data which predicted that capital expenditure would increase further in 2016-17 to £5,287 million, with the increase in investment funded primarily through institutions' own cash reserves.

101. HEIs will inevitably reassess their capital investment plans in the light of economic uncertainty, changing building costs (occurring as a result of inflation and the weakening of sterling) and their ability to fund planned investment levels by generating additional cash or increasing borrowing. 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.

Borrowing

102. At the end of July 2016, the sector reported borrowing of £9,082 million (equivalent to 31.2 per cent of income). This is £734 million higher than the level reported at the end of 2014-15, which was £8,348 million (29.8 per cent of income). Figure 12 shows the wide variation in the level of borrowing across the sector at 31 July 2015.

Figure 12: External borrowing as a percentage of total income (2015-16)



Note: Excludes one outlier.

103. As borrowing rises in the sector, interest payments will increase. This rise in 'fixed costs' could put pressure on any institution that fails to constrain other costs or to increase income.

104. 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, placing increasing financial burden on individual institutions' sustainability if not well managed.

105. In 2015-16, the sector reported a rise in interest and other finance costs of £74 million compared with 2014-15 (equivalent to 12.8 per cent), although some of this increase was due to the recognition of interest costs relating to pension deficit recovery plans and changes in the fair value of financial instruments, such as derivatives.

106. As part of the Memorandum of Assurance and Accountability between HEFCE and institutions, we introduced an approval process to assess whether increases in financial commitments by an HEI above a threshold would increase the risk to its future financial sustainability, and therefore to the public and collective student interests. This approval process, which currently uses a threshold based on an HEI's earnings before interest, tax, depreciation and amortisation, has been operating since 1 August 2014.

107. The adoption of the new financial reporting standard has implications for the financial commitment threshold, and we are modelling to assess whether a revised approach using adjusted operating cash flow would be more appropriate when assessing financial commitments. We expect to introduce a new approach to financial commitments from 1 August 2017.

Reserves and pensions

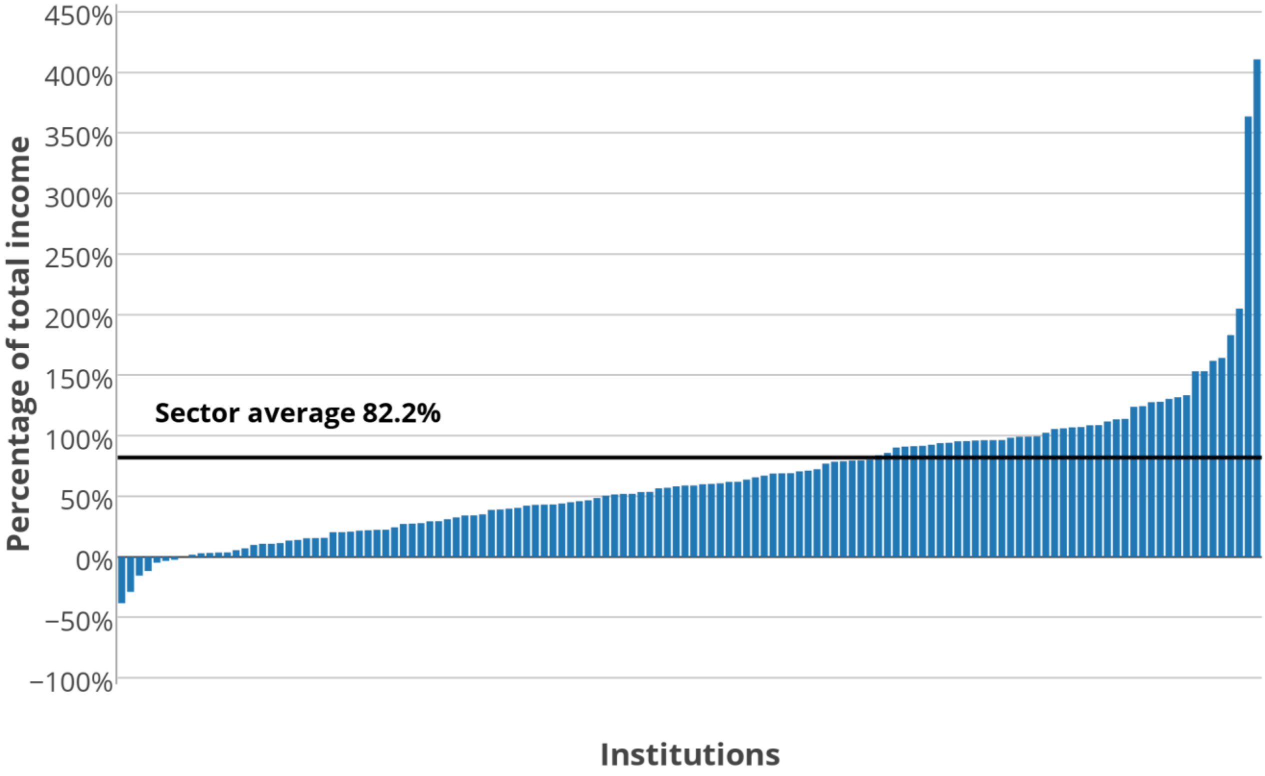
108. Reserves are an HEI's assets less its liabilities and, in very broad terms, can be used as a proxy for the overall value of an institution. These are the accumulated surpluses of an institution over its lifetime and are not the same as cash, although an institution could dispose of an asset if it was surplus to operational requirements (thereby converting it to cash).

109. Under the new financial reporting framework, reserves are categorised as restricted or unrestricted. Restricted reserves apply where there are restrictions on how an institution can use the funds, such as endowments and donations designated for a specific purpose. Unrestricted reserves[8] represent the value of the institution's accumulated funds through surpluses reported in its income statement, on whose use there are no restrictions.

110. After taking into account projections for pension deficits, the latest financial data shows that unrestricted reserves fell from £24.1 billion as at 31 July 2015 (equivalent to 86.1 per cent of total income) to £23.9 billion at 31 July 2016 (82.2 per cent of total income). However, the aggregate sector position masks a significant spread of financial strength and a concentration of large unrestricted reserves in a small number of institutions, with 10 institutions reporting 50 per cent of the sector's unrestricted reserve balance at 31 July 2016.

111. Unrestricted reserves as a percentage of total income also varied considerably at an institutional level. Figure 13 shows the level of unrestricted reserves, after deducting pension liabilities, as a percentage of total income in 2015-16. This shows results ranging from -38 per cent to 411 per cent at 31 July 2016.

Figure 13: Unrestricted reserves including pension liabilities as a percentage of total income (2015-16)



NB. Removal of the largest two values from the sector average reduces the average to 80.4 per cent.

[8] This is the unrestricted income and expenditure reserve reported in the Consolidated and Institution Balance Sheet.

112. Under FRS102, pension deficits are much higher, with liabilities relating to the deficit recovery plans for the sector's multi-employer pension schemes now reflected in institutional balance sheets. As a result, pension liabilities reported as at 31 July 2015 increased from £4.9 billion (under the previous financial reporting standards) to £7.1 billion under FRS102.

113. The latest financial data shows that reported pension liabilities increased by £2.4 billion in 2015-16, to reach £9.5 billion at 31 July 2016 (equivalent to a rise of 33.1 per cent). These were also 31.5 per cent higher than the level of pension liabilities projected by the sector last year, suggesting that actuarial pension deficits had been underestimated.

114. The sector's largest multi-employer pension scheme is the Universities Superannuation Scheme (USS), with the great majority of current staff working in HEIs that existed before 1992 being members of this scheme. Overall, 90 HEIs contribute to the USS, with employer contributions representing approximately 60 per cent of total contributions to the sector's pension schemes.

115. A complex mix of factors is contributing to the growing pension deficits across the sector, not least the prevailing economic conditions and the performance of asset investments. The latest interim valuation of the USS shows that the scheme ended the year with a net deficit of £10.0 billion (as at March 2016), compared with the previous year, where the deficit stood at £8.2 billion (as at March 2015), demonstrating the significant level of volatility in these valuations[9]. The next full triennial valuation is due to commence in 2017.

116. The revaluation of Local Government Pension Schemes, as at 31 March 2016, is due to be reported in the near future and is expected to show an increase in the associated deficit. It is estimated that nearly 20 per cent of the sector's employer contributions are paid to these schemes, so an increase in the deficit will inevitably lead to increases in employer costs, placing significant financial pressures on HEIs participating in these schemes.

Disclaimer

117. This report, which is based on information provided by HEFCE-funded higher education institutions, has been prepared for the benefit of HEIs 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.

[9] See https://www.uss.co.uk/how-uss-is-run/running-uss/annual-reports-and-accounts.

List of abbreviations

EU	European Union
FRS	Financial Reporting Standard
FT	Full-time
FTE	Full-time equivalent or equivalence
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
HESA	Higher Education Statistics Agency
HESES	Higher Education Students Early Statistics Survey
LGPS	Local Government Pension Scheme
PGR	Postgraduate research
PGT	Postgraduate taught
PT	Part-time
RDEC	Research and Development Expenditure Credits
SORP	Statement of Recommended Practice (in accounting)
TRAC	Transparent Approach to Costing
UG	Undergraduate
USS	Universities Superannuation Scheme