

March 2015/07

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 2013-14, as submitted to HEFCE in December 2014.

Financial health of the higher education sector

Financial results and TRAC outcomes 2013-14

Financial health of the higher education sector: Financial results and TRAC outcomes 2013-14

To	Heads of HEFCE-funded higher education institutions
Of interest to those responsible for	Audit, Estates, Finance, Governance, Management, Planning
Reference	2015/07
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Enquiries to	Nolan Smith, tel 0117 9317376, email n.smith@hefce.ac.uk , or Annette Wynne, tel 0117 9317377, email a.wynne@hefce.ac.uk .

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 2013-14, as submitted to HEFCE in December 2014, as well as the outcomes from the sector's Transparent Approach to Costing (TRAC) reporting for 2013-14, as submitted to HEFCE in January 2015.
2. The report is being published to provide universities and higher education colleges with feedback on their financial performance in 2013-14. It also provides other stakeholders with information about the current financial health of the sector. This report focuses on the financial results for 2013-14. For a more definitive assessment of the future financial sustainability of the sector, please see our earlier report 'Financial health of the higher education sector: 2013-14 to 2016-17 forecasts' (HEFCE 2014/26).

Key points

3. The sector's financial results for 2013-14 show a financially sound position overall. While the financial outturn was stronger than projected by the sector in July 2014, sector financial results were similar to those reported in 2012-13. There continue to be significant variations in the financial performances of individual institutions across the sector.
4. In 2013-14, the sector reported operating surpluses of £992 million, equivalent to 3.9 per cent of income. These were £49 million higher than surpluses reported in 2012-13 (which were also equivalent to 3.9 per cent of income), and 29 per cent higher than the levels projected by the sector in July 2014. The improvement in the financial outturn when compared with projected performance may be due to prudent forecasting, which is a pattern we have seen in previous years, but this also provides some evidence that the sector made efficiency savings during the year.
5. As part of our annual accountability process, we ask institutions to submit value for money reports to us showing how they make the best use of available resources. Our analysis of the

data from these reports indicates that the sector has made an estimated cumulative saving of £1.1 billion over the last three years (2011-12 to 2013-14). These efficiency savings have helped support the current financial performance of the sector. It will be important for the sector to maintain this efficiency drive in order to deliver long-term sustainability in the future.

6. The recently published Diamond review of efficiency, effectiveness and value for money in higher education notes that while the value for money reports provide a valuable resource for understanding efficiency and cost savings in the sector, a more robust, accessible and comprehensive mechanism is needed. HEFCE will work with the sector to develop this mechanism.

7. Despite the fall in public capital funding over recent years, the latest financial results show that the sector has been able to deliver a significant increase in capital investment in 2013-14, which at £3,250 million represents an increase of 23 per cent compared with the previous year.

8. To help fund this expenditure, the sector used £1,552 million from its own cash reserves (equivalent to 6.1 per cent of total income) and borrowed an additional £501 million. This caused total sector borrowing to rise to £6.7 billion at the end of July 2014 (equivalent to 26.3 per cent of income). Net liquidity also rose by £285 million to £7.7 billion at the end of July 2014, producing a net cash position in the sector of £1.0 billion. This is relatively small compared with an overall income of £25.6 billion and is lower than the net cash position reported in 2012-13, which was £1.2 billion.

9. While the level of capital investment in 2013-14 is a positive sign that the sector is increasing investment in infrastructure, the latest data available from the Estate Management Record shows that, at the end of July 2013, many higher education institutions (HEIs) still had large amounts of non-residential space in poor condition and the cost to the sector of upgrading this was estimated at £3.3 billion. However, it is important to note that this only reflects the cost required to upgrade this portion of the estate to a sound and operationally safe condition, and does not take into account the additional investment needed to bring it up to the standard required to satisfy rising student expectations and ensure that the sector's higher education provision can stand up to growing international competition.

10. Analysis of the 2013-14 TRAC results show that the sector reported a sustainability gap (difference between the level of surplus achieved by the sector and the level required to cover the full economic costs of its activities) of £883 million; a deterioration against the position in 2012-13, when the sustainability gap was £870 million. This means that, in the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities to secure their long-term sustainability.

11. 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 student demands, build capacity and ensure that the sector can remain internationally competitive. Government support also fosters confidence to others to continue to invest in the sector, including willingness of banks 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.

12. Discretionary reserves, after taking into account projections for pension deficits, increased by 6.7 per cent in 2013-14, to reach £12.3 billion as at 31 July 2014, equivalent to 48.0 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.

13. While sector reserves currently appear strong overall, from 2015-16 reserve levels and pension deficits will be significantly affected by the introduction of a new financial reporting standard (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, it will increase the transparency of the underlying deficits within the relevant pension schemes, which may impact on confidence levels in the financial strength of the sector.

14. The indicative results of the most recent triennial valuation show that the USS scheme deficit was £13 billion as at 31 March 2014 and USS employers are currently consulting with eligible employees on a range of proposed reforms designed to address this deficit. This includes a proposal to increase the employer pension contribution rate from 16 to 18 per cent. The final decision on all of the scheme reforms is due to be taken by the USS trustees in summer 2015.

15. While the sector has shown itself to be adaptable in coping with change, there continue to be some significant challenges and risks for the future. HEIs are due to submit their next set of financial forecasts for the period 2014-15 to 2017-18 in July 2015, and we plan to publish an overview and analysis of these forecasts in autumn 2015, which will focus on the 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 2017 (submitted by HEIs in July 2014) predicted lower surpluses, a fall in cash levels and a rise in borrowing, signalling a trajectory that is not sustainable in the long term.

16. This view is supported by the recent report on the sustainability of learning and teaching in higher education in England, published by the Financial Sustainability Strategy Group, which concludes that the sector is financially healthy in the short term, but warns that the impact of the 2012 funding changes may not yet be fully apparent. While the report acknowledges that HEIs are adapting to the demands of a more commercial and competitive environment, in doing so they are facing higher levels of risk and uncertainty. Some HEIs may be able to manage these risks within the type of strategies and operations they have at present but in future a continuation of 'more of the same' may not be enough to ensure sustainability.

17. Based on the financial results for 2013-14 and the July 2014 financial forecasts, no institutions are currently close to the risk of insolvency. This conclusion is supported by independent institutional audits and the sector's own projected continuation of positive cash inflows and healthy cash-backed reserves, although these are reliant on institutions achieving recruitment targets for home and overseas students, and on the level of public funding remaining as projected.

Action required

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

Background information

19. 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 2013-14. This does not include further education colleges or alternative providers of higher education¹.
20. The data used in this paper comes from the following sources:
- a. Financial data up to and including 2012-13 is from the Higher Education Statistics Agency (HESA) Finance Statistics Record, submitted each year to HESA by higher education institutions (HEIs).
 - b. Financial data for the year 2013-14 is from HEIs' financial returns, submitted to HEFCE in December 2014.
 - c. TRAC data is from HEIs' TRAC returns submitted to HEFCE in January 2015.
21. 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 December 2014².
22. Analysis of HEIs' financial forecasts submitted in July 2014 can be found in 'Financial health of the higher education sector: 2013-14 to 2016-17 forecasts' (HEFCE 2014/26)³.
23. The conclusions from the review of the sustainability of learning and teaching in higher education in England, published by the Financial Sustainability Strategy Group in March 2015, were also considered as part of our current assessment of financial health⁴.

2013-14 financial results

24. The financial results for the higher education sector in 2013-14 show a financially sound position overall. While the financial outturn was stronger than projected by the sector in July 2014, sector financial results were similar to those reported in 2012-13. It should be noted, however, that significant variations continue in the financial performances of individual institutions across the sector, with the main financial strength of the sector remaining in a small number of institutions.
25. Table 1 provides a summary of the key financial results for 2013-14, alongside the sector's results for 2011-12 and 2013-14.

¹ 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/2014/201426/.

⁴ Available online at www.hefce.ac.uk/funding/finsustain/pubs/.

Table 1: Summary of key financial indicators

	Actual		
	2011-12	2012-13	2013-14
Total income	£23,277M	£24,320M	£25,591M
Operating surplus	£972M	£943M	£992M
Operating surplus as % of total income	4.2%	3.9%	3.9%
Historical cost surplus	£1,138M	£1,208M	£1,272M
Historical cost surplus as % of total income	4.9%	5.0%	5.0%
Earnings before interest, taxation, depreciation and amortisation	£2,087M	£2,188M	£2,332M
TRAC sustainability gap	(£726M)	(£870M)	(£883M)
TRAC sustainability gap as a % of total income	(3.1%)	(3.6%)	(3.5%)
Cash flow from operating activities as % of total income	8.1%	8.3%	8.4%
Net liquidity as number of days' expenditure	118	123	122
External borrowings as % of total income	23.5%	25.6%	26.3%
Discretionary reserves excluding FRS17* as % of total income	56.0%	61.8%	64.4%

*FRS17 is the financial reporting standard on retirement benefits.

26. The key messages from the analysis of the 2013-14 annual financial accounts are included in the following section and the outcomes from the sector's TRAC reporting for 2013-14 are summarised in paragraphs 59 to 67 of this report.

Income

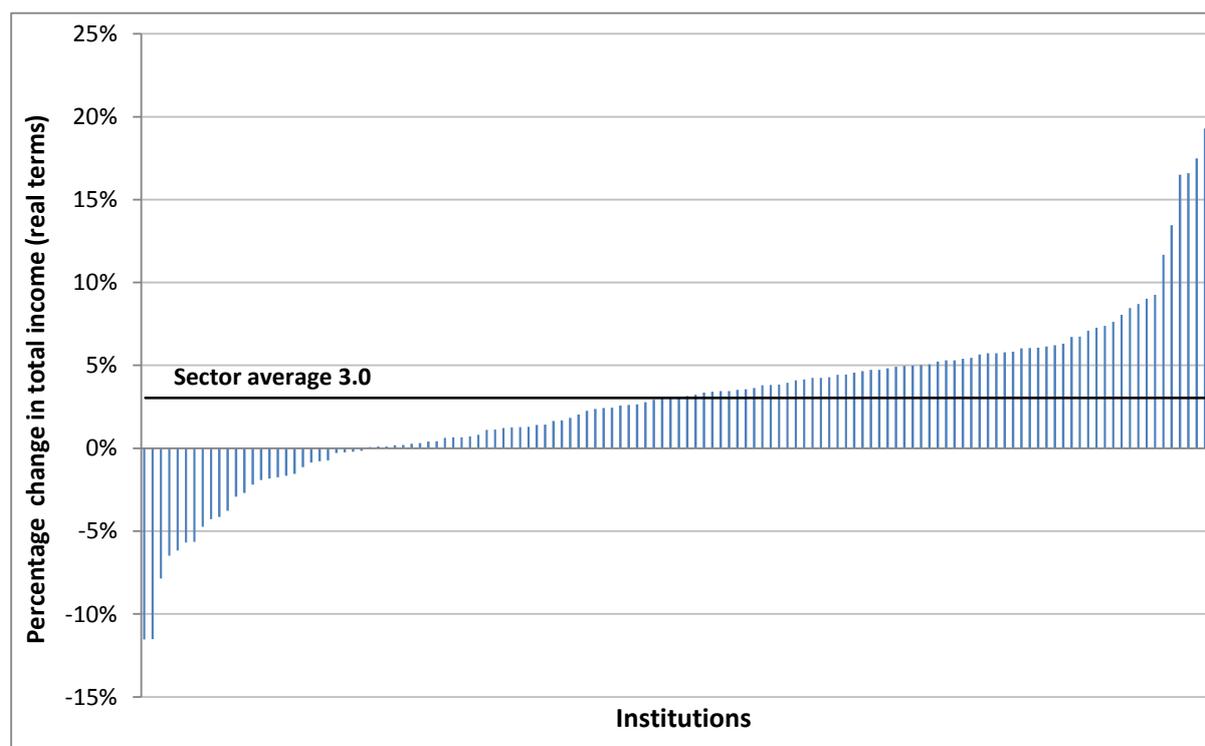
27. Total income rose by £1,271 million to £25,591 million during 2013-14, an increase of 5.2 per cent compared with 2012-13, although in real terms the increase was equivalent to 3.0 per cent. Table 2 provides a breakdown of sector income for the last two years.

Table 2: Breakdown of total income

	Actual		Change	
	2012-13	2013-14	£M	%
Funding council grants	£5,505M	£4,524M	-£981M	17.8%
Overseas fee income	£2,997M	£3,292M	£295M	9.9%
Tuition fees and education contracts (Home and European Union)	£7,145M	£8,695M	£1,550M	21.7%
Research grants and contracts	£3,872M	£4,117M	£245M	6.3%
Other operating income	£4,564M	£4,687M	£123M	2.7%
Endowment income and interest	£237M	£277M	£40M	16.8%
Total income	£24,320M	£25,591M	£1,271M	5.2%

28. While income increased overall, 27 HEIs recorded real-terms reductions in income in 2013-14, compared with 43 HEIs in 2012-13. The reasons for these income reductions were varied, including lower levels of research grant funding, reductions in overseas tuition fee income or lower 'other operating income'. Figure 1 shows the real-terms changes to total income recorded by HEIs between 2012-13 and 2013-14. This demonstrates the wide variation in performance across the sector.

Figure 1: Real-terms percentage changes in total income (2012-13 to 2013-14)



29. In cash terms, total tuition fee income (including fees from international students) increased by £1,845 million in 2013-14, equivalent to a 18.2 per cent increase upon 2012-13 levels. Table 3 provides a breakdown of tuition fee income received in 2013-14 compared with 2012-13.

Table 3: Breakdown of tuition fee income

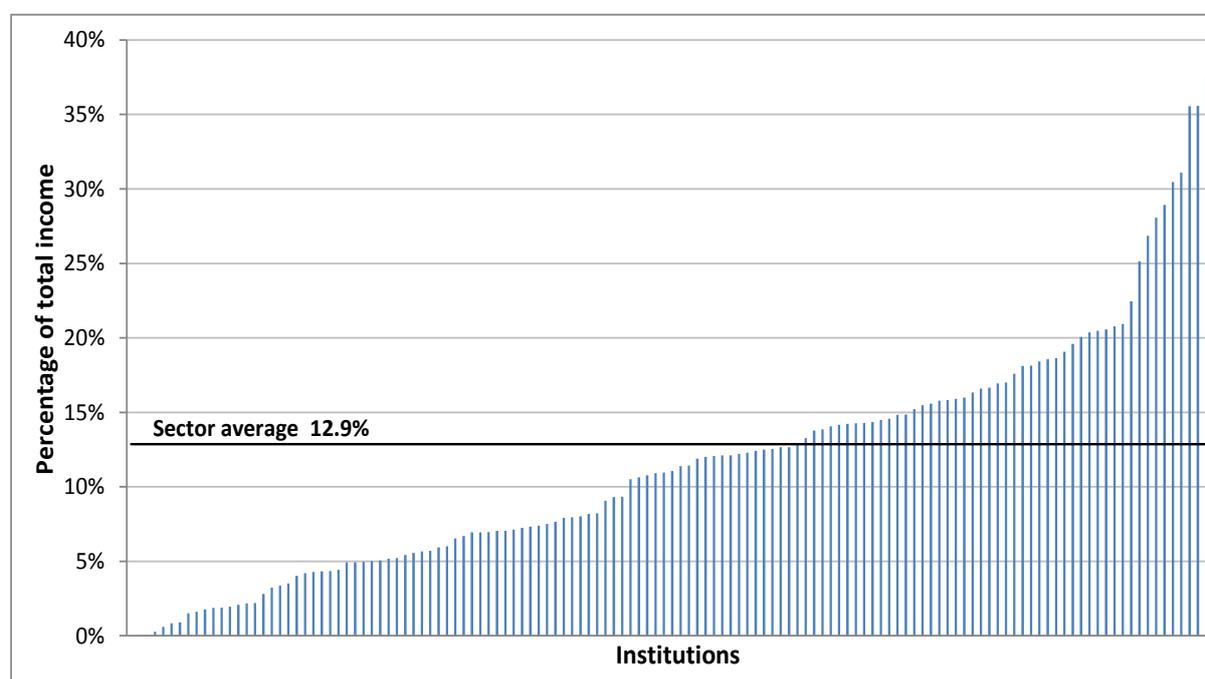
	2012-13	2013-14	% increase
FT UG (home and EU)	£4,432M	£5,829M	31.5%
FT PG (home and EU)	£679M	£695M	2.3%
PT (home and EU)	£619M	£654M	5.7%
Health (home and EU)	£750M	£768M	2.4%
Overseas	£2,997M	£3,292M	9.9%
Other	£666M	£749M	12.5%
Total fee income	£10,142M	£11,987M	18.2%

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

30. In 2013-14, the sector reported an increase in fee income from overseas students of £295 million, equivalent to a rise of 9.9 per cent compared with 2012-13. Overseas student numbers (across all years of study) also grew in 2013-14, but at a much lower rate (rising 1.7 per cent compared with 2012-13). 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. Total overseas student numbers were also 2.9 per cent lower than projected by the sector in July 2014, indicating that student recruitment was not as strong as expected earlier in the year.

31. One of the sector's most significant risks is that overseas recruitment will be lower than projected in the sector's financial forecasts, particularly as reliance on this source of income continues to grow. While dependence on overseas fee income varies between institutions (ranging from 0 per cent to 37.6 per cent of total income), the latest financial results show that the number of institutions reporting a greater reliance on this source of income grew again in 2013-14. 16 institutions reported overseas fee income of over 20 per cent of total income, compared with 14 institutions in 2012-13 and 10 in 2011-12. In 2013-14, the 20 institutions recording the highest income from overseas fees account for just over 50 per cent of the sector's total income from this source. Figure 2 shows the distribution in 2013-14.

Figure 2: Overseas fee income as percentage of total income (2013-14)



Expenditure

32. In 2013-14 the sector reported total expenditure of £24,446 million, an increase of 5.2 per cent in cash terms compared with 2012-13, but lower than the level projected by the sector in July 2014, which was expected to be 5.9 per cent higher than the previous year. Table 4 shows a breakdown of the sector's expenditure in 2012-13 and 2013-14.

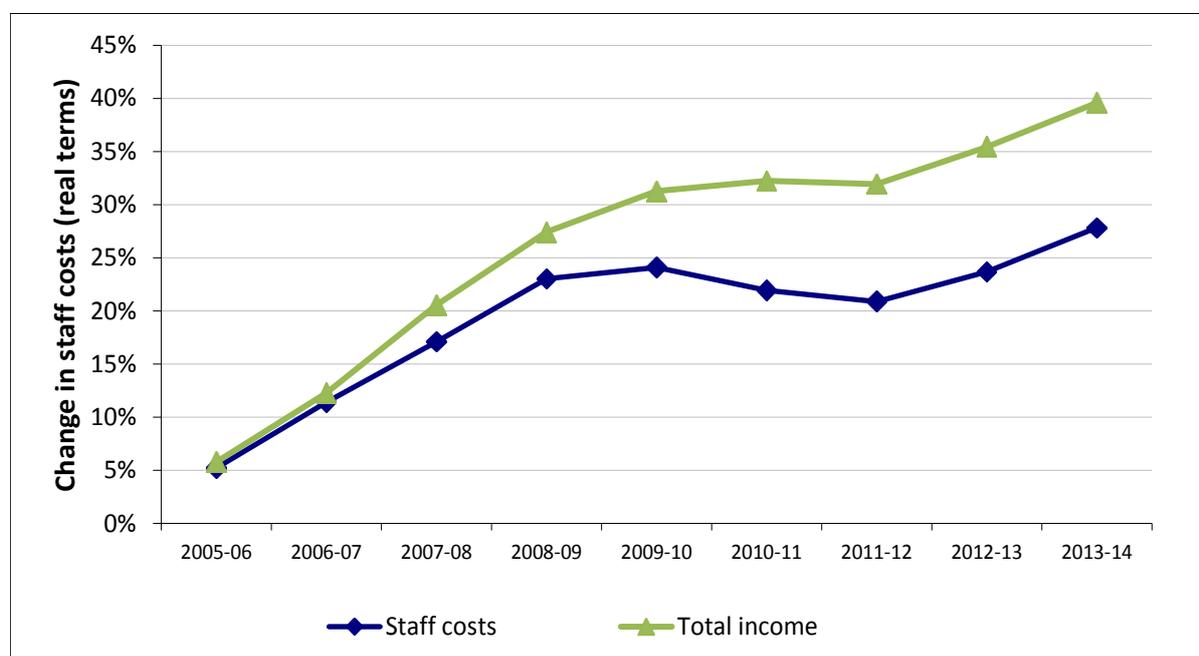
Table 4: Breakdown of expenditure

	2012-13	2013-14	% increase
Staff costs <i>as a % of total income</i>	£12,753M 52.4%	£13,461M 52.6%	5.6%
Other operating expenses <i>as a % of total income</i>	£8,769M 36.1%	£9,153M 35.8%	4.4%
Depreciation <i>as a % of total income</i>	£1,361M 5.6%	£1,472M 5.8%	8.2%
Interest payable <i>as a % of total income</i>	£357M 1.5%	£359M 1.4%	0.7%
Total expenditure	£23,239M	£24,446M	5.2%

33. The sector's biggest expenditure relates to staff costs, which totalled £13,461 million in 2013-14, equivalent to 52.6 per cent of total income.

34. In real terms, staff costs increased by 3.4 per cent in 2013-14. This compares with a real-terms fall in staff costs reported by the sector in both 2010-11 and 2011-12, and a real-terms rise of 2.3 per cent in 2012-13. 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.

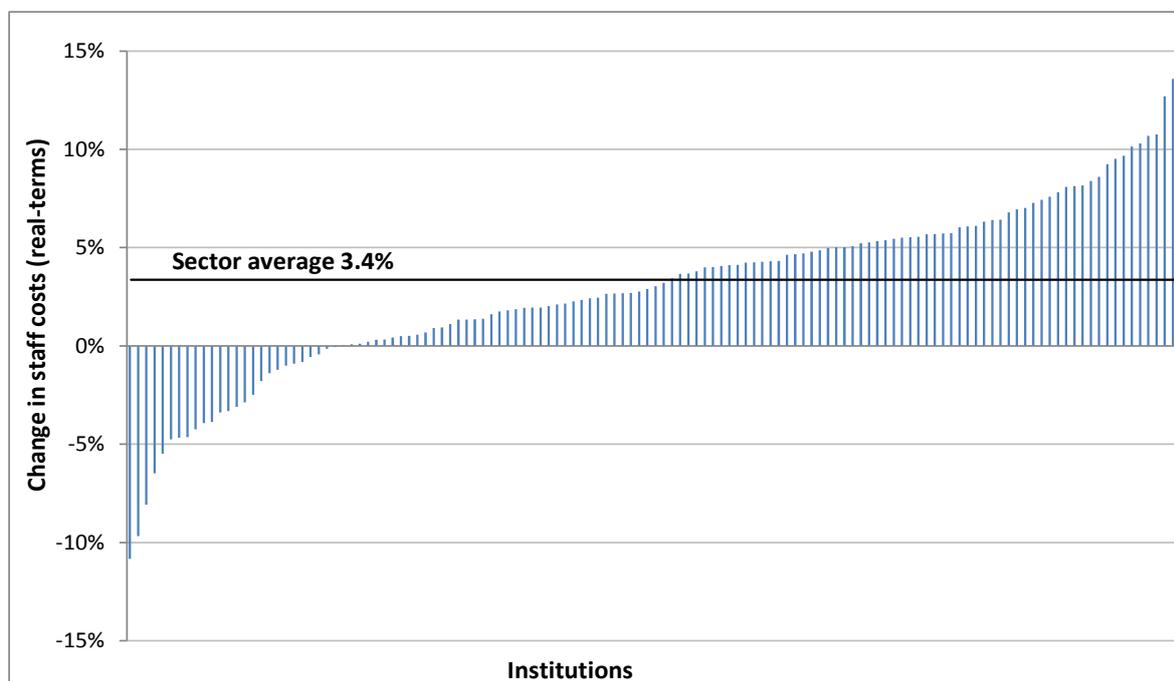
Figure 3: Cumulative real-terms change in total income and staff costs (2005-06 to 2013-14)



35. While the sector reported an overall increase in staff costs in 2013-14, the rise in staff numbers (up 3.7 per cent compared with 2012-13) caused average staff costs per employee to fall by 0.3 per cent (real terms).

36. 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 2012-13 to 2013-14.

Figure 4: Real-terms percentage changes in staff costs (2012-13 to 2013-14)

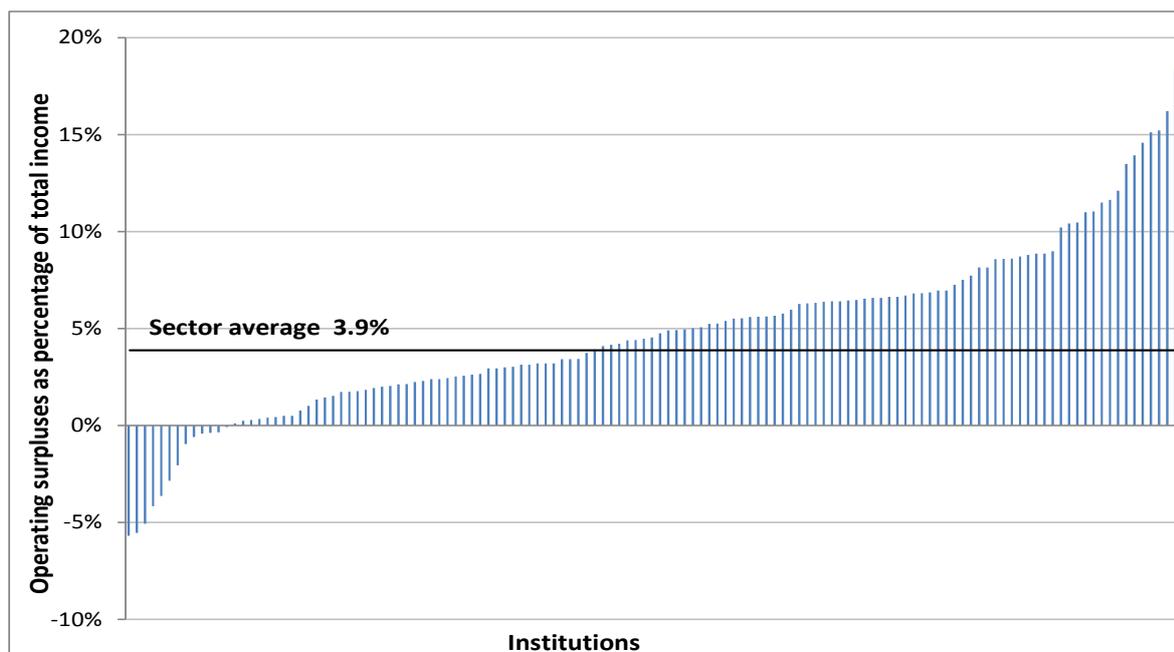


Surpluses

37. The sector's operating surplus (that is, its total income less its total expenditure before any exceptional items) increased by 5.1 per cent from £943 million in 2012-13 to £992 million in 2013-14. This was equivalent to a sector average of 3.9 per cent of total income, the same level as reported in 2012-13.

38. Although a surplus was made overall, 13 institutions reported operating deficits in 2013-14, compared with 14 in 2012-13. Figure 5 shows the level of operating surpluses as a percentage of total income reported by institutions in 2013-14.

Figure 5: Operating surpluses as a percentage of total income (2013-14)

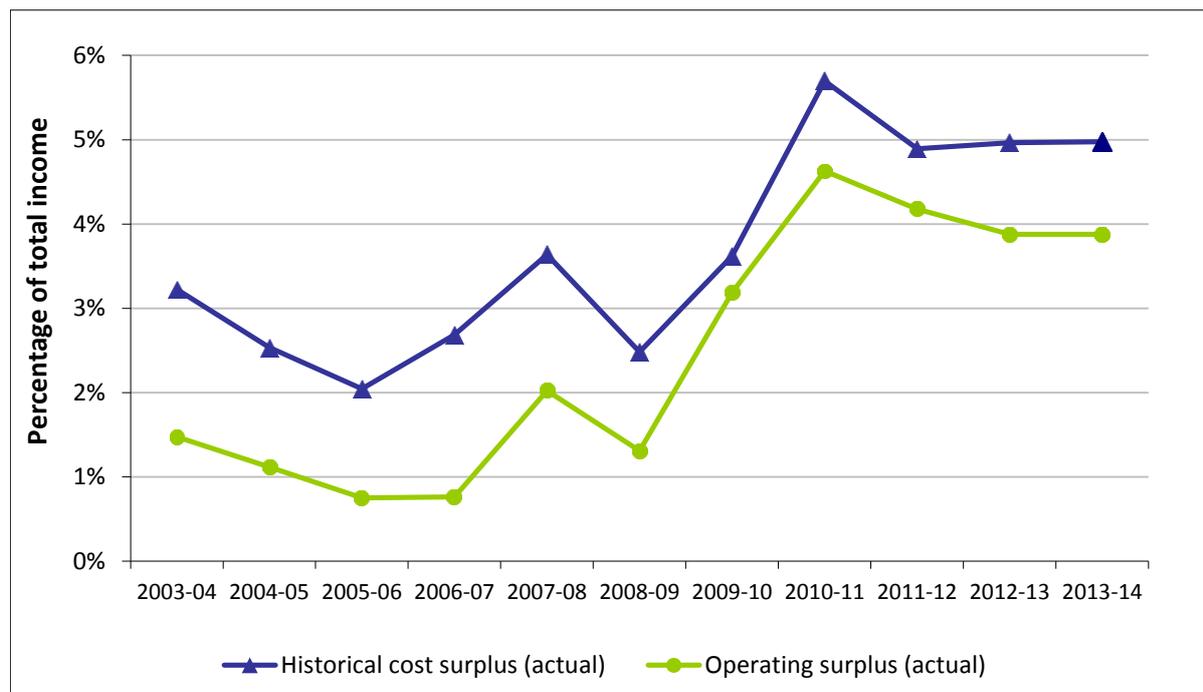


39. While the majority of institutions have produced better financial outturns in 2013-14 compared with the July 2014 forecasts, 30 institutions reported a decline in their operating performance compared with their earlier predictions.

40. On a historical cost basis the sector recorded a surplus of £1,273 million (5.0 per cent of total income), which again is significantly better than the average over the past 10 years (which was 3.9 per cent)⁵. The large difference between the operating and historical position in 2013-14 is partly accounted for by exceptional items (for example profit or loss from the sale of properties, or exceptional restructuring) totalling £100 million. Figure 6 shows the level of operating and historical cost surpluses as percentage of total income since 2003-04.

⁵ Historical cost surplus (or deficit) is derived by adjusting for the difference between historical cost depreciation and the actual depreciation charged on revalued assets, and 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.

Figure 6: Operating and historical cost surpluses as percentage of total income 2003-04 to 2012-13



Liquidity and cash flow

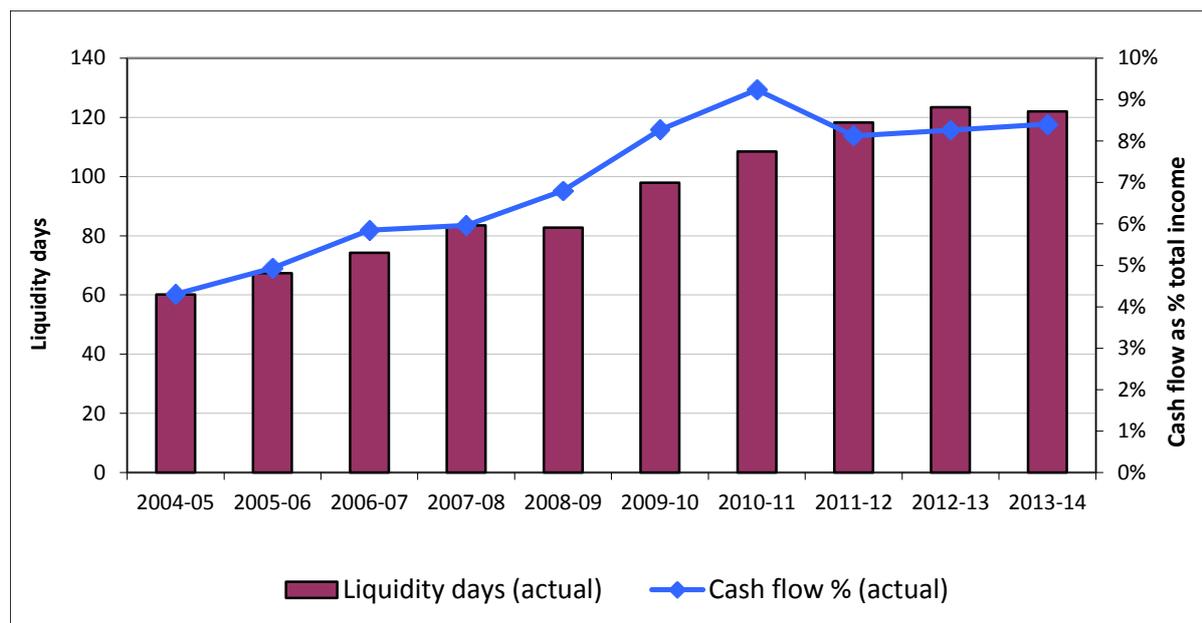
41. At the end of 2013-14 the sector had net liquidity of £7,681 million, equivalent to 122 days' expenditure. This is higher than the level forecast in July 2014 which was 114 days, but lower than the level of 123 days reported at the end of 2012-13. Four institutions had liquidity of less than 20 days, compared with five in 2012-13.

42. Most HEIs spend capital funds mainly during the summer months, just after the end of the financial year. This means at the end of July each year institutions can be holding onto high levels of cash which will be invested in the coming months. As charities it is also important that HEIs maintain a level of cash to manage risk and uncertainty.

43. Cash flow from operating activities rose from £2,010 million in 2012-13 to £2,151 million in 2013-14, equivalent to 8.4 per cent of total income. This is higher than the level forecast in July 2014, which was 7.5 per cent. This is a positive indicator of solvency.

44. 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 2004-05 to 2013-14.

Figure 7: Liquidity days and cash flow 2004-05 to 2013-14

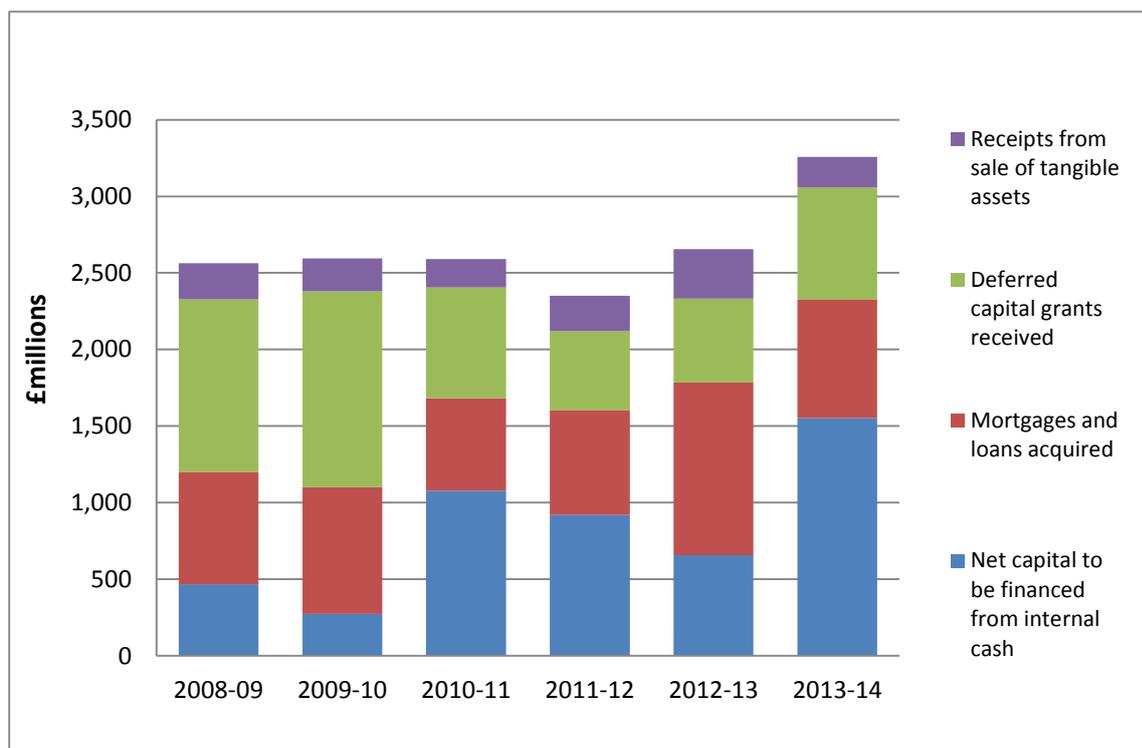


Capital expenditure

45. Buildings and related infrastructure represent the ‘public face’ of a university, and help it to attract and recruit new students, as well as having a direct impact on the student experience. With rising student expectations (resulting from higher fees) and increasing competition in the home and international markets, the sector needs to increase investment in infrastructure.

46. Despite the fall in public capital funding over recent years, the latest financial results show that the sector has been able to deliver a significant increase in capital investment in 2013-14, which at £3,257 million represents an increase of 23 per cent compared with the previous year. Figure 8 provides a breakdown of how capital expenditure was funded in the period from 2008-09 to 2013-14.

Figure 8: Funding breakdown of capital expenditure 2008-09 to 2013-14

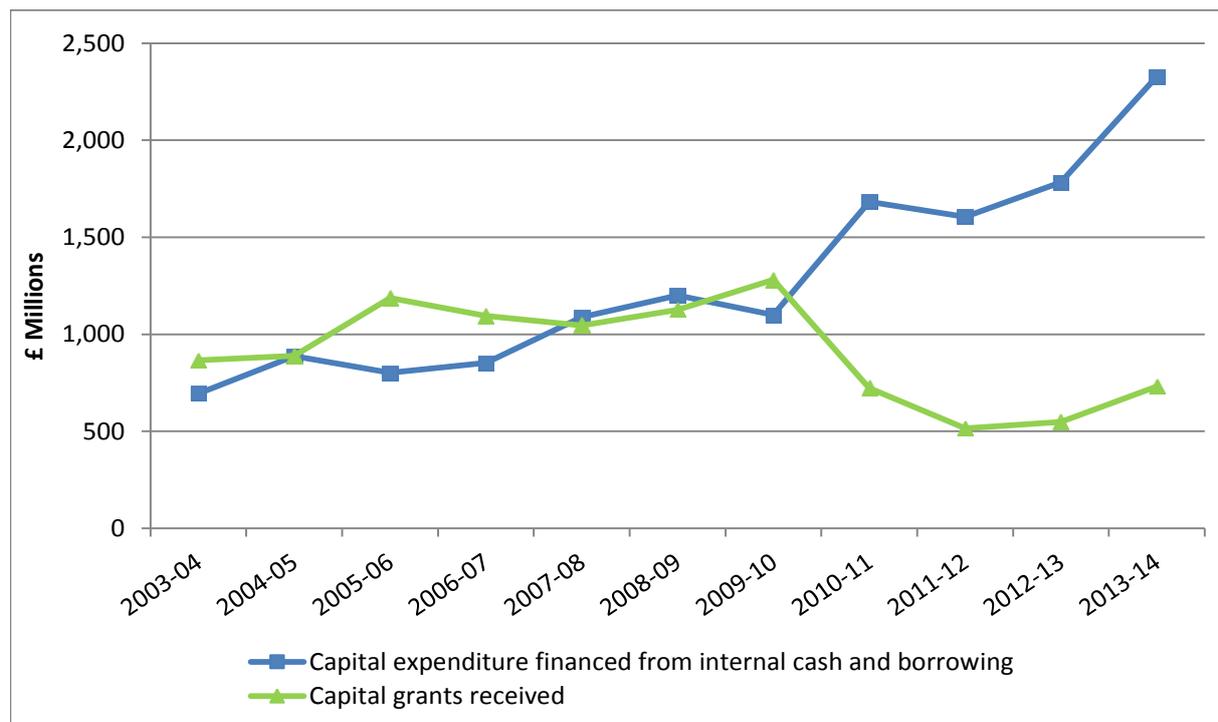


47. In an era where capital funding from Government is high there is less need for institutions to generate cash to re-invest in their infrastructure. The more government funding for capital reduces, the more institutions need to generate themselves, either through increased surpluses or by leveraging 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 investment and meet finance costs.

48. Figure 9 shows the level of deferred capital grants received by the sector, alongside the level of capital financed by additional borrowing and internal cash⁶. This shows a sharp increase in the level of capital expenditure that was financed by a combination of internal cash and borrowing in 2013-14, which was required to support the large increase in capital investment in 2013-14.

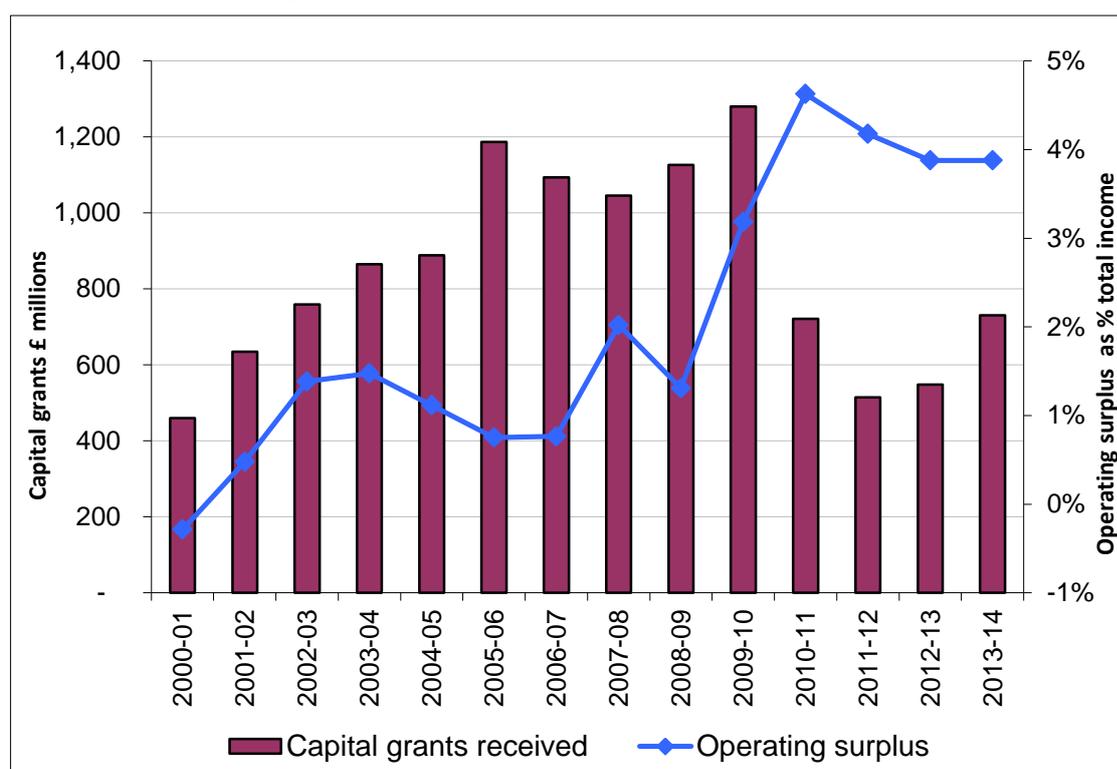
⁶ Deferred capital grants are the cash sums received by institutions in the year, although the income will be reported in institutions' income and expenditure accounts spread over the estimated useful life of the related capital assets.

Figure 9: Capital grant funding and capital expenditure financed through internal cash and borrowing 2003-04 to 2013-14



49. Figure 10 shows deferred capital grants received by the sector over the period 2000-01 to 2012-13, alongside the operating surpluses achieved by the sector. This demonstrates the changing nature of how institutions finance their business. Before 2010 the sector received considerable capital funding from Government, which meant that institutions did not need to generate high levels of surpluses. Since 2010 the level of capital funding has significantly reduced, meaning that to maintain investment levels institutions have needed to increase their operating surpluses, their borrowings or both. The chart shows that they have increased surpluses, enabling them to finance their capital investment plans despite the fall in public capital funding.

Figure 10: Operating surpluses and capital grant funding 2000-01 to 2013-14



50. Although the sector has invested significantly in infrastructure over recent years, data collected as part of the Estate Management Record indicates that on 31 July 2013 many institutions still had large amounts of non-residential space in poor condition, with an associated cost to upgrade the estate of £3,327 million (an increase of 18.8 per cent compared with the backlog on 31 July 2012)⁷. However, this only reflects the cost required to upgrade this portion of the estate to a sound and operationally safe condition, and does not take into account the additional investment needed to bring the estate up to the standard required to satisfy rising student expectations and to ensure that the sector’s higher education provision remains internationally competitive.

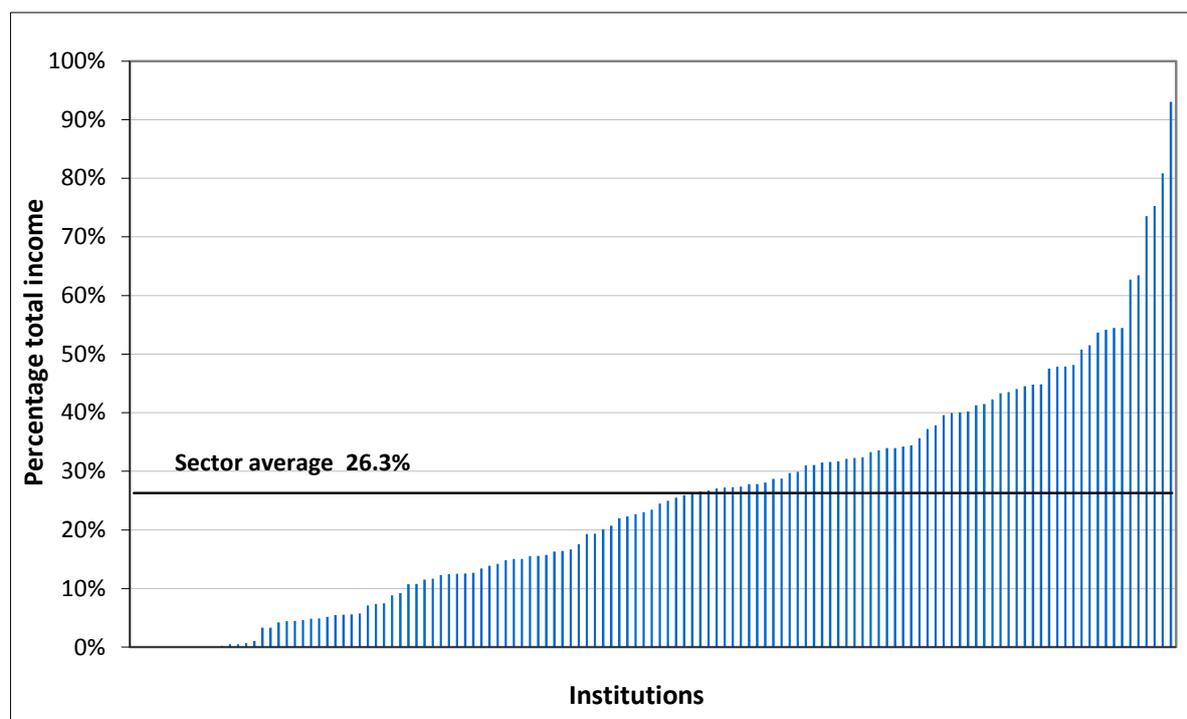
Borrowing

51. At the end of July 2014, the sector reported borrowing of £6,722 million (equivalent to 26.3 per cent of income). This is £501 million higher than the level reported at the end of 2012-13, which was £6,221 million (25.6 per cent of income), but £75 million lower than the level forecast in July 2014.

52. Figure 11 shows the wide variation in the level of borrowing across the sector at 31 July 2014.

⁷ This data is sourced from the Estates Management Record for 2012-13 (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.

Figure 11: External borrowing as a percentage of total income (2013-14)



53. Reported borrowing levels are expected to increase as a result of the implementation of a new financial reporting standard (FRS102), which, from 2015-16, introduces new criteria for an institution to assess and recognise borrowing relating to its service concession arrangements (where 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 borrowing being recognised on an institution’s balance sheet, where previously they might have been treated ‘off balance sheet’. Although not new borrowing, this may impact on the perceived indebtedness of the sector.

54. As important as the absolute level of borrowing is the ability of the borrower to service the cost of borrowing. In 2013-14, the sector reported interest payments of £359 million (compared with £357 million in 2012-13). The cost of increased borrowing has to date largely been mitigated by the exceptionally low interest rates. 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. The number of financial covenants attached to borrowing agreements also appears to be increasing, with covenants covering both financial performance and balance sheet strength.

Reserves

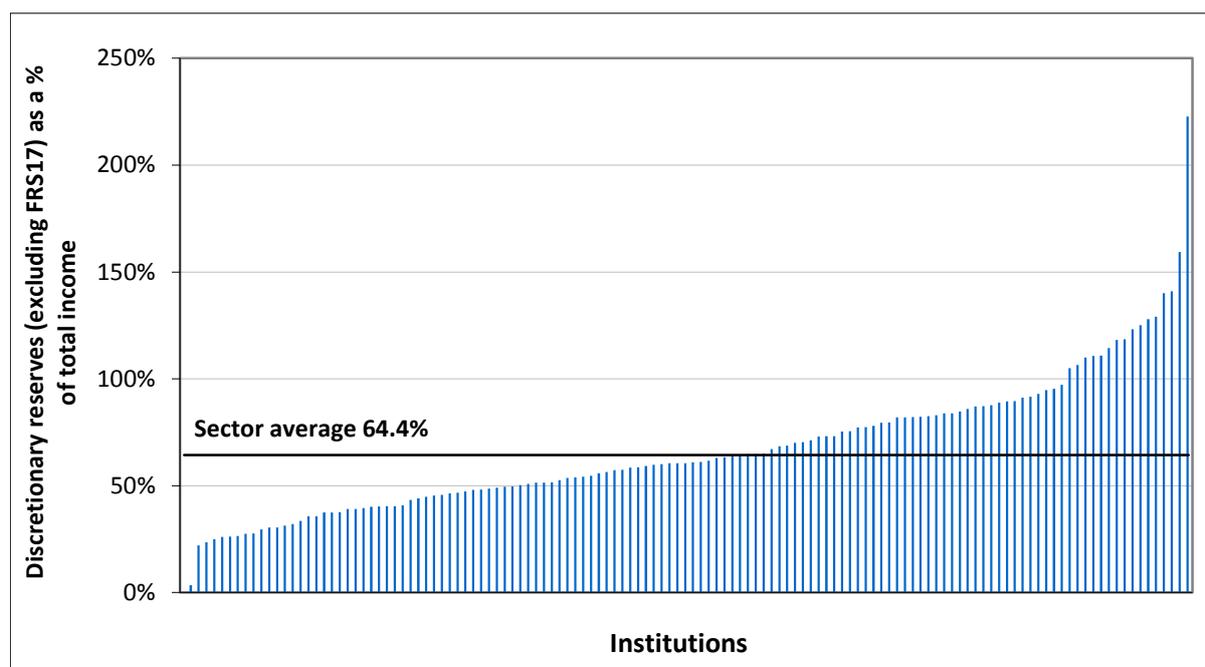
55. Discretionary reserves at the end of 2013-14 totalled £12,292 million, after taking into account the impact of the financial reporting standard on retirement benefits (FRS17)⁸. This reporting standard, which requires pension scheme surpluses or deficits to be included in the

⁸ Discretionary reserves are equal to expendable endowments plus general reserves from the balance sheet.

balance sheet (but not yet those of multi-employer schemes such as the Universities Superannuation Scheme (USS)), makes comparisons with previous years more difficult. Without FRS17, reserves totalled £16,472 million, equivalent to 64.4 per cent of total income.

56. Total reported pension scheme deficits (excluding those relating to multi-employer schemes) increased by £678 million to £4,180 million in 2013-14, reducing reserves to 48.0 per cent of income. 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 12 shows discretionary reserves (excluding FRS17) as a percentage of total income for all institutions as at 31 July 2014.

Figure 12: Comparison of discretionary reserves excluding FRS17 as a percentage of total income 2013-14



57. While sector reserves are currently strong overall, from the academic year 2015-16 reserve levels and pension deficits will be significantly affected by the introduction 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 within 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.

58. The indicative results of the 2014 triennial valuation show that the USS scheme deficit was £13 billion as at 31 March 2014. USS employers are currently consulting with eligible employees on a range of proposed reforms designed to ensure the continued viability of the scheme. This includes a proposal to increase the employer pension contribution rate from 16 to 18 per cent, with effect from 1 April 2016. The final decision on the reforms is due to be taken by the USS trustees in summer 2015.

Transparent Approach to Costing return 2013-14

59. 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 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.

60. The full economic costs include: direct costs (such as staff costs and equipment); a reasonable share of 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 infrastructure⁹; and the full costs of sustaining activities including investment in infrastructure and future productive capacity, innovation and human capital.

61. TRAC data from HEFCE-funded HEIs for 2013-14 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 £883 million, a deterioration against the position in 2012-13, when the sustainability gap was £870 million.

62. Table 5 shows a summary of the TRAC results for 2013-14, alongside the results reported for 2011-12 and 2012-13. This shows the level of surplus achieved by the sector against the level required to cover the long-run or full economic costs of its activities. For 2013-14, the adjusted operating surplus reported in the sector's annual financial statements was £1,064 million, equivalent to 4.2 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 £1,947 million, or 7.6 per cent of total income in 2013-14.

⁹ 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.

Table 5: TRAC summary 2011-12 to 2013-14

	2011-12	2012-13	2013-14
Target sustainability surplus to cover long run costs (full economic costs)	£1, 761M	£1, 876M	£1, 947M
as % of total income	7.6%	7.7%	7.6%
Actual surplus*	£1,036M	£1,007M	£1,064M
as % of total income	4.5%	4.1%	4.2%
Sustainability gap	(£726M)	(£870M)	(£883M)
as % of total income	(3.1%)	(3.6%)	(3.5%)

* 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.

63. While table 5 shows the total sustainability gap reported by the sector, Table 6 shows the 2013-14 data across 'teaching, research and other activities' for HEFCE-funded HEIs¹⁰.

Table 6: TRAC income and full economic costs by activity 2013-14

	Teaching		Research	Other	Total
	Publicly funded	Non-publicly funded			
Income	£10,601M	£3,644M	£6,793M	£4,425M	£25,463M
Full economic costs	£10,382M	£2,667M	£9,204M	£4,093M	£26,346M
Surplus (deficit)	£219M	£977M	(£2,412M)	£333M	(£883M)
Surplus (deficit) as % of income	2.1%	26.8%	(35.5%)	7.5%	(3.5%)
Recovery of full economic costs 2013-14	102.1%	136.6%	73.8%	108.1%	96.6%
Recovery of full economic costs 2012-13	100.6%	133.3%	75.6%	109.3%	96.5%

¹⁰ Sector TRAC results exclude data for one newly designated HEI, currently exempt from submitting TRAC data.

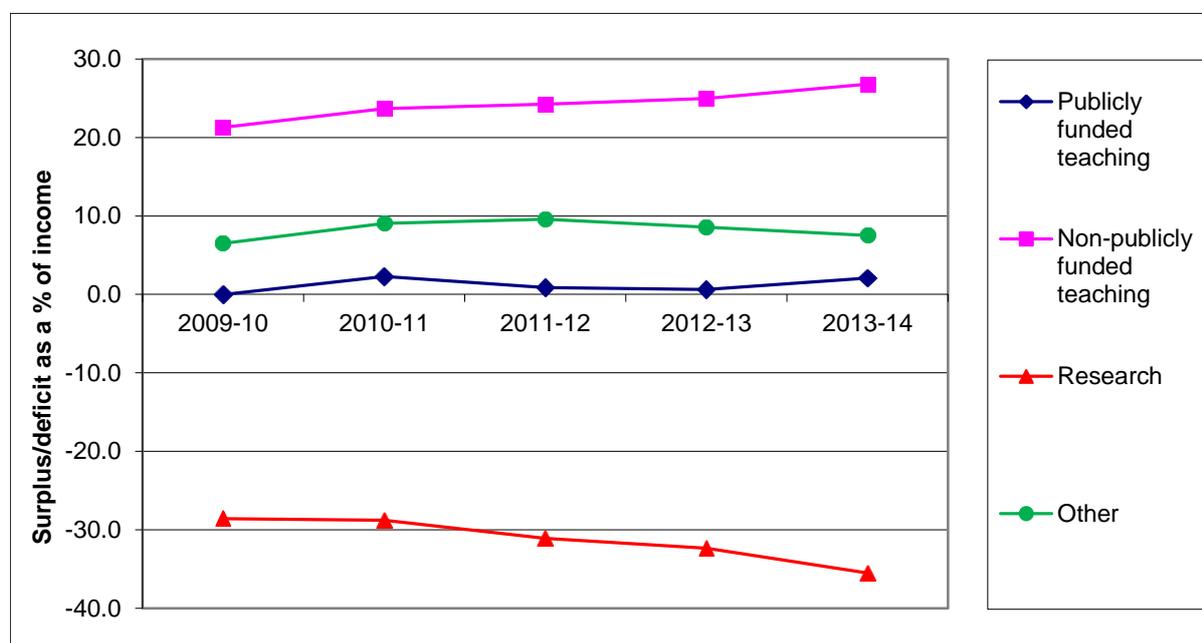
64. These figures show a pattern which has been broadly constant for some years, the main features being that:

- publicly funded teaching shows a position just slightly above break-even (compared with break-even in previous years)
- non-publicly funded teaching makes a significant surplus
- research is significantly in deficit.

65. When comparing income with costs, the TRAC data for 2013-14 shows that the sector recovered 96.6 per cent of the full costs across all of its activities; a marginal increase from the recovery rate reported in 2012-13, which was 96.5 per cent. However, the TRAC results for 2013-14 show that the sector's research activities continue to report a significant deficit across all sponsor categories, with the deficit for research activities totalling £2,412 million (equivalent to a deficit of 35.5 per cent when compared with research income).

66. Figure 13 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 from 2009-10 to 2013-14, and demonstrates the increasing research deficit over this period.

Figure 13: Surplus/ deficit as a percentage of income 2009-10 to 2013-14



67. Overall, the data shows that surpluses on non-publicly funded teaching and other activities are insufficient to support the shortfall on research, and the increasing sustainability gap for 2013-14 reflects the fact that the sector is not generating enough income to finance all of its activities and investment. On a single-year basis 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

68. The financial results for the sector in 2013-14 are sound overall, and stronger than those projected by the sector in July 2014, although significant variations continue in the financial performances of individual institutions across the sector.

69. Overall, the TRAC results for 2013-14 show that in the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities and maintaining sustainability. Increased surpluses are needed to build capacity to invest, innovate and enhance the performance and reputation of teaching and research.

70. The sector is increasingly dependent on its capacity to generate sufficient surpluses for sustained investment in infrastructure, whose quality is critical for the successful delivery of quality teaching and research, for the ability of HEIs to attract and recruit new students, and to secure their long-term sustainability.

71. 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 there is a continuing risk that future public funding of higher education could be constrained if the overall economic climate does not improve.

72. HEIs are due to submit their next set of financial forecasts for the period 2014-15 to 2017-18 in July 2015, and we plan to publish an overview and analysis of these forecasts in autumn 2015. Until then, our view is that the sector's financial position is currently stable overall. However, financial projections for the period ending 31 July 2017 (submitted by HEIs in July 2014) predicted lower surpluses, a fall in cash levels and a rise in borrowing, signalling a trajectory that is not sustainable in the long term.

Disclaimer

73. 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
FTE	Full-time equivalent/equivalence
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
HESA	Higher Education Statistics Agency
PG	Postgraduate
PT	Part-time
RFI	Return for financing and investment
TRAC	Transparent Approach to Costing
UG	Undergraduate
USS	Universities Superannuation Scheme