

New JNCHEs Sustainability  
Issues Working Group

# The Financial Health and Sustainability of the HE sector

Interim Report January 2011



# Contents

	<b>page</b>
Background .....	1
Introduction and Summary .....	2
How can we assess financial health and sustainability? .....	4
What do institutions need to do to be sustainable? .....	6
Changes in the financial and policy context .....	7
Recent trends in funding .....	9
How has the higher education sector coped with these changes? .....	12
The financial health and sustainability of the sector in 2010 .....	13
a. Analysis of operating surpluses .....	13
b. Cash and Liquidity .....	18
c. Balance sheet items: reserves, assets, borrowing .....	19
d. Key financial risks .....	21
Summary on financial health .....	23
Provisional analysis of sustainability .....	24

## **Background**

1. In December 2008, the report “Review of Higher Education Finance and Pay Data” was published by the JNCHES. It was agreed during 2010 that it would be timely to update the financial parts of this report (basically section 4). Some preparatory work has been done towards this, overseen by the Sustainability Issues Working Group (SIWG), and a small sub-group established for this purpose. The report was written by Jim Port of JM Consulting.
2. It has become clear that this work cannot be completed before the summer of 2011 because of uncertainty about the future funding and regulatory environment for the sector. A key factor is that the normal cycle in which HEIs in England produce three-year financial forecasts in December each year did not take place in 2010 and so an important source of data will not be available for some time.
3. However, the SIWG decided that, even though the full report cannot be produced at present, it would nevertheless be useful to produce a statement of the position of the sector at this time, before the radical changes now being planned, and also to discuss the conditions that institutions will need to satisfy to be sustainable. This is a different sort of report with more narrative and less data. It draws on some of the work already done, and on available data, which are not necessarily fully up-to-date or consistent across the whole of the UK, to provide the best assessments that can readily be made at this time.
4. In line with the discussions in the group, this report focuses much more significantly on sustainability than the 2008 report.

# Introduction and Summary

## **Conclusions of the 2008 report**

5. The 2008 report noted that the financial health of the higher education sector went through a low point in the 1990s, due to a combination of falling public funding for teaching, rapid expansion of research which recovered less than its full costs, and inconsistent financing of capital infrastructure.
6. The Dearing review which was published in 1997, led to several government initiatives to improve the finances of the sector, including stabilisation of the unit of resource for teaching; reform of the public funding of research; new capital grant schemes; and (after lengthy debate) the introduction in 2006-07 of variable student tuition fees in England.
7. The JNCHES report noted that it would take some time for these measures to have their full effect, due to accumulated backlogs of under-investment, and that new challenges and opportunities had arisen in a more complex and costly operating environment. These included greater domestic and international competition; institutions having to invest more; having a lower proportion of secure public funding; and experiencing raised costs of marketing, tendering and negotiation.
8. That report concluded that while most institutions were financially stable in the short-term, they were not making sufficient financial surpluses to cover their long-term needs for investment in estates and other infrastructure and they were facing new financial challenges and risks which threatened their sustainability.

## **Developments since the 2008 report**

9. Even while the analysis was being completed for the 2008 report, the world economies had begun to experience the effects of the “credit crunch” and resulting turbulence which led to the most severe economic downturn for several decades, Some reductions in public funding for higher education have already taken place, and the measures being taken by the coalition government will lead to a sustained reduction in public funding, chiefly for teaching, but also for research and for capital. At the same time, the impact of the proposals in the Browne review of student finance will fundamentally change the environment in England – notably by removing nearly all public block grant funding for university teaching in the arts and humanities and by creating a more open and competitive market for students and fee income.
10. The implications of these changes cannot be analysed fully until further announcements are made by the governments in Westminster, Edinburgh, Cardiff and Belfast, and the relevant legislation in respect of tuition fees is enacted. However, the headlines of funding for 2011-12 and beyond have now been announced, and it is clear that these changes will increase the degree of turbulence and risk for HEIs; and that many HEIs will find that maintaining financial health and sustainability is significantly more challenging than in the last decade.

## **Summary of conclusions**

11. Assessing the financial health of the sector depends on looking at a combination of actual historic data on institutional financial performance, and at institutions’ forecasts of their future performance. In assessing financial health in early 2011, these two aspects of the assessment lead to very different conclusions.

12. The historic indicators of financial health look relatively strong: institutions' financial performance in 2007-08 and in 2008-09 was good relative to the previous years. Operating surpluses were improved (to 2.1% in England in 2007-08, and 1.4% in 2008-09, compared to 1% in both 2005-06 and 2006-07). Liquidity (availability of cash to manage operations) was also at a high point relative to recent years. Indications are that the results for 2009-10 may be even better. Of course, these results were influenced by the relatively good public funding in the latter half of the decade, and by institutions preparing for tougher times to come.
13. At the time of writing, there is too much uncertainty about the future public funding and regulatory regime for institutions to make (and reveal) robust three-year financial forecasts as they normally do (in England) in December each year. Those made in December 2009 must now be regarded as out of date in their assumptions, but they showed a significant forecast decline in financial health. In 2010, the sector had much more challenging news about the future levels and structure of public funding, and it is very likely that the next set of forecasts which will be made in 2011 will show a further decline – particularly in parts of the sector which are dependent on attracting students who may be averse to perceived high levels of debt on graduation, and in institutions with a strong arts and humanities focus.
14. We conclude that the financial health of the sector is now more problematic than it was in 2008, because of the significantly higher financial risks and threats it now faces. While most institutions have a level of reserves, cash, and financial flexibility which is good relative to recent years, and which has proved to be survivable in a relatively well funded and stable higher education environment, this level of financial strength may prove inadequate for the more demanding and unstable future conditions.
15. The assessment of sustainability has to draw upon a wider range of evidence, and of much more diverse types, than for financial health. Much of this evidence is qualitative; it is forward-looking and involves anticipating the market and environment for at least 5-10 years ahead; and some is specific to the different positions and missions of different institutions. Unlike the position with evidence of financial strength, there are not (in general) consistent data publicly-available about the performance of institutions relative to their strategic plans. This makes assessment of sustainability more complex, and does not lend itself so readily to sector-level generalisations. There are also important differences between England, Scotland and Wales due to the different contexts, policies, and funding in each country. Despite these difficulties, it is possible to draw some general conclusions at this interim stage, but a full assessment will have to wait for the new JNCHES report.
16. We conclude that the sustainability of the sector, which was assessed as problematic in the 2008 report, would now have to be assessed as in a worse position in 2010, despite the partial relief of 2-3 years of relatively good financial performance.
17. This report also discusses the conditions required for sustainability. There is no absolute right answer here as each institution has to consider the needs of its own circumstances and aspirations. However, the report identifies six key conditions that will be critical for most institutions. These are:
  - Financial health
  - An academic strategy
  - A financial strategy
  - Adequate recurrent expenditure to maintain a vibrant and healthy academic community, plus adequate investment in physical infrastructure
  - Governance and management
  - Appropriate processes for monitoring and review of its performance.

# How can we assess financial health and sustainability?

## Definitions

18. **Financial health** is well understood in the sector. A formal definition could be:
- An institution is financially healthy if it is covering all its short-run (operating) costs and making adequate investment to at least maintain its current productive capacity and is able to cope with financial pressures in the short-term (i.e. over the normal three-year period of financial forecasts in higher education).*
- Or in short-hand, we might say that it “can cover its costs, pay its bills, and has a little headroom for contingency and investment”.
19. **Sustainability** goes beyond financial health. The formal definition which has been used in the sector for several years is:
- An institution is being managed on a sustainable basis if, taking one year with another, it is recovering its full economic costs across its activities as a whole, and is investing in its infrastructure (physical, human and intellectual) at a rate adequate to maintain its future productive capacity appropriate to the needs of its strategic plan and students, sponsors and other customers’ requirements*
- Or in shorthand, we might say that it is “operating today without damaging ability to do so tomorrow” or is “maintaining at least the current capacity to respond to changing demands”.
20. It is necessary to avoid a potential confusion with ecological or environmental issues. One way to do so could be to use the term **financial sustainability**, but this is potentially unhelpful since sustainability is broader than financial health. It is about the conditions needed to deliver the whole educational business of the institution (i.e. student learning and achievement, research and scholarly outputs, employer and community engagement etc.) including the productive capacity (i.e. staff, intellectual property, reputation, infrastructure, equipment, systems, governance and management) needed to deliver them.
21. In this report we therefore use the term **institutional sustainability** which better communicates the fact that we are concerned with the sustainability of the full range of academic activity and all necessary human, intellectual and physical resources needed to support them. This is a much broader requirement than financial health (although that is course an essential part of the requirement).
22. However, this does not imply that saving individual institutions is necessarily the major objective. The policy of the UK Government is to encourage a range of different providers of higher education, and a more open market. A natural consequence of this may be that some existing providers may cease to exist.

## Sustainability is a more demanding requirement than financial health

23. Financial health can be assessed using some well-understood indicators which are used in England by HEFCE in making assessments of institutions’ risk status<sup>1</sup>;

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<sup>1</sup> SFC in Scotland, and HEFCW in Wales use similar indicators although their monitoring processes are different.

are used internally in many institutions; and were used in the 2008 report. These indicators chiefly relate to four main factors: institutions; and were used in the 2008 report. These indicators chiefly relate to four main factors:

- financial surplus
- cash and liquidity
- the strength of the balance sheet
- key financial risks of an institution.

While no single one of these indicators will necessarily indicate financial health, an assessment that includes all four will normally give a robust indication (or will highlight questions for further investigation).

24. This assessment of financial health is not just formulaic however, as it has to interpret a mixture of past performance and future forecasts (which are of course a matter of judgement by individual institutions).
25. Financial health, measured in this way, is a necessary but not a sufficient condition for sustainability, which goes beyond financial health in several respects:
  - It needs to consider a **longer timescale** (at least 10 years);
  - It is **forward-looking** and so an assessment will involve assumptions and forecasts about the environment and the ambitions of the institution. These may be informed by past performance, but that alone will not indicate sustainability;
  - It requires a clear **academic/corporate strategy** (sustainability cannot be managed or assessed in the abstract from an idea of what the institution is about). It is thus about **working towards the mission** of the institution and so encompasses performance in the main businesses of the institution plus the state of health and productivity of the institutional resources, assets, and capability necessary to support these businesses;
  - It is about **understanding and adapting successfully to the environment** in which the institution operates. The policy and funding environment in higher education is changing dramatically and will be characterised by a much higher degree of opportunity and risk for many institutions, and for the sector as a whole. In this environment, leadership and clear strategic vision are much more important than in a more stable situation, and a dynamic strategy of entrepreneurialism and risk-taking may be a requirement for sustainability. These qualities are usefully described as **adaptive capacity** – i.e. the institution has the financial headroom and the management “nimbleness” and culture which will permit it to respond quickly and effectively to both opportunities and threats;
26. Assessing sustainability is therefore about assessing a state of an institution in relation to its environment and to the role it intends to play in the sector. This is necessarily more complex and will involve more judgement than assessing financial health. It has to be done by each institution in the light of its own circumstances, and is the responsibility of the governing body, advised by the senior management. External bodies like funding councils cannot fully assess sustainability without engaging with institutions, although they may use some indicators to give them a view of sustainability at sector level, and to indicate potential concerns that they can then follow up with individual HEIs as appropriate.
27. A HEFCE-funded project (UK-wide) is currently working to develop such indicators (the sustainability metrics project) and initial findings and recommendations from this are expected to be available for discussion in the sector early in 2011. These could inform any full update of the 2008 JNCHES report later in 2011.

# What do institutions need to do to be sustainable?

28. It follows from the above that the main conditions that would be necessary for an institution to manage its own sustainability are:
- a. **It must be financially healthy** as measured normally by some combination of the four indicators noted above. A simple test which would be effective in the majority of cases is whether the institution has been generating enough cash (and will continue to do so) to finance its operations and necessary investment. As discussed below, a level of operating surplus in the region of 3-5% might be a good indication of this in most cases.
  - b. **It must have an institutional (academically-driven) strategy** which takes account of the strategic landscape and sets out (realistically) where the institution wishes to be in the medium-term – say 5 years. Parts of this plan (e.g. any major academic developments and the estates strategy) will have to look at a longer time frame.
  - c. Integrated with this institutional plan, **it needs a financial strategy** (which may or may not be a separate document), but covers the essential elements of:
    - Assessing what level of cash and resource the institution needs to deliver its strategies sustainably
    - Determining how this will be raised
    - Setting financial objectives – for levels of surplus, reserves, investment, borrowing etc.
    - Determining how the HEI needs to manage its main resources and costs (staff, estates etc.)
    - Providing an analysis of key financial risks and action needed to manage them
  - d. It needs to **spend enough** on its recurrent budgets to maintain a healthy and vibrant academic community (staff and students), supported by the academic and support services and resources which are need in a higher education institution. It also need to **invest enough** in its physical assets (chiefly buildings and equipment) to maintain a physical infrastructure which permits this academic community to thrive and to be productive.
  - e. It needs the **governance and management skills** and processes to develop and deliver these plans, involving a wide range of stakeholders as appropriate (including most importantly, staff, students, local and regional communities, employer and professional interests, and its principal funding bodies). An institution which cannot command the confidence of its stakeholders may not be sustainable.
  - f. It needs appropriate processes for **reviewing and monitoring its own performance** (KPIs, strategy reviews, benchmarking, audit etc.)
29. Most HEIs in normal circumstances will need to satisfy all six of these conditions in a way that is appropriate to their needs and circumstances. It is of course true that institutions can survive without satisfying all these conditions, but it is unlikely that they could continue to perform to a level appropriate to their mission in the long-term, or in challenging circumstances (and so might not be sustainable).

# Changes in the financial and policy context

30. The context within which HEIs operate has been changing over the past decade, and the pace of change will accelerate in the next 2-3 years – particularly as a result of the recent government announcements about public funding and about their response to the Browne review, including the new regulatory environment within which higher education will operate. Although it is too early to foresee the full implications of these changes, some themes are already clear.

## Recent strong growth in higher education

31. The 2008 report illustrated the very significant and sustained growth in both student numbers and research which the sector has experienced over the last twenty years.
32. Although the public funding for teaching and research has not grown to the same extent (see discussion of funding below), this growth, coupled with the benefits of economies of scale; efficiency improvements; and new sources of funding (notably overseas student fees) has enabled the sector to advance, to innovate, and to develop in a way that would be much more challenging in a static environment, or (even more so) in one of declining public funding which the sector now faces.

## A mixed economy with government regulation

33. HEIs are private not-for-profit organisations with charitable status. They receive varying amounts of public funding and retain a strong public service ethos. They are all subject to public accountability requirements, and a range of other regulation (e.g. of publicly-funded student numbers and of academic quality), and they are required to implement government policies as part of their public service role.
34. HEIs also operate in a competitive environment to attract students, staff, research grants, commercial income and donations. They are not fully funded and need to earn non-public income, and many of them borrow to finance investment. They are therefore operating with costs of financing and risk, and they have to make surpluses to help to finance their operations and investment.
35. Recent changes have made it easier for private providers (not part of the publicly-funded HE sector) to enter this market and to grow their presence there and this is now an explicit aim of government policy. UK HEIs are also experiencing stronger competition from overseas institutions – both public and private.
36. This trend towards a greater commercial and market ethos will accelerate (in England at least) as HEIs will charge higher tuition fees, will face competition from private providers as well as other HEIs, and will face new forms of regulation intended to protect consumers and to ensure their contribution to other objectives of government.

## Diverse sources of funding for HEIs

37. HEIs have to manage a large number of different sources of finance. Figure 1 shows the main sources of income in 2008/09 as recorded in HESA<sup>2</sup> figures.

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<sup>2</sup> The Higher Education Statistics Agency publishes data collected annually from every HEI.

38. Figure 1 includes elements of both public and private income. The public income includes the core funding or block grant (lines 1 and 3) which make up approximately one third of total income at the sector level. Figure 1 also shows various other sources of both public and private income, including, of course, student tuition fees and specific education and research contracts – which may be either public or private (see further discussion just below).
39. The funding specifically for teaching makes up just over a half of higher education income, while that for research is just under a quarter.

**Figure 1 Sources of income for UK HEIs 2008/09**

<b>Income of UK HEIs 2008/09</b>	<b>£m</b>	<b>£m</b>	<b>%</b>
<b>Teaching</b>			
1. Recurrent grants for teaching	5,754		
2. Tuition fees and education contracts	7,282		
<b>Total specifically for teaching</b>		13,036	50.70
<b>Research</b>			
3. Recurrent grant for research	1,834		
4. Research grants and contracts			
Research Councils	1,531		
UK government	706		
UK charities	896		
Other (industry, EU, overseas)	1011		
Total research grants and contracts	4,144		
<b>Total specifically for research</b>		5,978	23.25
5. Other services rendered	1,568		
6. Residences and catering	1,411		
7. Other operating income	1,268		
8. Various grants and income	454		
9. Endowment and investment income	357		
<b>Total Income</b>		<b>25,708</b>	<b>100</b>

Source: HESA 2008-09

40. The reducing dependency of institutions on public funding was shown in the 2008 report. Non-public sources of income made up approximately 32% of income in 1994/95 and rose to around 40% of income in 2000 and have remained broadly constant since. However, this apparently stable picture disguises the impact of increasing student tuition fees (except in Scotland) which do not affect this percentage as these regulated fees are counted as public expenditure (and indeed the up-front costs are to the Treasury through student loans).
41. The actual definition of what is public and non-public is quite complex (see box overleaf), but in England, the proportion of total income from the various streams of

Home and EC student fees has doubled from 5% in 2005-06 to 10% in 2008-09, and will of course increase more from 2012-13. (HESA data for HEFCE-funded HEIs)

## Public and non-public income

The HEFCE definition of public income includes: funding council grants (including TDA and LSC grants), home and EU student fees (paid by local authorities and the Students Loan Company), income from local authorities, health authorities and hospitals, Research Council grants and post-graduate fees, and other Government and EU grants for research and teaching.

Private income is that which comes from:

- UK charities
- Overseas student fees
- Residences and catering
- Other research income
- Other income (fees, services, endowments, etc.)

## Recent trends in funding

### Funding for teaching

42. Teaching is the largest activity and is the core business of all HEIs, accounting for approximately 50% of their costs and income. The figure on page 22 of the Browne report (very similar to Figure 4.3 in the JNCHES 2008 report), shows that the unit of publicly-funded resource for teaching (£ per student), fell significantly during the 1990s, and that this decline was arrested and reversed since the early 2000s, partly due to the introduction of two new sources of income for teaching:
  - regulated student fees (not in Scotland) became much more significant from 2006/07 and built up to provide a significant additional funding stream by 2008/09;
  - new capital grants for teaching provided an enhanced and predictable stream of additional funding for institutions (replacing more ad hoc previous grant schemes).
43. Post-Browne, the concept of a “unit of resource” for teaching (i.e. a standard national view of the funding for a student) will become much less meaningful as each institution will decide what level of resourcing it wishes to adopt depending on the fees it can charge and a variety of other factors.
44. The big change will be a substantial reduction in the total public funding for teaching, particularly focussed on non-priority subjects. The announcements made so far indicate that the order of these reductions will be:
  - For 2011-12 which is referred to as a transition year, there will be a reduction of approximately 6% of public teaching funding in England, plus a much larger percentage reduction in capital grants and a smaller one in research funding. The details of how this is to be allocated are not yet announced.

- The big change in England will come in 2012-13 and beyond as the public funded teaching core grant in England will be very significantly reduced (and almost totally removed for arts and humanities subjects), but compensated by the freedom for institutions to raise regulated tuition fees.
  - In Scotland, the funding council's budget for higher education in 2011-12 will be reduced in cash terms from £989m to £926m (by 6%) and there will be a large reduction in funding for capital grants
  - In Wales, the Welsh Assembly Government (WAG) has announced a 10% reduction in university funding for the financial year 2011-12, and the picture beyond that is uncertain. A number of other changes are also in train (strategic funding, regional planning) which will lead to some HEIs losing further public income beyond the 10%. The WAG has also announced that Welsh-domiciled students will not pay the higher fees whether they study in England or in Wales.
45. It is worth stressing that there remains significant uncertainty about all these public funding decisions and the way they will impact on institutions. Much of the detail is yet to be finalised – a White Paper is expected in spring 2011.
46. However, the overall picture is clear. Institutions have suffered a significant decline in the core publicly-funded resource available for teaching over a long period. This was beginning to recover to a limited extent in the late years of the decade to 2010/11 but the funding for teaching will now fall significantly in 2011-12 in all countries of the UK. In 2012-13 and beyond, there will be further significant reductions in England, which will be compensated (to differing extents for different institutions and disciplines) by increased student fee income.
47. Overseas (i.e. non home or EU) students are important in this context as their fees are not regulated and so institutions can charge a market fee and recruit additional students without government regulation. This source of income has grown rapidly in the last decade and it is now very significant at sector level (9% of income in 2008/09). Many institutions are financially-dependent on this extra source of income to offset losses on other aspects of (publicly-funded) teaching. There is a concern that a combination of rapid development of well-funded universities in the main countries sending students to the UK (Singapore, Hong Kong, China, India and Malaysia) plus travel restrictions and increased costs in the UK will reduce the attractiveness of the UK to some of these international students, so reducing one of the few unregulated sources of income of UK institutions.

### Funding for research

48. Research is the second largest academic activity – accounting for approximately a third of the sector's costs and a quarter of its income. Research is funded through the dual support system whereby infrastructure, training for research, and research without an external sponsor is funded by a block grant from the funding councils (most of which is called QR, driven by volumes and quality measured in the previous RAE/REF) while the costs of research projects and contracts are funded by public and private funders on a competitive basis.
49. Data from TRAC (the standard activity costing system used by all HEIs) shows that all research activity is in deficit. This deficit was very significant in the early 2000s, but a number of improvements in the public funding of research were introduced in the mid-2000s, and were listed in the 2008 report. However, research is still significantly in deficit – by approximately 30% (see below for more details).
50. This continuing research deficit is not surprising (although there are concerns about its magnitude). The research councils fund projects at 80% of the full economic costs (plus some capital funding). Many other funders (including some charities, the

EU, private industry, and some government departments) fund projects below full economic cost. Many institutions do more research without an external sponsor, and take on more part-funded projects than their block grant funding will directly support.

51. The 2010 Wakeham report<sup>3</sup> was partly a response to government concern about these continuing deficits and their implications for sustainability and value for money of the public investment in the university research base. The report examined the reasons for the deficits and looked at evidence on the growth in volumes of research, and for evidence of efficiency and sustainability. The report recommended new steps to monitor and improve the sustainability and efficiency of university research.
52. Public funding for research will be cut, although not as significantly as for teaching. The government statements about “level cash” for research include assumptions about efficiency gains which appear to be larger than can realistically be achieved by institutions and there will also be cuts in capital funding for research.

### Funding for capital

53. Unlike fully-funded public bodies, HEIs have always provided some of their capital investment themselves (e.g. from endowments, fund-raising, commercial activities, and borrowing). They have also depended partly on public capital grants, the availability of which has varied greatly over the years. This unpredictability acted against strategic and efficient planning for capital developments.
54. As with teaching and research, public funding for capital fell behind in the 1990s, and a survey in 2001 showed that the sector had a backlog of necessary investment in facilities for teaching and research of approximately £8bn. New sources of government capital funding were introduced on a predictable formulaic basis in all four countries (the names of these schemes and the amounts of funding varied). A second national survey (in 2006) showed that good progress had been made but the sector still had a significant backlog of investment required to bring existing buildings and equipment up to the functionality and condition required for modern higher education (particularly in respect of teaching).
55. Public funding for capital has now been severely reduced, and institutions will need to finance their capital investment strategies to a much greater extent from their own cash. If they are unable to do so, the risk is not just one of “slightly shabby buildings, or of missing out on a “feel-good” factor”, it is that UK higher education will fail to provide a world-class experience to students, and will fall behind its international competitors, many of whom already invest more in this part of the student experience.

### International Comparisons

56. UK higher education is a success story. The UK is a leading destination for international students and rivals the USA as the most popular destination for international students. In 2008/09, 14% of full-time students in the UK were domiciled outside the UK (including students from Europe). The UK has one of the most productive research bases in the world, and also scores very highly on student completion rates.
57. The UK invests a lower proportion of GDP in higher education than the OECD average (1.3% in 2007 compared to 1.5%) and a number of competitor countries invest more per student (Australia, Canada, Japan, USA). The trend has increased from 1.1% in 1998 but the UK has remained behind the average over this period. The percentage of public expenditure on higher education institutions as a proportion of GDP in the UK is also lower than the OECD average (0.7% in 2007 compared to 1.1%)<sup>4</sup>.

..... 3 *Financial sustainability and efficiency in full economic costing of research in UK HEIs. UUK/RCUK*  
4 *OECD. Education at a Glance.*

# How has the higher education sector coped with these changes?

58. It is clear from the above brief survey that, even before the challenging funding changes announced in 2010, the HE sector had experienced a significant financial squeeze in recent years as its volume of activity grew much more than its public funding.
59. The impact of this financial squeeze was felt or accommodated in four different ways:
- **enhanced efficiency and productivity** of institutions, assisted by opportunities for growth and funds for strategic development;
  - **some neglect or deferment of necessary investment** in physical infrastructure and student support services;
  - **a reduced rate of innovation and development** in scholarly activity, in teaching techniques and technology, in the curriculum, and in the student learning experience;
  - **general stress and pressure on staff, resources and on the student experience.**
60. The 2008 report provides more detail and quoted some of the sources of evidence for these changes. Without repeating all this, it is worth noting:
- a. At a time of significant and sustained growth, the sector delivered much higher throughputs of both teaching and research without a commensurate increase in public funding and with measurable improvements in efficiency in the use of space, staff, administration and with some rationalisation and collaboration between institutions;
  - b. The pay modernisation process in the sector was necessary, but had high costs for institutions both in terms of direct pay costs and in terms of the gearing effect on pensions;
  - c. At the time of the latest national survey (2006), the sector still had a significant backlog of capital investment required to bring existing buildings and equipment to the functionality and condition required for modern higher education (particularly in respect of teaching). With the level of surpluses being generated by institutions, it required “several years” of public capital grants to enable it to address these deficiencies;
  - d. The 2008 FSSG report on the Sustainability of Teaching and Learning in English Universities<sup>5</sup> provided evidence of several areas in which UK teaching and learning was falling behind the needs and expectations of students and of sustainability. Many of these are about recurrent spending rather than capital investment;
  - e. Evidence assembled for the Browne review by Universities UK showed that even leading well-managed universities were unable to provide the levels of resource and investment needed to give all students access to the full range of learning opportunities and facilities which the HEIs mission and strategic plan required.
61. All these pressures are likely to continue, and unless institutions can find ways to address them, they are in danger of falling behind relative to international and national competitors, and to the objectives they and their funders and students set for them.

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5 *Financial Sustainability Strategy Group, published 2008*

# The financial health and sustainability of the sector in 2010

62. We noted above that there are four main indicators of financial health: financial surplus; cash and liquidity; the strength of the balance sheet; and key financial risks of an institution. We review each of these below. It has to be recognised that this is only a partial assessment due to the lack of robust financial forecasts.
63. Assessing sustainability is more complex as discussed above, and involves bringing in a number of non-financial factors, in many cases without the benefit of national statistics. Nevertheless, there are a number of sources of evidence, and these are also reviewed below. Again, this can only provide an initial assessment.

## **a. Analysis of operating surpluses**

64. The single most appropriate indicator of financial health is the operating surplus (or deficit) reported in institutions annual accounts. This shows the difference between income and expenditure on the normal operations of the institution.
65. Surpluses are necessary for any institution which is not to stagnate or decline. They are needed for a variety of purposes, but the most commonly quoted purposes in institutions' financial strategies are:
  - Investment in academic improvements including the student experience
  - Investment in estates, including dealing with backlogs and remedial maintenance
  - Building reserves to provide some security to deal with risks and contingencies
  - Building reserves to cover pensions liabilities (note that many of these are not included in institutions reported accounts)
  - Providing finance to subsidise activities which are part of their missions but are not fully funded, including much research, widening participation, knowledge transfer, support to local and regional economies, employer and community engagement etc.
66. The ability to make a surplus consistently shows that an institution is managing its costs and is delivering activities and outcomes that are of value to its customers and funders. An institution which is unable to make surpluses on a consistent basis is very unlikely to have a secure future.
67. Operating surplus data for the UK sector reported to the funding councils for England, Scotland and Wales are shown in the table below (the forecasts are from 2009 annual forecasts in England: those in Scotland and Wales are not published in the same way).

**Figure 2: Operating surpluses: published data for 2005-06 to 2008-09 and forecasts for England from HEFCE (actuals highlighted)**

	Actuals				Forecast			
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
England/NI	1.0	1.0	2.1	1.4	0.8	1.1	1.1	0.9
Scotland	1.4	1.6	1.3	0.5				
Wales	1.7	2.3	2.7	1.9				
UK	1.0	1.1	2.1	1.3				

68. The data show that in England 2007-8 and 2008-9 were relatively better years than recently but that in December 2009 institutions were forecasting a decline in levels of surplus to around 1%. Early indications are that 2009-10 will be another good year, but it seems highly likely that the next set of forecasts submitted by English institutions (i.e. for 2010-11 and beyond) will be revised down rather than up<sup>6</sup>.
69. In Scotland, the level of surplus at sector level has improved since the early part of the decade (in 2000-01 the sector had an operating deficit of 0.7%) but it is now lower than in England (and of course tuition fees are not charged in Scotland). As in England, Scottish institutions are forecasting very modest operating surpluses (1% or below through to 2011-12)<sup>7</sup>.
70. In Wales, the average surplus has been consistently higher than in England as shown in the table and this may reflect a degree of conservatism in Welsh institutions (their borrowing is also much lower than the UK average - see below)<sup>8</sup>.

### How variable are surpluses?

71. The figures above are averages for the sector in each country. Actual surpluses vary widely between institutions. In 2008-09, the range was from a deficit of 15% to a surplus of 21.5%. There were 40 institutions making deficits on their operating costs; and 49 making surplus of 3% or larger.
72. The 2008 report considered whether there was any systematic variation in the levels of surplus by type of institution (such as, for example, Russell Group universities having on average a higher level of surplus). It noted that there was no strong systematic pattern of this kind. However, this could change after the implementation of the Browne recommendations which are expected by some commentators to lead to a greater differentiation in the financial performance of different types of university.
73. It should be noted that surpluses can vary from year to year for reasons not connected to basic financial health, and that it would be wrong to read too much into small differences, or into just one or two years of data.

6 *Annual Accountability Returns: Outcomes for 2009. HEFCE Publication 2010/20*

7 *SFC Circulars*

8 *HEFCW Circular W10/17HE*

## Are these surpluses adequate?

74. The level of surplus required is a judgement for each institution which will depend on a number of factors that are specific to the institution. The right way for each institution to decide this is to build up an analysis of its requirements for cash as suggested in paragraph 65, and then to consider:
  - a. whether it has other sources of finance it could appropriately use to cover part of this cash requirement;
  - b. whether the residual cash requirement and implied surplus is a realistic (achievable) financial objective. (If not, it should revisit its academic objectives.) It is quite common for institutions to define a level of operating surplus that they require to be sustainable, but to decide that they cannot achieve this immediately and to work towards it over several years.
75. An operating surplus of 1-2% as achieved on average in 2008-09 is well below the level that many institutions would regard as necessary for the purposes listed in paragraph 65 (see discussion in box).
76. It could be noted of course that many institutions have managed for years with surpluses at these low levels (1-2%) and are apparently financially healthy. This needs to be seen against the background of a stable and relatively benign funding environment with opportunities for growth (funded additional student numbers), significant annual capital grants, and many institutions also having opportunities to rationalise campuses, dispose of assets etc. to improve efficiency.
77. The challenge for financial health is that most of these conditions have now changed: the opportunities for funded growth and public capital grants are both greatly reduced, and many of the efficiency measures cannot be repeated every year without cutting into productive capacity. Moreover the risks are now much higher than they were on average in the past decade.
78. We would conclude that even if a 1-2% surplus was adequate for financial health for many institutions in the past decade, it is unlikely to be adequate in the next five years. So, unless institutions can forecast and deliver surpluses at a higher level than this, we would have concerns about their financial health, as well as their sustainability.

### What level of surplus is required?

While the funding councils have never issued formal guidance on this, it is widely considered in the sector that in normal circumstances, institutions should ideally aim to make a surplus in the region of 3-5%. Few have achieved this.

Support for this view comes from the TRAC cost adjustments (see box below) which are a proxy for the level of additional expenditure required for sustainability. The TRAC-adjusted position (shown below in the main text) suggests that any level of operating surplus below about 5% may be inadequate in the medium-term.

It is also widely accepted that an appropriate average level of annual investment to maintain the functionality of physical infrastructure is 4.5% of insured asset value. (This does not translate directly into a required surplus, but it supports the idea that institutions need to generate a significant amount of cash to invest in infrastructure)

These are of course averages across the sector. Some institutions which have favourable circumstances (such as an efficient estate in good condition; access

to sources of cash other than from operating income; a portfolio which provides adequate income to cover full economic costs including necessary investment and improvements; a secure market position) may be sustainable at a surplus of 1% or 2%, and equally some others need significantly more than 3% (some have financial strategies which require a surplus of 7 or 8%).

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### TRAC and surplus-deficits by higher education activity

79. TRAC is the standard activity costing system used by all UK HEIs. TRAC allocates the expenditure of HEIs recorded in their published accounts across the main activities they undertake (teaching, research and other, with both teaching and research broken down by type of funding (public, non-public) and by type of external sponsor (research council, charity, industry etc.) in the case of research. In England, Northern Ireland and Scotland, institutions also calculate the TRAC costs of teaching different academic subject areas.
80. TRAC makes two cost adjustments to the accounts expenditure data which are intended to bring the TRAC costs onto a “full economic cost basis”. These are described in the box below.

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#### The TRAC cost adjustments

**The Infrastructure Cost Adjustment** is a technical accounting adjustment which ensures that depreciation of assets is charged on a “current value” (using an insurance valuation) and so more closely reflects the real economic cost of any assets which are held in institutions’ books at a historic cost. It is a self-regulating adjustment in the sense that it reduces to zero for institutions which are already accounting for depreciation at current costs.

This adjustment is about obtaining data on a consistent basis across all institutions. However, it may still leave an understatement of the full economic cost of infrastructure, as it assumes the value of estate, backlog maintenance levels, and annual maintenance spend are all appropriate to mission – which is not the case in some institutions. Moreover, there is no corresponding infrastructure adjustment for equipment because of the technical difficulty of costing of equipment.

**The return for financing and investment** is intended to ensure that institutions take account of the economic cost of capital. This covers the financing costs of institutions, including the existing costs of borrowing and the opportunity cost of institutional cash used for financing; it also provides funds for the rationalisation and development of institutions’ business capability and capacity. It does not however, specifically adjust for inadequate spend in areas such as student support and facilities, staffing levels etc.

Some people find it helpful to think of this adjustment as a pricing factor, rather than a cost, in the sense that it is a proxy for the higher level of recovery, and generation of cash for investment, that all institutions need to be sustainable. Because their current surpluses are so low, this adjustment leads to deficits (a need for more resources) in the TRAC-adjusted accounts.

Across the sector, the two cost adjustments added approximately £1.9bn to institutions costs in 2008-09 (7.6%).

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81. The 2008 report discussed the TRAC-adjusted surplus position which it noted may be considered a more appropriate indicator of financial health than the operating surplus in the accounts. It should be noted that TRAC surplus/deficits are quoted in two parts:
- As a short-run operating position (with the infrastructure cost adjustment included)
  - As the full economic cost (fEC) – or long-run sustainable position (with the RFI adjustment also included).
82. The TRAC reported surplus/deficits for the English sector for 2008-09 are shown in the Figure below (unpublished data from HEFCE).

**Figure 3: TRAC adjusted position, UK HEIs, 2008-09**

<b>£M</b>	<b>Total</b>	<b>As % of total expenditure</b>
Total income	24,990	
Total expenditure	24,650	
Operating surplus	340	
Infrastructure cost adjustment	(758)	3.1%
TRAC adjusted operating surplus/deficit	(418)	
Return for financing and investment	(1125)	4.6%
TRAC adjusted surplus/deficit on full economic costs basis	(1,544)	

83. The TRAC surplus/deficit by different activities is shown below

**Figure 4: TRAC surplus deficits by activity UK 2008-09**

<b>£m</b>	<b>Publicly-funded teaching</b>	<b>Non-publicly funded teaching</b>	<b>Research</b>	<b>Other</b>	<b>TOTAL</b>
Income	10,875	2,568	7,033	4,513	24,990
Costs	11,139	2,026	9,221	4,148	26,533
Surplus/deficit	(264)	542	(2,188)	366	(1,544)
Surplus deficit as % of income	(2.4%)	21.1%	(31.1%)	8.1%	(6.2%)

84. These two tables show that in 2008-09:
- On an operating cost basis, the sector made a small surplus of £340m (1.4%)
  - When the value of assets is placed onto a consistent basis by the TRAC Infrastructure Adjustment, this becomes an operating deficit of £418m (1.7%)

- When the RFI adjustment is included to give the long-run full economic cost, the whole sector is in deficit in deficit by 6.2%
- Publicly-funded teaching, which is the largest activity, makes a small deficit on an FEC basis (2.4%)
- Non-publicly-funded teaching, although a smaller activity, makes a large surplus (21%) – chiefly due to unregulated international student fee income
- Research is heavily in deficit (over 30% as a percentage of income) – a more detailed analysis of this in TRAC shows how the deficits vary by different types of research
- Other activities make a small surplus (8%)

### Conclusion on operating surplus

85. The levels of operating surplus achieved by institutions in recent years have been adequate for short-term financial health in a time of relatively stable policy and benign funding, including opportunities for funded growth for many institutions. However, there is evidence that this has not translated into a sufficient level of spending and investment for sustainability as defined above. As the environment becomes significantly more uncertain and challenging, the levels of surplus now being forecast are unlikely to be adequate for short-term financial health, and will lead to further threats to sustainability.
86. The pressures on sustainability are particularly strong in the case of research, which is heavily loss-making and is effectively being subsidised by a combination of overseas student fees and enterprise and commercial activities (Other in TRAC).

### b. Cash and Liquidity

87. Many finance directors would say that cash generated is the most fundamental measure of financial health (“cash is king”). They look at “operating cash”, i.e. the cash generated by normal operations of the business and which is available for investment to maintain its performance and productive capacity. This will be one of the key measures of both financial health and sustainability – but it is linked to operating surplus, which may be an easier concept to communicate to non-financial experts about the health of the institution.
88. Liquidity is a measure of the availability of cash and other liquid assets (financial solvency) expressed as the ratio of liquid assets to cash expenditure (i.e. excluding depreciation). It is usually converted into days – showing the proportion of a year for which the organisation has enough cash and liquid assets to meet its short-term commitments (such as paying wages) without depending on new income.
89. Most HEIs have a secure stream of income from the funding council, received in tranches over the year. Compared to many types of commercial business, they therefore have needed to carry a lower level of cash and liquid assets to continue to operate. However, this position will change with the implementation of the Browne recommendations. Much institutional income will come later in the year and with some uncertainty (from the Student Loans Company or from students and their parents) rather than in regular and predictable tranches from the funding council. Institutions are likely to need to spend more on debt control and to hold larger levels of cash as a contingency, and they will be exposed to additional costs of financing and of risk.
90. The table below shows the number of days’ net liquidity for the sector. This has improved in recent years, with variations between the countries of the UK, but in

England in 2009, institutions were forecasting a significant decline in liquidity (to around 50 days in 2011-12 and 2012-13). This forecast suggests a weakening of the sector’s ability to meet its short-term commitments.

**Figure 5: Net liquidity in days: actual and forecast**

	Actuals				Forecast			
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
England/NI	67	74	83	84	68			
Scotland	54	61	79	79				
Wales	96	87	100	101				
UK	67	74	85	84				

### Conclusions on liquidity

91. As the proportion of secure public funding reduces, and in the increasingly volatile and competitive environment now expected, institutions would be expected to require a higher level of liquid assets to finance their working capital and to cope with risks. Instead, they are forecasting a decline, and this must reflect some weakening of financial health, and is concern for sustainability.

### c. Balance sheet items: reserves, assets, borrowing

#### Reserves

92. Reserves represent income that is retained in the business, i.e. accumulated surpluses. Reserves are represented by the net assets shown in the balance sheet, i.e. cash, fixed assets, and debtors less creditors. They can provide an indication of financial strength but great care is needed about this because reserves are not all available. When initially generated, the surpluses were represented by cash, but some of that cash will have been used to cover the purchase of fixed assets. Only the part of the reserves that is cash-based can be regarded as available funds that could be used to run the business.
93. In England, reserves have been relatively stable at around 45% of income (£9bn in 2008-09), but pension scheme deficits which have to be included under a new reporting standard (FRS17) reduce this figure to £5.5bn (27% of income). Reserves are very unevenly spread across the sector (18 HEIs account for over half of the English sector’s total reserves).
94. In fact, the levels of cash reserves held by institutions are low – usually just enough for working capital (see discussion under liquidity above). Some assets may be realisable into cash (e.g. by selling land or buildings), but this is rarely quick, and it can only be done once. It is not normally a good policy to sell assets to finance normal operations (“Selling the family silver”) although it may well be justified to finance some form of strategic investment for the future.

## Assets

95. The main asset base of most institutions is their campus – land and buildings and equipment which are all used for educational purposes (and in many cases have no feasible or permitted alternative use). For this latter reason, assets in higher education are less “tradable” than those in business. They are often disposed of as part of an educational project – e.g. selling one campus to improve another, but institutions cannot simply sell publicly-funded assets without repaying the “Exchequer Interest” in the particular asset. Assets represent an element of financial strength, which is important when the financial health of institutions is being assessed (and is taken into account for example, by banks when assessing the credit-worthiness of HEIs seeking loan finance).
96. A typical research university has an asset base of several hundred million pounds and the careful strategic management of these assets is an important element of sustainability.

## Pensions deficits

97. The accounting treatment of pensions is complex. Reserves stated in the accounts include some pension scheme deficits under the accounts reporting standard FRS17, but multi-employer schemes including two of the main pension schemes in higher education, (the Universities Superannuation Scheme – USS, and the Teachers’ Pension Scheme – TPS), are not included.
98. In respect of short-term financial health, these pensions’ deficits add some uncertainty (and complexity) to the assessment of the position of different institutions, and are a negative factor affecting financial health. For example, if the excluded pensions scheme costs were included in accounts, or if employers’ contributions had to increase (which some commentators feel is likely), this would add to the sector’s costs and would reduce the UK sector surplus.
99. The medium-term impact of pensions on sustainability is a much more significant concern. This is not just a higher education problem as the nation faces a combination of more pensioners living longer and with increased expectations and rights due to raised salaries. A key uncertainty (and financial risk) for the sector is whether institutions will have to finance these increases in pensions costs in the future or whether, and to what extent, the government will do so.

## Borrowing and gearing

100. HEIs borrow for a variety of reasons, but normally to finance capital investments or projects that are too costly to be funded out of annual cash surpluses. The funding councils maintain controls and monitoring on the levels of institutional borrowing. Gearing shows total borrowing as a percentage of total income. The level of gearing in recent years has been very stable around 20%. There is no “ideal” or sustainable level of borrowing or of gearing. This will depend on the circumstances and degree of ambition (and appetite for risk) of each institution.

**Figure 6: External borrowings as % of income: actual and forecast**

	Actuals				Forecast			
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
England/NI	20	20	21	21	23	24	25	24
Scotland	13	11	13	11.6				
Wales	8.8	8.4	10	10.6				
UK	18.5	18.2	19.6	19.3				

101. Institutions take very different approaches to borrowing. Some are very debt-averse and their governors will only agree to borrow very limited amounts (or not at all) and only for very safe investments – usually student residences. This appears to be the profile in Wales, although it is quite variable between institutions (see the HEFCW circular referred to earlier).
102. Some other institutions see borrowing as a chance to make strategic investments more quickly, or which they would otherwise be unable to make. Some would even say that without exploiting every financing avenue open to them they will be unable to compete in the market. However, institutions which have high gearing have less potential for future borrowing and so could be said to have reduced capacity to respond to new financial opportunities and risks (high borrowing can reduce financial resilience).
103. HEFCE noted recently that borrowing is at the highest level it has ever been in the sector<sup>9</sup>, reflecting no doubt the cost pressures on the sector, the increased “marketisation” of higher education, and English institutions’ judgement that they need to diversify their sources of funding and to use all financing opportunities open to them.

### Conclusions on balance sheet indicators

104. HEIs in receipt of regular and secure public funding, which makes up a high proportion of their income have been able to maintain levels of liquidity, reserves and borrowing which have been sustainable within the stable and well-funded context (and with lenders such as banks regarding HEIs as a good risk, and being willing to negotiate flexible facilities). The Browne reforms will probably change the financial market’s perception of the credit worthiness of HEIs, but it is too early to assess what impact this will have. As this context is changing, all institutions will be thinking about the needs to strengthen their balance sheet, and many may find it more difficult (and expensive) to raise the finance they need.
105. As with the surplus position, this could be seen as a case where the past performance has been adequate for financial health, but not necessarily for sustainability. It may have to improve if institutions are to thrive in the more challenging environment ahead.

#### d. Key financial risks

106. Every institution has to assess the financial risks that are particularly relevant to its own strategy. These differ by type of institution, and with the strategy and stage of

<sup>9</sup> See the 2008 commentary on accountability returns and financial forecasts

development of each individual HEI, and over time. The generic risks that seem most significant for the sector as a whole at this time include:

- **Reduced public funding** particularly for teaching and for capital, but also for research
- **Increased volatility and unpredictability of student demand** – particularly for institutions which recruit students (as opposed to selecting)
- **Competition from private providers** who may have some in-built advantages over HEIs (e.g. not having to provide the full range of courses, more flexible staffing, less regulation)
- **The impact of the economic recession** reducing opportunities to generate income
- **Graduate unemployment** reducing the perceived value of a degree
- **Difficulty of maintaining overseas student recruitment** due to immigration policy measures and increased competition
- **Challenges to the high reputation of UK higher education and research** due to funding and immigration constraints and increasing competition from better funded countries
- **The different challenges of managing without growth**, including how to meet the demands from funders for increases in efficiency
- **Some costs rising much faster than funding** or than likely permitted increases in regulated fees
- **Pensions deficits and liabilities.**

107. The balance of risks is different for each HEI (or perhaps for each type of HEI), but it is clear that overall, risk is increasing for the sector and this is reflected in the (individually confidential) assessments made by HEFCE of the risk status of the 130 HEIs in England.
108. A recent UCU report<sup>10</sup> “Universities at Risk” uses four indicators to assess the risk to different institutions arising from the implementation of the CSR and Browne reforms. The indicators used are:
- Reliance on public funding
  - % of public funding for non-priority subjects
  - Number of students from poorest backgrounds
  - Reliance on non-EU student fees.
109. The report places HEIs in different risk categories according to the expected level of potential impact of the funding changes.

### Staff costs

110. Higher education is, of course, a heavily staff-intensive activity, and staff costs make up a high proportion (close to 60%) of the sector’s operating costs. Staff costs tend to increase faster than the level of indexation of public funding, and so put pressure on institutional finances. Managing and affording staff costs is therefore a key issue in financial management for institutions and many institutions’ governing bodies regard the ratio of staff costs to total costs as a key performance indicator. This is partly because staff costs are relatively “fixed” and if this ratio becomes too high, institutions have reduced flexibility to respond to risks or opportunities.

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<sup>10</sup> UCU report; *Universities at Risk*, UCU December 2010

111. Staff costs grew rapidly in the late years of the decade to 2010, chiefly because of the new pay framework and related developments. Fortunately, this happened at a time when institutional incomes were also growing due to a combination of improving public funding and increase in numbers of overseas students paying market level fees. Staff costs were accommodated by these growing incomes so that staff costs have remained broadly constant as a proportion of total institutional costs, and indeed the average percentage at UK sector level has declined slightly in the most recent years as shown in the table below

**Figure 7: Staff costs as a % of total expenditure (HESA data, provided by UCU)**

Year	Staff costs as %
1998-99	57.9
1999-2000	58.2
2000-01	58.2
2001-02	58.0
2002-03	58.5
2003-04	58.5
2004-05	58.4
2005-06	57.8
2006-07	57.8
2007-08	57.4
2008-09	56.8

## Summary on financial health

112. The main evidence on the short-term financial health of institutions and the sector comes from institutions' financial statements (surpluses or deficits, cash and liquidity, assets, reserves and borrowing), which show recent past performance; from institutions' financial forecasts of how this performance will evolve in the short-term; and additional information on the context in which they will be operating and the risks and opportunities they face.
113. In general, analysis of the data on performance suggests that the sector continues to be financially stable in the very short-term. Most institutions are making operating surpluses, which have improved since the 2008 JNCHES report, and have healthy levels of cash (liquidity) to finance their operations: - again improved since 2008. We expect this pattern to be seen to have continued in 2009-10 when the results for this year become available.
114. However, we know that public funding has already declined in 2010-11; will decline

further in 2011-12; and that the outlook for 2012-13 and beyond is for major reductions in public funding for teaching which may be compensated by increased fees. Annual financial forecasts made by institutions to their funding councils are not all available in the same way, but it is clear that the whole sector is forecasting some deterioration in financial health, and this is especially marked in England where it is clearest that funding for teaching in 2012 and beyond is to be radically restructured with much less block grant public funding; a more open market with students paying higher fees; and private providers more able to compete. These changes will increase the financial pressures and risks for many institutions.

115. There are some significant and interesting differences in Scotland and Wales where policy is diverging from that in England and the impact on institutions may be different, although the underlying pressure on public finances remains similar.
116. We conclude that the financial health of the sector is now more problematic than it was in 2008, despite the improved recent past performance in England in particular. It is problematic because of the significantly higher financial risks and threats institutions now face from a financial position where most still have a level of reserves, cash, and financial flexibility which was survivable in a better funded, more stable, (and more public-sector oriented) environment, but may prove inadequate for the more demanding and market-oriented future conditions.

## Provisional analysis of sustainability

117. As discussed above, assessing sustainability is more challenging (and inexact) than assessing financial health because it has to be forward-looking, and the criteria that can be used will differ across different types of institution. The work currently in hand for the HEFCE-funded project on sustainability metrics may lead to some indicators which could help in preparing a more complete up-date of the 2008 JNCHES report, with a full assessment of sustainability. However, in the meanwhile, it makes sense to use an approach that is broadly similar to that used in the 2008 report, which we have extended by drawing upon the “conditions for sustainability” discussed earlier in this report.
118. The tests of sustainability we have used for this interim report are therefore as follows.  
**Q1: *Does the sector have the basic financial health, effective governance and management, and adaptive capacity to enable it to deal with the risks and challenges it is facing, while continuing to deliver its core mission?***
119. The evidence for this is largely historic and includes the fact that most institutions are financially healthy and well-managed and the very good record of the sector in responding to challenges and “coping” with financial pressures. There is no doubt that in general institutions are well-managed and adaptable, but one would have to note that the environment is now much more unstable and challenging and what may have been an appropriate level of financial health and effective management and governance in the past might no longer be satisfactory in the future.  
**Q2: *Do institutions have realistic academic strategies, with integrated financial strategies which enable them to understand which part of the HE landscape they need to be in and what they have to do to get there?***
120. The evidence from a variety of sources is that strategy formulation is patchy, and there are pressures (e.g. to do loss-making research) which are sometimes allowed to

over-ride sustainability considerations. The best examples include many institutions with exemplary strategies, which take account of the future environment; set out a clear academic vision for the institution; assess what they need to do to make this sustainable; and have the planning and management frameworks to enable them to take hard decisions if necessary, and to follow-through the changes and improvements necessary to deliver the strategic objectives of the institution. Not all institutions have yet achieved this position, and the new environment will challenge institutions which do not have this clarity of purpose, or which are “trying to do too much”.

**Q3: *Are institutions spending enough on their academic core business, and investing enough to maintain its future capability and market position in an increasingly competitive environment where students, employers and government have raised expectations of what higher education will deliver?***

121. The evidence from a variety of sources (some quoted in this report) is that many institutions are not committing the level of resource required into the student experience, and investing enough to maintain their productive capacity, to innovate and develop their academic provision in the way that they should, or to compete with other HEIs and private providers in the UK, and with competitors in other countries where higher education is better funded.

**Q4: *Do institutions’ own assessments of their performance against their chosen critical KPIs - i.e. the small number which relate to the achievement of the key strategic objectives in their plans for sustainable development suggest that they are making progress towards delivering their strategic plans?***

122. Evidence on this is being assembled as part of the sustainability metrics project referred to above and it will be possible to say more on this later in 2011. At an institutional level, these assessments may be confidential (in some cases), but there is a fairly clear general picture, which triangulates with many other sources of information. This is that for many institutions, including some that would be regarded as having a world reputation, there are clear stress points in their operation, and areas in which they are unable to deliver the student experience they believe they should. This, of course, is before they experience the reductions in funding that have been announced recently.

**Q5: *Are there foreseeable new risks or threats to the sector’s financial position which could lead to a decline in the performance and resilience of institutions?***

123. The answer is clearly yes, but it is not yet clear exactly what and how, nor how they may differ in Wales and Scotland. And it is also important to note that changes of the kind envisaged in the next few years also present opportunities for some institutions.
124. Putting these considerations together, we conclude that the sustainability of the sector, which was assessed as problematic in the 2008 report, would now have to be assessed as in a worse position in 2010, despite the partial relief of 2-3 years of relatively good financial performance.

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