Grant Thornton

An instinct for growth™

The next move

Financial health of the higher education sector 2013

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Introduction

This is Grant Thornton's third annual review of the financial health of the higher education sector. Through these reports we aim to provide an independent analysis of the financial performance of UK universities.

In our 2012 report, we commented that the policies introduced by the Coalition Government had not at that time had a significant impact upon the financial health of the sector in 2010/11. The same conclusion could reasonably be reached for the 2011/12 financial year – a year which is perhaps most notable for its lack of notable headlines.

It is true that it has been a 'harder' year for the sector when compared to the prior year but overall the sector remains in sound health:

- Surpluses, although down 25% from the prior year to £1.12 billion, remain higher than the £0.9 billion generated in 2009/10
- Income rose 1.1% on the prior year to £27.7 billion
- Costs remain well managed, with staff costs increasing by only 0.3%, a decrease in real terms

The vast majority of universities have therefore ended their 2011/12 financial year in a position of strength to face the changes introduced in the current financial year.

It is the year in which we will start to see the impact and consequences (good and bad) of the new funding regime on individual institutions, the impact of the immigration restrictions imposed by the UKBA in 2012, changes to the provision of teacher training and continuing preparation for the forthcoming REF.

It is no surprise that with these changes impacting so much of the sector that, as we note in our article on risk, there is such homogeneity in the key risks now identified by universities – most notably those surrounding the recruitment of domestic students (and the delivery of an appropriate student experience), research income, government policy changes and the recruitment of international students.

Within this environment, there are also opportunities for universities, such as embracing the government's economic programmes, and taking their provision into new markets through the use of distance learning and the development of new technologies. Decisions made now will have far reaching consequences for the institutions as they continue to strive to meet their objectives in the future. We have sought to reflect this in the title of this year's report – 'The next move'.

The report contains key financial analysis but taking the risks and opportunities open to universities we also seek to provide some thought provoking ideas and guidance in a number of areas identified as financial risks by universities including ways of structuring remuneration and rewards to retain and attract the highest calibre staff, alternative ways to raise capital and considerations about how to maximise commercial stream income and the potential for fundraising.

This continues to be a challenging time to be working in and advising the higher education sector. We have heard the analogy that managing a university through the recent economic and political environment has been like trying to land a jumbo jet onto a postage stamp in thick fog. The higher education landscape is continuing to evolve, and we can have differing views on the merits and benefits of the changes being imposed, but as we enter 2012/13 the way forward is at least becoming clearer. To some degree the fog is clearing and the landing space may now be expanding.

I hope that you will find this report of interest and informative in helping you meet the challenges and opportunities that your institution is facing.

David Barnes
Head of Higher Education

Some headline statistics

	2011/12 £billion	2010/11 £billion	2009/10 £billion	2008/9 £billion
Total income	27.7	27.4	26.6	25.2
Surplus	1.1	1.5	0.9	0.3
Funding council grants	8.2	8.8	9.0	8.7
UK/EU tuition fees and contracts	6.5	6.1	5.8	5.2
Overseas tuition fees and contracts	3.1	2.8	2.4	2.1
Research grants	4.5	4.4	4.4	4.2
Staff costs	14.7	14.6	14.5	14.1
Net assets (total reserves)	23.7	22.3	19.7	18
Cash balances	3.1	2.8	2.4	1.9
Borrowing	6.2	5.7	5.3	4.6

Our categorisation of institutions

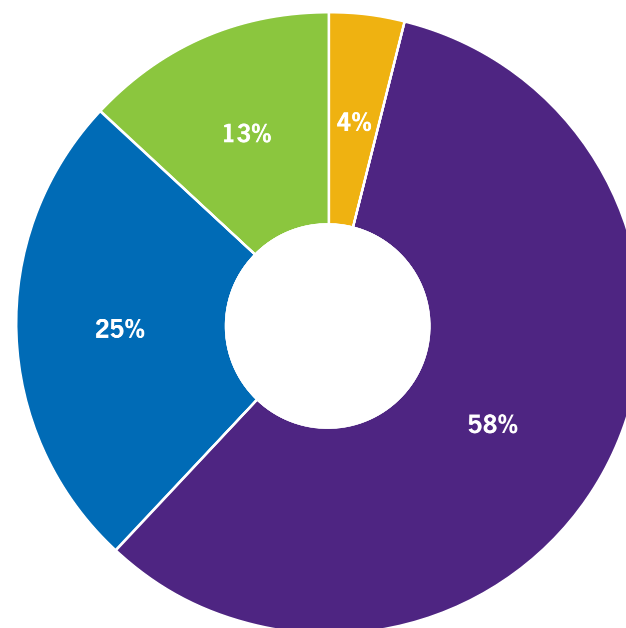
We have undertaken an analysis of the published accounts prepared by all UK higher education institutions (HEIs) for the financial year 2011/12[1]. We have extracted selected financial information from the accounts and have calculated indicative financial ratios as appropriate.

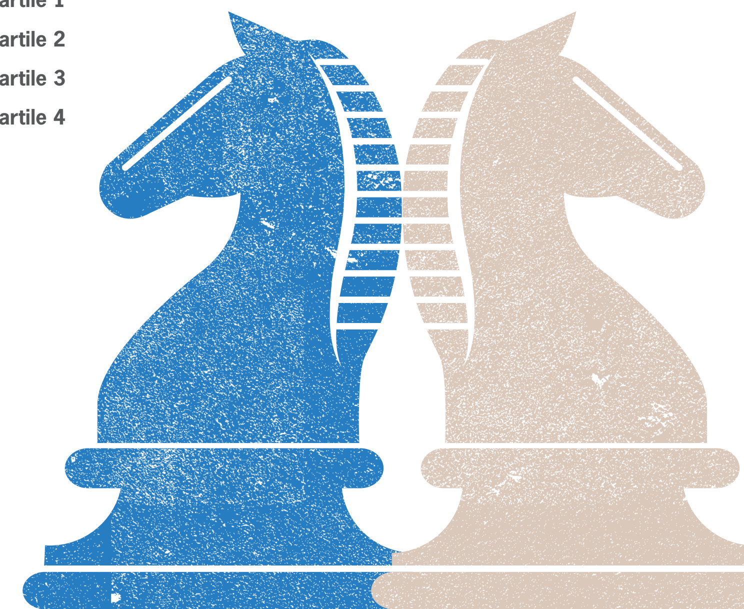
In the past, we have also examined the data aggregated within the various Mission Groups. This year, due to the movements between Mission Group, we have concluded that the Mission Group sub analyses has become less relevant to the financial health analysis that we perform. We have therefore chosen to categorise the institutions into quartiles based on income as we consider that the financial issues facing HEIs are more likely to be dependent upon their size than on any other single factor.

Details of the constitution of the quartiles are shown overleaf.

An analysis of the relative sizes of the bands is shown below.

2011/12: Income by quartile





[1] At the time of preparation, no accounts had been filed for Heythrop College, Glyndwr University or University of Glamorgan. Limited financial data was available for the Guildhall School of Music and Drama, and for the School of Pharmacy, University of London, which merged with the University of London part way through the period.

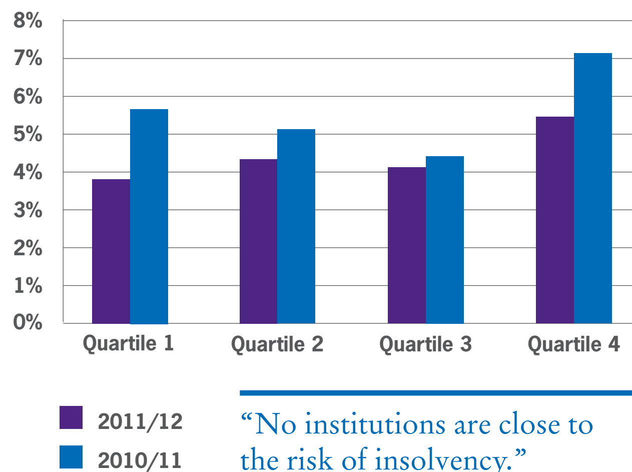
Quartile 1		Quartile 2		Quartile 3		Quartile 4	
Cardiff University	The University of Edinburgh	Anglia Ruskin University	University of Bath	Aberystwyth University	The Royal Veterinary College	The Arts University College at Bournemouth	The Royal Agricultural College
Durham University	University of Exeter	Bangor University	University of Bedfordshire	Aston University Birmingham	School of African and Oriental Studies, University of London	Bath Spa University	Royal College of Art
Imperial College London	University of Glasgow	Birmingham City University	University of Bradford	Birkbeck, University of London	Scottish Agricultural College	Bishop Grosseteste University College, Lincoln	The Royal College of Music
King's College London	University of Hertfordshire	Brunel University London	University of Brighton	Bournemouth University	Southampton Solent University	Central School of Speech & Drama, University of London	Royal Conservatoire of Scotland
London School of Economics and Political Science	University of Leeds	City University London	University of Central Lancashire	Buckinghamshire New University	St George's University of London	Conservatoire for Dance and Drama	Royal Northern College of Music
Loughborough University	University of Leicester	Coventry University	University of East London	Canterbury Christ Church University	Staffordshire University	Courtauld Institute of Art	School of Pharmacy, University of London
The Manchester Metropolitan University	University of Liverpool	Cranfield University	University of Essex	Cardiff Metropolitan University	University for the Creative Arts	The Glasgow School of Art	St Mary's University College, Twickenham
Newcastle University	The University of Manchester	De Montfort University Leicester	University of Greenwich	Edge Hill University	University of Bolton	Glyndwr University	Swansea Metropolitan University
Northumbria University	The University of Nottingham	Heriot-Watt University	The University of Huddersfield	Edinburgh Napier University	University of Chester	Guildhall School of Music and Drama	Trinity Laban Conservatoire of Music & Dance
The Open University	University of Oxford	Kingston University London	University of Hull	Glasgow Caledonian University	University of Cumbria	Harper Adams University College	University Campus Suffolk Ltd
Queen Mary, University of London	University of Plymouth	Lancaster University	University of Kent	Goldsmiths, University of London	University of Derby	Heythrop College	University College Birmingham
Queen's University Belfast	University of Reading	Leeds Metropolitan University	University of London	Institute of Cancer Research	University of Gloucestershire	Leeds College of Art	University College Falmouth
Sheffield Hallam University	The University of Sheffield	Liverpool John Moores University	University of Portsmouth	Institute of Education, University of London	University of Lincoln	Leeds Trinity University College	University of St Mark & St John
University College London	University of Southampton	London Metropolitan University	University of Salford Manchester	Keele University	The University of Northampton	The Liverpool Institute for Performing Arts	University of Abertay Dundee
University of Aberdeen	University of Strathclyde Glasgow	London South Bank University	University of St Andrews	Liverpool Hope University	University of Stirling	Newman University College	University of Chichester
University of Birmingham	University of Surrey	Middlesex University	University of Sussex	Liverpool School of Tropical Medicine	University of Sunderland	Norwich University College of the Arts	University of the Highlands and Islands
University of Bristol	University of the Arts London	Nottingham Trent University	Teesside University	London Business School	University of the West of Scotland	Queen Margaret University, Edinburgh	University of Wales
University of Cambridge	University of the West of England	Oxford Brookes University	University of Ulster	London School of Hygiene & Tropical Medicine	University of Wales, Newport	Ravensbourne College	The University of Winchester
University of Dundee	The University of Warwick	Royal Holloway University of London	University of Westminster	Robert Gordon University Aberdeen	University of West London	Rose Bruford College of Theatre & Performance	Writtle College
University of East Anglia	The University of York	Swansea University	University of Wolverhampton	Roehampton University London	University of Worcester	Royal Academy of Music	York St John University

The 2011/12 results as reported in the financial statements

‘Profitability’ of the higher education (HE) sector

In the financial year 2011/12, the HE sector generated a total surplus (before exceptional items) of £1.12 billion, representing 4.04% of income. This shows a significant decrease of 24.9% on the 2010/11 figure of £1.49 billion (5.44% of income), reversing the growth trend seen in the previous two years.

This reduction in profitability was apparent across the sector, with all quartiles seeing a reduction in profitability.



“No institutions are close to the risk of insolvency.”

In 2011/12, 15 institutions recorded a deficit compared to 10 institutions in 2010/11, while 97 institutions recorded a surplus of 3% of income or greater, compared to 109 in 2010/11. The reduction in surpluses may not necessarily be an indicator of financial difficulty, but could be caused by other reasons such as carrying out repairs and maintenance of the estate or through restructuring costs which may result in improved performance in subsequent years. We note that HEFCE have commented in their most recent report on institutions based in England (*Financial health of the higher education sector – 2011-12 financial results and 2012-13 forecasts – March 2013*) that, based on 2012/13 forecasts, no institutions are close to the risk of insolvency.

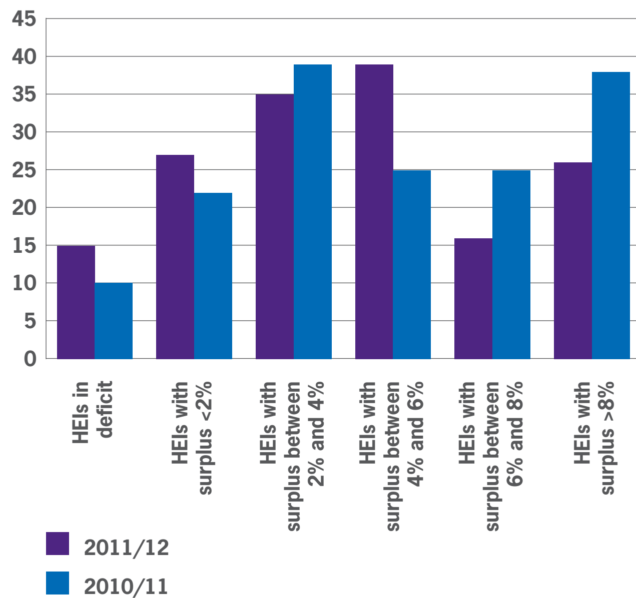
2011/12 is likely to be the last of the really bountiful years. From this point we will see the impact of government policy impacting on the income generated by the sector, and whilst it may well be that those institutions that are able to maintain their student numbers at the 2010/11 levels will generate higher surpluses from the revenue that the increased fees will provide, the impact of falling student numbers is likely to have a negative effect for many in the sector. Looking forward we can reasonably anticipate a further reduction of government funding into the sector as a result of the forthcoming Government Spending Review, and potentially the further polarisation of research funding following the forthcoming REF which may result in income levels being disproportionately allocated across the sector.

The questions that this analysis leads to is why is there the range of surpluses, why are they not at a higher level, and are they sufficient to meet the financial challenges that institutions are likely to face over the next few years whilst the transition to the new funding regime is completed. This is raised by HEFCE in their report:

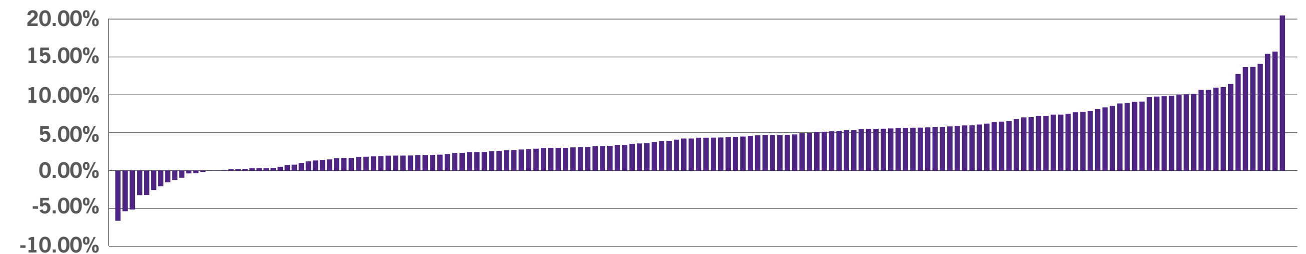
“Some institutions will need to increase surpluses in future years above current levels to ensure that the quality of the infrastructure in the higher education sector does not deteriorate, which would harm its long term sustainability.”

The distribution of surplus/deficit by institution across the sector for the past two years is shown in the graphs below.

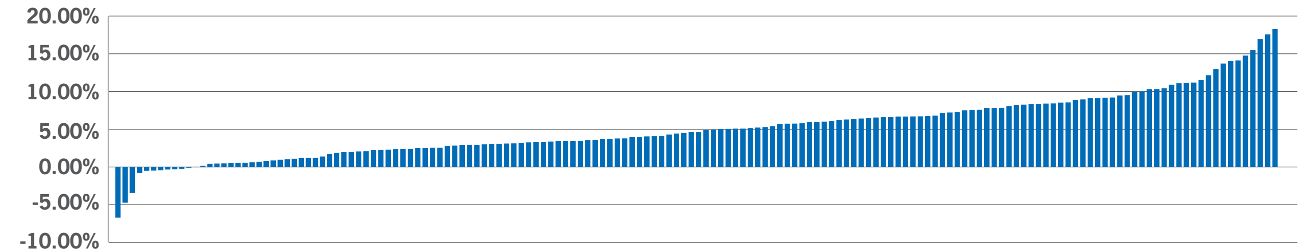
Distribution of surplus by institution 2011/12 and 2010/11



Distribution of surplus by institution 2011/12



Distribution of surplus by institution 2010/11



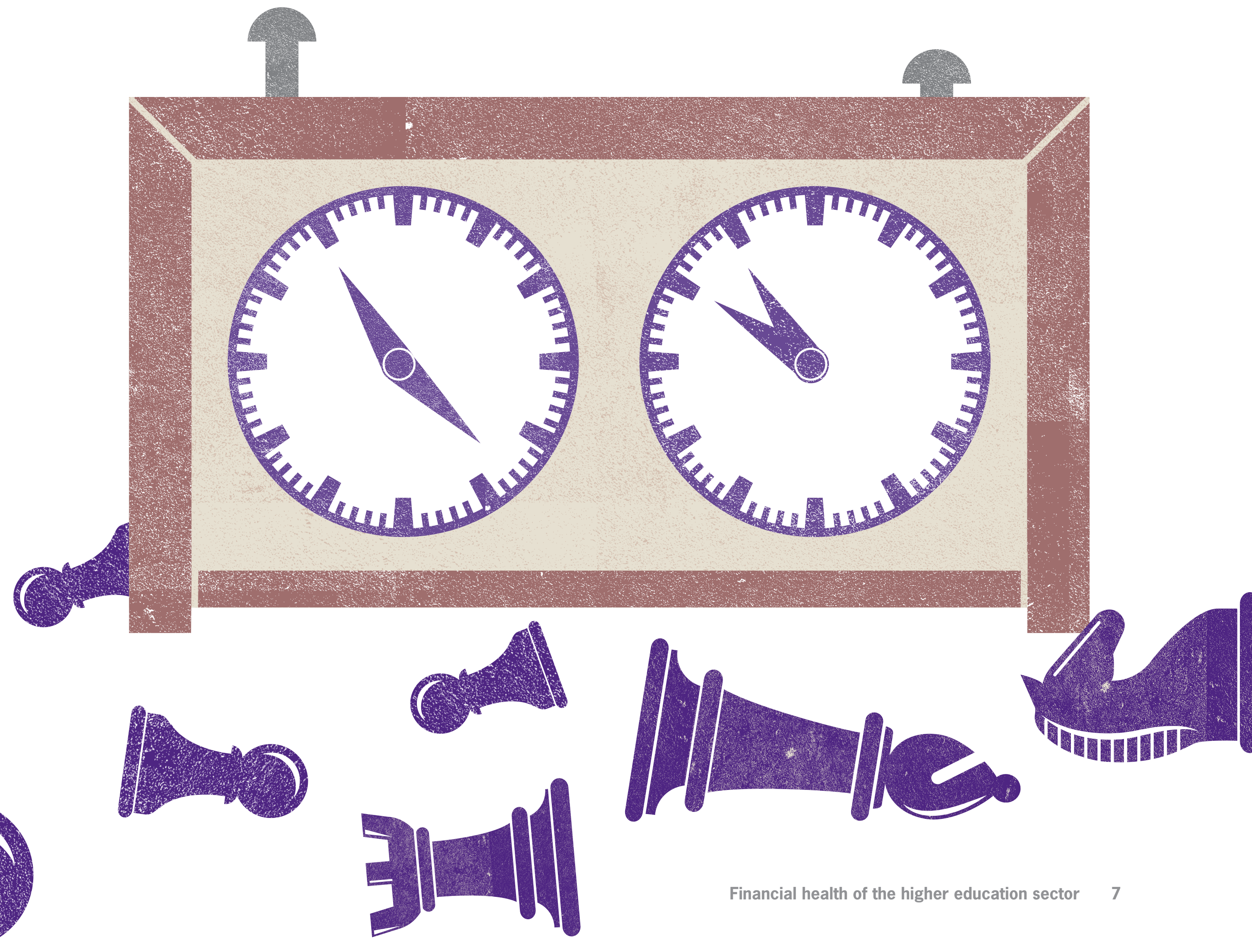
This shows the extremes as well as the median of the spread across the sector, and the slightly deteriorating picture across the two years. If student numbers are maintained at 2010/11 levels then we would expect there to be some 'super' profits in the next two years as the benefit of the higher fee regime starts to flow through. However, this will be heavily affected by the recruitment of students, and our anecdotal discussions with institutions this year suggest that it is likely that the recruitment levels will in fact be reduced. If this is the case then it may well be that the average surplus generated will be difficult to increase in accordance with HEFCE's statement, indeed it may be we see it falling still further.

Income

The sector generated income of £27.7 billion in 2011/12, a slight increase of 1.1% over the previous year's figure of £27.4 billion.

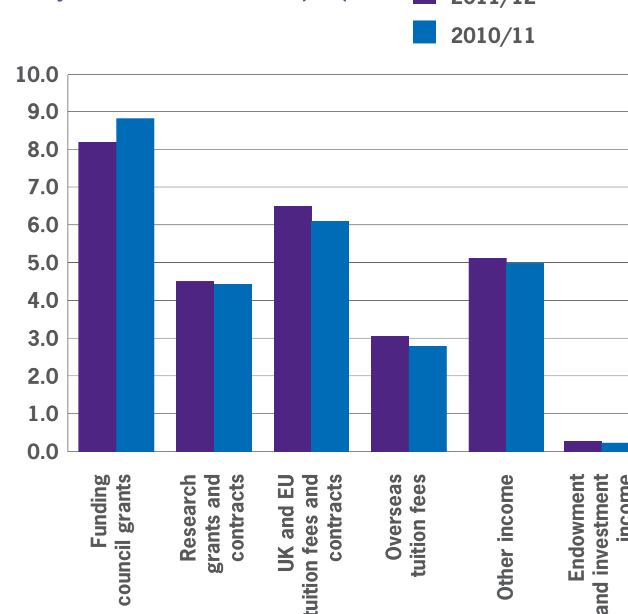
This small increase is a result of the fall in funding council grants being more than offset by increases in tuition fees for both home and overseas students. It should be noted that 2011/12 is the last year of the 'old' funding regime, before the introduction of the new tuition fee policies come into effect, so as well as increased fees from overseas students, the increase in tuition fees can be attributed to students taking up places to avoid the new fee regime (not going on gap years for example), and is reflected in the reduction in student recruitment in 2012/13.

It is likely that this trend of reduced reliance on funding council grants will continue, as proposed reductions in funding continues to bite. Whether or not the new tuition fee levels will continue to offset this reduction in the light of possible reductions in future student numbers remains to be seen, although HEFCE indicates in its report on the sector that English institutions are forecasting a growth in income in 2012/13.

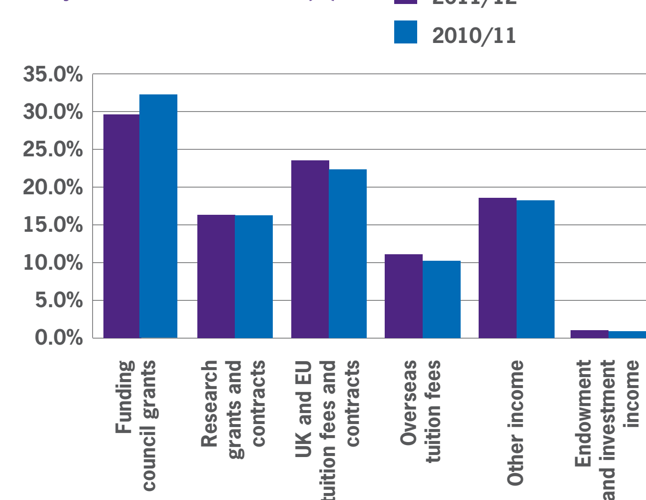


The following graphs show a detailed analysis of the sources of income compared to the previous year, both in absolute terms, and as a percentage of total income.

- Funding council grants accounted for £8.2 billion in 2011/12, a reduction of 7.1% from the 2010/11 level of £8.8 billion. Despite this decline, funding council grants still represent the largest single category of income for the sector, accounting for 29.6% of total income (2010/11: 32.2%)
- UK and EU tuition fees and contracts income was £6.5 billion in 2011/12, up by 6.5% from the 2010/11 figure of £6.1 billion. This income stream continues to grow in relative importance to the sector, representing 23.5% of total income, up from 22.3% in 2010/11
- Tuition fees for overseas students and contracts continue to grow, accounting for £3.1 billion of income in 2011/12, or 11.1% of total income. This was an increase of 9.7% from the 2010/11 level of £2.8 billion (10.2% of total income)
- Research grants and contracts increased by 1.8% to £4.5 billion in 2011/12. This income stream was very marginally more important to the sector in 2011/2, representing 16.3% of total income, compared to 16.2% in 2010/11



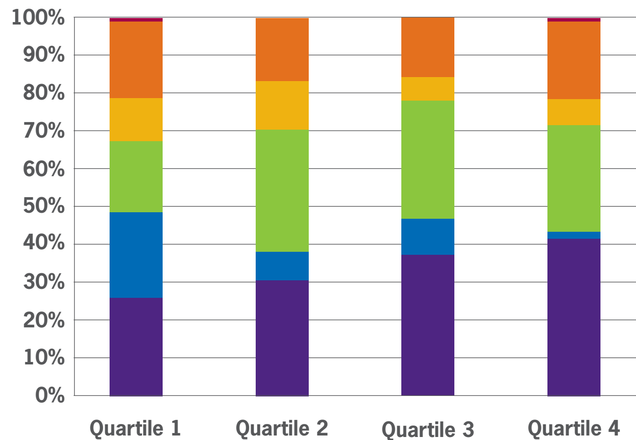
- Other income (which includes fees received in respect of student accommodation, and commercial income) accounted for £5.1 billion in 2011/12, 18.5% of total income. This showed an increase of 2.8% over the 2010/11 level of £5.0 billion (18.2% of total income)



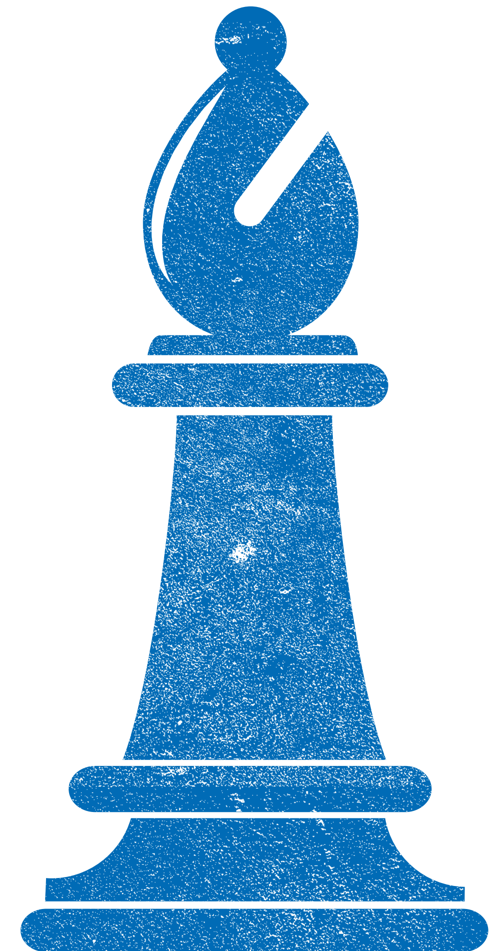
- Income from investments and endowments was worth £284 million in 2011/12 (just over 1% of total income). This was 18.9% up on the 2010/11 level of £239 million (0.9% of total income)

An analysis of income by type, and its relative importance to the four quartiles of the sector, is shown below.

Sources of income by quartile 2011/12



The strength of the largest institutions' income sources are made clear from this analysis with the relative proportion of research and other income providing a security against the potential implications of the new funding regime and volatility in student recruitment that may arise in the future. The smaller institutions and those who are primarily teaching institutions will need to make sure that they are managing their cost base to meet any reductions in income that may arise as they do not have the same buffer of protection.

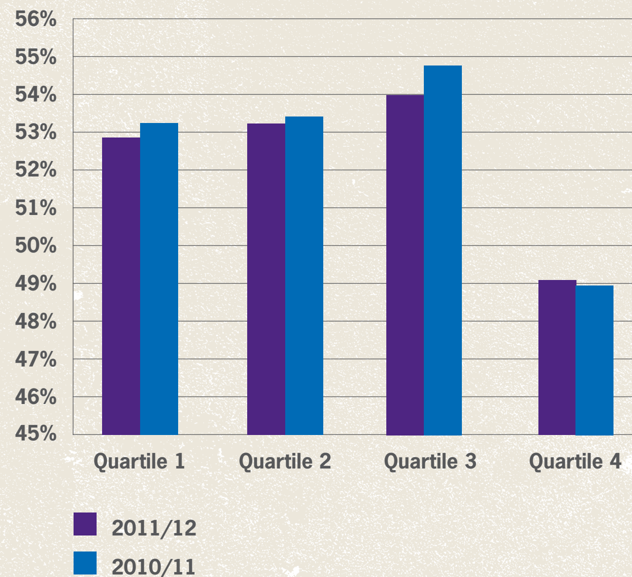


Staff costs

Staff costs are the single largest category of expenditure for any institution. In 2011/12, the total cost of staff (which includes National Insurance (NI) costs and pension contributions) was £14.68 billion, an increase of 0.3% over the 2010/11 figure of £14.64 billion. This small increase translates into a reduction in staff costs in real terms.

More importantly, staff costs continued to fall as a percentage of income, at 52.95% of income in 2011/12, compared to 53.42% in 2010/11. However, this reduction was not consistent across all quartiles, with the smallest institutions recording a slight increase in staff costs as a percentage in income, from 48.9% to 49.1%.

Staff costs as % income



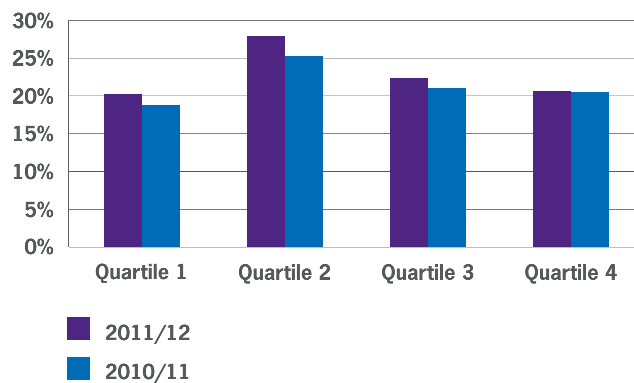
These real terms reductions in staff costs are the consequence of significant investment in reorganisation and restructuring that the sector carried out in recent years.

Staff numbers employed by the sector as reported in the accounts fell by 2,170 (0.7% of total staff) in 2011/12 compared to 2010/11. However, the numbers of academic staff fell by 2,888 (2.1% of academic staff), indicating an overall shift in the sector staff mix towards non-academic staff.

Borrowing

Total borrowing for the sector at the end of the 2011/12 financial year stood at £6.2 billion, an increase of £517 million (9.1%) from the equivalent figure at the end of 2010/11 of £5.7 billion.

Across the sector, borrowing represented 22.4% of income, up from last year's level of 20.7%. This increase was apparent across the sector, although significantly less in the quartile representing the smallest institutions.

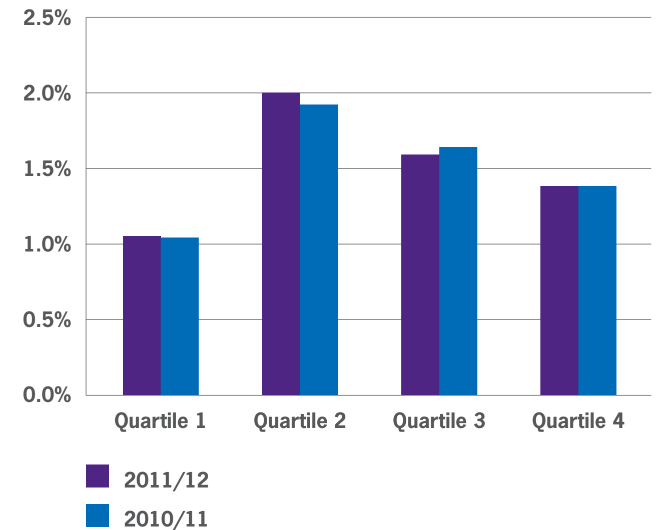


Interest costs

As important as the absolute level of borrowing is the ability of the borrower to service the cost of that borrowing. In 2011/12, the sector paid a total of £377 million in interest, an increase of £7 million (1.9%) over the equivalent figure for 2010/11 of £370 million.

This interest cost represented 1.36% of income, a marginal increase over the previous year of 1.35%.

The cost of interest as a percentage of income across the sector is illustrated below.



The current HEFCE Financial Memorandum requirements are that HE institutions should seek permission for additional borrowing if the cost of servicing its loans should exceed 4% of income. In 2011/12, there were four institutions whose interest costs exceeded 4% of income (2010/11: three).

Liquidity and gearing

Quick ratio

The quick ratio is an indicator of an organisation's liquidity and measures its ability to meet its short-term liabilities. It is calculated as the ratio of current assets (excluding inventories) to current liabilities.

The overall quick ratio for the sector for 2011/12 was 1.49, compared to the previous year of 1.40, indicating an improvement in short-term liquidity.

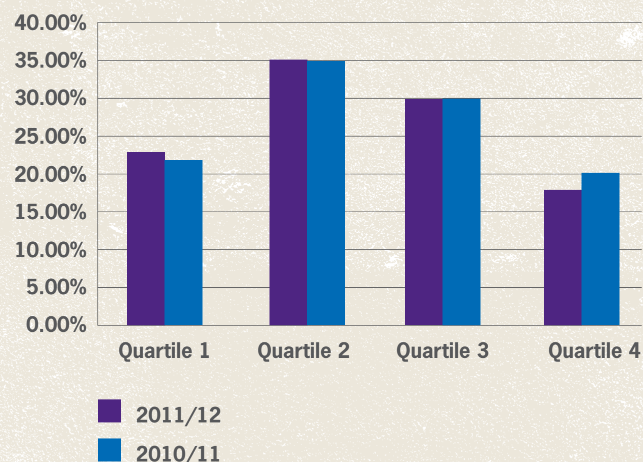
Of potential concern was the fact that 26 institutions had a quick ratio of less than 1.0, indicating a possibility that they would not be in a position to meet their short-term liabilities. The comparable number of institutions in the previous year was 27.

Gearing

The gearing (also referred to as leverage) of an organisation is the ratio of debt funding to internal reserves. There is no recommended value for this ratio, but it is generally accepted that organisations with higher gearing are more likely to be vulnerable to adverse changes in financial conditions, particularly increases in borrowing costs.

The average gearing for the sector in 2011/12 was 26.1%, which compares to a comparable figure for 2010/11 of 25.5%.

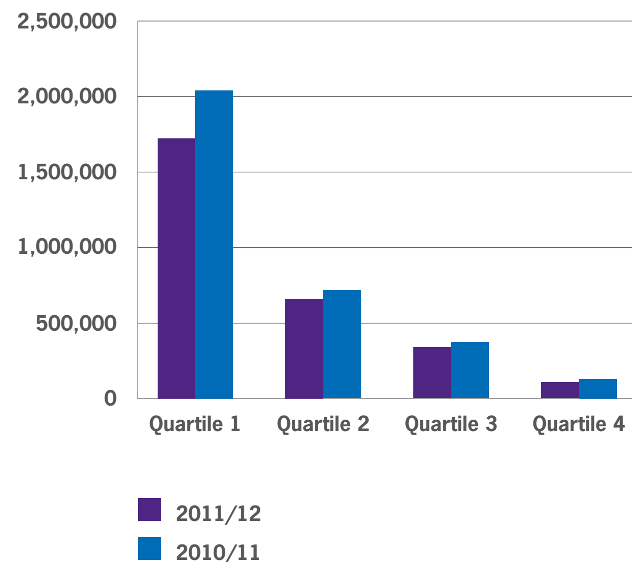
Gearing



Therefore, in broad terms across the sector and individual quartiles there has been relatively little significant change to the borrowing, gearing or liquidity of the sector. We will be interested to see how this position changes over the current and future years, and we suggest that care is taken by institutions to ensure that they continue to operate within any covenants they may have in place with their funders. This should ensure that robust working capital forecasts are prepared with appropriate scenario planning to assess the potential implications of any changes.

Capital expenditure

The sector spent £2.8 billion on capital expenditure in 2011/12, a reduction of £428 million (13.2%) from the previous year of £3.2 billion. This expenditure is in the context of continuing reductions in the capital grant funding of the sector, with expenditure being increasingly funded internally by institutions. This reduction in capital spend was apparent across the sector.



One of the regular comments we have made in recent years is on the variation in capital expenditure across the sector. It is stating the obvious, but with student expectations being changed by the consumer culture that is being introduced as a consequence of the government policies, the need to have quality estate, facilities and student accommodation is going to become increasingly important. If an institution has already carried out significant expenditure then it is likely to have a distinct competitive advantage over those that still need to make it; not having done it might result in negative league table or student comments and result in reducing the numbers recruited further – a self-fulfilling prophecy.

"The need to have quality estate, facilities and student accommodation is going to become increasingly important."

An assessment of financial strength (based on US Department of Education methodology)

In preparing the financial analysis of institutions within the HE sector, we look at some of the more commonly used financial ratios in order to understand the financial strength (or weakness) of the individual institutions. Last year, for the first time, we also used the methodology developed by the United States Department of Education to assess the financial condition of HEIs. Following the interest these calculations generated we have repeated the calculations in this report.

The methodology is designed to take into account an institution's total financial resources and provides a combined score of the measures of those resources along a common scale. This combined view of a number of different aspects of an institution's financial health includes:

(i) the capacity of the institution to cover its future expenses (the primary reserve ratio)

(ii) the ability of the institution to meet its financial liabilities (the equity ratio)

(iii) the ability of the institution to generate funds (the net income ratio).

The US Department of Education considers that any institution with a composite score of 1.5 or greater is financially 'responsible' and requires no additional oversight. An institution that scores between 1.0 and 1.4 (scores are rounded to 1 decimal place) is deemed to be financially responsible, subject to additional monitoring. Any institution with a composite score of less than 1.0 does not meet the standards of financial responsibility and may not be permitted to participate in certain Federal funding programmes.

We believe that it is inappropriate to publish the scores for the institutions that we have reviewed other than in general, aggregated terms, although for those institutions who wish to make the calculation, details of the methodology are shown on page 16.

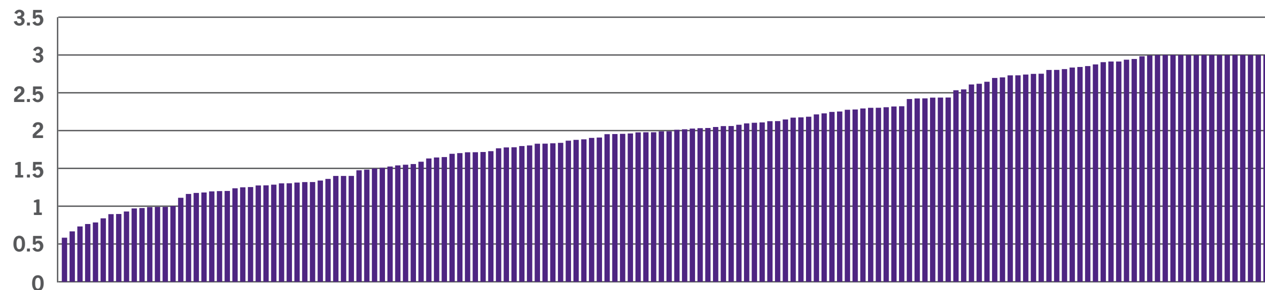
Application to UK HEIs

We have applied the US Department of Education ratio analysis to the financial results of UK institutions to derive the composite score for each institution. We have also calculated the comparative ratios for the prior year (2010/11). The analysis of the results is shown in the graphs on the next page.

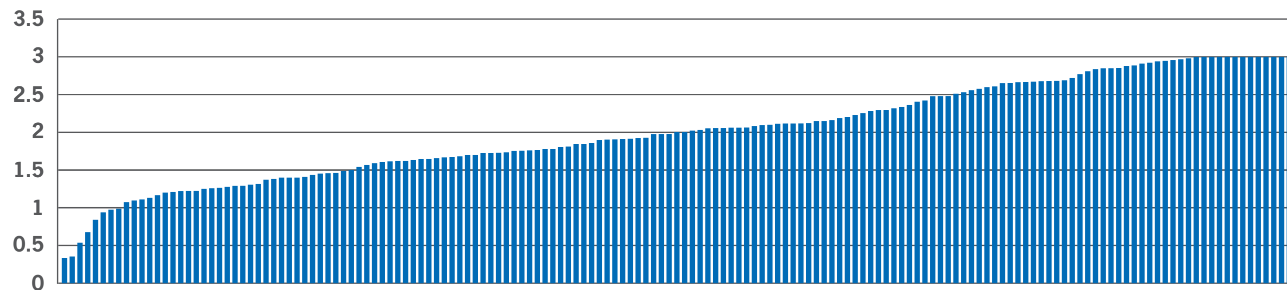
Whilst not necessarily supporting the US Department of Education conclusions from the composite score, we would note the following:

- 116 institutions (73.8%) (2010/11 – 121 institutions (76.7%)) have a composite score of greater than 1.5 – financially responsible without further oversight according to the US DoE
- 27 institutions (17.2%) (2010/11 – 30 institutions (18.9%)) have a composite score between 1.0 and 1.5 – financially responsible, but requiring additional monitoring
- 14 institutions (9.0%) (2010/11 – 8 institutions (4.4%)) have a composite score less than 1.0, which would potentially exclude them from certain Federal funding programmes in the US

Financial scores 2011/12



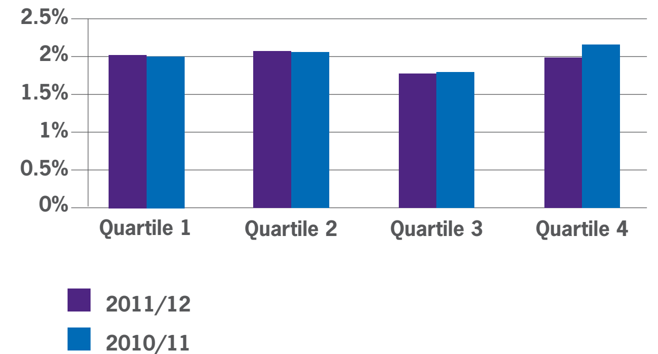
Financial scores 2010/11



Looking at 'average' institutions within the various quartiles, we note that all of the 'representative' institutions have a rounded composite ratio of 1.5 or greater.

As we have discussed, this scoring system was developed with US HE institutions specifically in mind, and there are some significant differences between the funding structure of US institutions and those in the UK. However, it should be noted that these Federal funding programmes include Title IV, HEA programmes that cover funding for US students attending universities in the United States and elsewhere in the world.

Financial scores



Calculation of the composite ratio

Stage 1 – computation of ratios

- Primary reserve ratio = expendable net assets ÷ total expenses
- Equity ratio = modified net assets ÷ modified assets
- Net income ratio = change in unrestricted net assets ÷ total unrestricted revenue

Stage 2 – computation of strength factors

- Primary reserve strength factor score = primary reserve ratio x 10
- Equity strength factor score = equity ratio x 6
- Net income strength factor score = 1 + (net income ratio x 25) (if ratio is negative)
- Net income strength factor score = 1 + (net income ratio x 50) (if ratio is positive)
- (Note that any strength factor > 3 is capped at 3; any strength factor < –1 is limited to –1)

Stage 3 – computation of composite score

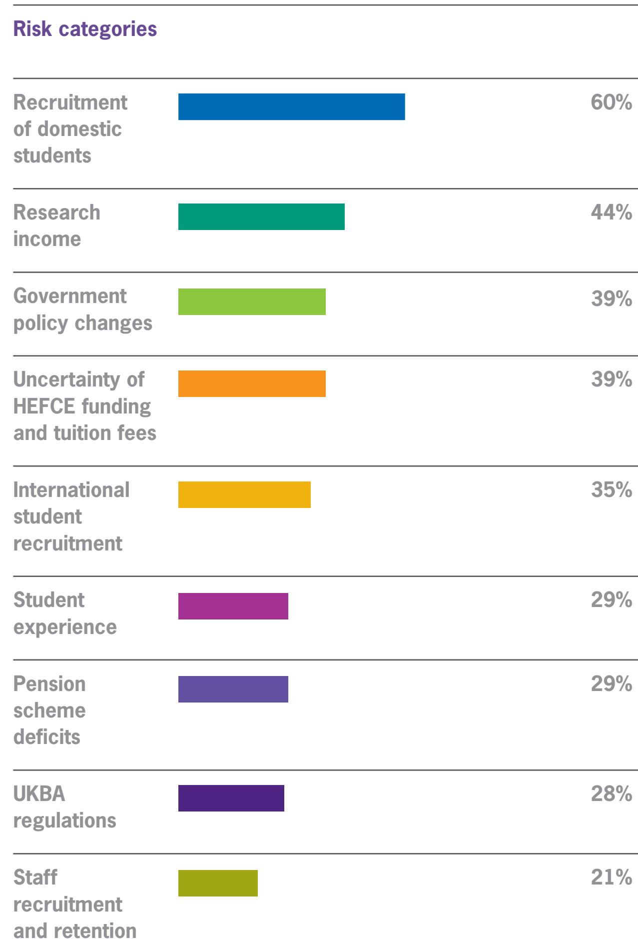
- Composite score = primary reserve strength factor score x 40% + equity strength factor score x 40% + net income strength factor score x 20%

Definitions*

- Expendable net assets = total net assets (net of pension liability) – endowments – fixed assets (including intangibles) + pension liabilities + long term borrowing
- Modified net assets = total net assets (net of pension liability)
- Modified assets = fixed assets + current assets

* Some adjustments have been made to the original definitions in the light of the information available

The risk landscape



"The business review must contain … a description of the principal risks and uncertainties facing the company."

(Companies Act 2006, Section 417; 3b)

"The OFR should provide information to assist funders and financial supporters to assess the strategies adopted by the institution and the potential for those strategies to succeed. The key elements of the disclosure framework to achieve this are … the resources, principal risks and uncertainties and relationships that may affect the institution's long term financial position."

(Higher Education Statement of Recommended Practice: Accounting for Further and Higher Education July 2007, Paragraph 27)

Last year we analysed the principal risks and uncertainties that institutions reported in their Operating Financial Review (OFRs) and we have repeated this exercise again in 2011/12.

As last year, all the 152 OFRs we reviewed included an overview of the risk management framework that was in place, but about a third of these (36%) did not provide any description of the institution's principal risks or future uncertainties. (34% of 164 in 2010/11).

Of the two thirds that did provide some detail of their principal risks, we noted that:

- there has been a concentration in the risks being reported
- the recruitment of domestic students is now of most concern to institutions; being included on 60% of risk registers
- as we predicted last year, the risk around student experience is becoming more prominent
- the inclusion of risks associated with changes in government policy has almost halved from 71% to 39%.

A concentration in the risks being reported

Speaking at BUFDG's annual conference in March 2012, Martin Bean, the Vice-Chancellor of the Open University, suggested that the four major threats facing the sector were:

- government policy and its impact on domestic student recruitment
- research income
- international student recruitment
- student experience.

This was not news to the audience, but it may have been the first time they were identified so starkly as risks. It is therefore unsurprising that there is a far greater consistency in the risks being reported across the sector in OFRs than there were in the previous year. The challenges facing student recruitment, the impact of tuition fees and importance of research or international activities are no longer risks segregated to particular mission groups or the age of the university. These are risks, challenges and opportunities facing all institutions.

Recruitment of domestic students
(2012 – 60%; 2011 – 41%)

It is also unsurprising that growing concerns about this risk have made it the one most frequently mentioned in OFRs. We also predict that this risk will remain of greatest concern for the foreseeable future, even for those universities who have been more successful with their student recruitment than they may have forecast.

What has been particularly interesting is the fact that initial figures show that 2013-14 applications have fallen by nearly seven per cent, although at the time of writing, UCAS has yet to release details of 2013-14 applications by individual institution. There are arguments both for and against doing this:

- On the one hand, it provides an element of protection to those institutions that have seen a reduction in numbers, to enable them to take rational steps to mitigate this risk
- On the other hand, in the age of transparency and consumer choice in the sector, with the arrival of Key Information Sets (KIS) being a prime example, one could argue that prospective students have the right to see the recruitment trends of their chosen institution, particularly when they are pledging significant tuition and maintenance fees to attend their chosen institution

Student experience
(2012 – 29%; 2011 – 13%)

In 2012 we predicted that the risks associated with the student experience would increase in significance in future years, and this seems to have been proved correct. In our own experience we are finding that HEI governors, vice-chancellors and senior management are increasingly focused on the 'student experience' or 'student journey' as part of their day to day management. It is a topic that cuts across all areas of university activity, and most institutions now have strategies and working groups to make clear exactly what a student will receive for their investment in their studies.

There are, however, a number of challenges to be managed if this risk is to be mitigated effectively:

- understanding what your prospective students want, and predicting future changes in those expectations
- managing the consistent delivery of academic and non-academic activities
- measuring the impact of the resources invested.

What the OFRs do not distinguish is the subtle distinctions between student experience and student satisfaction, the latter hopefully being captured as a measurable output of delivering the former. We raise this point as most, if not all, HEI strategic plans identify a target league table ranking. While the metrics and criteria behind some league tables remain a dark art, what is clear is that student satisfaction, often derived through the National Student Survey, is a principal driver of a number of measures.

Our challenge would be whether universities are doing enough to understand what drives league table performance to try and positively influence their position.

Government policy changes (2012 – 39%; 2011 – 71%)

At first glance, the reduction in the number of OFRs identifying changes in government policy as a risk may be surprising, but in practice, the most significant effect of the changes has now happened, ie the introduction of the new funding regime. Other potential changes, such as the future role of HEFCE, and the continuing discussions about whether international student numbers should be excluded rather than included in the UK's net migration figures, continue to cause uncertainty.

These are not new risks, and are already reflected in many OFRs and risk registers alike. Further, with such external risks, there is often very little that universities can do to influence them. Instead, the challenge is to remain agile enough to understand the impact of government policy changes, and identify the appropriate steps to take when the time comes to either protect existing sources of income, leverage additional income or reduce the cost base as may be necessary.

A significant absence

Our review has commented on those risks identified in the published OFRs and we have discussed the extent to which each is actually identified at institutional level.

One risk most notably absent in its own right from our analysis is that in respect of graduate employability. That is not to say that the concerns raised in respect of student experience do not relate to the end product, ie a graduate job, but given the investment of resources by universities to ensure that their students remain best placed to succeed upon graduation, it is a little surprising.

Effective governance

The risks previously identified confirm the continuing upheaval that the sector is going through. While we assume arrangements will be in place to manage these risks operationally, there is an overarching risk that governance, both at the executive and governing body levels, is not robust, transparent or effective enough to ensure that the risks are managed, objectives met and performance delivered in line with agreed targets.

Institutions are required to formally assess the effectiveness of their governance arrangements every five years. In our experience these assessments are moving from desk-based compliance reviews to more in-depth, independently-facilitated scrutiny of governance and how it is providing a framework to steer the institution forward, and we suggest that this may be an area where lessons can be learnt from other sectors where effective governance has already been under scrutiny, for example, with listed companies.

Good risk management in HEIs

Good risk management in HEIs requires senior management to have a sound understanding of the key challenges that will affect their strategic objectives and day-to-day operations that are underpinned by performance information in order to demonstrate at what point on the risk spectrum the university lies. If managed well, risk management enables universities to leverage from opportunities that present themselves and take more managed risk.

Last year we challenged universities to have better oversight of the assurances in place to enable all levels of management to have confidence that the controls and processes put in place to facilitate success are operating as they should be. The sector is moving forward on this, with senior management giving more challenge to the controls and processes identified on the risk register to really understand whether those risks are being managed in practice.

We would be interested to understand whether those risks identified in the OFR actually reflect the risks being managed in institutions' risk registers. Further, what are the priorities, controls and outputs of the risk management activities driven by those risk registers. In short, we are getting increasing clarity about what are the areas of highest risk, but the real question remains 'are they being managed?'.

Pensions in the higher education sector

As highlighted in the risk landscape, nearly a third of HEIs identify pension scheme deficits as a principal risk faced by the organisation. In this section we seek to explain some of the issues which need to be understood if the pensions exposure is to be properly managed and accounted for.

The main vehicles/schemes through which pensions are provided in the sector are:

- **Universities Superannuation Scheme (USS)** (a funded multi-employer private sector scheme)
- **Local Government Pension Scheme (LGPS)** (funded multi-employer public sector schemes, but allowing private sector participation)
- **Teachers' Pension Scheme (TPS)** (an unfunded multi-employer public sector scheme)
- **Self-Administered Trusts (SATs)** set up by institutions on an individual basis (private sector schemes).

Despite recent changes to some of these schemes (for example, the introduction of career average benefits and increases in retirement ages and member contributions) the sector's pension provision remains largely Defined Benefits (DB). This is in stark contrast to the private sector where, according to the National Association of Pension Funds (NAPF) 2012 survey, only 13% of DB schemes remain open to new joiners. Defined Contribution (DC) schemes are now provided for the great majority of private sector staff.

However, the cost and risk pressures of DB mean that, given a free hand, many institutions in the sector might want to review their pension arrangements with a view to introducing DC pensions (at least for new joiners). However whilst this may be possible, they will need to look at the basis on which they participate in their particular pension scheme, as closure may not be an option.

In any case in the short term at least, employers in the sector will need to continue to deal with their existing DB arrangements. They might therefore want to consider possible steps to mitigate the impact of pensions on their balance sheet and income statements. Below we provide a short update on changes in the general financial position of pension schemes over the last year and describe some ways in which institutions might be able to mitigate their pensions accounting risks.

How is the financial position assessed?

There are two key ways in which the pension liabilities are assessed at regular intervals. These are described in turn below.

The funding basis

The funding or 'ongoing' basis valuation is carried out every three years and the results are used to determine employers' cash contributions over the following period, until the next funding valuation.

For the multi-employer schemes such as USS, LGPS and TPS, typically it is the Administering Authority/ Trustee Board and the actuary who drive the process and set the key assumptions, which are set at a scheme-wide level. Individual employers can have an input into the process through occasional employer forums, but they have very little influence on the ultimate level of cash contributions they are asked to pay to their relevant scheme. For individual SATs, the employer will have considerably more control over the valuation process and their contribution requirements.

The accounting basis

The other key measure of pension liabilities is the accounting basis, which determines the amount that will appear on the employer's balance sheet as an asset or (more typically at present) a liability and the amount that appears in the income statement in respect of pension costs. Where required, accounting valuations are carried out every year to coincide with the institution's financial reporting date.

For those schemes such as LGPS and SATs where the assets and liabilities of the individual institution can be identified separately from other participants, the cost of pensions must be accounted for currently under FRS17. Deficits must be shown on the balance sheet and the cost of pensions accruing during the accounting period, shown in the income statement.

For other schemes such as USS and the TPS where liabilities cannot be separately identified, more simple cash accounting is applied and there is no balance sheet item for pension obligations. (It should be noted however, that USS is considering whether it will enable assets and liabilities to be separately identified in future, in which case FRS17 'on balance sheet' accounting will apply to its participating employers.)

Developments over the last year

For those institutions that do report pension costs under FRS17, whilst the last year has seen continued volatility, overall there has been a stabilisation in the financial position for most institutions. Inflation has been relatively stable, and, in comparison with recent years, the equity market performed reasonably well over 2012. However the positive impact of this was largely offset by a decline in corporate bond yields, which has meant lower discount rates (and higher liabilities) and lower returns on bond portfolios. Also, the trend for incorporating allowance for longer life expectancies into assessments of liabilities continued, which also acted to increase liabilities. Overall there remain significant pension deficits on the balance sheets of most institutions.

Can anything be done to address the situation?

Unlike the position on the funding basis which determines cash contributions, individual employers can have a major input into the position on the accounting basis. Whilst the impact of general market movements are largely unavoidable, institutions can influence the assumptions which determine how their liabilities are measured. Indeed the accounting standards require that the employer determines the actuarial assumptions (after taking appropriate actuarial advice).

For LGPSs, the appointed firm of actuaries will use standard assumptions for all participating employers, on the grounds of cost effectiveness (since they are required to produce disclosures for often hundreds of participating employers). There will usually be very little, if any discussion, between individual institutions and the actuaries over the assumptions. However, given that there is considerable subjectivity in the methods used to set the assumptions (and that they should also reflect individual institutions' characteristics) there is some scope to use assumptions which are different from those proposed by the actuaries.

We give some examples below of areas where the assumptions might differ from the 'standard' assumptions proposed by the actuary. However, it is important to note that the assumptions adopted must still be considered as acceptable under FRS17 and the institution's auditors will apply particular scrutiny where 'non-standard' assumptions are adopted.

There will also be some additional costs involved as the actuaries will typically charge to perform 'non-standard' calculations, and it may be necessary to take independent actuarial advice. The impact on accounts, however, can be significant.

Examples

Discount rate

One 'non-standard' method that is increasingly being used is the basis for the derivation of the discount rate assumption.

In the past, the discount rate, which under FRS17 should be determined by reference to market yields on AA-rated corporate bonds, tended to be set as equal to the yield on the iBoxx AA-rated Corporate Bond Index.

However, there has recently been a trend in the adoption of alternative methods, where the discount rate assumption is constructed using the expected future cashflows arising in each employer's scheme or section; or the iBoxx rate is otherwise adjusted to reflect individual scheme cashflows. Due to the upward sloping yield curve, these methods can produce discount rates which are up to 50 basis points higher than under the 'iBoxx method'. Such a change might typically be expected to reduce the assessment of liabilities by around 10%, often with a much greater impact on the deficit recorded on the balance sheet.

It can be argued that using these methods produces a discount rate that more accurately reflects the duration of the scheme's liabilities. Provided the method is adequately documented and the assumed duration of the scheme's liabilities is consistently reflected in other assumptions, these methods are acceptable.

Salary increases

Another area in which the individual institutions' characteristics can be more accurately reflected is in the salary increase assumption adopted. Recent government pay freezes have been reflected in the assumptions used by LGPSs. However, the institution-specific salary forecasts are often not accounted for. The assumption for future salary increases should be in line with the institution's long term plans for salaries. In some cases, this may involve additional pay freezes, or pay increases below the average public sector increases. This would also suggest that a lower assessment of the liabilities than provided on the 'standard' assumptions would be appropriate.

Mortality assumptions

The assumptions about future life expectancy are highly subjective and different views can be taken, for example about the 'base' mortality table to adopt and, to an even greater extent, towards the allowance made for future improvements in mortality, which is so uncertain. It may also be that the characteristics of an individual institution's membership are different from the scheme's population as a whole, in which case different mortality assumptions could be justified.

Therefore, as long as the assumptions remain acceptable to the auditor (that they can be justified for the particular population concerned and are not significantly out of line with industry norms), then it is possible to ask the actuaries to calculate the liabilities on alternative mortality assumptions.

Capital finance – the value and risks of bonds

In the current credit-starved market there is limited access to traditional sources of long term financing such as bank debt and such lending is generally accompanied by restrictive covenants. Although debt facility terms vary depending on the specific circumstances, and have traditionally been very favourable within the higher education sector, there has in recent years been some tightening of the terms available for the education sector. Due to the unattractive terms offered by some banks, and because of a desire to diversify funding sources, it is appropriate that educational institutions should consider alternative sources of debt funding.

For the right issuer, raising finance through bond issues can be highly advantageous. Universities with strong finances and good reputations are ideally placed to raise debt funds via the bond markets. Such finance could have a range of uses, not just in the more obvious estates development but also in other areas where low cost finance could give an institution a market advantage, such as in providing an alternative financing option to the Student Loans Company (SLC), enabling universities to effectively 'go private'. This was covered by a 2010 submission to the Lord Browne Review when the Russell Group of 20 leading universities argued that selling bonds could provide an alternative way of funding higher education, rather than relying on taxpayers' money via the state.

Bond issues can be less restrictive than other sources of finance, can provide access to a far wider array of investors and can be profile raising for the institution. There are a number of different types of bonds but several structures are emerging as being relevant to the needs of higher education, specifically publicly traded wholesale bonds, publicly traded retail bonds and privately placed unlisted retail bonds.

Overview of the bond market

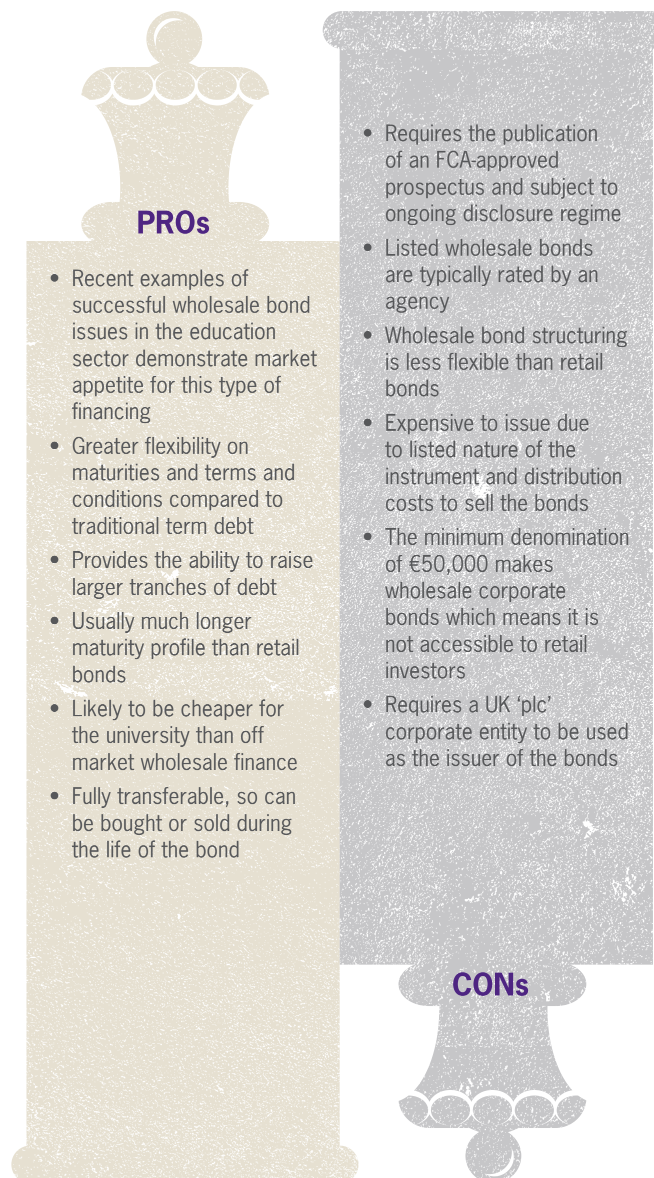
	Listed wholesale bonds	Listed retail bonds	Unlisted retail bonds
Typical issuer	Large, listed multinationals	Medium/small listed	Small listed/private
Typical size	£250 million	£50 million +	£10 million
Recent coupons	7.5%–10%	4.75%–7%	6%–7.5%
Maturity dates	5–50 years	5–10+ years	3–7 years
Transaction costs	Medium	Medium	Medium
Covenants	Yes	Flexible	Very flexible
Amortisation	No	No	No
Security	Secured/unsecured	Unsecured	Unsecured
Credit rated	Yes	Occasionally	No
Regulatory burden	FSA-approved prospectus, ongoing disclosure requirements	FSA-approved prospectus, ongoing disclosure requirements	Independently approved investment memorandum
Transferable	Yes	Yes	No
Qualifying for ISA	n/a	Yes	No
Qualifying for SIPP	n/a	Yes	Yes
Denominations	£100,000	£100	£100
Appropriate for the university	Potentially, dependent on size of fund raised	Potentially	Possibly

Publicly traded wholesale bonds

The London Stock Exchange wholesale bond market is well established and acts as a deep source of debt funding for larger corporates raising larger sums of long dated debt from institutional investors. The wholesale bond market has traditionally been used by global companies issuing bonds in excess of £250 million per issue, and has only recently seen issuances by not for profit institutions. Because the buyers of wholesale bonds are sophisticated, the instruments are sophisticated and typically include a full range of covenants, security requirements and an investment grade credit rating from an agency such as S&P or Moody's.

Wholesale bonds carry a minimum denomination of €50,000, and recent corporate wholesale bonds have been issued at an average gross coupon rate of between 7.5% to 10% for an average maturity of 30 years. A wholesale bond issue requires a prospectus to be approved by the Financial Conduct Association (FCA) and is subject to continuing obligations such as the publication of an annual report.

Two recent examples where wholesale bonds have been issued from the higher education sector are the University of Cambridge which raised £350 million at a coupon of 3.75% over a term of 40 years and De Montfort University which raised £110 million at a coupon of 5.375% over a term of 30 years.



Both examples demonstrated that there is institutional demand for investment grade debt issues from higher education institutions.

Publicly traded retail bonds

As investors have sought alternatives to bank deposits and equities, interest amongst UK retail investors in bond issuances has increased. Although the wholesale bond market has serviced the corporate bond market for many years, direct access to the retail market has, since 2010, been developed through the issue of listed bonds on ORB (the Order book for Retail Bonds), the London Stock Exchange's retail bond market.

ORB listed retail bonds are distributed to retail investors through private client brokers, wealth management firms or private banks and are typically issued in denominations as low as £1,000 rather than in denominations of £100,000 as in the wholesale bond market. Funds raised from the issue of UK retail bonds on ORB now exceed £2.5 billion since 2010 and has become a mainstream financing tool. As traditional bank debt becomes harder to secure and with retail investors seeking alternatives to low yielding bank deposits, listed retail bonds have become a credible source of corporate debt. Many of the recent UK listed retail bonds have been undertaken by issuers with well-known brands, some of whom have a credit rating, name recognition

therefore remains key to strong retail distribution of the bond offering. Listing a bond on the ORB requires the issue of an FCA-approved prospectus and bond issuers are subject to ongoing disclosure standards such as the publication of an annual report.

ORB has been used by issuers to raise as little as £20 million but has also demonstrated that institutional levels of debt funding can be raised with the London Stock Exchange issuing a £300 million bond in 2012. Average issue sizes are approximately £100 million with an average maturity term of 7.5 years, and have to date generally been fixed interest, non-amortising and medium term in commitment (between 5 and 10 years). ORB retail bonds have to date offered coupons between RPI +1% and 9.8%, with an average coupon of approximately 7.7%. Most recent issues have been undertaken by large branded issuers such as Tesco, HSBC and Severn Trent.

Retail bond pricing is influenced by different underlying factors to the wholesale bond markets and reflect the alternative investments that retail investors can participate in, such as equities and fixed rate deposits. The retail bond market facilitates smaller issue sizes as compared to the wholesale bond market, allowing institutions to tap into investor appetite for debt securities. Whilst the retail bond market is still in its relative infancy, recent large issuances are starting to underline the ability of retail bond markets to absorb multiple issues that more substantial funding programmes require. Retail bonds have several key advantages over term debt and the wholesale corporate bond market including greater flexibility on maturities, the ability to raise smaller tranches of debt, and greater cost efficiency and lower transaction costs.

Retail bonds can allow for greater diversification of funding sources and enable debt maturity profiles to be flattened avoiding large maturity peaks. Uses of funds can be for growth, refinancing and general corporate purposes, and standardisation of bond terms and structuring have started to take place in recent issues, enabling issuers to benefit from established market mechanics. Whilst ORB retail bonds have to date been issued by companies with a strong brand, it is anticipated that as the market's prominence grows, non-branded issuers will be able to successfully access the retail bond market in order to raise debt finance. Whilst more expensive money than wholesale bonds, the extra cost allows for covenant light structures subordinated to all other debt, less of an expectation that the bond is secured, and no expectation that the bond is rated by a credit agency.

PROs

- An increasingly common and popular financial instrument amongst retail investors
- Greater flexibility on maturities and terms and conditions compared to traditional term debt and wholesale corporate bonds
- Provides the ability to raise smaller, multiple tranches and at smaller denominations
- Likely to be cheaper for universities than any available wholesale finance
- Tax efficient for investors – can be held within SIPPs and within ISAs
- Fully transferable, so can be bought or sold during the life of the bond

CONs

- Requires the publication of an FCA-approved prospectus and subject to ongoing disclosure regime
- Whilst not a regulatory requirement, listed retail bonds are sometimes rated by an agency
- Relatively expensive due to listed nature of the instrument and distribution costs to sell the bonds
- Requires a UK 'plc' corporate entity to be used as the issuer of the bonds

Unlisted retail bonds

An alternative to listing retail bonds on ORB is the issue of unlisted retail bonds. Unlisted retail bonds are typically distributed to customers, clients, employees, alumni or a cohort that is identifiable and loyal to the bond issuer. Issue sizes are smaller than for listed retail bond issues and limited by the size and receptivity of the target cohort. Because the bond is not listed on a market, it is not subject to the same level of onerous regulation as a listed wholesale or listed retail bonds. Unlisted retail bonds do not require FCA approval, or the issue of a prospectus; they constitute a financial promotion and therefore typically require approval by an authorised firm (such as Grant Thornton UK LLP) under section 21 of FSMA.

Successful unlisted retail bond issuances have to date involved corporate bond issuers with strong brands and loyal customers (such as John Lewis or Hotel Chocolat). They often offer attractive investment terms (coupons range between 6% and 8%) and innovative features such as in store vouchers or products offered in lieu of cash interest. Unlisted retail bonds offer higher yields to retail customers than conventional deposit accounts so are, in turn, becoming increasingly attractive to retail investors. Companies have typically raised between £2 million and £10 million per issue although John Lewis successfully raised £57 million in February 2011 from its employees and customers. Unlisted retail bonds are typically unsecured, with very flexible covenants and unrated by a credit agency. Because of the relationship between the bond issuers and the bond investor, unlisted retail bond terms and coupons tend not to reflect market or 'commercial' rates.

Whilst unlisted retail bonds have not historically been used by not for profit institutions as a form of fundraising, they are now being examined by a number of education and charitable institutions as a flexible structure for issuing debt. Golden Lane Housing, a subsidiary of Mencap, is in the process of raising a £10 million unlisted retail bond at a coupon of 4% and a maturity period of five years. This bond, which is being marketed to both a connected cohort and unconnected potential investors, has demonstrated how a not for profit organisation can issue a bond at a coupon that is affordable and competitive for a bond issuer, whilst providing a return for the bond investor, notwithstanding that the coupon is below commercial rates of interest because of the 'social impact' component of the funding.

PROs

- An increasingly popular financial instrument amongst retail investors
- Greater flexibility on maturities and terms and conditions compared to traditional term debt and wholesale corporate bonds
- Provide the ability to raise smaller, multiple tranches and at smaller denominations
- Likely to be cheaper for the University than any available wholesale finance
- The University's loyal alumni base could increase the likelihood of a successful debt issue
- Can be held within SIPPs
- No requirement to publish an FCA-approved prospectus and not subject to credit ratings or an ongoing disclosure regime
- Relatively cost and time effective issue process
- Can be issued in a covenant light form and subordinated to all other debt lines

CONs

- Not transferable, so cannot be bought or sold during the life of the bond but can be redeemed on death
- May not be held within ISAs – may not be tax efficient for investors
- No current precedent for a not for profit organisation issuing an unlisted retail bond
- Typically requires that a UK 'plc' corporate entity is used as the issuer of the bonds

Balancing senior management pay structure in a demanding new world

Another issue facing the higher education sector is how to reward staff in the current environment, which Remuneration Committees of universities are finding increasingly challenging.

Not only is the whole sector in transition with some fundamental changes in funding and context but management is having to transition their roles. The question is whether the current remuneration structure for senior university management is fit for purpose.

In the past, university Remuneration Committees might have felt that they are operating in somewhat of a vacuum but, with the advent of some very real commercial pressures introduced by the fee driven environment in which universities now operate, this is now definitely not the case anymore. Universities are competing for students and need to have a robust value proposition for them. There is often a large element of real estate that needs sophisticated management plus the development of a commercial stream of income from conferences and assorted activities including spin-out companies. The myriad of skills and experience needed to run an organisation of this complexity is analogous to a large corporate organisation. Moreover, universities have to manage a diverse range of stakeholders and are high profile organisations.

However, the level and structure of senior management has not kept pace with the up-scaling of demands. In some cases, the composition of senior management itself has had to change to keep up with these demands, and the pay structures often resemble a public sector model – and in some cases are outdated.

What factors should be key for the university Remuneration Committees in determining the remuneration of Vice Chancellors and the senior executive team in the current climate? Some issues are considered below:

- **Addressing the pay structure** – hitting the right balance between fixed pay and pensions contributions in the light of the reduced Lifetime Allowance – where senior management have final salary pensions, there may be no/little scope to make further contributions/ accruals but the university is contractually obliged to include a pension payment in the annual pay
- **Reward for performance not failure** – if increases in remuneration are proposed these need to be justified on the basis of improved performance
- Appropriate performance related pay to align Vice-Chancellors and the senior executive team to the performance of the university. In turn, this gives rise to a number of related issues to consider:
  - *Performance measures* – such as linking rewards to a basket of financial, examination and other measures
  - Deferral of performance related pay to encourage longer-term behaviours
  - *Claw-back provisions* – such provisions, are widely used in the commercial environment and allow Remuneration Committees to reduce or recover award bonuses where subsequent results reveal a significant downturn in performance
- **Stakeholder views** – not being seen to be out of step with the pay freezes or minimal flat rate increases that the wider university staff have been subject to over the last few years
- **Public perception** – all Remuneration Committees now need to be acutely aware of the bad press associated with significant increases in remuneration of those in public roles, even where these can seemingly be justified

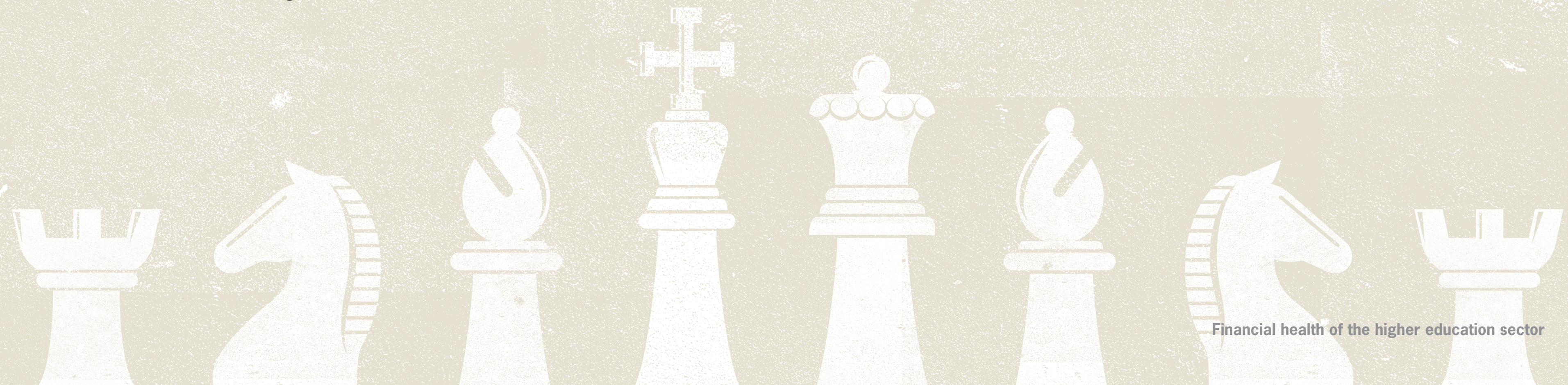
But what has actually happened? The following themes emerge in how university Remuneration Committees have been addressing these factors:

- A significant restructuring of the pay mix has occurred in many universities with Vice Chancellors and senior executives seeing an increase in fixed pay and a commensurate reduction in their pension contributions. This change to the structure of pay primarily reflects major changes to the way pensions are taxed. Tax relief on pensions contribution has been eroded by the reduction in the 'Lifetime Allowance' from £1.8 million to £1.5 million in April 2012 and this followed a reduction in the 'Annual Allowance' from £250,000 to £50,000 the year before. It is very possible that this restructuring of the pay mix was as a result of several Vice Chancellors being close to the lifetime allowance and hence there being no benefit in putting additional resources into their pensions.

We have also seen the use of 'payments in lieu' of pension contributions for similar reasons. Where such restructuring has occurred, although salaries have increased, in general, universities have steered clear of increasing the overall remuneration packages of the top management. For example, the Vice Chancellor's pay survey carried out by Grant Thornton for The Times Higher Education revealed that average total salary and pension payments for Russell Group Vice-Chancellors rose marginally from £308,000 to £311,000 in 2011/12. Whereas, within this, the average fixed pay rose by over 4% to £277,000

- An increasing use of benchmarking to ensure that remuneration is both market competitive to attract and retain high-calibre people but, at the same time, aligned with comparable institutions of similar size and structure

Therefore, university Remuneration Committees need to be mindful of these factors and navigate their way to produce a remuneration package that is both effective in aligning the senior executive team to the interests of the institution whilst, at the same time, being both competitive and yet robust enough to stand up to public scrutiny. This may mean some radical changes to the way that senior pay is structured and may need to be implemented over a number of years. We suggest this is an area that should be at the forefront of the Board of Governors' minds to consider whether the traditional public sector approach to remuneration of its senior management continues to remain appropriate in light of the competition and other pressures now entering the higher education market.



Maximising commercial income

The role that universities play in developing the UK's economy has become increasingly under the microscope in recent years.

Specifically, greater emphasis is now being placed on how HEIs can engage with private and non commercial organisations, respectively, to generate mutual benefit. In particular, HEIs are typically looking to generate additional income at a time when traditional funding streams are under increasing pressure. In addition, HEIs can use their skills and talents to help private and non commercial organisations enhance their competitiveness and/or sustainability.

The basis on which this analysis has been carried out is the HESA 'HE Business and Community Interaction Survey (HE-BCI), 2010/2011'. Within this survey, the income sources are noted from:

- **research related activities** – collaborative research involving public funding
- **research related activities** – contract research involving non public funding (ie with SMEs, non SMEs and non commercial organisations)
- **business and community services** (which includes consultancy work, use of facilities and equipment and courses/training for business and the community)
- **regeneration and development programmes** – (which includes ERDF, ESF, UK government and local and regional bodies)
- **intellectual property** – (which includes software and non-software licences and proceeds from sale of shares from spin off companies).

To place the third stream income in context, during the year 2010/11, HESA reported that total HEI income was £27,561 million and that within that figure, third steam income was £3,304 million, or 11.98%. In reviewing all HEIs, the average proportion of third stream income to total income was 9.3%.

Table 1 shows that consultancy income was the category that generated the largest amount of income (£1.1 million or 33.5% of the total) with IP income being the smallest at £69.4 million.

Table 1 – Share of third stream income by source HE-BCI, 2010/11[2]

	Income (£000)	%
Public research	871,649	26.4
Research	1,054,191	31.9
Consultancy	1,105,660	33.5
Regeneration	203,308	6.2
IP income	69,386	2.1
Total	**3,304,194**	

[2] Unless otherwise stated, all revenue figures in this paper are in £000's

Figure 1 sets the scene. It shows that approximately 20% of UK HEIs account for 65% of the income generated from the income sources noted in the survey.

Table 2 shows the average proportion of third stream income by quartile. This shows that the top quartile does generate the largest proportion of third stream income. However, there are some notable exceptions, some of which have been noted below where third stream income as a proportion of total income has exceeded 20%.

Within quartile 1, there are five HEIs that have achieved a ratio of third stream income in excess of 20% (Newcastle University, Queen's University, University of Hertfordshire, Loughborough University and Strathclyde University).

For quartile 2, both Swansea and Cranfield have also exceeded the 20% figure.

For the third quartile, London Business School and the Institute of Education recorded a figure of more than 20%.

Finally, for the fourth quartile, the University of the Highlands and Islands and the Conservatoire for Dance and Drama exceeded the 20% figure, the former actually recording the highest ratio across all HEIs (41.2%).

Figure 1 – Distribution of third stream income

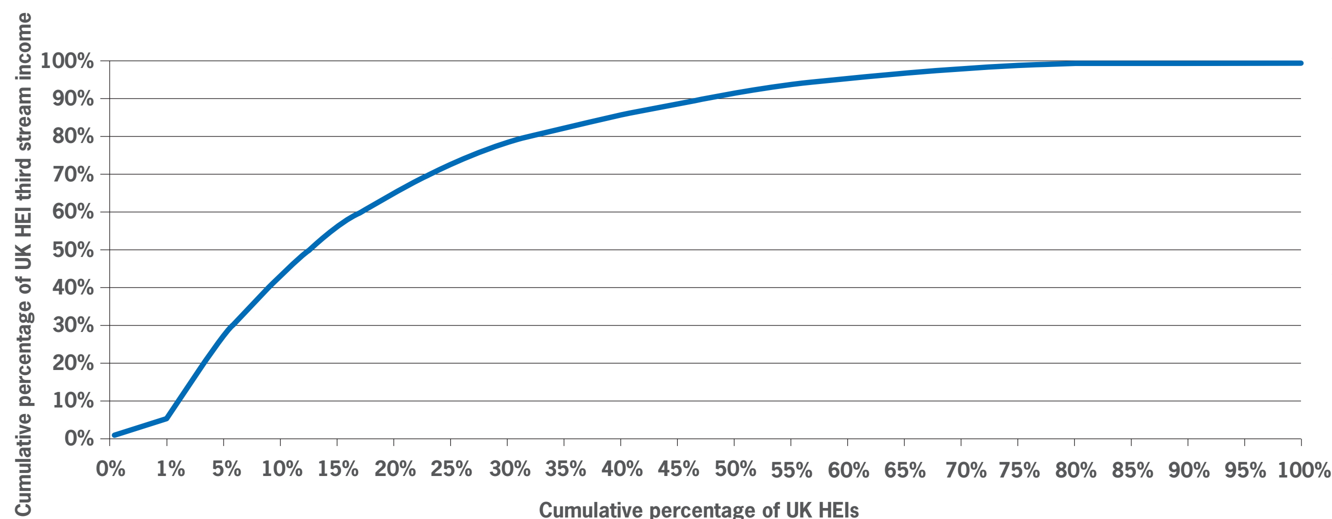


Table 2 – Average proportion of third stream income to total income

Quartiles	Average	Standard deviation	Number
1	13.4%	5.3%	41
2	10.1%	5.7%	41
3	8.1%	5.9%	39
4	5.8%	7.7%	39
Other	3.5%	3.1%	4
Total	**9.3%**	**6.8%**	**164**

Table 3 segments the different revenue streams by quartile.

Table 3 – Share of third stream revenues by quartiles

Quartiles	Public research	Research	Consultancy	Regeneration	IP income	Overall total
1	623,246	859,534	590,723	102,319	58,817	2,234,639
2	183,541	130,058	318,051	58,602	6,552	696,804
3	44,795	53,473	159,854	27,100	3,640	288,862
4	18,545	9,510	32,702	13,360	353	74,470
Other	1,522	1,616	4,330	1,927	24	9,419
Total	**871,649**	**1,054,191**	**1,105,660**	**203,308**	**69,386**	**3,304,194**

Quartiles	Public research	Research	Consultancy	Regeneration	IP income	Overall total
1	71.5%	81.5%	53.4%	50.3%	84.8%	67.6%
2	21.1%	12.3%	28.8%	28.8%	9.4%	21.1%
3	5.1%	5.1%	14.5%	13.3%	5.2%	8.7%
4	2.1%	0.9%	3.0%	6.6%	0.5%	2.3%
Other	0.2%	0.2%	0.4%	0.9%	0.0%	0.3%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Quartiles	Public research	Research	Consultancy	Regeneration	IP income	Overall total
1	27.9%	38.5%	26.4%	4.6%	2.6%	100.0%
2	26.3%	18.7%	45.6%	8.4%	0.9%	100.0%
3	15.5%	18.5%	55.3%	9.4%	1.3%	100.0%
4	24.9%	12.8%	43.9%	17.9%	0.5%	100.0%
Other	16.2%	17.2%	46.0%	20.5%	0.3%	100.0%

In breaking down the revenue streams by quartile, table 3 shows that it is clear that the quartile 1 accounts for the majority of income across all streams and hence provides for over 67% of all revenue from third stream activities.

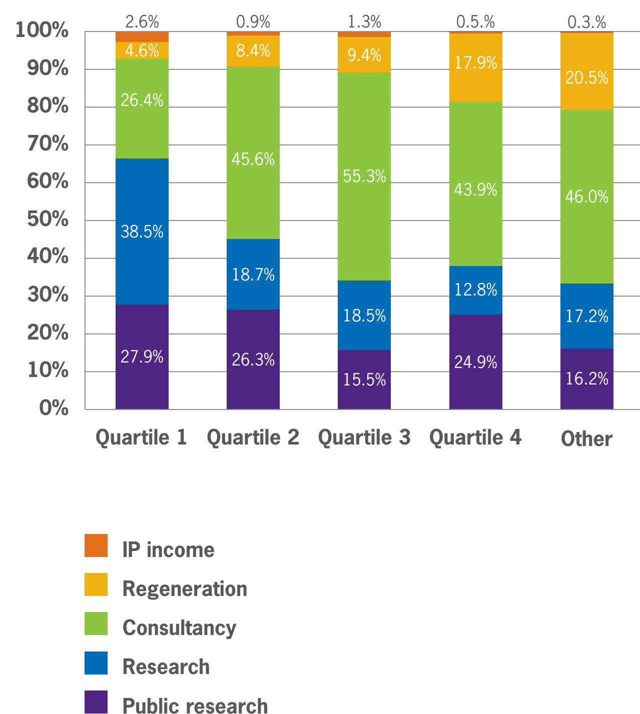
Whilst quartile 1 dominates the share of public and non public research as well as IP income, revenues from consultancy and regeneration are more spread between the quartiles, at least to some degree.

On the next page, Figure 2 highlights the differences in the way that the importance of the different revenue streams varies between quartiles. In particular:

- regeneration income becomes of increasing importance to those HEIs who are not in the highest quartiles
- similarly, consultancy revenue accounts for a smaller proportion of third stream income in quartile 1 (26.4%) compared to the other quartiles, all of whom generate at least 43.9% of their revenue from consultancy
- non publicly funded research shows that quartile 1 is engaging with this sector (SMEs, non SMEs and non commercial) as it accounts for over 38% of its revenue (compared to less than 19% for other cohorts)
- publicly funded research is relatively consistent, accounting for around 25% of revenues (apart from quartile 3 – 15.5%)

- in terms of IP income, even for the largest revenue generating quartile (quartile 1), it still only accounts for 2.6% of its income.

Figure 2 – Breakdown of third income by quartile and source



Conclusions

This data shows a significant variation in the way HEIs generate third stream income:

- Over 70% of publicly funded research is carried out by quartile 1 HEIs; the source of such funding coming from the UK government (c. 61%) and the EU government (33%)
- For non publicly funded research, a majority (over 63%) of the revenue was sourced from non commercial organisations with 32% coming from non SMEs
- Regarding consultancy revenue over 54% of such revenue comes from courses/training (of which over 76% does not come from SMEs or non SMEs)
- This suggests that HEIs are more likely to engage with non commercial rather than commercial organisations (SMEs/non SMEs) in their quest for third stream revenue
- Regeneration income is distributed more widely amongst the quartiles with quartile 1 only accounting for just over half of the total revenue (50.3%)
- Finally, regarding IP income, this source is again dominated by quartile 1 (over 90% if we include money generated from the proceeds of share sales from spin offs); whilst the concentration of this income within quartile 1 is one issue, the second, perhaps more important issue, is that the total revenue from this source was only £69.4 million (ie 2.1% of total third stream income)

This review and our wider awareness of various initiatives and activities by HEIs to develop third stream revenue seem to suggest:

- HEIs are looking to generate third stream income, especially given the current funding climate from public sources
- anecdotal evidence suggests that a significant number of innovative programmes have been introduced
- this leads to the natural question: if these initiatives exist, why are the data not reporting more positive results in general and within IP income in particular?

View from the private sector

John Leach is Chairman of Winning Pitch, a business consultancy that specialises in helping companies achieve high growth. To that end, he has recently extended his work with HEIs by taking up a position as 'Visiting Entrepreneur' in the Faculty of Humanities within the University of Manchester.

"I am really excited by the opportunity that my recent appointment has provided me. This is because I am passionate about trying to help HEIs realise their potential to work with their local communities to boost both their own income and that of locally based organisations.

In reviewing the HESA data on third stream income, I was struck by the fact that only just short of 12% of the total income in 2010/11 was generated from such sources. In particular, of the £3.3 billion attributed to third stream income only £69.3 million was identified (2.1%) as having been generated from intellectual property related activities such as licences or the sale of shares associated with spin out companies.

This tells me that there are a number of challenges that HEIs need to address if they are to more fully engage with local communities and hence generate greater revenues from non traditional funding streams. These include:

- **Speed** – we have all heard about how the rate of change is increasing within our connected and globalised world; the ability of organisations to take effective decisions quickly is becoming more important. This speed of thinking and implementation does not come naturally to HEIs
- **Knowledge sharing** – most organisations, whether they are in the public or private sectors, find it difficult to capture and share information and knowledge. The advent of social networks and media is starting to generate benefits to those who are able to share effectively. The irony is that the university sector, globally, played such an important role in the development of the internet/world wide web, not least as a way to encourage collaboration
- **Commercial development** – by sharing thoughts and ideas both internally and externally, an explicit benefit is likely to be the increased chance that an idea can be commercialised successfully
- **Tapping potential** – in general, the culture within HEIs is not conducive to enterprise and in many instances any entrepreneurial flair is cast aside in its infancy. However, scratch beneath the surface and one often finds significant entrepreneurial activity that may or may not be formally acknowledged by the institution. Therefore, the challenge is to help both academics and the institutions to create organisational structures and cultures that encourages enterprise whilst at the same time maintaining integrity and probity
- **Responding to REFs** – it is fine to say that HEIs need to do this and that but, in the first instance, some form of balance is required that maintains their core businesses whilst at the same time identifying how to leverage the skills and talents contained within."

It is worth keeping in mind the direction of travel that the UK government has often stated:

"There is a separate but critically important question of how we maximise the contribution of Government supported research to wealth creation. I support, of course, top class 'blue skies' research, but there is no justification for taxpayer's money being used to support research which is neither commercially useful nor theoretically outstanding.

The key is to find ways of transforming research into innovation. The UK has a strong record but we need to do more. This involves building stronger links between the UK's science and research base and the business community; to create more spin-out companies; and to provide a magnet for attracting overseas investors to the UK.

The important point from a national economic perspective is that we continue to increase the level of economic interactions between business and the research base, including spin-outs, licensing, consultancy and commissioned research."

Vince Cable – Science, Research and Innovation speech on 8th September 2010

The state of university fundraising

A review of the latest financial statements of the UK's largest universities (by income) shows some encouraging results in the area of philanthropic giving. During the last financial year, the University of Cambridge closed its 800th Anniversary Campaign after raising more than £1.17 billion and the University of Oxford's 'Oxford Thinking Campaign' announced that it had passed its initial target of £1.25 billion in Feb 2012, raising £1.37 billion by July 2012, before announcing a revised target of £3 billion.

Other success stories include the University of Edinburgh confirming that it had met its campaign's initial goal (set in 2006) of £350 million and its intention to continue the appeal with an extended target; the University of Birmingham declared that its 'Circles of Influence' campaign had achieved its £60 million target 12 months ahead of schedule and announced an increased target of £160 million; and the University of Nottingham reported that its 'Nottingham Campaign' was half-way to achieving its five year £150 million target after just one year.

2012 also saw the publication of 'The Review of Philanthropy in UK Higher Education' report to HEFCE by More Partnership which made a number of positive conclusions about the state of fundraising within the sector – not least that the funds raised annually by universities in the last five years have increased from £513 million (2007) to £693 million (2011) – an increase of 35%. In this time there was also a significant increase in the underlying number of donors – 132,000 in 2007 to 204,000 in 2011. Recent data published by the Ross Case Survey shows that this increase has continued, with a total of £774 million raised in 2011/12 from 213,000 donors.

However, despite the obvious advances in philanthropic giving, there is no escaping the underlying fact that the funds raised are still skewed significantly towards the larger universities. In 2011/12, 45% of philanthropic income went to the universities of Oxford or Cambridge and only four other institutions raised more than £20 million. Furthermore, the Ross Case Survey reported that 79 institutions had actually seen the amount raised through fundraising decrease from the prior year.

But there remains significant potential, not least of all in alumni fundraising. As the HEFCE report noted, only 1.2% of UK alumni currently give to their university (a figure they compare to the average of 10% at US public universities and over 50% of the UK population who donate to charity). Indeed, the report concluded that if the UK universities could increase this to 5% over the next decade, it would give the opportunity to receive £2 billion per annum from some 630,000 donors by 2022.

"45% of philanthropic income went to the universities of Oxford or Cambridge and only four other institutions raised more than £20 million."

This fact is further supported by our own research – as part of the work behind this report, we conducted a survey of our UK staff to gauge their views on fundraising efforts of the universities they attended.

Some notable findings of the survey include the fact that nearly 40% of our surveyed staff had never been contacted by their university and that, of those contacted, over 70% have been contacted annually or less and nearly 90% had made no donation in the past three years. (Survey of 705 staff surveyed between 25th January and 1 February 2013).

There are of course perception barriers to donating to universities which will need to be addressed by the sector and government as a whole – over 64% of those surveyed had not donated to their university because either they did not want to or because they did not think that their university needed any donations.

From our experience of working with the wider charity sector, we are aware that this is a hugely challenging time for fundraising. CAF's UK Giving Report 2012 showed a 20% real terms reduction during the 2011/12 with the public giving £2.3 billion less in real terms than the prior year.

In these times, any previous relationship which charities and universities have with potential donors can reap dividends and clearly universities have a head start with their alumni – if they are effectively engaged with the universities can realise more of their potential for financial support.

We believe that now more than ever, universities should be maintaining and developing investment in their alumni relations teams and ensuring that all opportunities for engaging appropriately with their alumni are taken. For instance, did your university take the opportunity of contacting select alumni after the government introduced the reduced rate of inheritance tax for those leaving more than 10% of their estate to charity?

"In these times, any previous relationship which charities and universities have with potential donors can reap dividends and clearly universities have a head start with their alumni – if they are effectively engaged with the universities can realise more of their potential for financial support."

But there are also philanthropic opportunities for universities outside of the UK which are rarely discussed. Looking further afield, universities must also ensure that they are taking advantage of when they have a presence within the growing markets of the world – not least of all South East Asia. CAF's World Giving Index published in February 2013, reiterates the huge potential for the growth of middle class philanthropy – projecting that the middle class globally will grow by 165% by 2030 (OECD data), with their spending power set to increase by 161% over the same period.

The report states that 70% of this growth is set to take place in areas outside of Europe and North America. Indeed it reported that 'were the world's middle classes to donate 0.4 per cent of their spending to charity (matching giving in the UK) they would be contributing $224 billion to civil society per year'.

The continued internationalisation of the UK higher education system means that an increasing number of UK universities now have overseas campuses or run dual awards programmes in which they are partnering with overseas universities or governments to validate and/or award courses being delivered in other countries.

Such circumstances provide opportunities for these universities to increase philanthropic giving from the very students, families, sponsoring employers (private, public and third sector) who are part of this emerging global middle class. Universities with these opportunities should ensure that they are not overlooked when they are preparing and updating their development and alumni strategies.

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David Barnes
Head of Higher Education
T 020 7728 2026
E david.barnes@uk.gt.com

Gary Devlin
Scotland and NI
T 0131 659 8554
E gary.j.devlin@uk.gt.com

Graham Nunns
North and Yorkshire
T 0113 200 2538
E graham.nunns@uk.gt.com

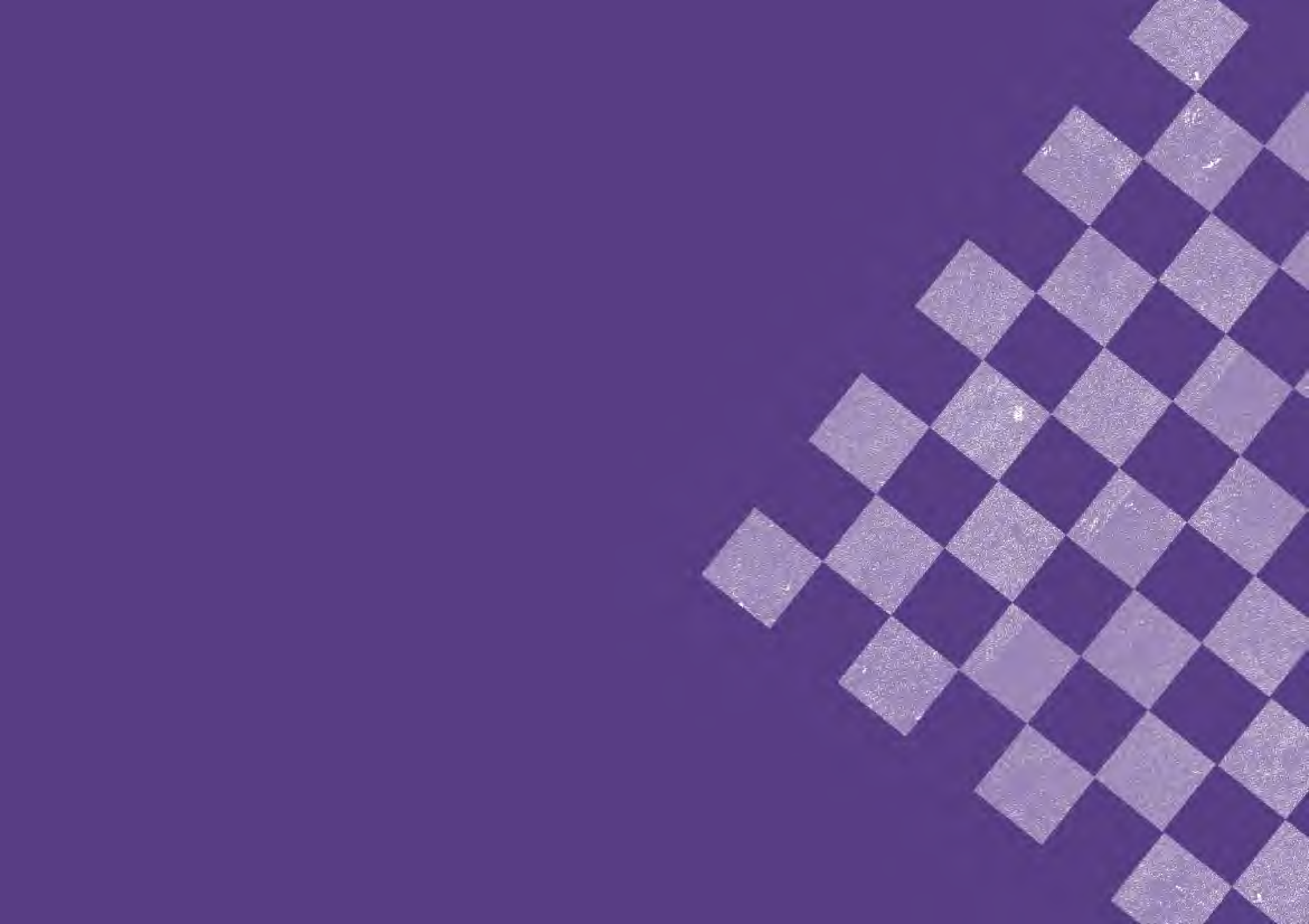
Carol Rudge
London and South East
T 0207 728 2400
E carol.rudge@uk.gt.com

Kyla Bellingall
Central West
T 0121 232 5359
E kyla.bellingall@uk.gt.com

Sally McKinlay
South
T 0117 305 7703
E sally.j.mckinlay@uk.gt.com

Steve Robinson
Central East
T 01536 315966
E steve.robinson@uk.gt.com

Toby Wilson
North West
T 0161 953 6930
E toby.wilson@uk.gt.com



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