FSSG
Financial Sustainability Strategy Group

‘Mind the gap’ – Understanding the financial sustainability challenge

A brief guide for senior managers and Governing Body members

July 2016

Foreword

Sustainability is a topic that means different things to different people. Environmental sustainability, organisational sustainability, financial sustainability, research sustainability… the list goes on. It is therefore perhaps not surprising that when 'financial surpluses', 'operating cash flows' and 'going concern' are thrown into the mix, confusion and misunderstandings can quickly arise. I am therefore pleased to provide a brief, high level paper to provide some clarity around the matter of financial sustainability in the higher education (HE) sector.

It is well documented how the funding of the UK HE sector has changed since the introduction of variable tuition fees in England, and differential fee structures in Scotland, Northern Ireland and Wales, which have coincided with the introduction of government austerity measures. The increased focus on the financial health of the HE sector has, amongst other things, highlighted the question of whether the financial surpluses reported in institutions' audited financial statements are an appropriate indicator of financial sustainability.

In this paper we have provided some additional context and understanding of the relationship between the surpluses in the financial statements, the estimated sustainable cost of institutions, and the gap between them: the so-called sustainability gap.

A sustainable financial position requires institutions to generate the necessary level of cash to finance an institution's operations and strategic needs over the medium to long term, including its investment in human and physical resources. Achieving a sustainable financial position is therefore complex. It requires medium to long-term decision making, backed up by a strong and clear financial strategy.

Viewing surpluses or deficits in isolation can be misleading as there are various levers that can be used to generate them, and some of these levers may be short term measures that do not contribute to the overall financial sustainability of the institution. Assessing institutional sustainability not only requires consideration of financial surpluses, liquidity and financial health, but goes beyond this to include appropriate non-financial performance measures. It involves considerably longer timescales and must be forward-looking, including an understanding of the vision and strategy of an institution and the changing external environment in which it operates.

I urge you to engage with this document and hope you find it useful.

Professor Mark E. Smith

Chair of the Financial Sustainability Strategy Group

1. Executive Summary

1. This paper explores the question of why institutions need to work towards achieving financial sustainability, the role of Governing Bodies in overseeing their progress, and considers the factors that lie behind the reported surpluses or deficits in the financial statements.
2. In recent years the Higher Education (HE) sector in the UK has reported a sound overall financial position, although there continue to be significant variations in the financial performance of individual institutions. Government reforms have resulted in changes to the financial strategies of many institutions, and reduced certainty in funding levels has increased the risk profile of some institutions and/or some aspects of their operations.
3. Governing Bodies have a vital role to play in ensuring the sustainability of their institutions in the long term, through setting and monitoring the institutional mission and strategy and in assessing institutional sustainability. Oversight of the institution's strategy and its enabling and supporting strategies, together with financial and non-financial indicators, provides the information to support Governing Bodies in discharging their responsibilities. The variability of awareness around why it is necessary to recover the full economic cost has been identified as an area where more information should be provided for members of Governing Bodies.
4. Financial sustainability is based upon generating sufficient cash to meet an institution's future capital, debt repayment and strategic needs. In some cases the levels of surplus or deficit reported in the financial statements are a result of a deliberate financial strategy to increase the resilience of the institution, such that it can better absorb any downside risks, should they materialise. Equally, there are additional pressures created by the need to respond to student needs and expectations, and to support the continued delivery of a high quality learning experience, which provides relevant, work-ready graduates to support the economy and society. Many institutions have chosen to respond to these issues by increasing their investment in human and physical resources – much of which has to be financed from reserves, efficiencies, asset sales or through borrowing. These matters are explored further in later sections.
5. Although financial surpluses have, on average, grown in recent years (both in absolute terms and as a percentage of turnover), the HE sector has reported an overall deficit each year through institutional Transparent Approach to Costing (TRAC) returns. TRAC records the full economic cost of all activities, including not only direct costs (such as staff costs and equipment) and support costs (such as IT, library and central costs), but also adjustments to reflect the full economic cost of sustaining activities. Investment in infrastructure and future productive capacity, innovation and human capital are all activities to be sustained.
6. The large and widening gap between the reported surpluses (or deficits) in the financial statements and the estimated sustainable cost of institutions – the so-called sustainability gap – has led some to question the validity of the TRAC sustainability adjustments, which make up the difference between the result in the financial statements and the TRAC surplus or deficit. Another interpretation is that the gap indicates that institutions may not be planning sufficiently to be sustainable.
7. Heads of institution, assisted by their Executive teams and Directors of Finance in particular, have a critical role in informing and guiding their Governing Bodies to ensure they understand the issues affecting sustainability for the institution. In turn, this enables Governing Bodies to challenge and guide the Executive to ensure decisions taken regarding

the scale and pace of efficiencies, investments and developments are appropriately balanced. The paper that follows sets out more detail on the considerations they should make in assessing institutional sustainability.

2. Background on the HE sector's financial performance

8. Each year the UK funding bodies publish information on the financial performance of the HE sector. HEFCE's most recent analysis of the financial health of the HE sector in England[1] found that for 2014-15 the accounts of the sector in England "show a financially sound position overall", but there was significant variation in the financial performance of individual institutions. In Wales, the operating surplus for the sector showed an improvement in 2014-15 against the previous year, and as in England, there was a variation in financial performance of institutions. When adjusted to take account of full economic cost adjustments using TRAC the Wales sector remained in deficit.[2] Looking across the whole of the UK, whilst the performance of individual institutions varies, when adjusted to take account of full economic cost adjustments, the HE sector remains in deficit.

9. Forecasts submitted to HEFCE for the period up to 2017-18 project increasing variation in the financial performance of institutions, with a widening gap between the lowest and highest performing institutions. In 2014-15, the sector in England reported operating surpluses of £1.6 billion, equivalent to 5.8 per cent of income, £608 million higher than in 2013-14 (when the operating surplus was equivalent to 3.9 per cent of income). This improvement is largely attributable to a number of higher education institutions (HEIs) recognising one-off Research and Development Expenditure Credits (RDEC) in their financial accounts. HEFCE estimated that £436 million of the increased surplus in 2014-15 was attributable to RDEC claims.

10. At a sector level in England, surpluses are forecast to fall to 2.4 per cent of income in 2015-16 and 2016-17, before rising to 3.3 per cent of income in 2017-18. Historically the HE sector has tended to outperform its forecasts, but with the uncertainties in overseas student recruitment and the changing pattern of funding and investment, this may not continue to be the case.

11. In Wales, the sector reported an operating surplus of £58.9 million in 2014-15 (including £15 million in respect of RDEC claims), equivalent to 4.1 per cent of total income (3.0 per cent of total income excluding RDEC). This compares to an operating surplus of £43.5 million in 2013-14 (3.2 per cent of total income).

12. In Scotland the HE sector recorded an overall surplus of £139 million (4.0 per cent if income) in 2014-15, somewhat higher than the overall level of surplus reported in 2013-14 (£97 million or 3.0 per cent of income). The reported surplus for 2014-15 included £49.9 million in respect of RDEC claims.[3]

13. The TRAC results for 2014-15 show that across all activities, the HE sector in England reported a sustainability gap (the difference between the level of surplus reported by the sector in the audited financial statements and the level required to cover the full economic costs of its activities) of £522 million (compared with the previous year, when the gap was

[1] HEFCE 2016/04, *Financial health of the higher education sector: Financial results and TRAC outcomes 2014-15* and HEFCE 2015/29, *Financial health of the higher education sector, 2014-15 to 2017-18 forecasts*

[2] HESA FSR April 2016, and summary of TRAC results from HEFCE database, March 2016

[3] Scottish Funding Council, Transparent Approach to Costing, *TRAC 2014-15* http://www.sfc.ac.uk/effective_institutions/TRAC/transparent_approach_to_costing.aspx

£883 million). Without RDEC, the gap for 2014-15 was £860 million (3.2 per cent of income). For the UK as a whole, the provisional TRAC results recorded a sustainability gap of £684 million, or £1,091 million excluding RDEC.

14. An earlier HEFCE financial health circular commented that the sustainability gap "means that, in the medium to long term, some institutions will need to generate larger surpluses to make progress towards covering the full economic costs of their activities to secure their long-term sustainability".[4] Of course, Governing Bodies could agree to moderate or slow down investment strategies, but in many cases revenue and capital investments are deemed necessary to meet student expectations, which in turn contribute to securing the future of the institution.

15. A key difficulty for many, particularly Governing Body members, is that the TRAC results and financial statement results are viewed in isolation without sufficient explanation of the differences or understanding as to what the full economic cost means, or why it is relevant.[5]

16. The TRAC return aims to present the sustainability gap in a clear and concise way. Figure 1 illustrates this for the UK HE sector:

[4] HEFCE 2015/07, *Financial health of the higher education sector: Financial results and TRAC outcomes 2013-14*

[5] The formal definition used in TRAC, and adopted in the Research Councils UK review of Full Economic Costing (fEC), 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'. *TRAC - A Guide for Senior Managers and Governing Body members.*

Figure 1: TRAC data 2014-15 (UK HE sector)

£M		Total	Total excluding RDEC[a]
Total income[b] (per audited financial statements for 2014-15)		32,804	32,398
Total expenditure[b] (per audited financial statements for 2014-15)		31,028	31,028
Operating surplus per audited financial statements		**1,775**	**1,369**
TRAC sustainability adjustments			
	Infrastructure adjustment[c]	862	862
	Return for financing and investment adjustment (RFI)[d]	1,598	1,598
Target surplus for sustainable operations to cover long run costs[e]		**2,460**	**2,460**
Sustainability gap (deficit)[f]		**(684)**	**(1,091)**

[a] The Research and Development Expenditure Credit (RDEC) scheme was established by Government in 2013 to offer tax incentives to companies to encourage greater investment in research and development. The scheme has now been amended so that universities and charities are unable to claim RDEC in respect of expenditure incurred on or after 1 August 2015; however, a number of institutions have made claims to HMRC for eligible expenditure incurred in the period 2012-13 to 2014-15. The net RDEC income claimed to date is included in the 2014-15 TRAC results. HEFCE undertook analysis of the latest financial accounts, to estimate the net RDEC income included in the TRAC income figures in 2014-15. As the RDEC income is a large one-off financial benefit to the sector we have shown two versions of the recovery on research activity and the sustainability gap figures, one including and one excluding the net RDEC income. The claims span two financial years with some universities expected to submit a further, final claim in 2015-16.

[b] The income and expenditure lines as reported in the financial statements are adjusted, where appropriate, in respect of joint ventures, minority interests and endowments in line with the TRAC guidance.

[c] The infrastructure adjustment adjusts the recorded depreciation charge on buildings (based on either historic cost or valuation in the financial statements) to an insurance-based replacement value to better reflect the full cost of maintaining the current infrastructure.

[d] RFI is based on a Ministry of Defence formula and is currently added to an institution's costs to represent the margin or surplus that HEIs need to make to be sustainable – covering the surpluses required for rationalisation, updating and development of future productive capacity, including both physical and human infrastructure, and the costs of raising and servicing short-term borrowing. The RFI adjustment is calculated as a percentage of asset value plus a percentage of expenditure, net of actual financing costs.

[e] Long run costs (full economic costs) are Total expenditure per audited financial statements plus Infrastructure adjustment and Return for Financing and Investment adjustment.

[f] The sustainability deficit is the difference between the actual operating surplus achieved and the target sustainability surplus to cover long run costs (full economic costs)

3. Why are surpluses necessary and why do they need to increase?

17. Simply put, the demands on institutions' finances are increasing. Surpluses are needed:

    - to generate funds for re-investment in the institution in response to rising student expectations and increasing national and international competition;
    - to finance higher operating and borrowing costs;
    - to foster confidence among others to continue to invest in the sector, including banks and other providers; and
    - to meet unforeseen adverse circumstances.

18. In the new competitive environment, operating costs are increasing as institutions invest to improve the student experience and student outcomes, enhance the quality of teaching and resources, introduce digital technology and new teaching and learning methodologies, renew course portfolios and strengthen their recruitment of international students amongst many other activities.

19. Pay costs are also increasing, in part as a result of changes to national insurance contributions, pensions and the forthcoming introduction of the apprenticeship levy, as well as to support the improvement in the student experience. For some institutions there is now a long term commitment to fund the deficit recovery plans of the mutual Universities Superannuation Scheme (USS) and Superannuation Arrangements of the University of London (SAUL) pension schemes, which have not previously been reflected fully in HEI financial statements as well as their own university schemes. Many universities are also part of Local Government Pension Schemes and are obliged to pay towards the deficits, which are substantial.

20. Although Government has continued to commit some capital funding for research, there is less grant funding available to support non-research related investments. A study found clear evidence that capital funding is associated with significant positive changes in a number of outcomes at HE institutions, including student numbers, numbers of researchers and contract and consultancy research income.[6]

21. In the absence of significant capital grant funding (see paragraph 28 for more detail), institutions need to generate significant surpluses and cash to fund the necessary capital spending. These surpluses are used to service borrowing costs or to build strong liquidity reserves from which the investments can be funded.

22. Increasing uncertainty in the HE sector also now means that institutions need to maintain reserves at a level that enables them to trade through difficult periods: for example instability in student demand, which has been on the rise.

23. Investment needs will tend to increase the sustainability gap (the difference between the financial statements result and the sustainable cost), unless robust plans are in place to ensure a sustainable operation. A further factor that the sustainability adjustments seek to address is that the investments discussed above are not "one off". Continued investment is required to support the evolution of institutions. Sustainability, by its nature, is longer term

[6] See for example, *A review of HEFCE capital expenditure*, July 2015. www.hefce.ac.uk/pubs/rereports/Year/2015/capitalreview/Title,104462,en.html

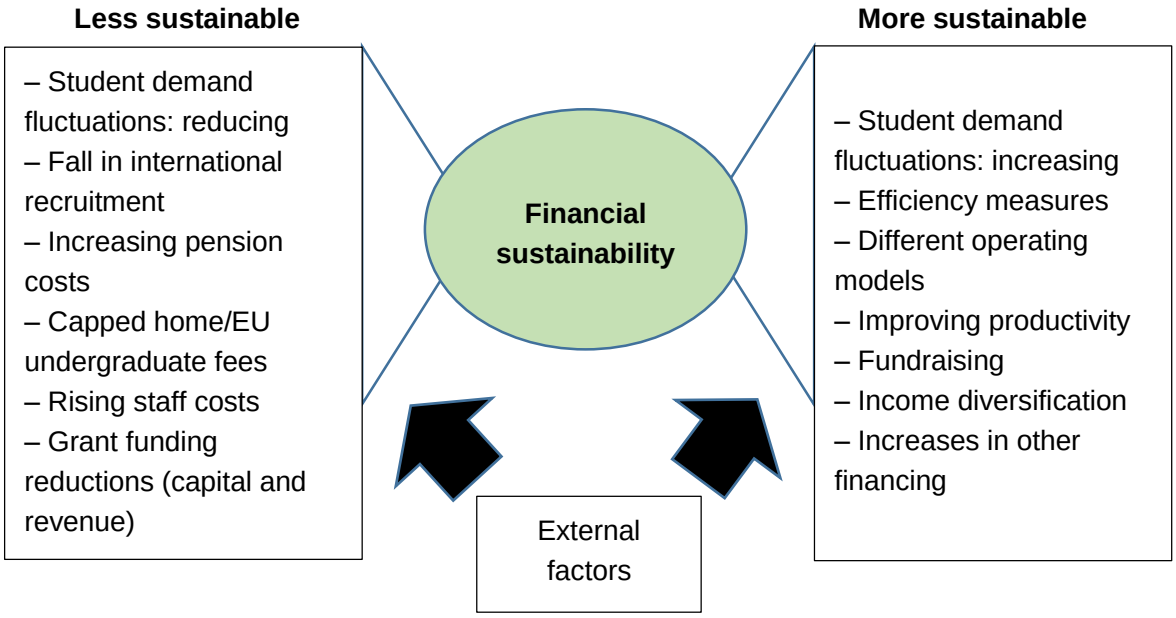
than the current generally accepted accounting principles approach to “going concern” which typically looks 12-15 months forward.

24. To further exacerbate the position, pressure is starting to mount on the levels of income earned, relative to the rate of growth in institutions’ costs. Whilst overall there has been modest growth in research income in recent years, research activity generates a loss. Across the whole of the UK HE sector, the loss on research activity, on a full economic costs basis, totalled £3.3 billion[7], (excluding RDEC income). Any loss must be subsidised by other activity, and in this case it is non-publicly funded activities that in part subsidise the loss on research activity (recording a surplus of £1.3 billion). There have been significant cuts in teaching funding grants in England where, in addition, inflationary increases have not yet been allowed beyond the £9,000 tuition fee limit for home/EU undergraduate teaching programmes in 2012. Notwithstanding the availability of research dual support funding[8] for a number of institutions, many other grant funding opportunities require an element of matched funding, which add to the pressure on institutions to generate surpluses on other activities.

25. Efficiencies are part of the solution to meeting these financial challenges and institutions have continually sought and delivered these as funding has reduced. In former times the availability of Government grant support allowed some institutions to set lower expectations for levels of surplus, but this is unlikely to be possible in the future. This means the need for self-funding continued investment is necessary and real.

26. Sustainability is complex and there are many factors that can affect it, some of which are outside of institutions’ control, but others can inform tactical strategies for institutions to pursue. Figure 2 illustrates these factors.

Figure 2: Factors influencing sustainability



Capital investment

[7] See UK sector summary: ‘TRAC income and costs by activity for 2014-15’ (May 2016) available at: www.hefce.ac.uk/data/

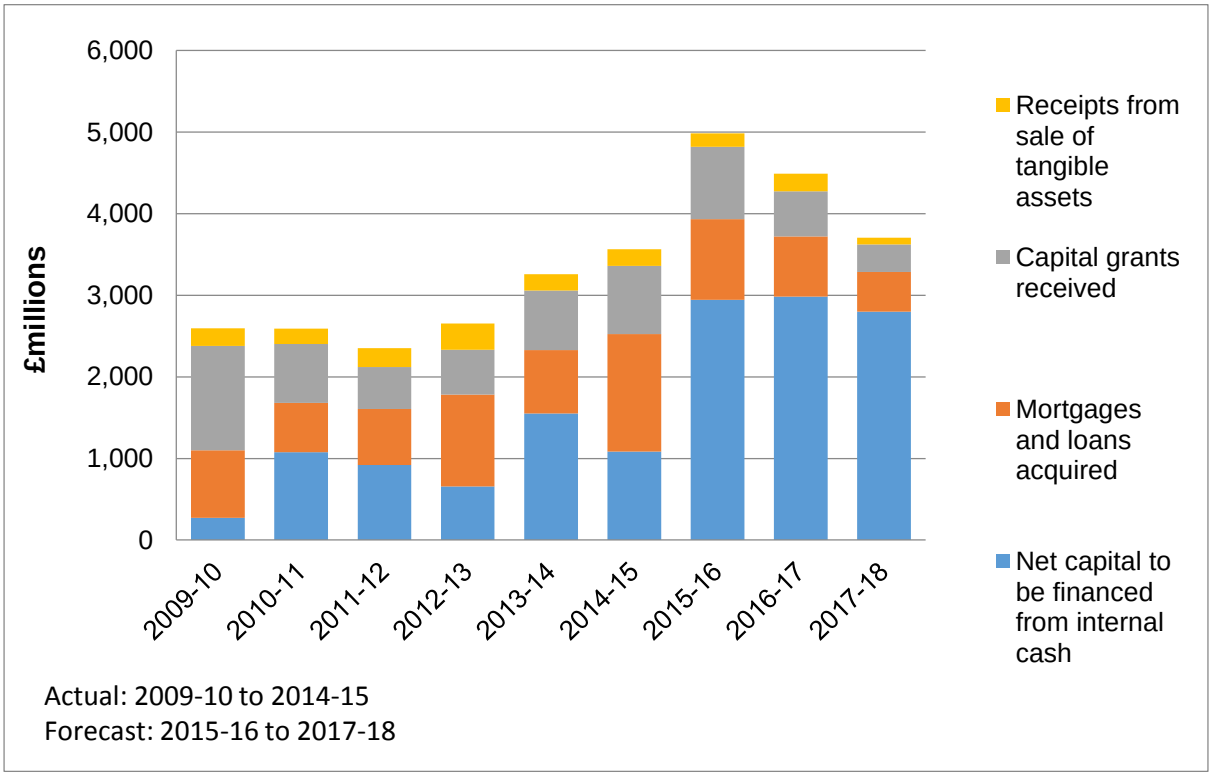
[8] In which university research funding is provided by both institutional block grants from the Funding Councils based on quality assessment exercises and by funding through peer reviewed competition from the Research Councils.

27. There remains a need for capital spending in the HE sector. Institutions need to invest in the quality of their estate to provide a high quality student experience and to attract new students and staff. Each of these is needed to help ensure that the HE sector can compete in the increasingly competitive global market. The most recent Estates Management Statistics show that, as at 31 July 2014, the HE sector in England still needed to invest £3.4 billion into its non-residential estate merely to upgrade it to a sound and operationally safe condition[9]. Further investment would be needed to enhance the existing offer to students. Significant spend is also required to develop IT infrastructure, for example. Although the other UK funding bodies do not publish the equivalent data, the pattern is likely to be similar across the UK.

28. The latest financial forecasts show that the sector in England is planning to deliver a substantial increase in capital investment over the forecast period (2014-15 to 2017-18). At over £17.1 billion, this represents an average annual investment of £4.3 billion, nearly 60 per cent higher than the previous four-year average (2010-11 to 2013-14).

29. The overall levels of capital grant funding have, at the same time, reduced. The graph that follows illustrates that whilst capital expenditure remained fairly constant between 2009-10 and 2012-13 (before growing significantly in 2013-14 and 2014-15) the pattern of capital funding has changed dramatically in recent years, with the proportion of capital financed by internal cash generation growing significantly, together with increased loan financing.

Figure 3: Funding breakdown of capital expenditure 2009-10 to 2017-18[10]

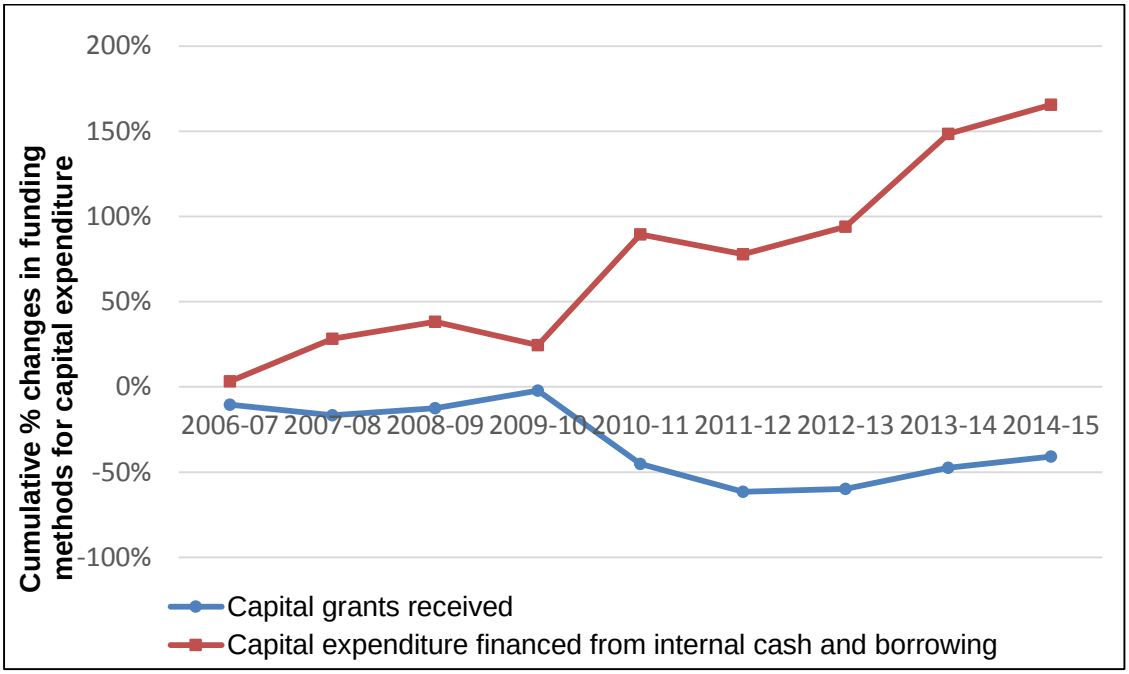


[9] This data is as reported in HEFCE 2016/04 *Financial health of the higher education sector: Financial results and TRAC outcomes 2014-15,* as extracted from the Estates Management Record for 2013-14 (collected by the Higher Education Statistics Agency). It represents the maintenance costs required to upgrade non-residential buildings to a conditions that is sound, operationally safe and exhibiting only minor deterioration.

[10] Chart provided by HEFCE

30. Figure 4 is extracted from HEFCE publication 2016/04 and shows the cumulative real-terms changes in the level of capital grants received by the HE sector in England since the base year of 2005-06, alongside the level of capital expenditure financed by internal borrowing and internal cash. It shows a steady increase since 2010-11 in the level of capital expenditure (financed by a combination of internal cash and borrowing), required to support the large increase in capital investment in this period. This increases the pressure on institutions to generate larger surpluses to provide a positive cash flow to fund investment and meet increased finance costs.

Figure 4: Cumulative real-terms changes in capital expenditure funding from 2005-06 to 2014-15[11]



31. This change in the balance of funding is one of the main factors behind a trend of reducing liquidity (cash) and increasing sector borrowing. As at July 2015 the HE sector in England had net liquidity of £8.3 billion (equivalent to 126 days' expenditure). Based on forecasts submitted in July 2015, the sector expected its liquid funds to fall to £5.0 billion as at 31 July 2018, equivalent to 67 days of expenditure: the lowest level reported since 31 July 2006. At the same time, borrowing increased from £6.7 billion at the end of July 2014 to £7.8 billion at July 2015, and is forecast to rise further to £9.2 billion at the end of July 2018. By this time the sector will be in a net debt position of £4.1 billion, rather than the current net cash position of approximately £0.5 billion.[12] HEFCE commented that this "trend of increasing borrowing and reducing liquidity is unsustainable in the long term".

Non-capital investment

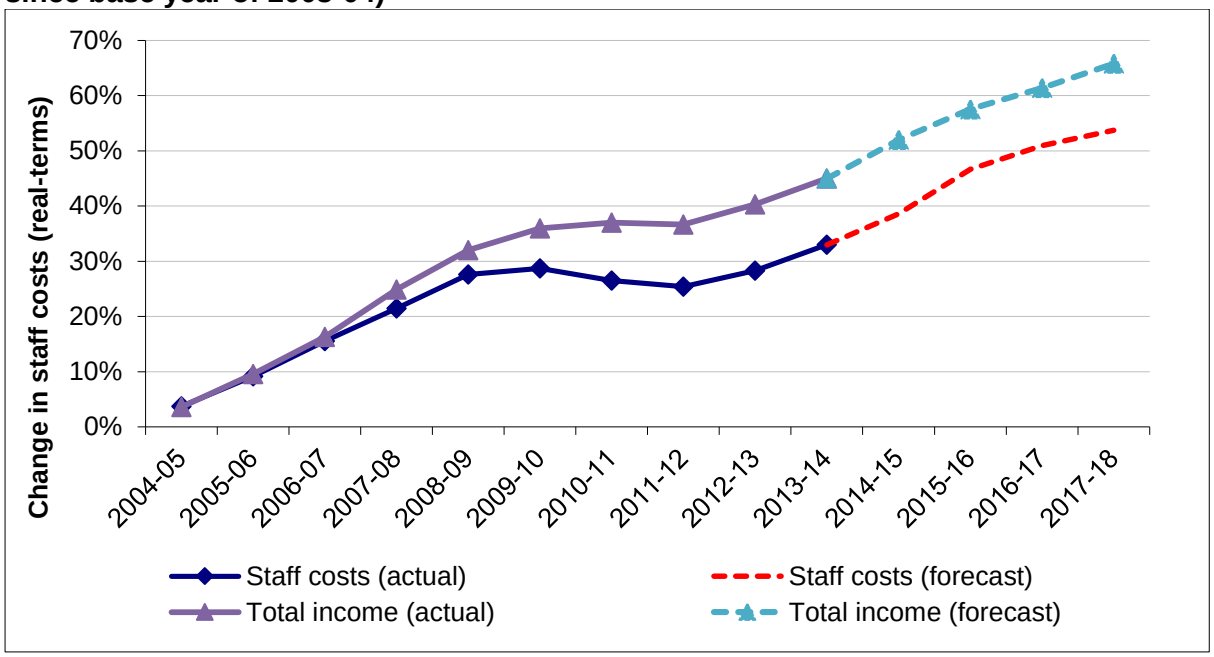
32. The need to fund capital expenditure is just one example of why institutions are now seeking to increase surpluses and cash generation. As outlined above, increasing staff costs are also a significant factor that is placing strain on the cost base. Whilst good facilities are expected by students, staff are the greatest influence on the success and experience of students. Continued investment in staff and in retaining staff is a key priority, which aligns with Government policy for improving standards and prospects for students.

33. Figure 5 compares the levels of real-terms increases in total income and staff costs over the past ten years, plus what the English HE sector is forecasting to happen over the next four years.

[11] HEFCE 2015/07, *Financial health of the higher education sector: Financial results and TRAC outcomes 2013-14,* Figure 9

[12] Note that the figures quoted are prior to the implementation of the new accounting standard FRS 102, which is expected to result in increased reported borrowing levels from 2015-16 as a result of the recognition of additional financial commitments on institutions' balance sheets.

Figure 5: Real-terms increases in total income and staff costs (cumulative increase since base year of 2003-04)



34. Income growth is keeping pace with the growth in staff costs in real terms, but pressures on staff costs are not all within the control of institutions and may limit investment in other areas. The projected rise in staff costs over the forecast period is caused by a combination of increasing pay and pensions costs and rising staff numbers, with forecasts showing that staff numbers in the English HE sector will be 7.1 per cent higher in 2017-18 compared with 2013-14.

35. Pension scheme deficits have grown in recent years with the resulting need for employers to pay more into schemes in the short term. Despite structural changes in some sector schemes, such as USS, deficits are likely to continue, resulting in additional costs, and continued pressure on the financial health of the HE sector.

36. The English sector is also forecasting other operating expenditure to rise between 2.6 per cent and 6.9 per cent (cash terms) per year in the period 2014-15 to 2017-18. Depreciation and interest payable are expected to increase at a faster rate, with depreciation rising between 6.7 per cent and 8.8 per cent per year, and interest payable rising between 2.2 per cent and 11.1 per cent (cash terms) per year in the same period. These increases reflect the sector's rising investment in physical infrastructure and increasing levels of external borrowing.

4. Responsibility for ensuring sustainability

37. There is a collective responsibility for ensuring sustainability within an institution, with ultimate responsibility resting with the Governing Body. The Head of Institution has responsibility for leading the institution and is accountable to the Governing Body for the performance of the institution in all respects. The Director of Finance should ensure that there is an agreed financial strategy in place, setting the tone and parameters for all associated plans, budgets and monitoring. All members of the executive team and the wider

institution are collectively responsible for the performance of their respective areas as well as ensuring compliance with all relevant rules and requirements.

38. Achieving sustainability is hard, however. To move towards this, decisions need to be taken in several areas and agendas within an institution. These include: the scale and timing of investments and efficiencies, staffing levels, areas of planned growth and other income streams. As each of these actions can be affected by external developments, continued reassurance and monitoring are important.

39. Sir William Wakeham's 2010 review of *Financial Sustainability and Efficiency in Full Economic Costing of Research in UK Higher Education Institutions* recommended that HEI governing bodies take a more proactive role in assuring themselves that there is an institution-wide strategy for financial sustainability and that the HEI has developed measures that assess the extent to which this is being achieved.[13]

40. The Financial Sustainability Steering Group (FSSG) developed metrics and a process to implement the report's recommendations which included an annual assessment and declaration by governing bodies to their funding council (called ASSUR). This has been implemented on a voluntary basis and is becoming a mainstream activity as part of the annual accountability reporting by many institutions across the UK. The most recent iteration of the Higher Education Code of Governance published by the Committee of University Chairs (CUC) states that one of the primary elements of governance is that "the governing body ensures institutional sustainability by working with the Executive to set the institutional mission and strategy. In addition it needs to be assured that appropriate steps are being taken to deliver them and that there are effective systems of control and risk management."[14]

41. The Code states that members of the Governing Body must be clear how institutional performance is measured, and which institutional-level Key Performance Indicators (KPIs) and other performance measures are to be adopted. The Governing Body have overall responsibility for the adoption of KPIs, although they will take advice from the head of institution and other relevant sources in identifying them and setting appropriate targets.[15]

5. Does TRAC provide a solution to understanding the sustainability gap?

42. As already outlined, there is a risk that institutions engage in short term decision making, which, whilst supporting a short term financial result, does not secure the medium to long term sustainability of the institution. TRAC provides a useful tool for members of Governing Bodies to understand the extent to which institutions' activities are sustainable. It also provides a basis for enquiry and challenge to the sufficiency of financial plans.

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[13] Research Councils UK/Universities UK (2010), *Financial Sustainability and Efficiency in Full Economic Costing of Research in UK Higher Education Institutions*
http://www.universitiesuk.ac.uk/highereducation/Pages/FinancialSustainabilityAndEfficiency.aspx#.VypiEYQrKVM

[14] Committee of University Chairs (2014), *The Higher Education Code of Governance*
http://www.universitychairs.ac.uk/publications/

[15] Guidance on the development and implementation of appropriate KPIs was included in the Committee of University Chairs 2014 report *Monitoring of Institutional Performance and the Use of Key Performance Indicators (Committee of University Chairs, November 2006)*

43. The TRAC sustainability adjustments (the Return on Financing and Investment, or RFI, and the Infrastructure Adjustment) generate the difference between the financial statements result and the full economic cost (the TRAC result) (see paragraph 15). The sustainability adjustments are designed to account for the fact that the 'real' cost of higher education activity is higher than the historical expenditure stated in most institutions' published financial accounts. This difference is due to a combination of understatement of asset values in many institutions (which account for property at historical cost rather than current valuation) and the need to allow a surplus or margin for risk, financing and development. This last point relating to risk is more pertinent given the increased uncertainty now faced by a number of institutions.

44. The two sustainability adjustments are accepted as a proxy to reflect these additional economic costs for sustainability of institutions' activities based on the historical financial position of HEIs, rather than the future cash need for an institution to be sustainable. FSSG is continuing to work to develop the Margin for Sustainability and Investment (MSI) as a development of the sustainability adjustments, capturing an indication of an institution's future (short-term) investment plans.

45. Of course the existing TRAC sustainability adjustments are not a perfect science, and do not provide an absolute indicator of sustainability, but they provide a clear basis for understanding what is needed for institutions to sustain their operations, and for management and governing bodies to make further enquiries. Where institutions set their strategy and manage their operations to generate a surplus sufficient to support their operating and future investment needs, the gap between the reported level of surplus and the full economic cost of their activities should reduce (although inflation means that typically it costs more to deliver tomorrow what is delivered today and therefore the gap may not close completely).

46. On the other hand, if institutions do not generate surpluses at this level and government funding or capital funding policies do not change, then a point will be reached where there is insufficient financial capacity to enable the continued development of the institution, the continued need to improve capital assets to attract students, the need to fund pension deficits and so on. In these circumstances, the so called sustainability gap would persist.

6. Becoming more sustainable

47. To be sustainable an institution has to make medium and long term decisions. These include: the pace and phasing of investment plans, financing strategies (including the cost of debt), prioritisation of asset replacement plans, strategic investment priorities, staffing structures, portfolio, delivery models and efficiency plans. All these decisions are also much wider than just the financial requirements. It is important that the benefits from the investment and finance decisions are clear from the outset, to deliver the strategic aims of an institution and maintain the focus on the student experience and the quality of teaching and research. This requires that senior management and the governing body are clear on how they will measure institutional performance.

48. It is vital that institutions establish and regularly monitor a range of performance indicators, both financial and non-financial (covering teaching and learning, research, student experience and other institutional performance areas that the Governing Body decides are important at any particular time), linked to the corporate strategy. Although they cannot tell

the whole story about institutional sustainability, adverse trends in non-financial indicators, as well as in respect of financial health measures, can provide a strong early warning indicator. It is important that the agreed indicators are refreshed periodically as institutions go through the natural cycle of new strategies and capital investment.

49. In appraising whether their institution's plans are sustainable, members of Governing Bodies, advised by senior management, should therefore assess whether:

    - The institutional strategy is clearly articulated and understood and takes account of the resources available and the environment in which the institution operates
    - Medium and long-term financial plans support the strategic ambition
    - Appropriate mechanisms are in place to measure institutional performance over a sufficiently long time period, and the data and analysis behind the resulting KPIs is sufficiently robust
    - They have sufficient information to provide appropriate challenge to management on financial and non-financial performance and assess institutional sustainability periodically.

50. Short term decision-making will at times be necessary, but the implications of such decisions should be clearly understood, and the sustainability of an institution is not eroded.

51. This paper is not exhaustive, but it aims to provide an insight into the sustainability gap and the related challenges facing institutions and the UK HE sector as a whole. Governing Body members are encouraged to use the analysis outlined above, together with further research into sustainability matters, using the links provided in the footnotes to this paper, to help challenge the plans of their own institutions to ensure that they are moving towards being sustainable in the medium to long term.