Understanding University & College Finances

Andrew McGettigan
@amcgettigan
https://andrewmcgettigan.org
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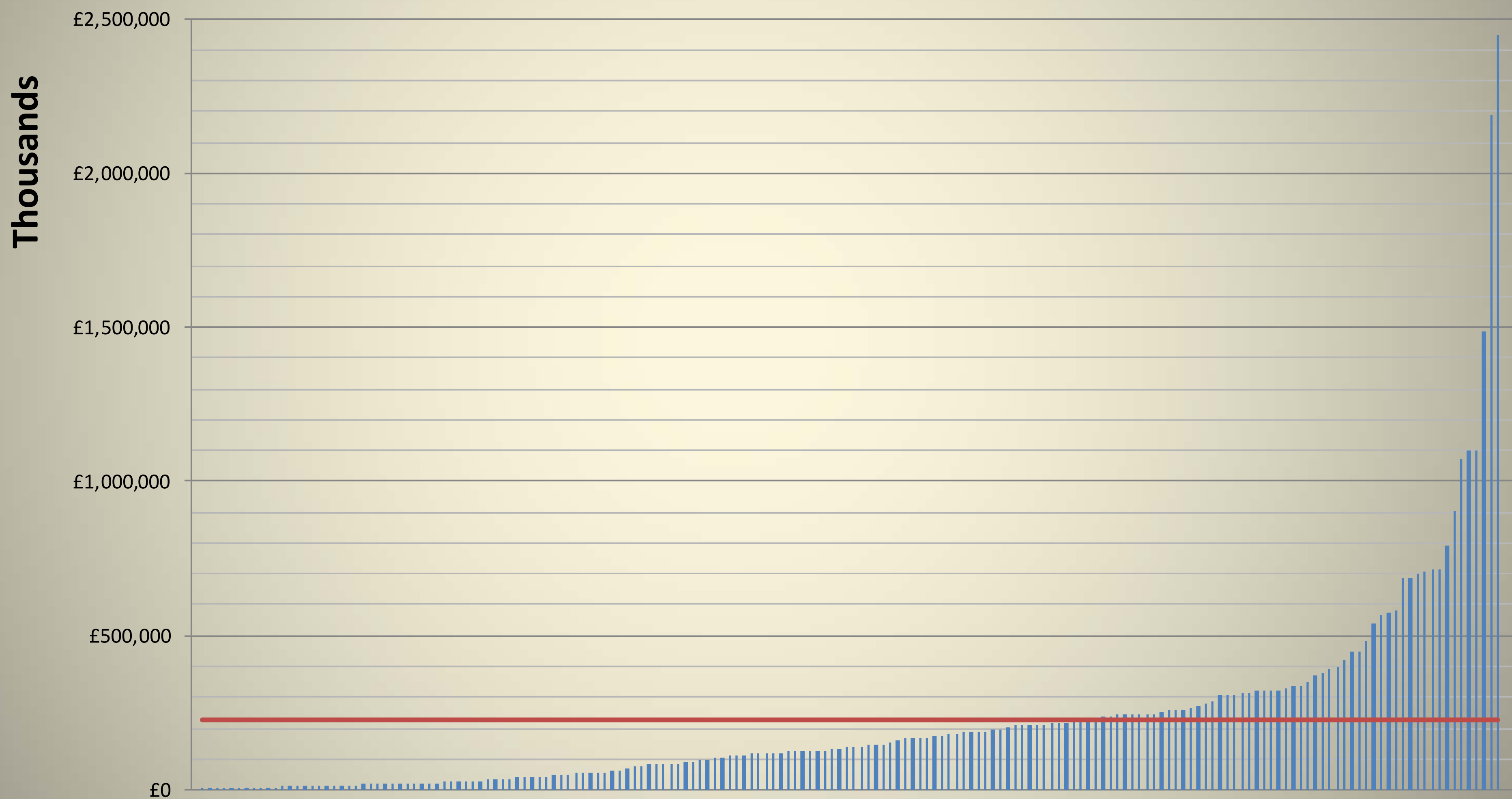
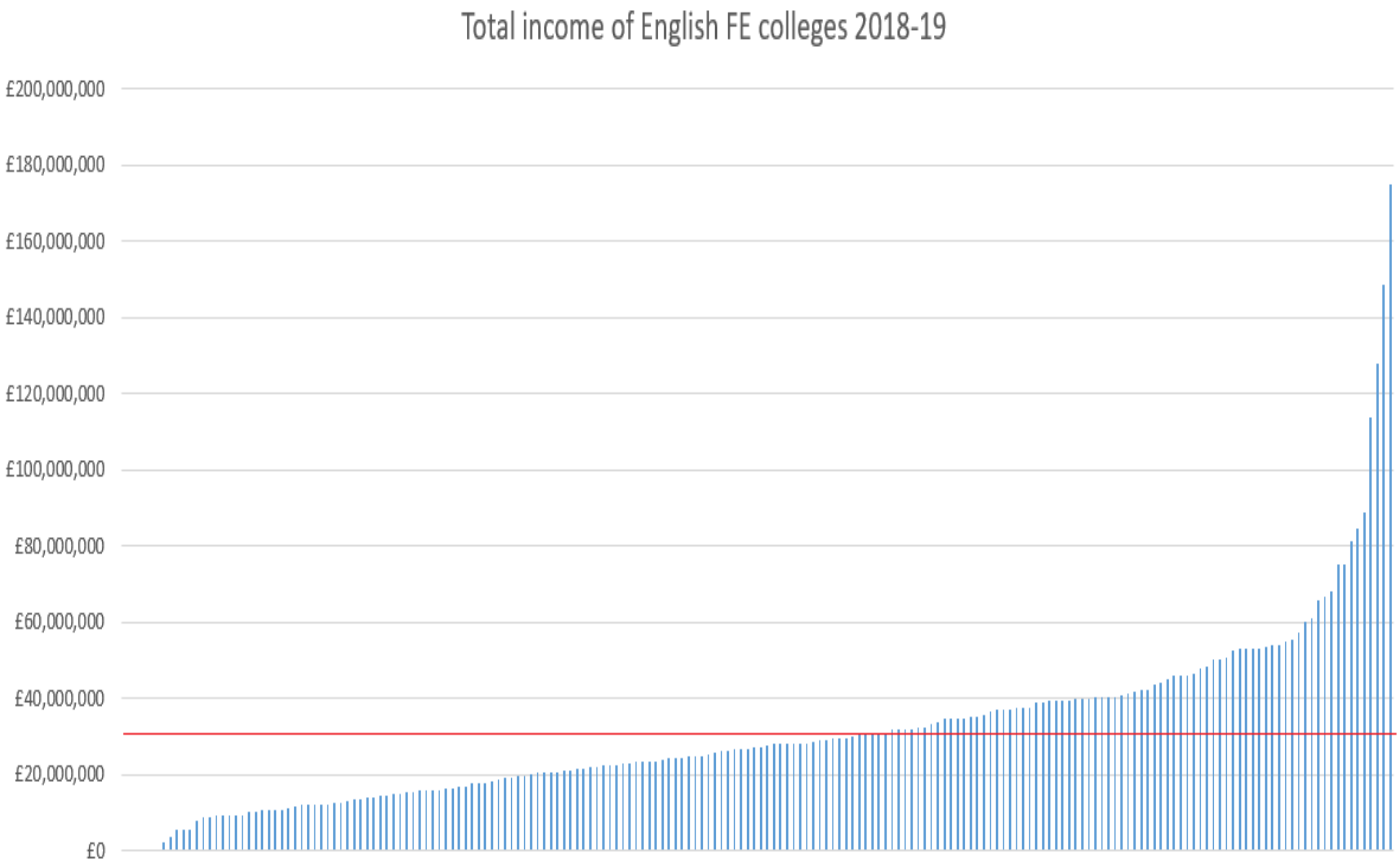
Overview

- Accounting Basics: surpluses & reserves & CASH!
- Liquidity & Solvency
- How are the in-year finances affected by the pandemic?
  - How big is the hit? Will it lead to losses?
- Could the hit be absorbed without staffing cuts?
  - Can we pause planned capital expenditure?
  - Can we utilise cash reserves?
  - Or could new funds be raised?
- Constraining factor: Covenants with lenders

Annual Income 2018/19, UK HEIs



Source: Hesa **Median income is £140million; Mean is c. £230m.**



Source: ESFA college accounts   Median income is £28m; Mean is £32m

Surpluses, Reserves, Assets & Liabilities

FINANCE & ACCOUNTING BASICS

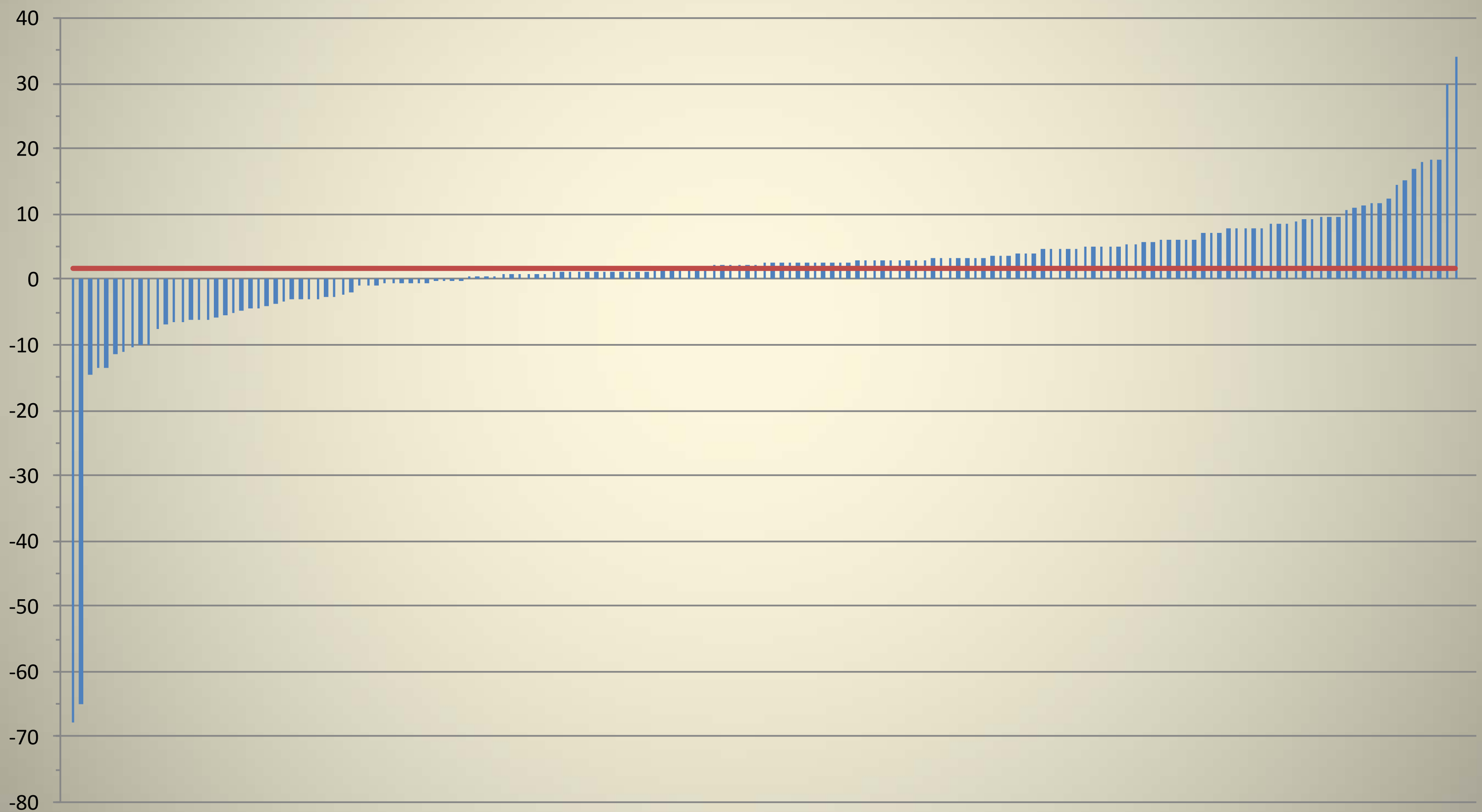
Financial Statements

- The Annual report includes 3 main financial statements:
  - ***Annual* Income & Expenditure**
    - money earned and spent
    - Is the business sustainable? Does it earn more than it spends?
  - **Balance Sheet**
    - What does the university own, what is it owed, what does it owe?
  - ***Annual* Cash Flow**
    - How has the cash position changed?
    - Some activities, e.g. borrowing, bring cash in that is not earned (not income)
    - Some income & expenditure, e.g. depreciation, does not involve cash
    - Cash is how most demands are settled
- **Notes** to the statements explain matters in more detail and are where important information is found

Universities aim to make surpluses

- Almost all universities are independent **charities**:
  - No owners, so not profit-making
  - Must reinvest ***surpluses***
- **Surpluses** are made when income exceeds expenditure over the accounting period
  - Universities typically *aim for* a minimum of 3-5% *operating* surplus
- Your institution may target **EBITDA** or **Net operating cashflow** instead: ability to generate cash from ordinary activities

Annual Surplus as % of Income, 2017/18 (Hesa)



Capital expenditure creates an Asset

- Capital expenditure is **not** current or operational expenditure
- Capital "Expenditure" *only* appears in the income-expenditure statement as *depreciation*
  - Cost is spread over the lifetime of the asset
  - E.g. A building is assumed to have 50 year working lifespan, so 2% of cost is added to expenditure in each subsequent year (e.g. from 2020/21 to *2069/70*)
  - Depreciation is *not* cash
- *Cash goes out in full <u>when</u> <u>it is spent</u> on creating the asset*
- Capital spending budget can be big – funded by grants, borrowing and by cash generated from operations ("free cash")
- **To preserve cash** it makes sense to *pause* non-essential capital spending

The Balance Sheet

- Balance sheet is made up of **assets** & **liabilities**
  - What the university owns / is owed (assets) and owes (liabilities) to others
  - A snapshot in time ("year end" – ie 31 July)
  - The value of **Outstanding Debts** are recorded here (loans, mortgages, bonds, etc.)
  - Loan **covenants** will not show up in Accounts. This may place restrictions on the university. Identity them!
- Some assets will be **current assets** (cash or near-cash)
  - Important for liquidity
- Some will be **fixed assets – e.g. property & land**
  - essential to what the university does **(**You might not want to sell it!)
  - And historic – what was paid at the time (it may not be worth this today)
  - These values might be better understood as *replacement* costs rather than a price that will be achieved in a sale.

Some assets & their values

	Note	Consolidated		University	
		2018–19 £000	2017–18 £000	2018–19 £000	2017–18 £000
Non-current assets					
Tangible assets	13	1,048,126	1,029,939	1,050,067	1,031,920
Investments	14	68,690	68,764	68,690	68,764
Endowment investments	15	258,074	233,462	258,074	233,462
		1,374,890	1,332,165	1,376,831	1,334,146
Current assets					
Trade and other debtors	16	149,235	100,908	149,457	101,063
Cash and cash equivalents		130,387	180,768	128,800	179,462
		279,622	281,676	278,257	280,525
Less: creditors: amounts falling due within one year	17	(311,162)	(276,982)	(309,547)	(275,480)
Net current assets/(liabilities)		(31,540)	4,694	(31,290)	5,045

What are these things? Look for more detail in the relevant note.
What do the values represent? Can you use them to settle claims? Can you raise funds against them or by selling them? Might be sunk or historic costs!
You can be most sure of “cash & cash equivalents” – “Current Assets”
Tangible assets is “biggest” – it’s land & buildings mostly

Net Assets & Reserves

- Net Assets: By how far does the value of what you own or are owed (assets) *exceed* what you owe (liabilities)
  - Net Assets = Assets - Liabilities
- For universities, which don't have equity, Net Assets is equivalent to Reserves
- "… reserves are an HEI's total assets less its liabilities and, in very broad terms, can be used as a proxy of the overall value of an institution." Hefce *Financial Health 2014/15*, March 2016
- "Funds" & resources at university's disposal.

Watch out with “reserves”!

- Two meanings of **reserves**:
  - **Cash or operating reserves** – current (liquid) assets
    - Working capital
    - To be spent on new initiatives: projects or estates
    - This is closer to everyday sense of “reserves”
  - **(General) reserves ie net assets** – includes *all assets* and especially property (fixed assets)
- JNCHES on Reserves: “However big your reserves are, they’re not the same as cash. To convert reserves into cash, you’ll have to sell assets. *Don’t assume those assets will sell for the amount showing on the balance sheet*.”

- And some of the reserves may be “restricted”
  - They belong to endowment funds or associated trusts
  - Cannot be consumed or disposed of like other reserves.

Committee of University Chairs definitions

Solvency: the **ability** of the University **to meet its liabilities in full**, ensuring that there is sufficient capital so that there is **an excess of assets over liabilities**;

(If you wound up the University, you would be able to pay off all debts, if necessary by selling assets)

i.e., the university has net assets, not net *liabilities (insolvent!)*

Liquidity: the ability of the University to meet its liabilities ***as they fall due****.*

- **A solvent institution may be illiquid.**
- “Illiquidity kills you quick.” / “Cash is king.” / etc.
  - Bankruptcy is most often associated with illiquidity
- Charities are advised to keep **90 days** of cash or near-cash reserves
  - ¼ of annual expenditure!

“Liquidity days”

- How many days of expenditure (exc. depreciation & other non-cash items) can be covered by current cash holdings?
  - 90 days is Charity Commission recommendation
    - Over half of UK universities met this level on 31 July 2019
  - 60 days is most universities’ minimum “working capital”
  - 30 days is now a “reportable event” to OfS
- Calculations vary: OfS does *not* include all current assets; the HESA published figures *do*
- Credit facilities:
  - “headroom” provided by unused overdraft or revolving credit facilities
  - OfS has counted such credit in its liquidity calculations

HOW ARE THE FINANCES AFFECTED BY THE PANDEMIC?

Analogy

If your income declines by £5,000 for a year:

- Would that mean you are facing a deficit or a reduced surplus? (income & expenditure)
- Can you cut back your spending to reduce your in-year deficit?
- Is there a big ticket, non-essential item that you can put off buying? (cf. capital expenditure)

Balance sheet

- Do you have savings you can draw on? (current assets)
- Can you raise money against your other assets? (sale or secured borrowing?)
- Can you access additional unsecured borrowing?

How big is the hit?

- Dependency on International Tuition fees
  - These cross-subsidise other activities, research in particular
  - So not just the bare income number
- These can be big numbers!
  - Manchester brought in £225million from international student fees in 2018/19
- Working assumptions across the sector:
  - 30-50% drop in International students is “central” scenario
  - Manchester looking at £100m+ drop in planned income
- Vulnerability to more prestigious universities offering more places to Home students to compensate for lost international students
- Other incomes streams affected – conferences, accommodation etc.

Drops in Income

- Based on *projected* income in forecasts, not year-on-year change
- *May not lead to a "loss" / deficit*
  - *It depends on what the original forecast was aiming at in terms of income & expenditure*
  - *£50m surplus becomes £20m surplus if £30m of income is "lost"*
- A loss-making institution might still generate cash from operations (once e.g. depreciation is excluded)
- What is your institution aiming at and why?
  - Covenants – I'll talk about these later
- *Cash is the key – does the Budget for 2020/21 show net cash outflow or inflow from operations?*
  - *Is there still cash earmarked for capital development?*

How far can the hit be absorbed by balance sheet?

- Can we pause or defer capital spending?
- How much capacity is there to absorb losses from cash reserves?
  - "Rainy day", contingency funds
  - Some liquid assets are needed for day-to-day operations ('working capital')
  - Maintain minimum liquidity
- Could new funds be raised?
  - Borrowing or Selling assets

It may be that there is little scope for these …

Can losses be handled otherwise?

Judgments & decisions

- Where are the costs falling?
- What is being prioritised? What is being protected?
  - Strategic investment?
- Is there a more fundamental problem with the "business model"?
  - "crisis as opportunity"

Cuts to staffing reduce capacity & ability to bounce back in future years

- How does the institution "see" the recovery?
  - How has it updated its forecasts for 2021/22 & 2022/23?

Toy example to illustrate ideas

Income / Expenditure => Cash

- The Budget/Forecast originally plans for a £20m surplus in 2020/21;
- was to have generated £35m in cash after cash non-items like depreciation are excluded

Capital Expenditure

- it planned to put £25m of that cash towards capital development

University of Frampton now fears it will lose £50m in projected international fee income

- *It is now facing a £30m* deficit *(loss), but would see operating cash* outflow *of £15m* [£50m drop in income subtracted from surplus & cash inflow]
- *It can only* suspend *£10m of capital development (contracts have been signed, there is essential maintenance etc.), leaving £15m of capital works & £15m cash outflow*
- ***So is facing an in-year cash shortfall of £30m on 2020/21***

Toy example continued: University of Frampton

It is facing an *in-year* shortfall of £30m cash.

Balance sheet

- Does it have enough cash in the bank to cover that £30m while maintaining minimum liquidity levels?
- Could it e.g. extend an overdraft to cover the cash shortfall?
- Or sell something?
- Or apply to government schemes? CCFF, CLBILS, BEIS research packages …

COVENANTS WITH LENDERS

Types of covenant

- “negative pledge” – veto over new borrowing or kinds of borrowing (e.g. secured)

Financial performance covenants:

- university or college needs to be run in accordance with them so that the lender is confident they will get their money back
  - These may be expressed as ratios between metrics
    - Or as minimum levels
  - These might be tested every year, but use an average of last three years
    - You may be allowed to breach once every three consecutive years with being classed as a breach!
  - Lots of variables and variation in the sector! The details will make a difference next year.
- How does the proposed budget for 2020/21 relate to covenants?
  - Is the university trying to avoid a breach?
  - Or claiming that it “isn’t *allowed* to run a deficit” (Sussex)?

Illustrative Examples

- Can your institution *service* its debts?
  1. Generate enough cash from operations to pay annual costs of servicing borrowing ("interest" + repayments)
     - A "multiple" may be applied to this – twice as big, or 1.25:1, etc.
  2. The university must keep its annual costs of borrowing below 5% of turnover
- Will the institution be able to pay off large *lump sums* scheduled a long way off?
  - Interest-only mortgages / bonds etc.
  - "operating leverage" (cash from operations: debt)
    - how big is this multiple? It might be limited to e.g. no greater than 1:5 or 1:6
- What is the relative size of the debt?
  1. Compared to income (HESA KFI)
  2. Compared to *net* assets (excess of assets over liabilities)
     - NB in debt:net assets, debt is on both sides of the ratio. If debt goes up, net assets go *down*
  3. Or net assets must be kept above e.g. £250m

COVENANT BREACHES

What might the lender demand?

- Payable on demand
- “Accelerated” payment
- Refuse to “rollover” or *extend* existing borrowing when repayment is due
- New tighter covenants for future
- Higher interest payments

May agree to waive
- Will want to see plans on how to recover
- And might want gesture of e.g. “pay restraint”
- Is there a big sum due shortly? May not be so lenient!

The lender may not be a *bank*
- Money funds; insurance companies; pension funds
- What strain will they be under next year?
- Do they have much business in the *UK* tertiary education sector?

Payable on Demand

19 CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	Consolidated 31 July 2019 £m	University 31 July 2019 £m	Consolidated 31 July 2018 £m	University 31 July 2018 £m
Bank overdraft	2.5	-	2.2	-
Secured loans	111.3	111.3	2.5	2.5
Service concession arrangements	6.2	6.2	5.9	5.9
Trade payables	8.0	8.0	8.1	8.1
Social security and other taxation payable	4.1	4.1	3.7	3.7
Accruals and deferred income	59.3	59.4	58.6	58.5
	191.4	189.0	81.0	78.7

At 31 July 2019 the University's outstanding secured loans have been classified as falling due within one year although the scheduled repayments under the facility agreement are for repayments of £109m to be made after more than one year. The reason for this accounting treatment are explained in note 20 below.

University of Swansea, 2018/19 Financial Statement

Renegotiation: University of Kent

Financing arrangements

On 29 January 2020 the University entered into new financing arrangements with its existing lenders. This has included agreement of new terms that will apply to its existing borrowing facilities up until 31 December 2021, incorporating a new suite of financial covenants, harmonised across all three lenders.

As a result of this new arrangement, from the date of the related agreement, the interest rates payable on existing loans will change from those disclosed in note 17 to the rates shown below:

Lender	Amount outstanding at 31 July 2019 (£000)	Rate from 29 Jan 2020 (%)	Maturity Date
National Westminster Bank plc	5,386	8.77	Jan 2022
National Westminster Bank plc	6,755	7.43	Nov 2028
National Westminster Bank plc	10,800	6.76	Oct 2030
Scottish Widows Limited	9,025	6.96	Jun 2029
European Investment Bank	47,479	4.25	Mar 2040
European Investment Bank	25,000	3.80	Sept 2042

Previously

Lender	Amount £000	Interest rate (%)	Term (years)	Maturity Date
National Westminster Bank plc	**5,386**	8.8	25	Jan 2022
National Westminster Bank plc	**6,755**	6.0	25	Nov 2028
National Westminster Bank plc	**10,800**	5.3	25	Oct 2030
Scottish Widows Limited	**9,025**	5.5	24	Jun 2029
European Investment Bank	**47,479**	2.6	25	Mar 2040
European Investment Bank	**25,000**	2.1	25	Sept 2042
	104,445			

Summary

- Finances are open to question, they do not dictate decisions
  - Interrogate them to understand what your management is prioritising & protecting
- What does the budget tell you about the implications for next year?
  - Income / expenditure
  - cashflow
- Does the balance sheet provide options?
- Is the institution worried about covenant breaches?
  - How is that distorting its recovery plans?
- How is it modelling future years? Will it have capacity to bounce back?
- Unevenness:
  - Small, struggling institutions – v. limited options
  - Large, research-intensive – big hit to income, but should have balance sheet capacity to mitigate that
  - A lot of variety between those two extremes

Useful Resources

- New Joint Negotiating Committee for Higher Education Staff (JNCHES) *An Insider's Guide to Finance and Accounting in Higher Education,* January 2011
  http://www.ucea.ac.uk/en/publications/index.cfm/gtofinance
- Committee of University Chairs*, Institutional Sustainability*, May 2017
- Michael Pearson, *Getting to Grips with Finance*, LFHE 2009
- Andrew McGettigan, "A Tale of Two Bonds", *Research Fortnight* 27 March 2013
- Andrew McGettigan *The Great University Gamble: money, markets & the future of higher education*, Pluto 2013
- Critical Education, "Policy Exchange's Accounting Errors", 19 October 2015
  https://andrewmcgettigan.org/2015/10/19/policy-exchangess-accounting-errors/
- Raj Bairoliya, *An Investigative Journalist's Guide to Company Accounts*, Centre for Investigative Journalism 2014
  http://www.tcij.org/resources/handbooks/investigative-journalists-guide-company-accounts
- Ciaran Walsh, *Key Management Ratios*, FT Prentice Hall, 2008 (4th edition)

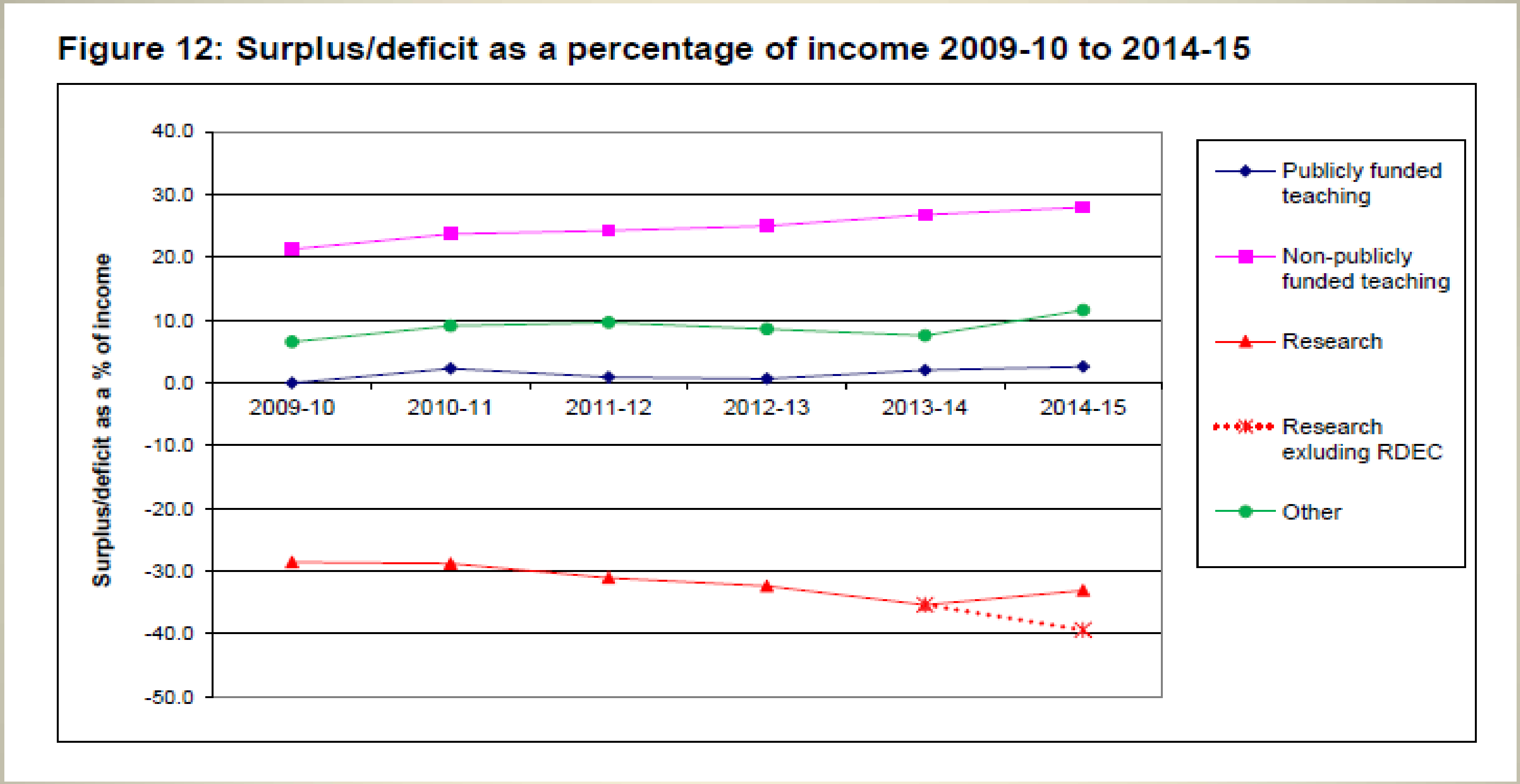
Government Covid response Schemes

- CCFF (Covid Corporate Financing Facility):
  - “paper” that Bank of England will buy
  - Very short term: only 12 months
  - Big sums, low interest: up to £1*billion*
  - Open until December
- C*L*BILS (Coronavirus *Large* Business Interruption loan scheme):
  - *Up to* 3 years, higher interest, not so big sums
    - Up to £200m or 25% of turnover
  - *Through banks*
  - *Need to have been “viable” before pandemic*
    - *Has your institution been running deficits repeatedly?*

BEIS research package

- Announced 27 June
- Not finalised detail yet
- Up to 80% of lost international fee income
  - NB!! This is against 2018/19 income *not 2020/21 projections*
  - 75% loan / 25% grant
  - Loan is likely to be 10-year, low interest
- BUT!
  - 2nd cap: amount of “non-publicly funded” research conducted at university
  - Research funded by business & charity
  - And maybe extra from “internal” funding, but this is unclear

Hefce Financial Sustainability



§91 Overall, the data shows that surpluses on non-publicly funded teaching and other activities are insufficient to support the shortfall on research, and the continuing sustainability gap for 2014-15 reflects the fact that the sector is not generating enough income to finance all of its activities and investment. £3.3 billion in 2015/16!

Borrowing

- Loans
  - Can be secured or unsecured
  - Could be Mortgages
  - Interest-only?
  - What is the repayment schedule?
  - older loans may have interest rate swaps attached
- Overdrafts
  - Usually short-term and expensive
  - Revolving credit facilities – fancier overdrafts
- Bonds
  - Public – like an interest-only loan, but designed to be tradeable on 2ndry market
    - Credit rating
  - “Private placement” – like a loan but “non-banks” “hold to maturity”
- Off-balance sheet – Special Purpose Vehicles
  - Usually student accommodation
  - Contractual terms are the issue for universities
  - Read the financial statement notes on “Interest & other finance costs”; “Creditors: longer-term”; “Lease obligations”