Monitoring underlying operating financial performance post FRS102

Outcome requested:	Finance and Investment Committee is invited to **approve:** • the cash basis target for monitoring the underlying financial performance of the University post FRS102 and • the addition of 2 internal financial KPIs
Executive Summary:	We have previously discussed moving from a surplus target to a cash target following the implementation of FRS102. This paper sets out the rationale for this decision and proposes a specific measure of performance which is a hybrid EBITDA calculation (earnings before interest, tax, depreciation and amortisation) which then also adjusts for: • capital grant receipts • changes to pension adjustments • revaluation of investments and endowments • loan interest swap • exceptional items This cash target, which is a clear measure of the underlying operating performance, will then be reconciled in the management accounts to the surplus position. Appendix 1 provides an illustration of this for our current financial forecasts, where: Table 1 shows the forecast surpluses pre-FRS102. Table 2 shows the forecast surpluses post FRS102. Table 3 shows the proposed cash earnings contribution targets and Table 4 shows the reconciliation of the cash earnings target to the forecast surplus. In order to continue monitoring our underlying financial performance it is proposed that additional internal financial KPIs are introduced for 2016/17: • Staff costs as a % of turnover excluding capital grant receipts and exceptional items. • Internal cash contribution target (as a percentage of turnover) and as an absolute measure against the long term cash target.
QMUL Strategy: strategic aim reference and sub-strategies [e.g., SA1.1]	6.1 Achieve enhanced investment in resources and facilities, for the benefit of students and staff, with an appropriate balance of contributions from across all components of QMUL

Internal/External regulatory/statutory reference points:	Statutory requirements, risk management
Strategic Risks:	11. Sustainable income streams for activities 12. Cost control, VFM and expenditure
Equality impact assessment:	Not required
Subject to prior and onward consideration by:	QMSE September 2016 FIC September 2016
Confidential:	No
Timing:	N/A
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Date:	12 September 2016
Senior Management/External Sponsor	Laura Gibbs Chief Operating Officer

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We have previously monitored our financial targets against agreed surplus targets, however this presents two challenges:

- Achieving the surplus target does not guarantee that the planned cash generation required for investment will be achieved (e.g. if non cash depreciation is £5m lower than budget but non pay spend is £5m higher than budget, the target surplus will be achieved but there will be £5m less cash available for investment).

- Post FRS102, there will be far more volatility of surplus, particularly in relation to capital grant receipts and pensions, which will distort the underlying operating position and complicate consistent target messages across the University.

If we accept that cash generation targets related directly to the underlying operating performance is a more helpful measure going forward, we then need to review which cash measure to use. The following 3 options to achieve this have been considered:

- A target based on absolute cash balances relating to operating activity –this is not recommended as movements in working capital (debtors and creditors) can distort and confuse performance against target.

- The standard EBITDA calculation (earnings before interest, tax, depreciation and amortisation). However as this figure now includes capital grant receipts it does not represent a target for our underlying operating cash performance and is therefore not recommended.

- A hybrid EBITDA calculation, this takes the EBITDA calculation but then also adjusts for:

    - capital grant receipts
    - changes to pension adjustments
    - endowment surpluses
    - exceptional items

Appendix 1 illustrates the proposed hybrid cash target in relation to our current financial forecasts, where:
Table 1 shows the forecast surpluses pre-FRS102.
Table 2 shows the forecast surpluses post FRS102.
Table 3 shows the proposed cash earnings contribution targets and
Table 4 shows the reconciliation of the cash earnings target to the forecast surplus.

This is the recommended option and if adopted will be incorporated in the management accounts, so that the Faculty / PS / central target contribution/costs reflect the hybrid EBITDA calculation with a clear reconciliation to the surplus target. As the adjustments are mainly accounted for in central the impact on current faculty / PS targets is limited to the presentation of research income, which will now show capital grant receipts for research equipment funded by research contracts separately. This has no impact on our external reporting of research activity in the financial statements or for external returns e.g. the REF except that we will now be recognising the income at the time the capital purchase is made rather than to match the depreciation cost over the life of the asset.

Finance KPIs

Due to the volatility of the surpluses under FRS102, it is noted that our two lead internal indicators of financial performance:

- Staff costs as % turnover
- Surplus as % turnover

Will continue to be calculated for external benchmarking but are less helpful in understanding our underlying financial performance internally. It is, therefore recommended that the following adjustments are made:

1. Staff costs as a % of turnover (excluding capital grant receipts and exceptional items)
2. Internal cash contribution target (as a percentage of turnover) and as an absolute measure against the cash for investment target.

Recommendation
To enable the University to better understand its underlying financial position QMSE is invited to approve:

- the cash target for monitoring the underlying financial performance of the University post FRS102 (a hybrid EBITDA calculation) and
- the addition of 2 internal financial KPIs detailed above.

Joanne Jones
Finance Director
12 September 2016

Appendix 1

Table 1 Pre- FRS 102 Surpluses	2016-17 £m	2017-18 £m	2018-19 £m
Faculty H&S	52.6	55.8	56.3
Faculty S&E	34.5	35.7	36.3
Faculty SMD	22.7	24	26.2
Professional Services / central / QMI	-96.7	-98.9	-101.2
Pre- FRS 102 Surpluses	**13.1**	**16.6**	**17.6**

Table 2 Post- FRS 102 Surpluses	2016-17 £m	2017-18 £m	2018-19 £m
Faculty H&S	52.6	55.8	56.3
Faculty S&E	34.5	35.7	36.3
Faculty SMD	36.1	24	26.2
Professional Services / central / QMI	-103.8	-109	-111.7
Post- FRS 102 Surplus (including overseas PGT growth)	**19.4**	**6.5**	**7.1**

Table 3 Proposed Underlying performance University cash target	2016-17 £m	2017-18 £m	2018-19 £m
Faculty H&S	52.6	55.8	56.3
Faculty S&E	34.5	35.7	36.3
Faculty SMD	22.7	24	26.2
Professional Services / central / QMI	-78.5	-79.4	-80.2
Underlying performance University Cash target	**31.3**	**36.1**	**38.6**

Table 4 Reconciliation of cash target to surplus	2016-17 £m	2017-18 £m	2018-19 £m
Underlying performance University Cash target	**31.3**	**36.1**	**38.6**
Non cash adjustments			
depreciation charge non cash	-32.1	-34.2	-33.5
pension liability adjustment non cash	2.2	2.3	2.2
Revaluation of investments and endowments	-0.8	-0.8	-0.8
Interest rate SWAP	0.5	0.5	0.5
Cash Adjustments			
Interest payable (excluding pension adjustment and SWAP)	-3.8	-4.9	-4.9
capital receipts H&S			
capital receipts S&E			
capital receipts SMD	13.4		
capital receipts central	8.7	7.5	5
Exceptional items			
University group surplus	**19.4**	**6.5**	**7.1**

Notes

1.The FRS102 surpluses differ from the HEFCE submission as they include the overseas PGT growth of £4.7m, £5m and £5.2m in 2016/17, 2017/18 and 2018/19 respectively

2. The interest payment has been adjusted in 2018/19 as Alumno is no longer anticipated to be a finance lease