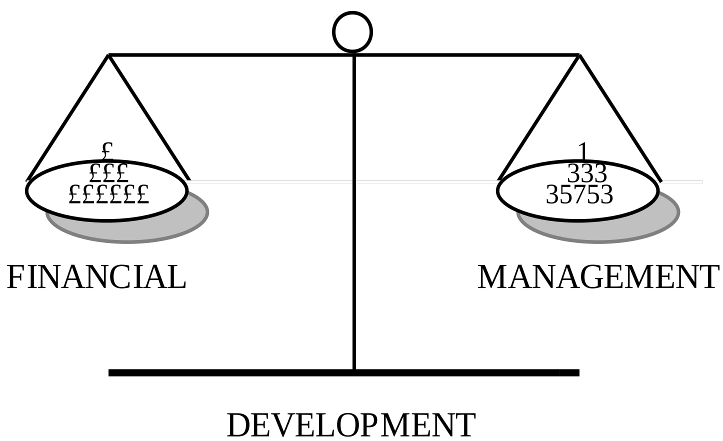
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

University Accounting

NO 161

THE INCOME AND EXPENDITURE ACCOUNT



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

THE INCOME & EXPENDITURE ACCOUNT (UNIVERSITIES)

Objective

The objective of the Income and Expenditure Account is to match earnings from activities with the costs of providing goods and services for a given period of time. It says nothing about the assets involved in generating surpluses (or deficits) nor does it necessarily indicate whether cash is being generated. However, it is a key document in assisting measurement and therefore improvement of Business Performance, which ultimately determines the sustainability of the organisation.

A surplus arises when Income exceeds attributable Cost. All incomes and all revenue costs (i.e. not the cost of assets purchased - which are capital costs) should appear in the Income and Expenditure Account. Note that it is not the cash received or paid which is shown but the amounts earned or incurred. (The Accruals concept of Accounting).

Income

Income represents amounts earned from activities during the period. It will normally be the invoiced value of goods and services provided to customers. It may therefore bear little relation to cash received. To the extent that income is generated without receiving cash the figure for debtors in the Balance Sheet will change. For a University the recognition of income can be problematic - not least because the income does not necessarily come from the customers. The key sources of income with some notes as to how income might be recognised are shown below:

<u>Grants from Funding Councils</u> - Normally received for an academic year on the basis of student numbers, grant income can therefore be recognised fairly easily as having been fully earned by the end of the year. If the grant has been based (and received) on expected student numbers and these turn out to have been lower than anticipated then there will need to be a provision for clawback i.e. the income will eventually be recognised on the actual number of students and the excess will have to be repaid. There may be recognition of extra income earned, to be received next year - if actual numbers were higher than expected and the funding body allows such additional amounts to be claimed. The recognition of income earned from grants during the academic year is fraught with problems (e.g. how much is earned in August?). Many institutions sensibly adopt a high level approach - releasing income based on proven student numbers on a monthly basis - that spreads annual income in line with costs incurred.

<u>Tuition Fees from Students</u> - For annual courses these are similar to Grants. Even if the money is received as lump sums from Student Loan Companies, it will still be shown as earned monthly. The cash flow consequences of "lumpy receipts" may have to be considered. Any provisions which may be required for potential bad debts would be treated as a cost (see below). For short courses the income is normally recognised at the completion of the course, or apportioned on the basis of days completed compared to total days if courses run over a month end. This latter approach is also used for longer courses which run over the year end.

Research Grants - Income is recognised on the basis of the percentage completed, often calculated by reference to costs incurred/total costs anticipated at completion.

Other Income - Most other income e.g. rents, catering, interest etc. are recognised when received, only allowing for accruals and prepayments if material. Donations are normally recognised when received, but can be accrued for if future receipt is certain e.g. a legacy is notified, or the tax on gift aid is claimed but not received.

Expenditure
In Retailing and Manufacturing organisations it is normal to calculate the Direct Costs of Goods sold to enable a comparison of the Gross Margin (Sales less Direct Costs) for different products. In the University sector this is often difficult as:

1. A major part of costs are staff costs (or directly related to staff time) and without a vast expenditure of effort in keeping detailed records it is not possible to allocate staff time to different "products" i.e. courses.
2. Cost allocation methods of the "overheads" premises, administration, human resources, student records, finance, etc have, of necessity, to be based on relatively arbitrary bases rather than detailed usage records, yet they often form part of the direct costs of delivering the service.
3. The increasing popularity of modular courses and the practice of allowing students to change courses mid year adds a considerable degree of complexity.

Thus many institutions have a summary Income and Expenditure Account with costs shown as staff and non-staff (analysed as appropriate) plus some form of resource allocation model, which is used for management purposes to help allocate summary totals of budgets and actual data across the academic departments, faculties or campuses.

In any event the basis for the recognition of costs is, or should be, the same as for income. Costs are recognised as incurred. Thus the cost is shown in the period when the goods and/or services are used - not when they are ordered nor when they are paid for. An example of this is the accrual at the month end on the costs of visiting lecturers who have failed to submit invoices (and any Income Tax or irrecoverable VAT which might be due on the payment).

In accounting it is generally agreed that: **It is better to be approximately right than to be precisely wrong.** Thus it is better to have an approximate accrual than to ignore expected costs merely because you do not know how much they are likely to be.

The breakdown in communications between Accountants and Actuaries on the true cost of Pension provisions during the last Century which resulted in the belated recognition of some billions of pounds worth of costs appearing in company and university accounts in this Century, is an example of what happens when you fail to accrue properly.

Classification of Overheads
Overhead analysis should always be determined by the business need. Having one account code avoids the possibility of miscoding but does not help informed analysis. Too many codes or headings causes inefficiency and destroys the value of the analyses; which is to help, not hinder informed management decision making.

Revenue not Capital Expenditure
The costs which appear in the Income and Expenditure Account are those for resources consumed. Where money is spent on substantial items which last for more than one accounting period e.g. buildings or equipment, the cost of this is effectively spread over their useful lives by "Capitalising" them i.e. putting the cost on the Balance Sheet and reducing it over the useful life by making a book entry by charging "Depreciation." Thus the purchase of an asset costing £10,000 with a five year life will result in an annual charge of £2,000. The £10,000 does not appear in the Income and Expenditure Account - but it will appear in the record of cashflows. Something similar occurs when large stocks of items e.g. stationery, are bought in one period but not used until future periods. If material these may be shown as assets on the Balance Sheet until they are used.

Bad Debts
A University may recognise income e.g. for Tuition fees or rent, but subsequently find that it cannot obtain the money. The charge for writing off these amounts will be shown separately - normally as a cost rather than as a reduction of Income.

Provisions and Contingencies
It is reasonable and indeed highly desirable, to make a provision for known future costs e.g. provision for bad debts, provision for redundancy costs, provision for pension liabilities. However these should only be for realistic items. It is not acceptable to make a contingency provision to smooth out the surplus for one year so that it can be released later to avoid a future deficit. If known future eventualities are to be provided for, this is best done by designating part of the reserves for that specific purpose.

Interest
If the University has borrowings, one of the costs will be the interest on these. To some extent this cost may be reduced by any interest earned which may be shown as income - in internal accounts these two amounts may be shown netted off.

Taxation
Most Universities are Charities and thus do not pay tax on their surpluses, nor reclaim tax on deficits! If they have substantial "Trading activity" which might be taxable, this is normally carried out through a subsidiary company which then gives its profits to the University under Gift Aid - so no tax is suffered.

If a University has to charge Value Added Tax on some activities it will show the income from those without addition of the VAT, which it collects from customers on behalf of the Government. It may be able to recover the VAT it has suffered on related costs. Otherwise costs in the Income and Expenditure Account will include any VAT charged by suppliers, since the main activity of education provision precludes recovery of VAT.

Surplus or (Deficit)
This is the amount of the difference between Income and Expenditure. For a University it is reasonable that over the long term it should generate modest surpluses. Any large or exceptional items may be worthy of separate identification. A Surplus will add to the University's Reserves in the Balance Sheet. A Deficit will reduce them.

Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

