

Financial Reporting and Activity Costing Group

***Report to the Higher Education Funding
Councils***

in

England, Scotland and Wales

July 2003

Context for the report

In July 2002 the Government published the outcome of its spending review covering 2003-04 to 2005-06. Alongside this it published *Investing in Innovation: a strategy for science, engineering and technology*, which includes actions to address concerns over the sustainability of the research base. Within this approach the Government expects universities and colleges progressively to put in place the necessary systems and policies, with a view to their individually achieving a sustainable position¹. *Investing in Innovation* went on to say:

“Given the importance of transparency to research customers and Government, and the importance of setting the right financial context for university [and college] decision-making, the Government will ask the Funding Councils to review, via an independent evaluation, how best to improve further universities’ [and colleges’] financial reporting and activity costing, building on the progress to date and balancing reporting requirements against the benefits to funding and universities [and colleges].”²

The Funding Councils decided to manage this requirement through a steering group – the Financial Reporting and Activity Costing Group (FRACG). Membership is drawn from the higher education sector and the Funding Councils, with an independent chair, Professor John Bull, formerly Vice-Chancellor of the University of Plymouth and formerly Treasurer of Universities UK. The full FRACG membership is at Appendix A.

In December 2002 the FRACG commissioned consultants KPMG to carry out work on its behalf and to focus on three issues:

- a. To assess the robustness of the Transparent Approach to Costing (TRAC) methodology for reporting full economic costs.
- b. To assess the validity of the present economic adjustments to reported expenditure made through TRAC – taking account of both the conceptual basis for the adjustments and the technical methods for calculating them.
- c. To review the present financial reporting arrangements for universities and colleges and recommend changes where these were considered necessary.

KPMG carried out its work between December 2002 and June 2003, reporting at regular intervals to the FRACG. The final report, dated 24 July 2003 from KPMG to the FRACG is

¹ Investing in Innovation: A strategy for science, engineering and technology (July 2002), paragraph 3.45

² Investing in Innovation: A strategy for science, engineering and technology (July 2002), paragraph 3.45. FRACG additional text in square brackets to clarify that requirements also extend to colleges of higher education

available on the HEFCE web-site at www.hefce.ac.uk under Good practice/Costing and Pricing.

Robustness of the TRAC methodology

The TRAC methodology was developed following the Government's 1998 comprehensive spending review and was accepted by the Science and Engineering Base Co-ordinating Committee (SEBCC) in June 1999 as meeting the Government's requirement. It has now supported reporting of full economic costs across five broad heading of activity for three years (1999-2000 to 2001-02) for all universities and colleges.

The review carried out by KPMG has confirmed that the methodology remains fit for purpose. TRAC takes the activity-based costing approach adopted by industry which has been translated successfully for use in higher education. This is the main lesson learned from other sectors and KPMG found no other sectors where there were practices that could also be translated for higher education use.

There had been a question whether changes to cost drivers could lead to changes in how indirect costs are allocated to activities. The conclusion reached, supported by data analysis at a number of universities, is that changes to cost drivers make only very marginal changes to the allocation of indirect costs (because there is a strong correlation between the key cost drivers within HEIs). This insensitivity is helpful in that it provides further confidence in the robustness of the TRAC methodology.

The main issue that has arisen from this part of the review is the best route to achieve the necessary level of assurance required by stakeholders. Assurance is required that the TRAC methodology has been applied properly and consistently in each institution so that stakeholders can have confidence in the reported full costs.

The present TRAC manual³ sets out how internal audit can provide assurance that the TRAC methodology has been applied properly and consistently. However, some stakeholders may require further assurance, with a more independent element. We are therefore recommending to the Funding Councils that they consider – with these stakeholders and with HEIs – options to provide this further assurance, bearing in mind the additional burden this will place on the HEIs. Those options could include:

- the extent to which external auditors could express an opinion on the work of internal audit in applying the TRAC methodology and the information in the annual returns to the Funding Council
- the scope for the Funding Councils' Audit Services to include reviews as part of their data audit programmes.

³ Transparent approach to costing, Volume I Overview and Implementation Pack; Volume II Reference Manual (July 2000); Volume IIa Updates and supplementary guidance (December 2002)

The Funding Councils should also consider the frequency of such work and whether a statistical sampling approach could be adopted to meet the necessary level of assurance.

Validity of the economic adjustments made to reported expenditure

HEIs are being encouraged to identify and recover the full economic costs of their activities. Present financial accounting arrangements, which apply Generally Accepted Accounting Practice, do not fully reflect economic reality as they record income and expenditure that relate to the accounting period being reported. It is therefore necessary to adjust reported expenditure so that the full economic cost of activities can be identified. This is essential if HEIs are to understand the long-term consequences of decisions and to take action to secure their long-term viability.

There are currently three adjustments made to the total expenditure reported in HEIs' audited financial statements. They cover:

- the difference between the costs of maintaining HEIs' present infrastructure in a fit and proper state and how much is actually being spent (the infrastructure adjustment)
- the amount required to cover the financing costs of the present infrastructure and to provide for investment to create new capacity (the cost of capital adjustment)
- spreading exceptional items over three years rather than the impact all falling on one year.

These adjustments were originally introduced to reveal the full economic costs of activities, rather than just what is actually spent.

The infrastructure and cost of capital adjustments are important in identifying the gap between the full economic costs of activities and the income being generated by those activities. How this gap is addressed is outside the scope of this report,

KPMG's conclusion, with which we concur, is that there is a strong case for the adjustments for both the infrastructure and the cost of capital if HEIs are to address the long-term sustainability of their operations.

However, there is scope to refine and improve the methods by which these two adjustments are calculated.

Infrastructure adjustment for buildings

KPMG examined a number of alternative valuation methods and concluded that the present use of insurance valuations to establish the value of buildings and other facilities provides

the best balance of accuracy and burden. As all HEIs already have insurance valuations and the information is updated annually we believe that the present arrangements should continue, although further work will be necessary to clarify the basis of HEIs' insurance valuations and to assess the frequency with which these should be reviewed.

Infrastructure adjustment for equipment

There is an equally strong case for the infrastructure adjustment to apply to equipment as well as to buildings. However, the range of accounting practices across the sector makes this a complex issue to resolve; and the scope of the review has not allowed this issue to be addressed in detail. Furthermore, considering the relatively short asset lives of equipment compared with buildings, it is not clear whether any subsequent difference between full costs and reported expenditure would be material.

We are therefore recommending that the Funding Councils, working with the JCPSG, carry out a pilot study to test if an infrastructure adjustment for equipment is likely to be material and justify this being included in future years.

Cost of capital adjustment

The present method for calculating this adjustment, which is linked to the profit formula for non-competitive government contracts, has been accepted as a proxy in the short-term. We accept KPMG's conclusion that this method is not an appropriate proxy in the longer-term and should be replaced by a more robust and sector-specific one.

KPMG considered a range of alternative methods and concluded that the most appropriate method to calculate this economic adjustment was:

- a risk-free rate of return on assets that would apply equally to all HEIs, plus
- a premium to reflect the risk profile of individual HEIs.

The risk-free rate of return would be based on the level of annual surplus necessary to generate the funds for future investment in physical resources. The additional premium would then reflect the relative risks depending on the mix of an HEI's activities.

We are recommending to the Funding Councils that they work with sector representative bodies – specifically with the British Universities Finance Directors Group (BUFDG) and the SCOP Finance network – to determine the risk-free rate of return and how the risk premium should be calculated.

Exceptional item adjustment

This adjustment does not represent an economic adjustment and conflicts with normal accounting practice. We are therefore recommending to the Funding Councils that the treatment of exceptional items under TRAC should be aligned with the requirements of

Financial Reporting Standard 3 – written off through the income and expenditure account in the year in which they arise – and that no adjustment be made in the annual reporting from 2003-04 onwards.

Review of the present financial reporting arrangements

HEIs have a number of routes through which financial information is reported, either publicly or to the Funding Councils. These routes have developed at different times and for different purposes. Activity reporting using the TRAC methodology was first required for reporting on data for academic year 1999-2000 to meet the government's requirements for increased transparency and accountability. We asked KPMG to consider the extent to which current reporting routes could be streamlined and to suggest areas where reporting could be further developed without increasing the burden on HEIs. We also asked KPMG to confirm the basis on which the requirements of *SSAP 25: Segmental reporting* apply in the sector for public reporting through the financial statements, and to consider alternative routes for activity-based reporting.

HEIs' published financial statements are based on accounting standards and are audited. They provide information on financial performance on a basis that informs stakeholders and other interested parties and allows them to broadly compare one HEI with another.

KPMG considered the applicability of segmental reporting to the higher education sector as defined by SSAP 25. They concluded that SSAP 25 is applicable to the higher education sector, as the SORP for Further and Higher Education Institutions requires that financial statements are prepared in accordance with applicable accounting standards. However, the standard as set out allows discretion to the directors of the entity in the definition of reportable business segments, and allows exemptions from the requirement to disclose information on a segmental basis. In addition, SSAP 25 applies to companies who exceed the criteria, multiplied by 10 in each case, for defining a medium sized company under the Companies Act. On the basis that this criterion also applies to the HE sector, a significant number of HEIs would not be required to adopt the standard. Accordingly, there would be little comparability across the sector. KPMG also concluded that it was not possible for the SORP or the Accounts Direction to be more prescriptive in respect of segmental disclosures since this would not be in accordance with the standard itself.

KPMG also considered the extent to which the objectives behind the present reporting on information on full economic costs (Transparency Review reporting provided directly to the Funding Councils) could be secured through including this information with the scope of HEIs' audited financial statements. They concluded that this was not possible, principally as the requirements went beyond present accounting standards and the adjustments were economic ones and not within the scope of normal financial reporting, based on accepted accounting practice. We concur with these conclusions.

KPMG's conclusion was that the reporting on activities was best secured through continuing with the present arrangements, whereby HEIs report annually to their Funding Council on the full economic costs across major activities. They also suggest that this reporting could be

enhanced if total income was also analysed across these major activity headings. We accept this conclusion and will therefore recommend to the Funding Councils that they discuss with HEIs expanding the annual Transparency Review return to include both income and full costs across the five headings: publicly funded teaching, non-publicly funded teaching, publicly funded research, non-publicly funded research, other.

We are aware that the Funding Councils are already reviewing the content of the Finance Statistics Return with the Higher Education Statistics Agency (HESA), with the expectation that this will lead to major reductions in the data provided through that return. We would urge the Funding Councils to bring that review to an early completion so that the data burden on HEIs can be reduced as soon as possible.

Implementation

This report includes a number of actions for the Funding Councils to take forward. Some will take longer than others to address. We would urge the Funding Councils to proceed quickly with these actions and publish a timetable for implementation as soon as possible.

Recommendations to the Funding Councils

This review has concluded that much of what is currently in place on activity costing and on financial reporting is robust and fit for purpose. However, there are areas where further improvements can be made and where some further work is necessary to refine the present methods employed.

We are, therefore, recommending to the Funding Councils that they:

- a. Confirm to stakeholders and to HEIs that the conceptual bases for the infrastructure adjustment and the cost of capital employed adjustment continue to be valid, while accepting that the following arrangements should be made for refining or reaffirming the methods for calculating the adjustments:
 - i. The insurance basis for calculating the infrastructure adjustment for buildings should be continued.
 - ii. Further work should be undertaken to clarify the basis on which HEIs insure their buildings and the frequency of periodic valuations.
 - iii. A pilot study should be carried out to test if an infrastructure adjustment for equipment is likely to be material and to justify this being added in future years.
 - iv. Work with sector representative bodies should be undertaken – specifically with the British Universities Finance Directors Group and SCOP

Finance network – to determine the risk-free rate of return and how the risk premium should be calculated.

- v. The exceptional items adjustment is not required. Exceptional items should be treated in accordance with Financial Reporting Standard 3 – written off in the year of occurrence – and that no adjustment be made in the annual reporting from 2003-04 onwards.

- b. Consider – with stakeholders and with HEIs – options to provide further assurance that the implementation of TRAC is both fair and reasonable, and robust, bearing in mind the additional burden this will place on the HEIs. Those options could include:
 - i. The extent to which external auditors could express an opinion on the work of internal audit in applying of the TRAC methodology and the information in the annual returns to the Funding Council.

 - ii. The scope for the Funding Councils’ Audit Services to include reviews as part of their data audit programmes.

- c. Consider the frequency and potential to adopt a statistical sampling approach to meet the necessary level of assurance.

- d. Confirm to stakeholders and HEIs that a more prescriptive approach to activity reporting through the published financial statements based on *SSAP 25: Segmental Reporting* would not be consistent with the requirements of the Standard or Generally Accepted Accounting Practice, and would not achieve the desired objective of reporting the full economic cost of activities consistently across the sector.

- e. Discuss with HEIs expanding the annual Transparency Review return to include both income and full costs across the five headings: publicly funded teaching, non-publicly funded teaching, publicly funded research, non-publicly funded research, other.

- f. Bring the review of the HESA Finance Statistics Return to an early completion so that the data burden on HEIs can be reduced as soon as possible.

- g. Proceed quickly with these actions and publish a timetable for implementation as soon as possible.

Financial Reporting and Activity Costing Group

Membership

Professor John Bull	Chair
Peter Darwen	Area Director, Finance Directorate, LSC
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