Help Our Scheme – Guide to Income Statement Management

What is Income Statement Risk?

The income statement is the reflection of the revenue, expenditure and viability of the Community Scheme. It provides details of the revenue mix and total expenditure incurred in the operations of the Community Scheme. Managing each of these aspects is integral to the sustainability of the Community Scheme.

Income statement risk management typically starts with the trustees/directors doing a review of all the key elements of the income statement in consultation with estate management /accountants. This will require a critical analysis of trends in both revenue/income and expense items. The key drivers of both revenue and expenses need to be reviewed. Budgets, revenue and expenditure need to be focused on around specific strategic operational objectives of the Community Scheme and prevailing regulatory requirements.

Effective risk management of the income statement will ensure that the Community Scheme makes deliberate and conscious decisions about the level of levies and the pricing of services it provides, and the extent of the expenses incurred in the generation of revenue or income and running of the operations of the Community Scheme.

The income statement is the reflection of the financial performance of the Community Scheme over a specific accounting period.

It shows how the Community Scheme accrues its revenue and income, and how it incurs its expenses from operational and non-operating activities.

Revenue

At the heart of the Income Statement of any Community Scheme is the revenue or gross income. Revenues/income need to be robust and consistent for a Community Scheme to be sustainable. The revenue dynamics of a Community Scheme need to be well understood, and potential disruptions to revenue need to be anticipated where possible and factored into budgets.

These can come about due to seasonality, payment delays, payment default, lessee/operator failure, supply chain breakdowns, political events, natural disasters, debtors' inability to pay and other socio-economic events e.g. depressed economy, low demand for services, declining prices, declining visitor numbers, unemployment, lockdowns, travel restrictions. Revenues/income should be steady, consistent and largely predictable if cash flow, expenses and costs are to be managed and covered.

The gross revenue/income of the Community Scheme needs to be continually monitored against the budget. Impacts on revenue/income can be rapid, permanent, slow or of a temporary nature, and this needs to be identified as early as possible.

True profitability/surplus is only realised when the inflow of cash from collections/levies due, sale of goods or the provision of services and investment income exceeds the outflow of cash associated with the sales made/services rendered, salaries and expenses incurred in the course of operations and general running of the Community Scheme.

All goods and services sold or rendered by a Community Scheme, need to be marked up sufficiently to not only cover their direct costs, but to make a contribution to the overhead costs and provide/result in a profit. Reliance on the cross-subsidisation of services needs to be very carefully managed, as this can severely impact the profitability, surplus and reserves of a Community Scheme.

All ancillary revenue charges and recoveries need to be budgeted for and recovered from owners and lessees where applicable e.g. leasing/rental costs of outsourced facilities, cell phone mast rentals, advertising billboards, water usage, electricity/gas usage, additional parking/mooring, recoverable meal charges, satellite TV, fibre connectivity, fines, security services, frail care services etc.

The higher the reliance on external revenues such as exit fees on the sale of units (shareblock), capital appreciation of assets (life rights), lease/rental recoveries for properties/units, rental income from cell phone masts, rental from billboard advertising or outsourced facilities such as dining rooms, restaurants, conference rooms, gyms, airfields etc. the greater the risk to the sustainable revenue base of the Community Scheme. Over reliance on other income can rapidly become a big problem, particularly if the economy declines and it becomes hard for owners to sell or if the market prices of units fall significantly. The underlying level of levies can itself become a major deterrent to potential buyers. The decline in the use of chargeable facilities where overheads are fixed, is obviously a major risk to a Community Scheme.

Profitability, Expense and Cost Management

To manage profitability and costs, a detailed understanding of the Community Scheme's revenue, expenses, cost dynamics and behaviour is required. Expenditure or operating expenses can be categorised as direct or indirect, fixed or variable. In some instances, you get semi-variable expenses. The scheme needs to analyse all its expenses and have a clear understanding of the mix and nature of them, i.e. are they fixed, variable or semi-variable, controllable or uncontrollable. Contracted costs also need to be clearly factored in and controlled e.g. monthly maintenance and service contracts, security and gardening contracts.

Accurate budgeting and tight management of expenditure within the budget are critical to achieving a budgeted surplus. Zero based budgeting also ensures that all expenditure is justified and motivated in isolation each year. While previous years expenditure will provide a guide to the level of expenditure, it should not be used to influence actual budgets.

All expenditure needs to be deliberate, justified and focused. No Community Scheme can afford wasteful expenditure or expenditure on “vanity projects” driven by Trustees/Directors.

Each of the income statement's key elements will have a material impact on the ultimate net income/surplus of the Community Scheme e.g. the level of revenue/income from levies or subscriptions/memberships, profit mark-ups on services, the level of general operating expenses, interest charges, salaries and wages, extraordinary items, expenditure arising out of contingent liabilities etc. As such, each area of the Income Statement has to be monitored and managed in line with budgets, projected run rates and essential expenditure that may be required, to ensure that an acceptable net profit/surplus will ultimately be achieved.

Particular areas of controllable expenditure are travel and entertainment, marketing and selling expenses. Notwithstanding that expenditure has been budgeted for, discretionary expenditure should still be motivated and justified before being undertaken.

The setting of levies or fees forms a critical part of the income exercise. The level of these needs to take cognisance of the overall level of expenses and costs and the regulatory requirements of establishing the required level of reserves and the building of reserves for unknown expenditure and unexpected repairs/maintenance/upgrades/improvements/projects.

Levies and fees need, however, to remain affordable to owners, fair, justifiable, realistic and collectable. Levies need to factor in the approval process at an AGM, timing lags and regulatory limitations on annual increases i.e. 10%. These also need to factor in a “margin” over the total costs/expenditure to ensure a surplus is achieved. The imposition of special levies should be the exception rather than the norm. Raising special levies to cover operating shortfalls and deficits should be a last resort. Special levies should be associated with project spend or infrastructure projects e.g. total refurbishment of buildings (as opposed to routine painting), or the building of new or the major refurbishment or upgrade of communal facilities.

Expenditure out of statutory reserves should be aligned to specific items as specified in the 10 year maintenance, repair and replacement plan (“MR&R plan”). Expenditure out of statutory reserves also needs to not only be motivated but needs the approval of the Trustees/Directors by resolution.

The raising of any debt or loans will bring with it interest expenses which will not only impact on the expense base of the Community Scheme but will need to be met out of cash flow.

Understanding how overheads grow and the relationship of expenses to each other due to increases or decreases in revenue/income, operational activity and volumes, is essential. Where a Community Scheme wants to achieve scale in certain areas of its operations, it needs to clearly understand the nature of its expenses, which expenses are largely fixed and where its revenue/income break-even levels are.

While not every expense can be anticipated, budgeting needs to factor in unexpected expenses and charges to ensure that a profit/surplus is achieved. For the same reason, a Community Scheme cannot allow unbudgeted controllable expenditure to take place if it is serious about achieving a budgeted surplus from operations/profits on services rendered.

It is not enough just to break even or show only a marginal surplus in the running of the Community Scheme. To build up meaningful reserves, the Community Scheme should be looking to build into the levy structure and the general pricing of services, sufficient margin and fat to enable not only regulatory reserve requirements to be met but additional reserves to be accumulated. This needs to become the normal practice of a Community Scheme to ensure that this objective is consistently achieved.

Managing Adverse Trends and Variances

A critical part of managing the income statement of the Community Scheme is the close monitoring of any macro trends/variances in the expenditure and revenue. The major reason for this is to try and stop/reverse or deal with any adverse situations that arise before they worsen or become entrenched.

On the revenue side this requires close monitoring of levies and ancillary income streams. Drops in volumes where services are rendered and unpaid levies can rapidly have a material impact on the income statement and in turn, cash flow. On the expense side it is important to identify which expenses have got out of control or are now reflecting a permanent negative variance to budget, and which might simply not be able to be stopped, contained and/or reversed.

In some instances, it might not be possible to change the expense dynamics or reverse the negative trend. In these cases, cutbacks in other areas may well be required to compensate for this if the income statement, cash flow and in turn the balance sheet are not to be permanently impacted.

Variance monitoring and the implementation of action steps to remedy if required, need to be done as soon as monthly management accounts become available. Leaving recurring monthly variances is not going to resolve any issues.