Supplement A to Circular 04/04

Papers Issued by the Sector Accounting Policies Group

May 2004

Contents

Accounting Treatment for Discontinued Activities

1 Colleges should ensure that they follow the requirements of Financial Reporting Standard (FRS) 3 *Reporting Financial Performance* in accounting for any discontinued activities, such as the selling of or closure of a company. FRS 3 defines discontinued operations as operations of the reporting entity that are sold or terminated and that satisfy all of the following conditions.

- The sale or termination is completed either in the period or before the earlier of three months after the commencement of the subsequent period and the date on which the financial statements are approved.
- If a termination, the former activities have ceased permanently.
- The sale or termination has a material effect on the nature and focus of the reporting entity's operations and represents a material reduction in its operation facilities resulting either from its withdrawal from a particular market or from a material reduction in turnover in the reporting entity's continuing markets.
- The assets, liabilities, results of operations and activities are clearly distinguishable, physically, operationally and for financial reporting purposes.

2 Operations not satisfying all these conditions are classified as continuing.

3 The Annex to this paper shows the necessary disclosure requirements in Casterbridge College for discontinued activities.

Effective date

4 This paper is effective for all colleges' financial statements commencing on or after 1 August 2003. Comparative information will be required for the year ended 31 July 2003.

LSC contact

Peter Darwen

Area Finance Director

27 January 2004

Click below for the necessary disclosure requirements

Casterbridge College Consolidated Income and Expenditure Account

Agency Arrangements

Introduction

5 This paper provides guidance to colleges regarding the interpretation by the Learning and Skills Council (LSC) of paragraph 67 of the *Statement of Recommended Practice: Accounting for Further and Higher Education October 2003* (SORP), titled “Agency arrangements”. The paper was approved by the Sector Accounting Policies Group at its meeting on 17 June 2003.

Background

6 The SORP states: “where the institution disburses funds on behalf of a Funding Council or other body and has no beneficial interest in the funds, the receipts and subsequent disbursement of the funds should be excluded from the income and expenditure of the institution where the FRS 5 test for the recognition of an asset is not met, that is, where the institution does not have control over the future economic benefits”.

Financial Reporting Standard 5 *Reporting the Substance of Transactions*

7 The objective of FRS 5 is to ensure that the substance of an entity’s transactions is reported in its financial statements. The standard is divided into four key areas:

- the substance of transactions
- recognition of assets and liabilities
- disclosures
- quasi-subsidiaries.

8 The core of the standard is that an entity should report the substance of the transaction into which it has entered. In determining the substance of a transaction, the following are required to be identified:

- whether the transaction has given rise to new assets or liabilities for the reporting entity
- whether it has changed the entity’s existing assets and liabilities.

9 Assets are defined as “right or other access to future economic benefits controlled by an entity as a result of past transactions or events”.

10 Liabilities are defined as “an entity’s obligations to transfer economic benefits as a result of past transactions or events”.

11 The recognition of assets and liabilities is defined as the process of incorporating an item into the primary financial statements under the appropriate heading. It involves depiction of the item in words and by a monetary amount and the inclusion of that amount in the statement totals. The standard requires recognition in the balance sheet of assets and liabilities if:

- there is sufficient evidence and existence of the item

- the item can be measured at a monetary amount with sufficient reliability.

Agency arrangements for further education colleges

12 What constitutes an agency arrangement will depend upon each individual fund and its own individual characteristics. However, the following can be considered to be agency arrangements:

- general access funds
- childcare support
- residential bursary funds.

13 The above funds are allocated by the LSC as part of further education (FE) learner support funds.

14 At present only the general access fund element of learner support funds is treated as an agency arrangement and, therefore, excluded from colleges' income and expenditure account. Childcare support and residential bursary funds are not currently treated as agency arrangements.

General access fund

15 This is a discretionary fund that covers general living and learning costs. Funds can be provided to students for a number of purposes:

- purchase of equipment
- student bursaries.

16 In addition to the above, the fund can be used to help with childcare support and accommodation needs.

17 Large items of equipment purchased from the access fund for a student's need will remain the property of the college and if returned to the institution for its own use, the access fund should be reimbursed with an amount representing the depreciated value.

Childcare support

18 Childcare support is used to support students' costs towards childcare provision. The provision should be registered but, in exceptional cases, the fund may be used for childcare that is charged for but not registered. Payments may be made to a third party, for example, a crèche or childminder.

Residential bursaries

19 These funds are intended primarily for students attending specialist colleges of agriculture and horticulture, art and design or on a course that attracts a number of students from beyond daily travelling distance. The fund can be used to help students reside in private accommodation as well as accommodation owned or managed by the institution.

Unspent funds

20 All unspent funds should be returned to the LSC.

Administration costs, interest and bank charges

21 Institutions are allowed to use up to 5 per cent of their allocation of learner support funds towards administration costs. Bank charges may not be deducted from learner support fund allocations. Interest earned on an institution's learner support accounts may be used to defray audit costs.

Meeting the requirements of the Statement of Recommended Practice

22 The key test is whether the college has any future beneficial interest in the funds. In the majority of cases the funds will be given to students to support their studies, and so the beneficial interest will be transferred from the college to the learner. Where this occurs, the funds should be excluded from the income and expenditure account. In the college's year-end financial statements there should be a separate note for each of the funds showing how they have been treated.

23 In some cases, funds might not be passed direct to the student but to a third party, in order to pay for student-related transactions, such as residential costs and equipment. In these cases, as the contract is between the college and the third party, the beneficial interest is not transferred from the college to the learner. Where this occurs, the funds should be included within the income and expenditure of the college. For example, large items of equipment purchased from the access fund for a student's need remain the property of the college.

Disclosure requirements

24 The disclosure notes for learner support funds in colleges' financial statements should be amended for income and expenditure consolidated in colleges' financial statements. The Annex to this paper discloses the required amendments to Casterbridge College model financial statements.

25 If you have any queries over the interpretation of this guidance please contact your financial statements auditor.

Ufi

26 Income and expenditure received for Ufi may also be affected by the above agency arrangements. The rules on accounting for Ufi funding is outlined in paragraph 107 of Circular 03/08 *Further Education Colleges: Accounting Policies and Return of Audited Financial Statements*. It states: "Where Ufi funding passes to organisations outside the sector the college should account for the income and expenditure gross to ensure all funding is captured within the sector's accounts. Where Ufi funding is passed to other colleges, it should be excluded from the recipient college's income and expenditure account. This will ensure the financial statements for the sector as a whole do not double count Ufi funding. Funding which is passed to other Ufi partners (for example, under franchising arrangements) should be included within the college's income and expenditure."

Requirement for new accounting policies note to the financial statements

27 Colleges are recommended to include a new accounting policies note on agency arrangements in their financial statements, for example:

> *The College acts as an agent in the collection and payment of learner support funds and as the recipient college for Ufi funding. Related payments received from the Learning and Skills Council and subsequent disbursements to students and colleges are excluded from the income and expenditure account and are shown separately in note XX.*

Effective date

28 This note is effective for all colleges' financial statements commencing on or after 1 August 2003. Comparative information will be required for the year ended 31 July 2003. Colleges should discuss with their financial statements auditors on the need for prior year adjustments, depending upon materiality.

LSC contact

Peter Darwen

Area Finance Director

23 July 2003

For the necessary disclosure requirements please click here

College Combinations – Financial Statements and Finance Record Due Dates

29 This paper clarifies the due dates of the receipt of audited financial statements and finance records for combining further education colleges by the local LSC. The paper was approved by the Sector Accounting Policies Group at its meeting on 17 June 2003.

Due date of receipt of audited financial statements

30 Paragraph 191 of Supplement D to Circular 03/08 *Guidance to the Preparation of the Notes to the Financial Statements* states the following:

> *Each of the merging corporations is required to prepare accounts to the date of dissolution. Unless directed by the Secretary of State, accounts should not be prepared for a period in excess of one year. The responsibility for completing the accounts rests first with the corporation to be dissolved. If the corporation is dissolved before the obligation can be satisfied, then the obligation passes to the new*

corporation. In a model B merger, the continuing corporation is not required to prepare a part-year set of accounts.

31 Paragraph 17 of Circular 03/08 *Further Education Colleges: Accounting Policies and Return of Financial Statements* states that colleges are required to submit their audited financial statements six months after the end of the accounting period. Therefore, the same principal should be used for college combinations. Where a corporation is being dissolved, then it is the responsibility of either the new corporation (model A merger) or continuing corporation (model B merger) to ensure that the audited financial statements of the dissolved corporation(s) are submitted to the local LSC within six months of the dissolution.

Due date of receipt of finance record

32 Colleges are also required to submit with their audited financial statements, to the local LSC, a finance record for the period. The following rules should be followed.

- If the combination occurs on 1 August, the new corporation (or continuing corporation) should ensure that the local LSC receives, within six months, a finance record for year ending 31 July for each of the pre-merger corporations.
- If the combination occurs part way through the year, a finance record is only required for the new corporation (or continuing corporation) for that year. No finance record is required for the dissolving corporation(s).

33 This will avoid double counting of college data in the LSC's database.

LSC contact

Peter Darwen

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23 June 2003

Higgs Report: *Revised Combined Code on Corporate Governance*

Introduction

34 This paper summarises the Higgs Report: *Revised Combined Code on Corporate Governance* (the Code). The paper was approved by the LSC's Sector Accounting Policies Group at its meeting on 1 October 2003.

35 The code issued in July 2003 supersedes and replaces the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998.

Main features of the Code

36 The Code's overall aim is to enhance board effectiveness and to improve investor confidence by raising standards of corporate governance. The main features of the Code are:

- new definitions of the role of the board, the chairman and non-executive directors
- more open and rigorous procedures for the appointment of directors and from a wider pool of directors
- formal evaluation of the performance of boards, committees and individual directors, enhanced induction and more professional development of non-executive directors
- the separation of the roles of the chairman and the chief executive to be reinforced
- a chief executive should not go on to become chairman of the same company
- closer relationships between the chairman, the senior independent director, non-executive directors and major shareholders
- a strengthened role for the audit committee in monitoring the integrity of the company's financial reporting, reinforcing the independence of the external auditor and reviewing the management of financial and other risks.

37 The Code incorporates the substance of Derek Higgs' and Sir Robert Smith's proposals. The main areas of difference are:

- modification of the Code's structure to include not only main "principles" and "provisions" but also supporting "principles", allowing companies greater flexibility in how they implement the Code
- the board chairman to be able to chair the nomination committee
- clarification of the roles of chairman and the senior independent director, emphasising the chairman's role in providing leadership to the non-executive directors and in the communication of shareholders' views to the board
- smaller companies below the FTSE 350 are only required to have a minimum of two independent non-executive directors
- rigorous review rather than special explanation when non-executive directors are re-elected beyond six years.

38 The intention is that provisions should be as clearly defined and verifiable as possible, so that companies can report unambiguously whether or not they have followed them. The supporting principles are cast in more general terms and leave the detailed method of implementation up to the college to decide.

39 If the Code is applicable to colleges, they will be required to make a statement on how they have applied the main and supporting principles. The statement should also include confirmation that the college complies with the Code's provisions or, where it does not comply, provide an explanation as to why this is the case.

Required action by colleges

40 As the Code will come into effect for colleges' financial year ending 31 July 2005, no action is required at this time. However, colleges need to be aware of the new Code and should consider its impact on their corporate governance.

41 The LSC is awaiting guidance from HM Treasury. Once received, guidance on the applicability and implementation of the Code will be provided to colleges.

42 Colleges can obtain a copy of the Code from the Financial Reporting Council's website (www.frc.org.uk/combined.cfm).

LSC contact

Peter Darwen

Area Finance Director

10 October 2003

Land and Buildings Owned by a Third Party – Responses to Consultation

Introduction

43 This paper gives the results of the consultation with FE colleges on land and buildings owned by third parties and outlines how their comments will be implemented by the LSC.

Background

44 On 23 December 2003 the LSC wrote to all FE colleges requesting their comments on a paper regarding land and buildings owned by a third party. The aim of the paper was to ensure colleges follow the principles of FRS 5 *Substance of Transactions* and the Statement of Recommended Practice (SORP) when accounting for land and buildings owned by third parties.

45 Colleges were requested to comment on four questions by 30 January 2004. These questions were as follows:

- Is your college fully compliant with FRS 5?
- Do you agree that all colleges should disclose a value for all land and buildings in their accounts?
- If the LSC decided to enforce the accounting policy, would it cause a problem for the college?
- Is there any further guidance on this subject which you would like the LSC to issue?

Responses

46 The LSC received replies from 175 colleges (44 per cent of FE colleges). This represents an excellent response. The LSC would like to thank colleges for so enthusiastically responding to the consultation.

47 The results of the consultation exercise is detailed in Table 1.

Table 1: Summary of consultation on land and buildings owned by a third party.

Question		Yes	No	Neither
1	Is your college fully compliant with FRS 5?	152	13	10
2	Do you agree that all colleges should disclose a value for all land and buildings in their accounts?	141	25	9
3	If the LSC decided to enforce the accounting policy, would it cause a problem for the college?	26	143	6
4	Is there any further guidance on this subject which you would like the LSC to issue?	31	138	6

48 An analysis of the responses to the questions is detailed below.

Question 1 – Is your college fully compliant with FRS 5?

49 The LSC would expect **all** colleges to be fully compliant with UK accounting standards, including FRS 5. Indeed, financial statements auditors state in their opinion whether colleges have prepared their accounts in accordance with the further and higher education SORP and UK accounting standards.

Question 2 – Do you agree that all colleges should disclose a value for all land and buildings in their accounts?

50 Of the respondents, 81 per cent (141 colleges) indicated that they agreed that all colleges should disclose a value for all land and buildings in their accounts. However, a significant minority (15 per cent of those colleges responding) indicated that it would cause a problem for them if the LSC decided to enforce the accounting policy. As 11 of the 26 colleges who indicated that it would be a problem for them are designated institutions, the LSC has consulted with the Charity Commission and amended the paper accordingly.

51 Table 2 details comments from those colleges disagreeing with Question 2.

Table 2: Comments from those colleges disagreeing with having to disclose a value for all land and buildings in their financial statements.

Number of colleges	Comment
2	No benefit to the users of the accounts
1	Should only be a note to the accounts
2	Should be taken on a case-by-case basis
1	Impossible to value

1	Cost of valuation
2	It will present an inaccurate and significantly adverse picture of the college's financial performance during the year

Question 3 – If the LSC decided to enforce the accounting policy, would it cause a problem for the college?

52 Of the respondents, 82 per cent (143 colleges) indicated that it would not cause a problem for them if the LSC enforced the accounting policy, whilst 14 per cent (25 colleges) said it would cause a problem.

53 Table 3 details comments from those colleges who indicated that it would cause a problem for them if the LSC decided to enforce the accounting policy.

Table 3: Comments from those colleges who indicated that it would cause a problem for them if the LSC decided to enforce the accounting policy.

Number of colleges	Comment
4	Extra depreciation charge will have an adverse effect on operating position
6	Cost of valuation
2	Trust issues

Question 4 – Is there any further guidance on this subject which you would like the LSC to issue?

54 Of the respondents, 17 per cent (30 colleges) requested the LSC to provide more guidance. Table 4 provides the areas on which colleges would like the LSC to provide further guidance.

Table 4: The areas on which colleges would like the LSC to provide further guidance.

Number of colleges	Comment
2	Examples of the benefits and risks that may be transferred together with indicative details of how to assess whether a substantial proportion of risks and rewards have transferred
2	More guidance on basis of calculation
1	An explanatory document to governors and trustees to aid their understanding
2	Examples of the accounting treatment used by colleges should be provided with preferred options suggested for different situations
1	If the transfer from revaluation reserve flows through the Statement of Historical Cost surpluses and deficits, the income and expenditure account will show a permanent (for the next 34 years) deficit of about £200,000. The LSC would

	need to ensure any such accounting entries do not impact upon the financial health group of the college. It would not be satisfactory to leave that decision to the local LSC
2	Guidance on how to value use of land and buildings owned by a third party
1	Guidance on any requirement to carry out periodic revaluations

Revised Paper on Land and Buildings Owned by a Third Party

Introduction

55 This paper provides guidance to colleges on the most appropriate accounting treatment for land and buildings owned by a third party, such as a trust, and held for use by the college.

Background

56 A number of colleges occupy premises which are owned by third parties and for whose occupancy no (or minimal) rental payment is required. On the whole, the type of colleges affected will be some Catholic sixth-form colleges; some agricultural colleges; some sixth-form colleges; and designated colleges. However, it is possible that all FE colleges could come under this category.

57 The position becomes more complicated when these colleges receive LSC grants for capital projects. The element of the capital project financed by the LSC will appear on the balance sheet, whilst the proportion financed by the third party might not!

Financial Reporting Standard 5 *Substance of Transactions*

58 Colleges are reminded that they should abide by the principle of FRS 5 *Substance of Transactions*. Even though the institution might not own the land and buildings it occupies, in substance all benefits and risks from using the buildings have been transferred to the institution. For example, the college could be responsible for all the repairs and maintenance of the land and buildings.

Circular 03/08 *Further Education Colleges: Accounting Policies and Return of Audited Financial Statements*

59 Paragraph 47 of Supplement D to Circular 03/08 *Guidance to the Preparation of the Notes to the Financial Statements* states that colleges which occupy premises owned by third parties should disclose in the notes to the financial statements the full circumstances, in order to give the reader of the statements an understanding of the college's position. In practice, though, some of the above colleges have opted to disclose a valuation for land and buildings on their financial statements, whilst others have not.

F&HE SORP October 2003

60 The LSC reiterates in paragraph 25 of Circular 03/08 that, in preparing their financial statements, colleges are required to follow the requirements of the Statement of Recommended Practice: Accounting for Further and Higher Education (F&HE SORP).

61 Paragraph 57 of the F&HE SORP October 2003 indicates that the following accounting policy should be applied for land and buildings owned by a third party:

> *A number of institutions occupy premises which are owned by other bodies and for which occupancy no annual or nominal rental payment is made. In some cases there may be no formal agreement to occupy. Where no formal occupancy exists, the institution may wish to consider regularising the position by the establishment of a lease or licence in respect of the premises concerned. Where an institution enjoys the use of an asset, which it does not own and for which no annual or nominal rental is paid, whether or not such use is regulated by a licence or lease, the Financial Statements must disclose this.* ***If practicable, a value should be attributed to this benefit and be capitalised, with a corresponding credit to the Revaluation Reserve, and thereafter depreciated over the period of use.***

Definition of "if practicable"

62 The F&HE SORP does not provide a definition of "if practicable". However, the LSC would normally expect a college to provide a value for its land and buildings owned by a third party. Paragraph 18 of FRS 15 *Tangible Fixed Assets* permits an asset to be excluded from capitalisation either where:

- no reliable cost or valuation can be obtained; or
- the cost of obtaining a valuation is greater than the benefit to the users of the financial statements in assessing the management's stewardship of the assets.

63 This policy must be applied on an asset-by-asset basis.

Materiality

64 The Auditing Practices Board, in its Glossary of Terms issued in March 1995, states: "Materiality is an expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole. A matter is material if its omission would reasonably influence the decisions of the users of the institution's reports and financial statements."

65 Colleges should discuss the appropriateness and materiality of the above accounting treatment with their financial statements auditors, prior to implementing the policy.

The way forward

66 The question of whether or not a college should capitalise its land and buildings, when owned by a third party, depends upon whether it has rights or other access to ongoing future economic benefit. If it does, then the asset should be recognised.

67 Economic benefit can be met through service potential as well as cash flow. The test of whether the college has “control” of the rights or other access should be taken on a case-by-case basis.

68 “Control” means the ability to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits. There are a number of possible circumstances that can arise, including the following.

- Where the land is owned by a charitable trust established in favour of a named college, then the ability of that college to control the economic benefit is clear: ongoing occupation is recognised and indeed explicit in the trust. In such circumstances, the college should recognise the use of the land and buildings as an asset. In such cases the trustees cannot, consistently with such trusts, direct the college to quit the charity premises. There should be clear disclosures relating to the accounting policy adopted and disclosure that the college does not enjoy the legal rights of ownership, for example, rights of sale or to the proceeds of sale.

- Where the land is owned by a charitable trust for an educational purpose but not linked to that educational provision being made through a specific college, there is less clarity. In such cases, the trustees would appear to have discretion as to the body that may occupy the property in the future. In the case of *Governing Body of Henrietta Barnett School v Hampstead Garden Suburb Institute* (1995) 93 LGR 470 (a school's case, not FE), the judge said that there was nothing to stop the foundation trustees in such a case from serving notice to quit, provided reasonable notice was given. In such cases it may be more problematic to argue that the college has clear rights and access to future economic benefit.

- It is possible for land to be formally leased to a college. In these circumstances the situation will be clear in that the college will have rights and access to future economic benefits and therefore should capitalise its leasehold interest.

69 Therefore, colleges must first establish the legal position of their occupation and use this to determine whether or not they should capitalise. For completeness, the accounts should state the basis of their occupation and any material conditions that may attach to their occupation.

Valuation date

70 The valuation date should be the later of:

- the date of incorporation; or

- the date of assuming occupancy.

71 For those colleges which were incorporated under section 143 of the Learning and Skills Act 2000, such as voluntary-aided sixth-form colleges,

then the valuation date should be taken as 1 April 2001, unless the date of occupancy was later than this.

Recommendation

72 When a college's land and buildings are either partly or wholly owned by a third party, such as a trust, and held for use by the institution, then the college needs to ascertain whether a value can be attributed to this benefit and capitalised, with a corresponding credit to the Revaluation Reserve. The asset will then be depreciated over its remaining estimated life.

73 If a value cannot be ascertained, then the college should disclose only in the notes to the financial statements the full circumstances, in order to give the reader of the statements an understanding of their position.

Effective date

74 This note is effective for all colleges' financial statements commencing on or after 1 August 2003. Comparative information will be required for the year ended 31 July 2003. Colleges should discuss with their financial statements auditors on the need for prior year adjustments, depending upon materiality.

LSC contact

Peter Darwen

Area Finance Director

23 February 2004

New Accounting Directives

Introduction

75 This paper provides the LSC's view regarding the relevance and interpretation of new accounting directives issued by the accounting standards board (ASB) in July 2003. The paper was approved by the LSC's Sector Accounting Policies Group at its meeting on 1 October 2003.

Background

76 As part of the strategy of gradual introduction of international standards into the United Kingdom, the ASB published on 24 July 2003 Financial Reporting Exposure Draft (FRED) 32 *Disposal of Non-current Assets and Presentation of Discontinued Operations.* The FRED continues the ASB's process of aligning UK accounting standards with international standards, as part of a managed process of change leading to the adoption of international standards for European Union listed companies from January 2005.

77 The ASB requests comments on the proposals in FRED 32 by 24 October 2003.

78 The ASB also published in July 2003 a draft Urgent Issues Task Force (UITF) abstract titled "Purchases and Sales of Own Shares". This UITF abstract is not addressed, on the grounds of its limited applicability to the sector.

Financial Reporting Exposure Draft 32 *Disposal of Non-current Assets and Presentation of Discontinued Operations*

79 FRED 32 presents proposals for a UK accounting standard based on the International Accounting Standards Board's (IASB) exposure draft, ED 4, which was published on 24 July 2003.

80 The key principles of the IASB's proposals on the measurement and presentation of discontinued operations are consistent with existing US Generally Accepted Accounting Principles (US GAAP). These include:

- the classification "held for sale" for non-current assets meeting certain criteria
- the concept of a disposal group
- the requirement that assets and disposal groups held for sale should be measured at the lower of carrying value and fair value less costs to sell
- non-depreciation of assets held for sale, either individually or within a disposal group (even if the assets are still in use)
- separate presentation on the face of the balance of assets held for sale and the assets and liabilities within a disposal group
- the definition of discontinued operations.

81 In order to qualify for treatment as "assets held for sale", management must be committed to sell the relevant assets.

82 The ASB has expressed some reservations about the proposals. These include:

- the suspension of depreciation on assets awaiting disposal that continue to be used
- the confusion that may arise from the early identification of businesses or assets held for sale, which may in due course remain as part of continuing operations.

Required action by colleges

83 No action is required by colleges at this time. However, colleges need to be aware of FRED 32 and should consider its impact on their financial statements. If in doubt, colleges should contact their financial statements auditors.

LSC contact

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Area Finance Director

10 October 2003

Organisational Reviews

Introduction

84 This paper provides guidance to colleges on the accounting treatment of exceptional support payments to colleges where an organisational review is being conducted. The paper was approved by the LSC's Sector Accounting Policies Group at its meeting on 1 October 2003.

Background

85 In March 2003 colleges in financial health group C or having the potential to move into financial health group C were allowed to bid for exceptional support funding from the LSC. This exceptional support funding was to be used to support their current financial position on the basis that they agreed to an independent organisational review leading to an agreed action plan for change. No other conditions were attached to the granting of the exceptional support.

86 Although the organisational reviews were to be conducted between April 2003 and March 2004, it was a prerequisite that the colleges' corporations consented to these reviews being undertaken and that the LSC was notified of this by 31 March 2003.

87 A total of 34 colleges successfully bid for the exceptional support funding. In the majority of cases, the funding awarded relates to the clearance of net current liabilities.

Terms of reference of the reviews

88 The terms of reference of the review set out the basis for reviewing the college to assess its ability to:

- operate on an effective basis
- provide a curriculum that meets the needs of the local area
- maintain a suitably qualified staffing structure
- invest in its infrastructure
- maintain long term financial viability
- be in a position to manage change.

Accounting treatment

89 The accounting treatment for exceptional support payments is detailed in paragraphs 43 to 45 of Supplement D to Circular 03/08 *Guidance to the Preparation of the Notes to the Financial Statements*. Paragraph 44 states the following:

> *In most cases (unless the terms and conditions indicate otherwise), exceptional support funding should be recognised as income in the college financial year in which it is received*

and disclosed separately in note 2 Funding Council Grants to the financial statements. If the amount is material to a college's financial statements, then it should be shown separately instead on the face of the income and expenditure (I&E) account in accordance with FRS 3 Reporting Financial Performance. Colleges will need to discuss the disclosure of such grants with their financial statements auditors.

90 As the payments of the exceptional support funding was made to colleges by May 2003, the income should, therefore, be recognised in their financial statements for the year ending 31 July 2003, and disclosed separately on the face of the I&E account, if material.

Effective date

91 This note is effective for all colleges' financial statements commencing on or after 1 August 2002.

LSC contact

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10 October 2003

Subsequent Expenditure on Existing Fixed Assets

Introduction

92 This paper provides guidance to colleges on the most appropriate accounting treatment for subsequent expenditure on existing tangible fixed assets, such as building refurbishments. The paper was approved by the LSC's Sector Accounting Policies Group at its meeting on 2 December 2003.

Background

93 As more funds are becoming available for colleges to implement updated property strategies, there is an increasing incidence of the capitalisation of expenditure on buildings arising in colleges' financial statements. There is a tendency for colleges to assume that all significant "project-related" expenditure on their estate is capital expenditure and account for it accordingly.

94 Where the project involves the complete demolition of a building and its replacement, there is little debate with the college that any remaining net book value of the individual building should be written out of the books and the new expenditure capitalised. However, where the work involves only a partial demolition or the substantial renovation or redevelopment of a building, for example the first two floors of a four-storey building, there is some significant room for debate.

95 If colleges adopt a policy of capitalising the additional expenditure without taking account of the existing carrying value of the building, there is a risk of

double counting, that is, the carrying value of the building could be overstated resulting in future depreciation charges being too high.

96 In paragraph 15 of Circular 03/13 *Capital Handbook*, the LSC indicates that

> *the existing £100,000 qualifying project expenditure threshold has led to the submission of relatively small expenditure projects which might otherwise be regarded as part of a college's general or long-term maintenance programme and in some cases there is doubt whether or not this expenditure can be capitalised in the college's accounts.*

97 To address these concerns, the LSC has adopted a similar approach to that of the financial memorandum whereby colleges will be eligible to seek grant support for projects related to a percentage of the college's turnover. From 1 November 2003, the minimum thresholds for capital support applications are as follows:

- £100,000 or the equivalent of 5 per cent of a college's annual turnover; or
- where the college has an annual turnover of over £10 million, this minimum threshold is pegged at £500,000.

Financial Reporting Standard 15 *Tangible Fixed Assets* Guidance

98 Relevant extracts from FRS 15 are attached to this paper. The principles regarding subsequent expenditure on existing tangible fixed assets are set out in paragraphs 37 to 41. The key issue is that the subsequent expenditure "is recognised as an addition to the asset to the extent that the expenditure improves the condition of the asset beyond its previously assessed standard of performance" (paragraph 37).

Capitalisation of expenditure

99 The issue of a capital grant does not necessarily mean that the expenditure must be capitalised. Similarly, the expenditure could be capitalised even though no capital grant is forthcoming. The capitalisation of expenditure will be largely dependent upon the accounting policies adopted by the college. However, colleges are reminded that these accounting policies should reflect the requirements of FRS 15 and guidance issued by either the Further and Higher Education Board for the Statement of Recommended Practice or the LSC.

100 Subsequent expenditure on existing fixed assets should only be capitalised if it increases the expected future benefits from the existing fixed asset beyond its previously assessed standard of performance.

101 In deciding the most appropriate accounting treatment of any subsequent expenditure, colleges must consider the following questions.

- Was the expenditure originally part of the college's long-term maintenance programme?

- Is the net book value of the existing asset plus the subsequent expenditure greater than its market value?

- Is there a **significant** prolongation of the fixed asset's useful life beyond that conferred by repairs and maintenance?

- Is there an increase in its capacity?

- Is there a **substantial** improvement in the quality of output or a reduction in the previously assessed operating costs?

- Is there a **substantial** improvement in the open-market value of the fixed asset?

- Is the college satisfied that its proposed accounting treatment (to capitalise or not to capitalise) would be no different whether it received a capital grant or not for the project?

102 The following flowchart summarises this process. If in doubt over the most appropriate treatment, colleges should contact their financial statements auditors.

Please click here

Accounting treatment where demolitions or the removal of substantial parts of the asset

103 Where the subsequent expenditure includes the demolition or removal of substantial parts of an existing building, part of the expenditure incurred would not meet the test outlined in paragraph 98 above, and part of an existing asset would no longer exist. To capitalise all the subsequent expenditure without impacting on the existing net book value could therefore overstate the value of the asset after the work was completed.

Alternative treatments

104 If the college, on implementing FRS 15 for the first time, decided to adopt a policy of revaluation, then this issue would be resolved at the next review. However, for those colleges who did not, then this option is not available. Other possible alternatives include the following.

- Obtain an estimate from the college's supporting architect of the proportion of the proposed project expenditure that adds to the asset (in line with the standard) and that which impacts the existing asset and account for the expenditure (capital or revenue) accordingly.
- Carry out an impairment review of the asset on completion of the project – the estates were valued on incorporation on a depreciated replacement cost (DRC) basis. It would be possible for the DRC to be re-computed for the building in question and any material impairment recognised on that basis.
- To the extent that any renovation was subject to a capital grant, the grant is deferred in the balance sheet and released to income and expenditure to match the depreciation charge. It would be possible to construct an argument that an element of the grant should be released in proportion to the impairment, mitigating the impact on the college's financial statements.

105 To ignore the issue entirely in the face of the growing number of projects being planned would risk the college's estate being materially overvalued. Colleges should have clear direction on the subject and should take into account the proposed accounting treatment and consequences in their grant applications and property strategies.

Effective date

106 This paper is effective for all colleges' financial statements commencing on or after 1 August 2003.

LSC contact

Peter Darwen

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4 December 2003

Extracts from Financial Reporting Standard 15 *Tangible Fixed Assets*

Summary

107 Paragraphs 34 and 35 – Subsequent expenditure undertaken to ensure that the asset maintains its previously assessed standard of performance, for example routine repairs and maintenance expenditure, should be recognised in the profit and loss account as it is incurred. Without such expenditure the depreciation expense would be increased because the useful economic life or residual value of the asset would be reduced.

108 Paragraph 36 – Subsequent expenditure should be capitalised in three circumstances, where the expenditure:

- enhances the economic benefits of the asset in excess of its previously assessed standard of performance
- replaces or restores a component of the asset that has been treated separately for depreciation purposes and depreciated over its individual useful economic life; or
- relates to a major inspection or overhaul that restores the economic benefits of the asset that have been consumed by the entity and have already been reflected in depreciation.

Detailed provisions

109 Paragraph 37 – Subsequent expenditure on a tangible fixed asset is recognised as an addition to the asset to the extent that the expenditure improves the condition of the asset beyond its previously assessed standard of performance. Examples of subsequent expenditure that results in an enhancement of economic benefits include:

- modification of an item of plant to extend its useful economic life or increase its capacity
- upgrading machine parts to achieve a substantial improvement in the quality of output.

110 Paragraph 38 – Some tangible fixed assets require, in addition to routine repairs and maintenance (which is treated in accordance with paragraph 34), substantial expenditure every few years for major refits or refurbishment or the replacement or restoration of major components. For example, a furnace may require relining every five years. In accordance with paragraph 83, for depreciation purposes an entity accounts separately for major components (for example, the furnace lining) that have substantially different useful economic lives from the rest of the asset. In such a case, each component is depreciated over its individual useful economic life, so that the depreciation profile of the whole asset more accurately reflects the actual consumption of the asset's economic benefits. Subsequent expenditure incurred in replacing or renewing the component is accounted for as an addition to the tangible

fixed asset and the carrying amount of the replaced component is removed from the balance sheet in accordance with paragraphs 72 and 73.

111 Paragraph 39 – The same approach may also be applied to major inspections and overhauls of tangible fixed assets. For example, an aircraft may be required by law to be overhauled once every three years. Unless the overhaul is undertaken, the aircraft cannot continue to be flown. The entity reflects the need to undertake the overhaul or inspection by depreciating an amount of the asset that is equivalent to the expected inspection or overhaul costs over the period until the next inspection or overhaul. In such a case, the cost of the inspection or overhaul is capitalised when incurred because it restores the economic benefits of the tangible fixed asset and the carrying amount representing the cost of the benefits consumed is removed from the balance sheet in accordance with paragraphs 72 and 73.

112 Paragraph 40 – The accounting treatment for subsequent expenditure should reflect the circumstances that were taken into account on the initial recognition of the asset and the depreciation profile adopted (or subsequent revisions thereof). Therefore, when the carrying amount of the asset already takes into account a consumption of economic benefits, for example, by depreciating components of the asset at a faster rate than the asset as a whole (or by a previous impairment of the asset or component), the subsequent expenditure to restore those economic benefits is capitalised. The decision whether to identify separate components or future expenditures on overhauls or inspections for depreciation over a shorter useful economic life than the rest of the tangible fixed asset is likely to reflect:

- whether the useful economic lives of the components are, or the period until the next inspection or overhaul is, substantially different from the useful economic life of the remainder of the asset
- the degree of irregularity in the level of expenditures required to restate the component or asset in different accounting periods; and
- their materiality in the context of the financial statements.

113 Paragraph 41 – Where it has been determined not to account for each tangible fixed asset as several different asset components or to depreciate part of the asset over a different timescale from the rest of the asset, the cost of replacing, restoring, overhauling or inspecting the asset or components of the asset is not capitalised, but instead is recognised in the profit and loss account as incurred in accordance with paragraph 34.

Annex: Casterbridge College Model Financial Statements

[insert picture 8]