Circular **04/04**

For Action: Responses to Annex A are requested by 31 December 2004 (Pilot and Pathfinder colleges) and by 31 January 2005 (for rest of sector).

Finance

Accounts Direction to Further Education Colleges for 2003/04

Summary

The purpose of this circular is to provide direction to colleges and financial statements auditors on the preparation of colleges' annual financial statements. The Learning and Skills Council (LSC) has consulted college financial statements auditors and sector representatives on this guidance. This guidance supplements that in the *Statement of Recommended Practice: Accounting for Further and Higher Education Institutions 2003* and Circular 03/08 *Further Education Colleges: Accounting Policies and Return of Audited Financial Statements*. This circular is applicable for the year ending 31 July 2004, and highlights issues for future years.

This circular is of interest to principals and chief executives of further education colleges, finance directors at further education colleges, financial statements auditors, executive directors of local LSCs and other key organisations.

Supplements A–C

Available on the LSC's website: www.lsc.gov.uk. Please refer to the contents page of this document for supplement titles.

May 2004

Learning+Skills Council

Contents

Annexes

Supplements

Executive Summary

Date: May 2004

Subject: Accounts Direction to Further Education Colleges for 2003/04

Intended recipients: Principals and chief executives of further education colleges, finance directors at further education colleges, financial statements auditors, executive directors of local Learning and Skills Councils and other key organisations.

Status: For information and response.

Content: This circular supplements the *Statement of Recommended Practice: Accounting for Further and Higher Education Institutions 2003,* Circular 03/08 *Further Education Colleges: Accounting Policies and Return of Audited Financial Statements* and consolidates all guidance on accounting policies issued since Circular 03/08.

The circular consists of the main circular, which details the changes in accounting policies guidance from Circular 03/08, and three supplements:

- Supplement A: Papers issued by the Sector Accounting Policies Group since Circular 03/08
- Supplement B: Finance Record 2003/04 Proforma
- Supplement C: Notes and Guidance on the Finance Record 2003/04.

The key changes are:

- from 2004/05 onwards, all colleges to submit their audited financial statements within five months of the financial year end
- accounting for tolerance and recovery of funds 2003/04
- revised corporate governance statement, which combines the statement of the systems on internal financial control with the corporate governance statement
- three new benchmarking schedules in the finance record, which are optional for 2003/04 but mandatory for 2004/05 onwards.

Date of response: The following should be submitted to the local LSC no later than 31 January 2005:

- audited financial statements of the college and its subsidiaries (where applicable) for the year ending 31 July 2004
- hard copy of the finance record for the year ending 31 July 2004, which has been signed by the Principal or Chief Executive of the college
- financial statements auditor's management letter, including the college's response.

The following should be submitted via the LSC's web portal no later than 31 January 2005:

- college's finance record for the year ending 31 July 2004.

Where the college has been confirmed as a Pilot or Pathfinder college for the audit of its individualised learner record, then the submission date for the above documents is 31 December 2004.

Further information

For further information, please contact the appropriate Learning and Skills Council local office, or write to:

Provider Financial Support Team
The Learning and Skills Council
Cheylesmore House
Quinton Road
Coventry CV1 2WT
www.lsc.gov.uk

Responses to this document

Responses to Annex A are requested by 31 December 2004 (Pilot and Pathfinder Colleges) and by 31 January 2005 (for rest of sector)

Enquiries

Peter Darwen
Regional Finance Director for the East Midlands
Email: Peter.Darwen@lsc.gov.uk

Accounts Direction to Further Education Colleges for 2003/04

Section 1: Introduction

Introduction

1 The purpose of this circular is to provide direction on the preparation of colleges' financial statements for the year ending 31 July 2004 and to identify issues that will require consideration for future years. This direction supplements that in the *Statement of Recommended Practice: Accounting for Further and Higher Education Institutions 2003* (the SORP) and Circular 03/08 *Further Education Colleges: Accounting Policies and Return of Audited Financial Statements,* and consolidates all guidance on accounting policies issued since Circular 03/08.

2 In publishing this guidance, the Learning and Skills Council (LSC) has consulted college financial statements auditors and sector representatives (please see paragraphs 22 to 27).

3 The LSC's accounting policies for the sector are applicable to all colleges, regardless of their size, constitution or complexity. They are not currently applicable to external institutions, private training providers or other public bodies in receipt of LSC funding.

4 The accounting policies need not be applied to immaterial items. Guidance on the determination of what is material may be found in statement 2.401 The *Interpretation of "Materiality" in Financial Reporting* issued by the Council of the Institute of Chartered Accountants in England and Wales.

Revisions to Accounting or Auditing Guidance

5 Circular 03/08 took account of Financial Reporting Standards (FRSs) up to FRS 19 *Deferred Tax* and various exposure drafts. This circular considers:

- FRS 17 *Retirement Benefits*
- Financial Reporting Exposure Draft 32 *Disposal of Non-Current Assets and Presentation of Discontinued Activities*
- International accounting standards
- Derek Higgs Report: *Revised Combined Code on Corporate Governance*
- Turnbull Combined Code Compliance
- revised corporate governance statement incorporating statement of internal financial control
- payment performance
- statement of principles for financial reporting – proposed interpretation for public benefit entities
- agency arrangements
- college combinations – due date of returns
- accounting for discontinued activities
- subsequent expenditure on existing fixed assets
- land and buildings owned by a third party

- organisational reviews
- accounting for recovery of funds 2003/04
- audit opinion 2003/04
- going concern and impairment reviews
- finance record 2003/04
- financial benchmarking in further education colleges.

6 The following Financial Reporting Exposure Drafts (FREDs) and Urgent Issues Task Force (UITF) abstracts are not addressed on the grounds of their limited applicability to the sector:

- UITF Abstract 36 *Contracts for Sales of Capacity*.

7 If colleges consider the guidance referred to in paragraph 6 may be relevant to their particular circumstances, then they should discuss accounting treatments with their financial statements auditors.

Return of Audited Financial Statements for 2003/04

8 The financial relationship between the LSC and colleges is set out in its financial memorandum as detailed in Further Education Funding Council (FEFC) Circular 99/48 *Financial Memorandum*. The financial memorandum sets out the terms and conditions on which payments of grant will be made from the LSC to institutions. A specific responsibility of the college is to provide the LSC with audited financial statements for the financial year no later than five months after the year end.

9 To take account of the new arrangements for auditing individualised learner records (ILRs), the LSC temporarily amended this requirement in Circular 02/07 and Circular 03/08 so that audited financial statements for the years ending 31 July 2002 and 31 July 2003 were to be submitted no later than six months after the year end. However, where a college was classified as a Pilot college for the audit of its ILR, then the submission date for its audited financial statements was amended to 31 December 2003.

10 For the 2003/04 audit of the ILR, 97 colleges have been classified as Pathfinders and will be subject to a reduced level of audit (once confirmed). For these colleges and Pilot colleges the submission date for their audited financial statements has been amended to 31 December 2004. For all other colleges, the submission date for their audited financial statements remains at six months after the financial year end. It is the LSC's intention to bring back the requirement of the submission of the audited financial statements to five months after the year end from 2004/05 onwards, as the abolition of retrospective clawback and the change to regularity audit in 2004/05 should mean that colleges' accounts can be closed sooner.

11 Each college should send an original signed copy of its audited financial statements for 2003/04, together with its signed finance record and, where applicable, copies of the audited financial statements of its subsidiaries, to the relevant local LSC to arrive on or before 31 January 2005 and by 31 December 2004 for Pathfinder and Pilot colleges.

12 A cover sheet for the returns is attached at Annex A to this circular.

Audit Reports and Management Letters

13 Colleges should send a copy of the final version of the financial statements auditor's management letter, including the college response, to the relevant local LSC by 31 December 2004 (for Pilot and Pathfinder colleges) and 31 January 2005 (for the rest of the sector).

14 Financial statements auditors are reminded that where they are unable to express an unqualified opinion on the college's

financial statements, they should immediately communicate this to the principal, the chair of the corporation and the chair of the audit committee. They should also inform the head of finance at the relevant local LSC.

Guidance

15 Colleges with queries on how to apply the LSC's guidance on accounting policies to the particular circumstances of their own college may wish to consult their financial statements auditors or the local LSC. Colleges wishing to make general points about the development of accounting guidance should contact Peter Darwen, the Regional Finance Director for the East Midlands (Peter.Darwen@lsc.gov.uk).

Approval of Reports and Financial Statements

16 The reports and financial statements must be approved by the corporation. They should be signed and dated as follows.

- The members' report should be signed and dated by the chair of governors on behalf of the corporation.
- The balance sheet should be signed and dated by the principal and one other member of the corporation, usually the chair of governors; the director of finance is not required to sign it.
- The statement of the responsibilities of the members of the corporation should be signed and dated by the chair of governors.
- The revised corporate governance statement should be signed and dated by the chair of governors and the principal.

17 The above items should normally be signed on the same date. They must also be signed on or very shortly before the date on which the college's financial statements auditor signs and dates its audit report.

Section 2: The Development of Accounting Policies for the Further Education Sector

Statement of Recommended Practice: Accounting for Further and Higher Education Institutions

18 For all accounting periods commencing on or after 1 August 1999 all further education (FE) institutions have had to prepare their financial statements in accordance with the requirements of the *Statement of Recommended Practice: Accounting for Further and Higher Education Institutions* (the SORP). In October 2003 the Higher Education/Further Education Board for the SORP (the HE/FE SORP Board) issued a revised SORP, which is effective for all accounting periods commencing on or after 1 August 2003. The LSC would like to reiterate that the revised SORP is the primary document to be followed by colleges. A copy of the SORP may be downloaded from the LSC's website (www.lsc.gov.uk/National/Partners/PolicyandDevelopment/FEcolleges-Finance/sapg.htm).

19 The SORP is intended to apply to all colleges, including voluntary aided sixth-form colleges, voluntary controlled sixth-form colleges and specialist designated institutions. Where these bodies are constituted as companies limited by guarantee they should follow the SORP with any additional disclosures required to comply with the *Companies Act 1985*.

20 As the further and higher education sectors have special financial and reporting issues that are different from other organisations that have charitable status, the Further and Higher Education SORP takes precedence over the Charities SORP. Where a college is a separate registered charity and seeks clarification on the basis on which to prepare its accounts, then it should discuss its position with its financial statements auditors and the local LSC.

21 The Accounting Standards Board (ASB) wishes to see the continuance of a high-quality SORP for the further and higher education sectors. To meet this objective, the LSC has agreed the following with the HE/FE SORP Board.

- The HE/FE SORP Board will issue accounts direction on any necessary amendments to the SORP. This accounts direction is published by the LSC through its annual accounting policies circular. This ensures that all institutions in the further and higher education sectors prepare financial statements on a comparable and consistent basis.
- Additional disclosure requirements, such as corporate governance statements, are issued by individual funding councils.

Sector Accounting Policies Group

22 The LSC wished to introduce a proactive and interactive approach to the development of guidance on accounting policies to the sector. In January 2002 the Sector Accounting Policies Group was formed.

23 The membership of this group includes representatives from:

- college financial statements auditors
- the Association of Colleges
- the college finance directors' group
- the Department for Education and Skills
- Higher Education Funding Council for England
- Education and Learning Wales
- Scottish Funding Councils
- local LSCs.

24 The group's aims are to encourage colleges to consider new guidance on accounting policies as early as possible and to provide a forum for the bringing together of any issues and/or problems over their implementation. The LSC wishes to inform the sector of the decisions of the Sector Accounting Policies Group on a timely basis. The group meets every two to three months with the publication of the minutes of the meetings and relevant papers through the LSC's website. For further information on papers published, reference should be made to www.lsc.gov.uk/National/Partners/PolicyandDevelopment/FEcolleges-Finance/sapg.htm.

25 Since the publication of Circular 03/08, the following papers have been published:

- FRED 32 *Disposal of Non-Current Assets and Presentation of Discontinued Activities*
- *Agency Arrangements*
- *College Combinations – Due Date of Returns*
- *Subsequent Expenditure on Existing Fixed Assets*
- *Land and Buildings Owned by a Third Party*
- *Organisational Reviews*
- Derek Higgs Report: *Revised Combined Code on Corporate Governance*.

26 For ease of reference, the above papers have been provided in Supplement A to this circular.

27 It is expected that the Sector Accounting Policies Group will feed back to the HE/FE SORP Board issues over the implementation of accounting directives from the ASB.

Section 3: Update to the Statement of Recommended Practice

28 The accounting guidance on the following FRSs and FREDs have been issued after consultation with the HE/FE SORP Board.

Financial Reporting Standards

Financial Reporting Standard 17 *Retirement Benefits*

29 Under the transitional arrangements of the FRS, there is no requirement to implement the accounting standard fully until the year ended 31 July 2005. The LSC recommends that colleges do **not** adopt the standard early and fully implement FRS 17 in the current year in the light of ongoing discussions and debate nationally in respect of this accounting standard. Colleges should ensure that, for their financial statements for the year ended 31 July 2004, they disclose in a note to the accounts what entries would be made in the financial statements if the FRS were fully implemented. These are the same disclosure notes as those required for colleges' financial statements for the year ended 31 July 2003.

Financial Reporting Standard 17 valuations at 31 July 2002 and 31 July 2003

30 As at 24 November 2003, the LSC had received 397 out of an expected 408 financial statements and 385 finance records from colleges. These returns indicate that there is a total net pension liability of £430 million as at 31 July 2002.

31 On 15 October 2003 a letter was sent to colleges asking them to provide details of their net pension asset or liability for the year ending 31 July 2003. By 24 November 2003 the LSC had received details from 242 colleges, who had a total net pension liability of £504 million. If the 242 college returns were extrapolated to estimate the liability for the whole sector (395 colleges), the net pension liability would be in excess of £835 million.

32 Unless the stock market continues to improve, it is likely that the next actuarial review of the local government pension schemes (LGPS) due in April 2004 will result in higher contributions.

Financial Reporting Exposure Drafts

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

33 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.

34 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.

35 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.

International Accounting Standards

36 For accounting periods beginning on or after 1 January 2005, the UK's listed companies must use European Union-adopted international accounting standards in their group financial statements. Although it is not known at this stage whether FE colleges will have to follow the same rules, it would appear to be inevitable as the ASB is reviewing all of its existing accounting standards to ensure compliance.

37 Colleges should continue to prepare their financial statements using the principles outlined in the SORP. It is expected that guidance on the implementation of international accounting standards will be issued by the HE/FE SORP Board at a later date.

Section 4: Other Guidance

38 The following guidance has been issued by the Sector Accounting Policies Group since the publication of Circular 03/08. For further details, please refer to Supplement A of this circular.

Higgs Report: *Revised Combined Code on Corporate Governance*

39 In July 2003 the Financial Reporting Council issued the Higgs Report: *Revised Combined Code on Corporate Governance* (the Code). This Code supersedes the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998.

40 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 chair 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 chair and the chief executive to be reinforced
- a chief executive should not go on to become chair of the same company
- closer relationships between the chair, the senior independent director, non-executive directors and major share holders; and
- 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.

41 Although the Code is effective for reporting periods beginning on or after 1 November 2003, there is currently no indication of any mandatory application of the Code on FE colleges. However, colleges need to be aware of the new Code and should consider its impact on their corporate governance.

Turnbull Combined Code Compliance

42 It is expected that all colleges will now be able to make a full compliance statement with the requirements of Turnbull's Combined Code in their financial statements for the year ended 31 July 2004.

Revised Corporate Governance Statement Incorporating Statement of Internal Control

43 In 1999 the FEFC drew colleges' attention to best practice in aspects of corporate governance by requiring the principal, as accounting officer, to make a statement on the system of internal financial control of the college. After the publication of Turnbull's Combined Code, the LSC added to this requirement, by asking the chair of governors to make a statement on the corporate governance of the college.

44 In the interests of cutting bureaucracy, the LSC has decided to combine the two statements. The revised corporate governance statement incorporating the statement of internal control is provided at Annex B to this circular. The statement must be signed jointly by the principal as accounting officer and the chair of the board.

45 Previous LSC and FEFC guidance on the two corporate governance statements recommended minimal changes to the wording of the model examples. However, as

colleges are different in complexity and size, there is a need to change this requirement. Therefore, the statement at Annex B should be tailored to the college's own requirements, showing:

- what work had been done to embed risk management in the corporate governance of the college; and
- what assurance can be gained by the reader of the college's accounts.

46 The LSC has considered whether it would be useful to provide a checklist to help colleges prepare their revised corporate governance statement, but has decided against this approach because:

- risk management processes and controls will vary between colleges depending upon the size and complexity of the risk
- embeddedness means a continuous process of managing risk
- the danger of a "tick box" approach when there is a need to think outside the box.

Payment Performance

47 In Circular 03/08 the LSC indicated that for all accounting periods commencing on or after 1 August 2003 colleges must include, in the members' report of the financial statements, a statement on their payment performance during the period.

48 On 3 June 2003 the LSC presented a seminar on Circular 03/08 and its requirements at the Association of Colleges (AoC) College Finance Directors' annual conference. Unfortunately, the feedback in the seminar indicated that a significant number of colleges were finding it difficult to comply with the new payments performance requirement.

49 After discussing their concerns with the Sector Accounting Policies Group on 17 June 2003, the LSC decided to waive the mandatory requirement, and this change in policy was relayed to all colleges in a letter from Peter Darwen dated 23 June 2003. This waiver remains in place for colleges' financial statements ending 31 July 2004. However, as the LSC regards the payment performance statement to be of benefit to all users of colleges' financial statements, it recommends that colleges should look at implementing the policy when practically possible.

Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities

50 In May 2003 the ASB issued the discussion paper Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities. This discussion paper explains how the Statement of principles should be interpreted in financial reporting by public benefit entities, such as colleges. Comments on the discussion paper were requested to be received by the ASB by 1 August 2003.

51 No action is required by colleges at this time. However, colleges need to be aware of this discussion paper and should consider its impact on their financial statements.

Agency Arrangements

52 This paper provides supplementary guidance to paragraph 67 of the SORP, titled *Agency Arrangements*. The paper covers the accounting rules for learner support funds and/or recipient colleges of Ufi funding. It recommends that a new accounting policies note on agency arrangements and an amended learner support funds note should be provided in colleges' financial statements. The guidance note is effective for all college financial statements commencing on or after 1 August 2003.

College Combinations – Financial Statements and Finance Record Due Dates

53 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.

Accounting for Discontinued Activities

54 Colleges should ensure that they follow the requirements of FRS 3 *Reporting Financial Performance* in accounting for any discontinued activities, such as, the selling of, or closure of a company.

55 FRS 3 defines discontinued operations as operations of the reporting entity that are sold or terminated and that satisfy all 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.

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

57 An example of the necessary disclosure requirements in Casterbridge College for discontinued activities is provided in Supplement A to this circular.

Subsequent Expenditure on Existing Fixed Assets

58 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 college 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. There is, however, a risk of 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 capital grant applications and property strategies.

59 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.

60 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 the fixed asset's 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?

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

Land and Buildings Owned by a Third Party

62 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 SORP when accounting for land and buildings owned by third parties.

63 The following paragraphs represent a summary of the revised paper on land and buildings owned by a third party. For further details and an analysis of the responses to the consultation, colleges should refer to Supplement A of this circular.

Revised paper on land and buildings owned by a third party

64 The question on 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.

65 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.

66 "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 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.

67 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.

68 If the college ascertains that it should be attributing a value for the use of the asset, then this value should be capitalised, with a corresponding credit to the Revaluation Reserve. The asset will then be depreciated over its remaining estimated life. If the college ascertains that it should not be attributing a value for the use of the asset, 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.

Organisational Reviews

69 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. The paper provides guidance to colleges on the accounting treatment of exceptional support payments to colleges where an organisational review is being conducted.

Arrangements for the Recovery of Funding for Underachievement against Funding Agreement

70 The arrangements for the recovery of funding for underachievement against funding agreements for the year ending 31 July 2004 are set out in Circular 04/03 *FE ILR Funding Claims 2003/04 Funding: ILR Interim and ILR Final Funding Claims 2002/03.* Therefore, there will be:

- no recovery of funds or reduction in subsequent years' allocations for colleges achieving 97 per cent or more of their planned activity in 2003/04 (the 3 per cent "tolerance" mechanism)
- the opportunity for colleges achieving below 97 per cent of planned activity to bring themselves within the 97 per cent threshold by returning baseline funds for 2003/04 and 2004/05
- payment in full for overdelivery in key priority areas, such as 16–18 growth and basic skills

71 Where the college has been classified and confirmed as a Pathfinder college for the audit of its ILR, then it will not suffer any recovery of funding for underperformance.

72 Colleges are reminded that those colleges failing to achieve the return deadlines set out below:

- may not benefit from the new tolerance arrangements; and
- will have their funding based on the actual level of activity delivered in the year, subject to the de minimis limit of £5,000, in respect of clawback of funds.

Deadlines

73 Table 1 shows that there are a series of deadlines which colleges are facing over the coming months.

Table 1: Recovery and tolerance deadlines

Event	Further education college	Further education college (Pilot and Pathfinder)	Date of recovery of funds
Agreement with local LSC to reduce 2003/04 and 2004/05 allocation, where activity is expected to be below 94%	30 July 2004	30 July 2004	No later than 20 August 2004
Submission to local LSC of 2003/04 ILR year-end outturn claim	31 August 2004	31 August 2004	
Submission to local LSC of ILR interim claim 2003/04	31 December 2004	30 November 2004	
Submission of interim audit opinion 2003/04	31 December 2004		
Submission to local LSC of Pilot or Pathfinder audit report 2003/04		30 November 2004	
Submission to local LSC of colleges' 2003/04 financial statements and finance record	31 January 2005	31 December 2004	
Agreement with local LSC to reduce 2003/04 and 2004/05 allocation, where activity is between 94% and 97%	31 January 2005	31 January 2005	No later than 20 February 2005
Submission to local LSC of ILR final claim 2003/04	11 February 2005	31 January 2005	
Submission of final audit report 2003/04	11 February 2005		
Recovery of funds where activity below 97%			March, April and May 2005
Recovery of funds regardless of 3% tolerance where deadlines for submission of ILR returns not met			March, April and May 2005

Treatment of the Tolerance and Recovery of Funding in Colleges' 2003/04 Financial Statements

74 The accounting treatment of the tolerance and recovery of funding in colleges' 2003/04 financial statements is summarised by the flowchart at Annex C to this circular.

75 Where colleges achieve at least 97 per cent of their planned activity (based on the ILR auditor's interim opinion), the LSC's expectation is that they will recognise 100 per cent of their allocation in the financial statements. However, at the time of finalising their financial statements, colleges should consider the likelihood of achieving the 11 February 2005 final return deadline, in forming a view on the level of income to include in the accounts (that is, potentially not including the tolerance within income). If the college believes it will not meet this final return deadline, and wishes to exclude the tolerance from income, it should be treated either as a payment on account or a provision. It is recommended that colleges discuss the most appropriate treatment with their financial statements auditors.

76 *For example, although the ILR auditor's interim opinion indicates a college is likely to achieve at least 97 per cent of its planned activity, the college has had a history of late ILR final claims being submitted to the local LSC. Therefore, as a prudent measure, the college wishes to exclude amounts up to the 3 per cent de minimis limit (for example, 2 per cent if at 98 per cent for each interim opinion) from its income for the year. After discussions with their financial statements auditors, the college makes a provision for the tolerance.*

77 Colleges expecting to achieve between 94 per cent and 97 per cent of their planned activity (based on the interim opinion) would be expected to agree with the local LSC by 31 January 2005 the return of funds to bring them to the 97 per cent threshold. In this situation, whilst the local LSC expects that the 3 per cent tolerance should be recognised as income in the accounts, individual circumstances should once again be taken into account in determining the most appropriate accounting treatment.

78 *For example, if the interim opinion indicates the college will achieve 95 per cent of its allocation, the income recognised in the accounts could be either 98 per cent or 95 per cent. In both cases, the 2 per cent of allocation should be included in the 2003/04 financial statements as a creditor due within one year. Whilst the LSC expects that the 3 per cent tolerance should be recognised as income in the accounts, individual circumstances should once again be taken into account. If it appears likely that the deadlines will not be met, and the college does not wish to include the tolerance within income, it may be more appropriate to recognise the amount as a provision rather than a payment on account. An appropriate narrative should also be included in the financial statements in relation to this.*

79 Colleges expecting to achieve below 94 per cent of their planned activity (based on the interim opinion) that **have not** negotiated a reduction in their allocation by 30 July 2004 should account for the recovery of funds in full and show the amount as a creditor due within one year.

80 *For example, if the ILR auditor's interim opinion indicates the college is estimated to achieve 92 per cent of its allocation, a creditor due within one year should be included in the 2003/04 financial statements for 8 per cent of the allocation.*

Unplanned growth funding

81 Where colleges have evidence of over-achievement in areas eligible for growth funding based upon the interim opinion, the LSC expects the overachievement to be included within debtors.

2004/05 financial statements

82 Where a college has adjustments relating to its 2003/04 allocation from the LSC (for example, where the 3 per cent tolerance is not recognised in the accounts and the college achieves the February 2005 deadline and is therefore entitled to the this funding and/or where the college's final outturn differs from the estimated outturn based on the interim opinion) the college should show the difference between its final 2003/04 outturn and that recognised in the 2003/04 accounts as a separate line in the funding council grants note under the heading "adjustment to recurrent funding in relation to prior year". This could result in either a positive or negative adjustment in 2004/05.

83 A flowchart summarising the above actions effect on colleges' financial statements is provided at Annex C.

Audit Opinion 2003/04

84 In September 2002 the LSC provided a revised model audit opinion for 2001/02, which was to be used by the college's financial statements auditor when issuing the standard unqualified audit opinion for the year ending 31 July 2002.

85 In January 2003 the Institute of Chartered Accountants in England and Wales (ICAEW) issued Technical Release 01/03 *The Audit Report and Auditors' Duty of Care to Third Parties*. This technical release was in response to the *Royal Bank of Scotland v Bannerman* case, which concerned the duty of care owed by a firm of accountants (Bannerman) to its client's bankers.

86 Since this date audit firms have been adding disclaimers to their audit opinions on colleges' financial statements for the years ending 31 July 2002 and 31 July 2003. These disclaimers state that no responsibility is owed other than to the college corporation. The LSC's position remains that these disclaimers are unacceptable, and that it will continue to rely on such audit reports. Where such disclaimers were included in colleges' audit reports, the local LSCs have written to the colleges and the financial statements auditors rebutting the disclaimer.

87 The LSC has not issued a model audit opinion since September 2002, as it has been trying to resolve the duty of care issue with the auditors. It is hoped that these issues will be resolved in the coming months. Subsequently, the LSC plans to consult the Sector Accounting Policies Group and publish a revised model letter of engagement and audit opinion for use by the financial statements auditors of colleges' 2003/04 financial statements.

Going Concern and Impairment Reviews

88 Where colleges and/or their financial statements auditors have concerns about the appropriateness of the value of assets or the use of the going concern basis for the preparation of accounts, they should contact the LSC's national director of finance and the executive director at the relevant local LSC.

Finance Record 2003/04

89 The finance record was designed to be an electronic version of the audited financial statements. When the LSC wishes to refer to the financial performance of the sector or of individual colleges (for example, when making submissions to ministers or publishing bench-marking information), it uses the finance record as its source.

90 For the 2003/04 finance record, colleges are requested to:

- send a signed paper copy of their finance record with the audited financial statements to the local LSC by 31 January 2005; and
- submit an electronic copy over the LSC's web portal.

91 Where a college does not have an Internet connection with sufficient capacity to return data in this way, it may arrange with its local LSC to use its connection. A designated computer will be set aside to enable it to transfer the data to the LSC database via the secure portal.

92 Supplement B of this circular provides a copy of the finance record and Supplement C provides notes and guidance on the completion of the finance record, including the instructions on using the web portal. Colleges should download the finance record worksheet from the LSC's website and return the worksheet via the web portal by 31 January 2005.

93 Where the college has been confirmed as a Pathfinder or Pilot college, the return date for the financial statements and finance record is 31 December 2004.

Financial Benchmarking in Further Education Colleges

94 Each year, the LSC carries out a benchmarking exercise in respect of FE colleges. The LSC has been considering for some time now how it can improve its support to FE colleges, and one way that has been identified is through the improvement of this benchmarking facility.

95 Therefore, the LSC has included three extra schedules to the 2003/04 finance record, which will be used as a basis for providing colleges with extra benchmarking data. The advantages to colleges are as follows.

- Presentation of data is improved, so that value comparisons as opposed to percentage comparisons can be shown.
- Spurious accuracy is removed so that only high-level comparisons are shown.
- Family groups (for comparison purposes) have been redefined on the basis of size, college type and widening participation factors.
- Family groups may be amended with ease to show different comparisons.
- Financial data in respect of colleges in financial health group C is excluded from the comparison data, thereby only showing a comparison against good or acceptable levels of financial performance.

96 Colleges which participate in this exercise will receive a detailed report that clearly shows how their financial position compares against a nominal college of their size and situation – based on financial data from colleges in financial health groups A and B.

97 The LSC is fully aware of the need to minimise the level of information requests that are made on colleges, and so for this first year it is making the completion of the additional schedule **optional**, albeit strongly recommended for colleges in financial health group C. However, in order to provide robust benchmark comparisons, the LSC needs a large number of colleges in all financial health groups to complete the additional schedules. It is hoped, therefore, that as many colleges as possible will be able to assist the LSC in this exercise.

98 The LSC has consulted with the College Finance Directors' Group (CFDG) and AoC in taking this project forward. This project has been recognised as being of benefit to colleges. The LSC would like to make the completion of the additional schedules mandatory for colleges' 2004/05 finance records. Prior to taking this action, though, the LSC has agreed to consult with colleges regarding this change, once the first year's exercise has been completed. This consultancy will probably take place early in 2005.

Next Sector Accounting Policies Group Meeting

99 The next meeting of the Sector Accounting Policies Group is on 22 June 2004. If you wish the group to publish any guidance on accounting policies, please contact Peter Darwen (Peter.Darwen@lsc.gov.uk).

Annex A: Cover Sheet for the Return of Audited Financial Statements and Finance Record for the Year Ended 31 July 2004

Cheylesmore House
Quinton Road
Coventry
CV1 2WT
T 024 7682 3264
F 024 7682 3334
www.lsc.gov.uk

Reference: Circular 04/04

This cover sheet must be completed by all colleges. Please photocopy, complete and return to the relevant local LSC office by 31 January 2005 or for Pilot and Pathfinder colleges by 31 December 2004.

Learning+Skills Council

Name of college *(please print)*
Code
Contact for queries *(please print)*
Telephone no.

Returns enclosed (please tick)

- One signed copy of the college's audited financial statements for 2003/04. ☐
- One signed paper copy of the college's finance record for 2003/04. ☐
- One copy of each of the college's subsidiary undertakings audited financial statements for 2003/04.* ☐
- One copy of the financial statements auditor's management letter for 2003/04, including college response. ☐
- *If these accounts have not yet been signed please return an unsigned copy indicating when you expect to be able to forward a signed copy. ☐

Annex B: Revised Corporate Governance Statement Incorporating Statement of Internal Control

Please refer to paragraphs 43 to 45 of the main circular for further information on Annex B.

Revised Corporate Governance Statement (Full Compliance)

1 The College is committed to exhibiting best practice in all aspects of corporate governance. This summary describes the manner in which the College has applied the principles set out in Section 1 of the Combined Code on Corporate Governance issued by the London Stock Exchange in June 1998. Its purpose is to help the reader of the accounts understand how the principles have been applied.

2 In the opinion of the governors, the College complies with all the provisions of the Combined Code in so far as they apply to the further education sector, and it has complied throughout the year ended 31 July 2004.

The Corporation

3 The composition of the Corporation is set out on page .... It is the Corporation's responsibility to bring independent judgement to bear on issues of strategy, performance, resources and standards of conduct.

4 The Corporation is provided with regular and timely information on the overall financial performance of the College together with other information such as performance against funding targets, proposed capital expenditure, quality matters and personnel-related matters such as health and safety and environmental issues. The Corporation meets each term.

5 The Corporation conducts its business through a number of committees. Each committee has terms of reference, which have been approved by the Corporation. These committees are finance and general purposes, remuneration, search and audit.

6 All governors are able to take independent professional advice in furtherance of their duties at the College's expense and have access to the Clerk to the Corporation, who is responsible to the Board for ensuring that all applicable procedures and regulations are complied with. The appointment, evaluation and removal of the Clerk are matters for the Corporation as a whole.

7 Formal agendas, papers and reports are supplied to governors in a timely manner, prior to Board meetings. Briefings are also provided on an ad hoc basis.

8 The Corporation has a strong and independent non-executive element and no individual or group dominates its decision-making process. The Corporation considers

that each of its non-executive members is independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

9 There is a clear division of responsibility in that the roles of the Chair of the Corporation and Principal of the College are separate.

Appointments to the Corporation

10 Any new appointments to the Corporation are a matter for the consideration of the Corporation as a whole. The Corporation has a search committee comprising … which is responsible for the selection and nomination of any new member for the Corporation's consideration. The Corporation is responsible for ensuring that appropriate training is provided as required.

11 Members of the Corporation are appointed for a term of office not exceeding four years.

Remuneration Committee

12 Throughout the year ending 31 July 2004, the College's remuneration committee comprised …. The committee's responsibilities are to make recommendations to the Board on the remuneration and benefits of the Principal and other senior postholders.

13 Details of remuneration for the year ended 31 July 2004 are set out in note … to the financial statements.

Audit Committee

14 The audit committee comprises three members of the Corporation (who exclude the Principal and Chair). The committee operates in accordance with written terms of reference approved by the Corporation. Its purpose is to advise the Corporation on the adequacy and effectiveness of the college's systems of internal control and its arrangements for risk management, control and governance processes.

15 The audit committee meets on a termly basis and provides a forum for reporting by the College's internal and financial statements auditors, who have access to the committee for independent discussion, without the presence of College management. The committee also receives and considers reports from the LSC, as they affect the College's business.

16 Management is responsible for the implementation of agreed audit recommendations, and internal audit undertakes periodic follow-up reviews to ensure such recommendations have been implemented.

17 The audit committee also advises the Corporation on the appointment of internal and financial statements auditors and their remuneration for both audit and non-audit work.

Internal Control

Scope of responsibility

18 The Corporation is ultimately responsible for the College's system of internal control and for reviewing its effectiveness. However, such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can provide only reasonable and not absolute assurance against material misstatement or loss.

19 The Corporation has delegated the day-to-day responsibility to the Principal, as Accounting Officer, for maintaining a sound system of internal control that supports the achievement of the College's policies, aims and objectives, whilst safeguarding the public funds and assets for which he or she is personally responsible, in accordance with the

responsibilities assigned to him or her in the Financial Memorandum between the College and the Learning and Skills Council (LSC). He or she is also responsible for reporting to the Corporation any material weaknesses or break-downs in internal control.

The purpose of the system of internal control

20 The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of college policies, aims and objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively and economically. The system of internal control has been in place in Casterbridge College for the year ended 31 July 2004 and up to the date of approval of the annual report and accounts.

Capacity to handle risk

21 The Corporation has reviewed the key risks to which the College is exposed, together with the operating, financial and compliance controls that have been implemented to mitigate those risks. The Corporation is of the view that there is a formal ongoing process for identifying, evaluating and managing the College's significant risks that has been in place for the period ending 31 July 2004 and up to the date of approval of the annual report and accounts. This process is regularly reviewed by the Corporation.

The risk and control framework

22 The system of internal control is based on a framework of regular management information, administrative procedures including the segregation of duties, and a system of delegation and accountability. In particular, it includes:

- comprehensive budgeting systems with an annual budget, which is reviewed and agreed by the governing body
- regular reviews by the governing body of periodic and annual financial reports which indicate financial performance against forecasts
- setting targets to measure financial and other performance
- clearly defined capital investment control guidelines
- the adoption of formal project management disciplines, where appropriate.

23 The College has an internal audit service, which operates in accordance with the requirements of the LSC's Interim Audit Code of Practice. The work of the internal audit service is informed by an analysis of the risks to which the college is exposed, and annual internal audit plans are based on this analysis. The analysis of risks and the internal audit plans are endorsed by the Corporation on the recommendation of the audit committee. At minimum annually, the Head of Internal Audit (HIA) provides the governing body with a report on internal audit activity in the college. The report includes the HIA's independent opinion on the adequacy and effectiveness of the college's system of risk management, controls and governance processes.

Review of effectiveness

24 As Accounting Officer, the Principal has responsibility for reviewing the effectiveness of the system of internal control. The Principal's review of the effectiveness of the system of internal control is informed by:

- the work of the internal auditors
- the work of the executive managers within the College who have responsibility for the development and maintenance of the internal control framework

- comments made by the College’s financial statements auditors and the LSC-appointed ILR auditors in their management letters and other reports.

25 The Principal has been advised on the implications of the result of his or her review of the effectiveness of the system of internal control by the audit committee which oversees the work of the internal auditor, and a plan to address weaknesses and ensure continuous improvement of the system is in place.

26 The senior management team receives reports setting out key performance and risk indicators and considers possible control issues brought to their attention by early warning mechanisms, which are embedded within the departments and reinforced by risk awareness training. The senior management team and the audit committee also receive regular reports from internal audit, which include recommendations for improvement. The audit committee's role in this area is confined to a high-level review of the arrangements for internal control. The Corporation's agenda includes a regular item for consideration of risk and control and receives reports thereon from the senior management team and the audit committee. The emphasis is on obtaining the relevant degree of assurance and not merely reporting by exception. At its October 2004 meeting, the Corporation carried out the annual assessment for the year ended 31 July 2004 by considering documentation from the senior management team and internal audit, and taking account of events since 31 July 2004.

Significant internal control problems (if applicable)

27 (If there are significant internal control problems, record here an outline of the actions taken, or proposed, to deal with them. The wording should be tailored to reflect the circumstances of the case).

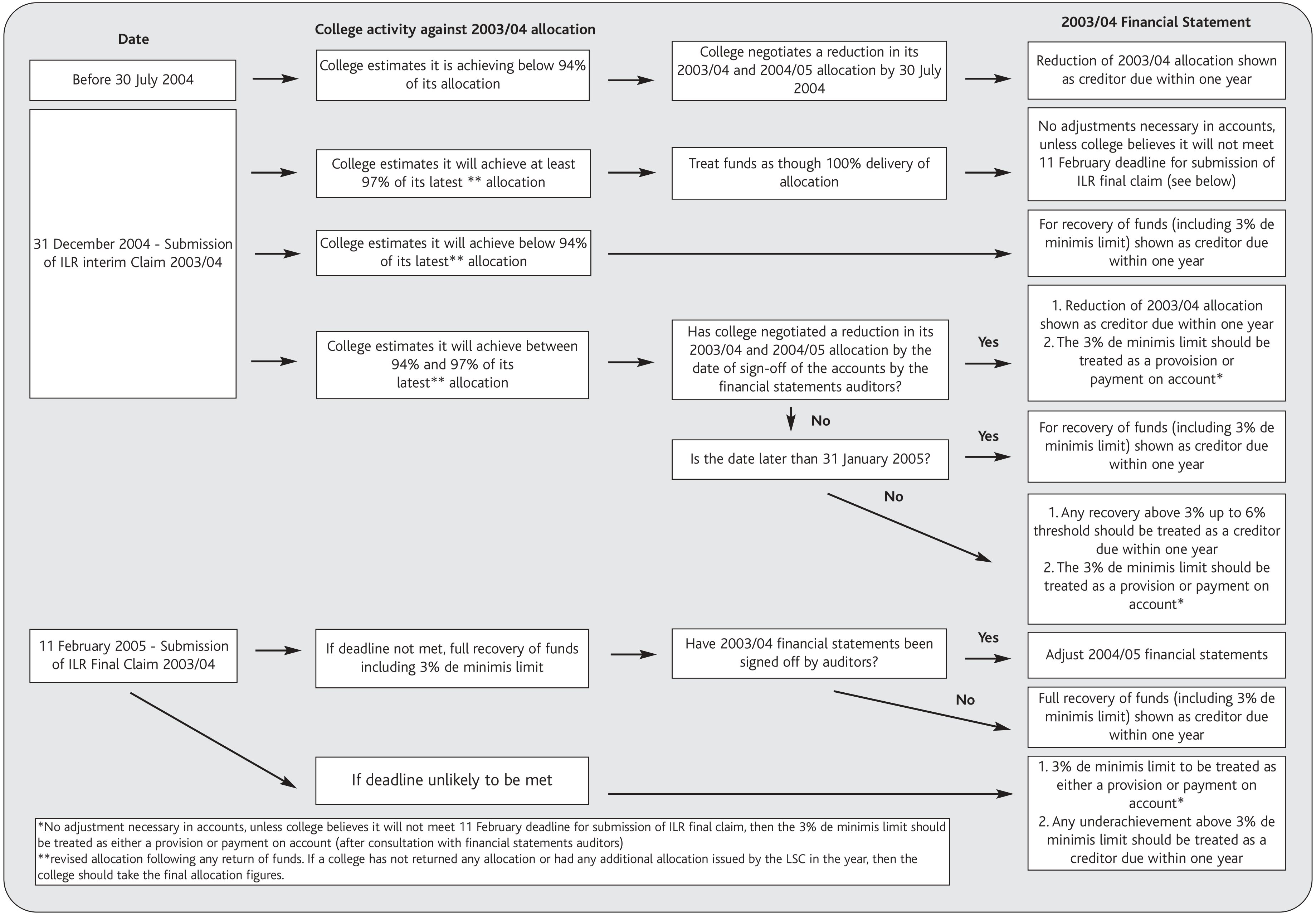
Going Concern

28 After making appropriate enquiries, the Corporation considers that the College has adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Signed
Date
Chair

Signed
Date
Principal

Annex C: Recovery of Funds Flowchart 2003/04



Notes

This publication is available in an electronic form on the Council's website: www.lsc.gov.uk

The Learning and Skills Council offers an alerting service for any circular posted to our website, to subscribe to this service visit
http://www.lsc.gov.uk/subscriptions.cfm

Publication enquiries: 0870 900 6800

Reference CIRC/AA000/1019/04