

Chapter 6: Detailed Guidance on Specific Topics

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Accounting for Subsidiary and Associate Companies, and Joint Ventures

Use of College companies

- 6.1 In May 2000, the FEFC issued guidance on College companies and joint ventures in *College Companies, Joint Ventures: A Good Practice Guide*. Guidance is also available in *Related Companies: Recommended Practice Guidelines* by Robson Rhodes (March 1996), based on a study which was commissioned by HEFCE. Colleges may wish to consult with their financial statements auditors before making a decision on whether to establish a subsidiary undertaking. Colleges should also be aware of the new Charities Act 2006, though the implementation date means that there will not be any direct impact on the operation of a College company in 2009/10.
- 6.2 It is the responsibility of each College and its Corporation to ensure that the activities of its subsidiary and associated undertakings and those of any joint venture to which it is a party are within the scope of its primary powers under the Further and Higher Education Act 1992. Colleges are also reminded of the amendments to section 19 of this Act made by the Learning and Skills Act 2000. Colleges are given a specific power to subscribe for, or otherwise acquire, shares in or securities of a company, but this power may not be exercised for the purpose of conducting an educational institution. Colleges should not participate in companies for the purpose of the provision of education, if that provision is funded wholly or partly by the LSC and its successor organisations, unless the LSC and its successor organisations consents. Colleges are advised to obtain independent legal advice on the exercise of their power to participate in companies.

Subsidiary undertakings

- 6.3 A full copy of each subsidiary undertaking's audited financial statements should be sent to the appropriate funding agency with a College's own audited financial statements. If a subsidiary undertaking was dormant during the year, then this should be stated in a covering letter and a copy of these accounts will not be required. If a subsidiary undertaking's financial statements were not signed by the return date for College accounts, a draft copy should be provided with the College's financial statements and a signed copy should be provided as soon as it becomes available.

Links with other companies

- 6.4 Where a College has links with companies and other organisations, these will normally be the subject of a formal memorandum between the College and the company or joint venture in accordance with FEFC Circular 99/14 *College Companies, Joint Ventures and Overseas Operations*. Where a College has material business links with any companies or other organisations which, for any reason, are not consolidated or disclosed as subsidiary undertakings, associates or joint ventures, then details of these business links and any related potential liabilities will be disclosed in the notes to the accounts. Comparative figures are not required. Colleges will prepare a full list of business links for discussion with their financial statements auditors, and will agree with these auditors which are material and require disclosure. Examples of such links include:
- a link through a trust which controls a company or organisation with which the College has (or has had) dealings
 - a situation where the College is a major or minor partner in a large European grant-funded project. For example, under the terms of an ADAPT project each partner may bear liability in respect of the project as a whole to a varying degree (full, partial, joint and several, or none) and this requires disclosure.
- 6.5 In circumstances such as these, the nature of material links will be disclosed together with details of:
- the name of the company or organisation
 - the principal activity
 - any investment by the College
 - whether any of the activities take place outside England.
- 6.6 Details of any material contingent liability will be disclosed in the note on contingent liabilities.

Associates and joint ventures

- 6.7 FRS 9 *Associates and Joint Ventures* requires the use of the equity method of accounting for associates and the gross equity method of accounting for joint ventures. It prohibits proportional consolidation, which is currently adopted for some joint ventures, and proposes an accounting treatment for “joint arrangements that are not entities” that is broadly similar to proportional consolidation. FRS 9 requires such arrangements to be accounted for at the individual entity level, as well as on

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consolidation. Many collaborative activities will fall within the scope of FRS 9 and Colleges are advised to consult their financial statements auditors on accounting for proposed collaborative initiatives.

6.8 FRS 9 sets out definitions of “joint arrangements that are not entities”. An entity would be carrying on a trade or business of its own, not just part of the business of the organisations. The following are examples of joint arrangements that are not entities:

- where the partners derive their benefits from products or services taken in kind rather than by receiving a share in the results of trading
- where each partner’s share of the output of the joint activity is determined by supply of inputs.

6.9 Colleges need to assess whether they are entering into a joint venture or a joint arrangement; most partnerships currently operating between Colleges are joint arrangements.

6.10 Under a joint arrangement each College should account for its own share of the assets, liabilities and cash flows of the arrangement. The share should be set out in the memorandum of understanding between the partners.

6.11 Where the cash flow for a particular project undertaken by a partnership is via a lead College, then that College will record the cash receipt and outflow in its published cash flow statement as:

- Receipt of grant for partnership £xxx
- Transfer of grant to partnership £xxx.

Any sums not transferred at the year end should be recorded as payments received on account.

6.12 Paragraphs 6.10 and 6.11 apply whether a College is preparing consolidated accounts or single entity accounts.

6.13 An example might be as follows.

Four Colleges have a partnership arrangement to set up a shared network and develop learning materials to deliver over that network.

A grant towards setting up the network is received by a lead College.

Each College contributes, in equal proportions, learning materials and a share of running costs.

Each College will record within its operating activities:

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- *its contribution to running cost*
- *the costs of developing learning materials*
- *depreciation on its share of assets*
- *its share of release of deferred capital grant.*

Each College will record on its balance sheet a quarter of the value of the fixed assets owned by the partnership and relevant proportion on the deferred capital grant.

The lead College will record the receipt and transfer of the grant.

- 6.14 If the partnership is deemed to be a joint venture, then the following treatment should be applied in consolidated accounts:
- the share of joint venture income should be shown as a deduction from group income (which will include it)
 - the share of operating surplus of the joint venture should then be added back in
 - the share of assets and liabilities of the joint venture should be shown on the balance sheet under investments.
- 6.15 Where consolidated accounts are not prepared, the information at paragraph 6.11 and the effect of including it should be included by way of a note.

Acquisition of private training providers

- 6.16 A number of Colleges have acquired the business of private training providers. Each of these acquisitions should be considered on its own merit and acquisition or merger accounting applied as appropriate. It is presumed that acquisition accounting will apply in the majority of cases.

Discontinued activities

- 6.17 When Colleges sell or close one or more of their subsidiary or associate undertakings, they should ensure that they follow the requirements of FRS 3 *Reporting Financial Performance* in accounting for any such discontinued activity. 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

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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.

6.18 Operations not satisfying all of these conditions are classified as continuing.

6.19 The necessary disclosure requirements in Casterbridge College for discontinued activities are as shown in Tables 6.1 to 6.5:

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Table 6.1: Consolidated income and expenditure account for the year ended 31 July 2010.

	Notes			Total	Total
		Continuing operations	Discontinued operations	2010	2009
		2010	2010	2010	2009
		£'000	£'000	£'000	£'000
INCOME					
Funding body income	2	33,996		33,996	36,921
Tuition fees and education contracts	3	3,609		3,609	4,944
Other grants and contracts	4	228		228	303
Other income	5	2,467	83	2,550	1,875
Endowment and investment income	6	2,003		2,003	1,437
Total income		42,303	83	42,386	45,480
EXPENDITURE					
Staff costs	7	24,200	127	24,327	28,542
Exceptional restructuring costs	7	1,551		1,551	0
Other operating expenses	9	12,623	127	12,750	13,557
Depreciation	13	4,038		4,038	2,802
Interest payable	10	108		108	0
Total expenditure		42,520	254	42,774	44,901
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and before tax		(217)	(171)	(388)	579
Gain on disposal of discontinued operations	40	210	0	210	0

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Loss on disposal of assets	13	(9,420)	0	(9,420)	0
<hr/>					
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and disposal of assets but before tax		(9,427)	(171)	(9,598)	579
Taxation	11	(12)	0	(12)	(12)
<hr/>					
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and tax	12	(9,439)	(171)	(9,610)	567
Transfer from accumulated income within specific endowments		50	0	50	0
<hr/>					
(Deficit)/surplus for the year retained within general reserves		(9,389)	(171)	(9,560)	567
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Table 6.2: Consolidated statement of historical cost surpluses and deficits for the year ended 31 July 2010.

	Notes	Continuing operations	Discontinued operations	Total	Total
		2010	2010	2010	2009
		£'000	£'000	£'000	£'000
(Deficit)/surplus on operations before taxation		(9,427)	(171)	(9,598)	579
Difference between historical cost depreciation and the actual charge for the year calculated on the revalued amount	23	1,416	0	1,416	1,431
Realisation of property revaluation gains of previous years	23	16,920	0	16,920	0
Historical cost surplus for the year before taxation		8,909	(171)	8,738	2,010
Historical cost surplus for the year after taxation		8,897	(171)	8,726	1,998

Table 6.3: Consolidated statement of total recognised gains and losses for the year ended 31 July 2010.

	Notes	Continuing operations	Discontinued operations	Total	Total
		2010	2010	2010	2009
		£'000	£'000	£'000	£'000
(Deficit)/surplus on continuing operations after depreciation of assets at valuation and tax		(9,439)	(171)	(9,610)	567

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Unrealised surplus on revaluation of fixed assets	13	5,100	0	5,100	0
Appreciation of endowment asset investments	22	2,200	0	2,200	0
New endowments	22	100	0	100	0

Total recognised gains relating to the period

(2,039)	(171)	(2,210)	567
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Reconciliation

Opening reserves and endowments	92,679	0	92,679	92,112
Total recognised (losses)/gains for the year	(2,210)	0	(2,210)	567

Closing reserves and endowments

90,469	0	90,469	92,679
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Table 6.4: Consolidated cash flow statement for the year ended 31 July 2010.

	Notes	2010	2009
		£'000	£'000
Cash inflow from operating activities	25	1,671	774
Returns on investments and servicing of finance	26	1,895	1,437
Taxation	11	(12)	(12)
Capital expenditure and financial investment	27	(7,731)	(6,363)
Management of liquid resources	28	1,850	0
Financing	29	4,464	(36)
		<hr/>	<hr/>
Increase/(Decrease) in cash in the year	30	2,137	(4,200)
		<hr/>	<hr/>

Reconciliation of net cash flow to movement in net funds/(debt)

Increase/(decrease) in cash in the period		2,137	(4,200)
Cash held by company disposed of during year	41	(17)	0
Cash inflow from new secured loan	29	(4,500)	0
Cash inflow from liquid resources	28	(1,850)	0
Change in net funds resulting from cash flows	29	36	45
		<hr/>	<hr/>
Movement in net funds in the period		(4,194)	(4,155)

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Net funds at 1 August	10,587	14,742
	_____	_____
Net funds at 31 July	6,393	10,587
	_____	_____

In this statement, figures in brackets refer to cash outflows and all other figures are cash inflows to the College.

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Table 6.5: Notes.

Note 14 Investments

	College	College
	2010	2009
	£'000	£'000
Investments in subsidiary companies	6	6
Investments in associate companies	0	0
	<hr/>	<hr/>
Total	6	6
	<hr/> <hr/>	<hr/> <hr/>

At the start of the year the College owned three subsidiary companies, ABC Limited, XYZ Limited and 123 Limited.

The College owns 100 per cent of the issued ordinary £1 shares of ABC Limited, a company incorporated in England and Wales, and 100 per cent of the issued ordinary £1 shares of XYZ Limited, a company incorporated in England and Wales. The principal business activity of XYZ Limited is carrying out training of employees on behalf of employers. The principal activity of ABC Limited is the rental of property. The College also owns 10 per cent of the issued ordinary capital shares of PQR Limited, the initial cost of which was £200.

123 Limited was sold on 25 July 2010. Income and expenditure to the point of sale and transactions relating to the sale are included in these consolidated statements and notes. ABC Limited did not trade during the financial year. The results of XYZ Limited have been included in the consolidated statements and notes.

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Note 40

Discontinued activities

	Continuing	Discontinued	Total	Continuing	Discontinued	Total
	2010	2010	2010	2009	2009	2009
	£'000	£'000	£'000	£'000	£'000	£'000
Income						
Funding body income	33,996	0	33,996	36,921		36,921
Tuition fees and education contracts	3,609	0	3,609	4,944		4,944
Research grants and contracts	228	0	228	303		303
Other income	2,467	83	2,550	1,825	50	1,875
Endowment and Investment income	2,003	0	2,003	1,437		1,437
Total income	42,303	83	42,386	45,430	50	45,480
Expenditure						
Staff costs	24,200	127	24,327	28,496	46	28,542
Restructuring costs	1,551		1,551	0		0
Other operating expenses	12,623	127	12,750	13,514	43	13,557
Depreciation	4,038		4,038	2,802		2,802
Interest payable	108		108	0		0
Total Expenditure	42,520	254	42,774	44,812	89	44,901

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Surplus/(deficit) on operations after depreciation of tangible fixed assets at valuation and before tax	(217)	(171)	(388)	618	(39)	579
Gain on disposal of discontinued activities	210		210			0
Loss on disposal of assets	(9,420)		(9,420)			0
Taxation	(12)	0	(12)	(12)		(12)
Surplus/(deficit) on operations after depreciation of assets at valuation and after tax	(9,439)	(171)	(9,610)	606	(39)	567

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Note 41 Sale of business

	2010
	£'000
Net assets disposed of:	
Debtors	33
Cash at bank	17
Creditors	(26)
Loans	(234)
	<hr/>
	(210)
Gain on disposal	210
	<hr/>
	0

The business sold during the year contributed £8,000 to the group's net operating cash flows. In selling the business the College secured loans and loan stock of £234,000

College Combinations

6.20 FRS 6 *Acquisitions and Mergers* indicates that there are two methods of accounting for College combinations: acquisition accounting and merger accounting.

- Acquisition accounting regards the College combination as the acquisition of one College by another; the identifiable assets and liabilities of the acquired College are included in the consolidated balance sheet at fair value at the date of acquisition, and the results from the date of acquisition are included in the profit and loss account. The difference between the fair value of the consideration given and the fair values of the net assets of the entity acquired is accounted for as goodwill.
- Merger accounting treats the entities being combined as equal partners, with the balance sheets and profit and loss accounts being combined without any restatement of net assets.

6.21 The FRS states that acquisition accounting should be used for all College combinations, except where the following five criteria have been met:

- criterion 1 – neither College is portrayed as acquirer or acquired
- criterion 2 – all Colleges, as represented by the corporations, participate in establishing the management structure and management personnel of the combined College: those decisions should be made on the basis of consensus rather than purely by the exercise of voting rights
- criterion 3 – the relative sizes of the two Colleges are not so disparate that one College dominates the combined College by virtue of its size. A College would be presumed to dominate if it is judged to be more than 50 per cent larger than each of the other proponents to the combination. However, this presumption may be rebutted if the College can clearly show that there is no dominance
- criterion 4 – only applicable to the private sector
- criterion 5 – only applicable to the private sector.

College combinations involving one or more further education corporations

6.22 There are two ways in which a combination involving one or more FE corporations can be achieved:

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- model A – a new corporation is established, the existing corporation(s) is/are dissolved and the property, rights and liabilities of the dissolved corporation(s) are transferred to the new corporation
- model B – a corporation is dissolved and its property, rights and liabilities are transferred to an existing corporation.

It is a decision for the corporation(s) involved as to which model is followed. Either process gives the same result, with two or more corporations becoming one.

6.23 For the period 1 April 1993 to 31 August 2002, there were:

- 16 model A combinations (31 per cent of all combinations)
- 35 model B combinations (69 per cent of all combinations).

For the period 1 September 2002 to 31 August 2007 there were:

- 3 model A combinations (including one triple dissolution) and
- 23 model B accounted combinations.

6.24 The accounting treatment for College combinations will depend upon meeting of the three relevant criterion in FRS 6 Acquisitions and Mergers outlined in paragraph 6.21. A model 'A' combination is *likely* to result in merger accounting and a model 'B' combination is *likely* to result in acquisition accounting, though neither treatment should be presumed. Colleges should discuss the most appropriate accounting treatment with their financial statement auditors prior to the combination occurring. It is however likely that acquisition accounting will apply in the majority of cases. Institutions should however consider the substance of the transactions and not just the legal form when arriving at a decision.

Merger accounted combinations

6.25 Where the reorganisation is to be accounted for as a merger (for example, model A), the income and expenditure and cash flows of both Colleges will be brought into the financial statements of the combined College from the beginning of the financial year in which the merger occurred. The corresponding figures should be restated by including the results for both Colleges for the previous period and their balance sheets for the previous balance sheet date.

6.26 Any adjustment necessary to achieve uniformity of accounting policies will be made. However, the carrying values of the assets

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and liabilities of both Colleges are not required to be adjusted to fair value on consolidation.

6.27 The following disclosures should be made for the period in which the merger took place:

- the names of the Colleges which have merged
- the date of the merger
- whether the combination has been accounted for as an acquisition or a merger.

6.28 The combined College should also disclose the following information:

- a an analysis of the current period's income and expenditure account and STRGL into:
 - amounts relating to the merged College for the period after the date of the merger; and
 - for each College, amounts relating to that College for the period up to the date of the merger
- b an analysis between the merging Colleges of the principal components of the income and expenditure account and an STRGL for the previous financial period
- c the aggregate book value of the net assets of each merging College at the date of the merger
- d the nature and amount of significant accounting adjustments made to the net assets of either College to achieve consistency of accounting policies, and an explanation of any other significant adjustments made to the net assets of either College as a consequence of the merger
- e a statement of the adjustments to consolidated reserves resulting from the merger.

6.29 The analysis of the income and expenditure account required above will show, at minimum:

- income
- operating surplus
- exceptional items split between continuing operations
- discontinued operations and acquisitions
- surpluses before taxation
- taxation

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- extraordinary items.
- 6.30 Where a merger takes place after 31 July, but before the financial statements are published, the merger should be disclosed in the financial statements of both Colleges as a significant post-balance sheet event. The financial statements should be approved by the corporation in existence at the date of approval.
- 6.31 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 a 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 combination, the continuing corporation is not required to prepare a part-year set of accounts.
- 6.32 Where a corporation is being dissolved, then it is the responsibility of either the new corporation (model A combination) or continuing corporation (model B combination) to ensure that the audited financial statements of the dissolved corporation(s) are submitted to the **main funding body** within five months of the dissolution.

Acquisition accounted combinations

- 6.33 Where the reorganisation is to be accounted for as an acquisition (for example, model B combinations), there are four points to consider in addressing the implementation of acquisition accounting:
- how to account for the results of the dissolved College in the financial statements of the continuing College
 - establishing the fair value of the assets and liabilities of the dissolved College at the date of dissolution, for inclusion in the balance sheet at that date
 - determining the amount of any positive or negative goodwill arising, and its accounting treatment in the continuing College's financial statements
 - making appropriate disclosures in the continuing College's financial statements.

Accounting for post-acquisition results

- 6.34 The results of the dissolved College should be included in the income and expenditure account of the continuing College from

the date of combination. This means that both revenue and expenses for the dissolved College will need to be apportioned between the pre- and post-acquisition periods. Where there is a clear case for identifying individual items to a specific period, this should be done. However, in general time apportionment is likely to be the most appropriate method of splitting the income and costs across periods. With the transition to demand led funding, more care will be needed to establish the allocation of income though and due consideration of claims submitted and the payment of those claims should be taken.

Fair value

- 6.35 FRS 7 *Fair values in acquisition accounting* requires the identifiable assets and liabilities of the dissolved College as the acquired entity to be included in the consolidated financial statements of the continuing College at their fair values at the date of acquisition. They should be measured at fair values that reflect the conditions at the date of the acquisition. Fair values should be based on the value at which an asset or liability could be exchanged in an arm's length transaction. The fair value of monetary items, such as debtors and creditors, should take into account the amounts expected to be received or paid and their timing. Unless they can be measured at market value, the fair values of non-monetary assets, i.e. land and buildings, plant and equipment, will normally be based on replacement cost, but should not exceed their recoverable amount as at the date of acquisition. The recoverable amount should reflect the condition of the assets on acquisition, but not any impairments resulting from subsequent events.
- 6.36 In practice assessing the value of the dissolved College's monetary assets should not be difficult, as management are likely to have good information on the recoverability of debtors and the expected payment dates for liabilities. The more difficult area will be fixed assets where a market value may be costly and/or difficult to obtain, so depreciated replacement cost is likely to be the logical route. The FRS suggests that relevant indices may be used to calculate replacement cost, and where these have not changed significantly, it may be possible to argue that the depreciated replacement cost of fixed assets is not materially different from book value. In the case of land and buildings such an argument may prove difficult, although the specialised nature of many educational buildings should help.

Goodwill

- 6.37 Goodwill usually arises under acquisition accounting as the difference between the consideration and the fair value of the net assets acquired. Where the fair value of the net assets is greater than the consideration, the result is negative goodwill. Both goodwill and negative goodwill are generally accounted for in the balance sheet. In the case of the dissolved College, the absence of any consideration would mean a very substantial negative goodwill figure in the balance sheet of the continuing College, if accounted for in accordance with the relevant standard, FRS 10 *Goodwill and Intangible Assets*.
- 6.38 However, after careful consideration, it is deemed that it would be inappropriate to treat the fair value of the dissolved College's net assets acquired as negative goodwill. Instead, the transfer should be accounted for as in substance a **gift**. This follows the suggested treatment in the ASB's *Statement of Principles for Financial Reporting Interpretation for Public Benefit Entities*, and the 2007 SORP which requires all gifts (cash or non cash) to be included in the income and expenditure account.
- 6.39 It is also recommended that the "gift" should be shown in the statement of recognised gains and losses (STRGL). FRS 3 requires all gains and losses recognised in a period to be taken to the I&E account unless otherwise permitted or required by standards or the law. The preferred approach is however to take the gain directly to reserves through the STRGL. This would avoid significantly distorting the income and expenditure account itself in the year of accounting for the transaction and the need to review the presentation and headings in the income and expenditure account. By virtue of using the STRGL to recognise the gift, the value will be included within the income and expenditure reserve by the conclusion of that year of account.
- 6.40 If a College decides to recognise the gain in the I&E account though, in the interests of providing a true and fair view for the institution concerned it is suggested that the "gift" is included below the "Surplus on continuing operations after depreciation of assets at valuation and before tax" line, alongside the line for dealing with significant asset disposals. ***Further to FRS 18.58, whether the income and expenditure account or the statement of recognised gains and losses approach is adopted, it will constitute a disclosable override of the provisions of FRS 10.***

Disclosure

- 6.41 First of all, it will be necessary to include within the accounting policies note, ideally under the basis of preparation section, an explanation that in accordance with the 2007 SORP, the combination of the continuing College and the dissolved College has been accounted for as an acquisition for nil consideration from the date of acquisition.
- 6.42 The accounting policies note should also explain that where an acquisition is carried out at nil or nominal consideration and there is an excess of the fair value of the assets acquired over the fair value of the liabilities assumed, then the resulting gain has been treated as a gift and reflected in the income and expenditure account or statement of recognised gains and losses for the year (whichever is agreed by the governors). It will be necessary to explain that this is an override of FRS10 which is necessary in the view of the Board of Governors in order for the financial statements to give a true and fair view.
- 6.43 Detailed disclosures are also required: for each class of the dissolved College's assets, with book values, adjustments (including those arising from bringing accounting policies into line) and fair values; the pre- and post-acquisition results of the dissolved College; and the effects on the cash flow statement.

Due date of receipt of finance record

- 6.44 Colleges are also required to submit with their audited financial statements, to the **appropriate funding body**, 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 **appropriate funding body** 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).

This will avoid double counting of College data in the database.

Agency Arrangements

Introduction

6.45 This section provides guidance to Colleges regarding the interpretation by **the LSC and its successor organisations** of paragraph 55 of the 2007 SORP, titled “Agency arrangements”.

Background

6.46 The SORP states: “Where the institution disburses funds it has received as paying agent on behalf of a funding body or other body, and has no beneficial interest or risks related to the receipt and subsequent disbursement of the funds, these funds should be excluded from the income and expenditure of the institution. Any commissions received whilst acting as agent would be included as income”.

Financial Reporting Standard 5 *Reporting the Substance of Transactions*

6.47 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.

6.48 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.

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

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

6.51 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

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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 Colleges

6.52 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.

6.53 The above funds are allocated by the **LSC and its successor organisations** as part of FE learner support funds.

6.54 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 accounts. Childcare support and residential bursary funds are **not** currently treated as agency arrangements.

General access fund

6.55 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.

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

6.57 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

6.58 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

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charged for but not registered. Payments may be made to a third party, for example, a crèche or childminder.

Residential bursaries

6.59 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

6.60 All unspent funds should be returned to **the appropriate funding body**.

Administration costs, interest and bank charges

6.61 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

6.62 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.

6.63 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

- 6.64 The disclosure notes for learner support funds in Colleges' financial statements should be amended for income and expenditure consolidated in Colleges' financial statements. The necessary disclosure requirements are provided at Note 39 of Chapter 4 in this Handbook.
- 6.65 If you have any queries over the interpretation of this guidance please contact your financial statements auditor.

Other agency arrangements

- 6.66 Colleges will also receive other income which it disburses on behalf of a third party and has no beneficial interest in the funds, for example, Adult Learning Grants, Educational Maintenance Allowances (EMA) and trainee allowances paid through work-based learning and Entry to Employment. In these instances the College should also exclude the income and expenditure from its accounts if the FRS 5 test for the recognition of the asset is not met.

Train to Gain income

- 6.67 Many Colleges will also act as consortium lead partners for income streams such as Train to Gain and will administer the claims on behalf of the partner organisations. The arrangements for these Train to Gain consortia vary but will include a mixture of College providers and private training providers, with the lead College able to deduct a percentage of the income earned (a "top slice") before passing it on, to cover administration and quality control procedures. The required disclosures within the lead College financial statements will depend on the nature of the organisation the funds were earned by, but will be:-
- the College should recognise its share of the income earned as a top slice when the right to consideration has been given i.e. the claim has been made in the ILR
 - the College should recognise any income earned in its own right on the same basis
 - where the College is passing funds on to a partner College or a non College partner, those amounts should be netted off against the income earned such that both elements are excluded from the accounts altogether

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- a table reconciling the gross income claimed to the net income shown in the financial statements should be included within the notes to the accounts.
- where Colleges foresee either an actual or contingent liability existing within their arrangements as a result of the risks associated with being a lead College and not being able to recover any clawback of funds from the appropriate partners, then provision or disclosure should be made within the accounts accordingly.

The right to consideration occurs when the claim has been made in the ILR. It is not expected that Colleges will need to consider accruals or deferrals of such income except insofar as they represent invoiced claims made up to the year end but not yet processed. This will include the achievement element of the funding for a learner (25% of the funding) for which the right to consideration will be triggered by the internal or external verification process concluding that achievement is appropriate. Where this occurs before the year end then an appropriate accrual should be considered. It is not expected that historic achievement rates will be used to project an achievement rate to be applied to learning in progress at the year end. It is also not appropriate to consider deferring the delivery costs through a Work In Progress provision. These principles will apply to all similar arrangements including ESF.

Higgs Report: *Revised Combined Code on Corporate Governance*

Introduction

- 6.68 This section summarises the Higgs Report: *Revised Combined Code on Corporate Governance* (the Code). The guidance was approved by the LSC's Sector Accounting Policies Group at its meeting on 1 October 2003.
- 6.69 The code issued in July 2003 superseded and replaced the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998. In July 2005 the Financial Reporting Council (FRC) announced that it would be conducting a review into how companies and investors have progressed in implementing the 2003 Combined Code on Corporate Governance. Initial findings and recommendations were reported in January 2006 and the FRC published an updated version of the Code in June 2006. A small number of changes were made to the previous version of the Code but which do not affect the

substance of the following text. Early adoption of the updated Code was encouraged on a voluntary basis for reporting years beginning on or after 1 November 2006.

Main features of the Code

6.70 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.

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- 6.71 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 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.
- 6.72 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.
- 6.73 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

- 6.74 No action is required at this time. However, Colleges need to be aware of the Code and should consider its impact on their corporate governance.
- 6.75 Colleges can obtain a copy of the Code from the [Financial Reporting Council's](#) website.

Land and Buildings Owned by a Third Party

Introduction

- 6.76 This section 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

- 6.77 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 Colleges could come under this category.
- 6.78 The position becomes more complicated when these Colleges receive funding body grants for capital projects. The element of the capital project financed by the funding body will appear on the balance sheet, whilst the proportion financed by the third party might not.

Financial Reporting Standard 5 *Substance of Transactions*

- 6.79 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.

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- 6.80 Section 5.80 of Chapter 5 *Guidance on the Preparation of the Members Report and 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. The latter option should always be accompanied by an explanation as to why the valuation is not available as this is not expected to be a frequent occurrence.

Statement of Recommended Practice: Accounting for Further and Higher Education July 2007

6.81 The LSC **and its successor organisations** reiterated in section 2.1 of Chapter 2 of the Accounts Direction Handbook that, in preparing their financial statements, Colleges are required to follow the requirements of the 2007 SORP.

6.82 Paragraph 95 of the 2007 SORP 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 no rental or a nominal rental is made. In some cases there may be no formal agreement to occupy. Where an institution enjoys the use of an asset which it does not own and for which no rental or a nominal rental is paid, whether or not such use is regulated by a licence or lease, the financial statements must disclose this and, **if practicable, a value should be attributed to this benefit and be capitalised, with a corresponding credit to deferred capital grants** (which should subsequently be released to the income and expenditure account in accordance with paragraph 54), and thereafter depreciated over the period of use... Where no formal occupancy agreement exists, the institution should consider regularising the position by the establishment of a lease or licence, as this will assist in determining a value for the benefit.”*

This represented a change from the previous guidance whereby the corresponding credit would have been made to the Revaluation Reserve (see paragraph 6.94 below).

Definition of “if practicable”

6.83 The SORP does not provide a definition of “if practicable”. However, a College would normally be expected 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.

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

Materiality

- 6.85 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.”
- 6.86 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

- 6.87 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.
- 6.88 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.
- 6.89 “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 case, not FE), the judge said that

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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.

6.90 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

6.91 The valuation date should be the later of:

- the date of incorporation; or
- the date of assuming occupancy.

6.92 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

6.93 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.

6.94 As noted above, the 2007 HE/FE SORP made changes to the accounting treatment for donated land (credit to income and expenditure) and for assets occupied by institutions but owned by third parties (credit to deferred capital grants) and removed a reference to inherited loans from which the historic treatment of inherited land and buildings (credit to revaluation reserve) could be inferred. The change in accounting treatment would be expected to only affect a relatively small number of institutions but in view of an ongoing review of the implementation of the 2007 SORP and the desire to retain comparability across the sector the LSC gave the opinion that the existing accounting

treatment using the revaluation reserve should be maintained in 2007/08. This view was revisited in 2008/09 based on discussions with the audit firms, the LSC and HEFCE.

- 6.95 The lack of clarity around the requirements of the original Accounts Direction and the basis for the initial credit being taken to the revaluation reserve left room for doubt as to the most appropriate treatment for such assets. In the absence of such clarity it is likely to be ***most appropriate to continue with the existing accounting treatment in respect of land and buildings inherited from local authorities, with the addition of a clear accounting policy to state how tangible fixed assets inherited from local authorities are accounted for in accordance with this guidance. An example policy is shown below with new text highlighted:***

Land and Buildings

Land and buildings inherited from the Local Education Authority are stated in the balance sheet at valuation on the basis of depreciated replacement cost as the open market value for existing use is not readily obtainable. **The associated credit is included in the revaluation reserve. The difference between depreciation charged on the historic cost of assets and the actual charge for the year calculated on the revalued amount is released to the income and expenditure account reserve on an annual basis.**

- 6.96 There is a separate, but related issue in respect of land or other property which was ***owned by other organisations*** but vested in Further Education colleges. A review of the relevant Acts of Parliament indicates that any land occupied by institutions not owned by the local education authority (e.g. land owned by churches, charitable trusts etc) was not covered by this legislation and therefore the accounting treatment required by the 2007 SORP (paragraph 95) is unaffected (ie "Where an institution enjoys the use of an asset which it does not own and for which no rental or a nominal rental is paid, whether or not such use is regulated by a licence or lease, the *financial statements* must disclose this and, if practicable, a value should be attributed to this benefit and be capitalised" onto the balance sheet at value with the corresponding credit to deferred capital grants (for buildings) or income (for land) instead – ***a change from the 2003 SORP.***

The above also represents a change from the 2007/08 Accounts Direction which required the existing treatment (ie credit to revaluation reserve) to be maintained in view of the desire to

maintain comparability across the sector and pending further discussions and review of implementation of the 2007 SORP over the last few months. ***In view of this change in guidance, a prior year adjustment may have been necessary in the 2008/09 accounts of a small number of colleges. An example policy is shown below:***

Buildings owned by third parties

Where the College enjoys the use of an asset which it does not own and for which no rental or a nominal rental is paid, if practicable, a value is attributed to this benefit and capitalised, with a corresponding credit to *deferred capital grants* which are subsequently released to the income and expenditure account over the useful economic life of the asset at the same rate as the depreciation charge on the related asset(s).

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

Subsequent Expenditure on Existing Fixed Assets

Introduction

- 6.98 This section provides guidance to Colleges on the most appropriate accounting treatment for subsequent expenditure on existing tangible fixed assets, such as building refurbishments.

Background

- 6.99 As Colleges are being encouraged to implement 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. However, the College must demonstrate that the criteria within UK GAAP have been satisfied in order to do so and this guidance seeks to set out the issues to be considered.
- 6.100 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

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building, for example the first two floors of a four-storey building, there is some significant room for debate.

6.101 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.

6.102 In Circular 03/13 *Capital Handbook*, the LSC noted the need to apply minimum thresholds for capital support applications and set these in relation to a percentage of the College's turnover. From 1 November 2003, the minimum thresholds for capital support applications were 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

6.103 In November 2006 the LSC issued an updated Capital Handbook and restated the minimum qualifying project expenditure in Annex B, table 5 as:

Most recent audited College turnover	Minimum qualifying project expenditure
Less than £2 million	£100,000
More than £2 million and less than £10 million	5% of College turnover
More than £10 million	£500,000

Financial Reporting Standard 15 *Tangible Fixed Assets* Guidance

6.104 Relevant extracts from FRS 15 are set out at 6.120 below. The principles regarding subsequent expenditure on existing tangible fixed assets are set out in paragraphs 37– 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

6.105 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

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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 Higher Education and Further Education Board for the Statement of Recommended Practice (HE/FE SORP Board) or **the LSC and its successor organisations**.

- 6.106 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.
- 6.107 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?

Component accounting

- 6.108 The 2007 SORP introduced an explicit heading of component accounting (paragraph 94) such that “where a tangible fixed asset comprises two or more major components with substantially different useful economic lives, each component should be accounted for separately for depreciation purposes and depreciated over its individual useful economic life. For example, a building should be split for depreciation purposes between the structure of the building and items within the structure, such as general fittings.”
- 6.109 The principles of component accounting have resided within FRS 15 since its publication as the attached extracts demonstrate (sections 6.119 below) however they may not have been followed previously. With significant estates developments in the making for most Colleges, the guidance from FRS 15 and the 2007 SORP should be considered when determining the depreciable lives of major assets. Early discussions with the College’s property advisors will enable the appropriate information to be obtained to make a fair judgement in that respect.

Accounting treatment of costs incurred prior to construction commencing

- 6.110 A typical capital project for a College will incur significant levels of expenditure even before the construction phase commences. These costs will include the preparation of a property strategy and the subsequent feasibility study; applications in principle (AIP) for grant funding support and detailed project applications once the AIP has been approved. The accounting treatment for these costs and the associated funding should be considered carefully in the light of existing accounting guidance.
- 6.111 It is not expected that the costs of a property strategy, nor of the feasibility study itself, will be capitalised by a College. Such costs should be expensed as they are incurred and any associated funding support for the feasibility study, be accounted for as a revenue grant.
- 6.112 Directly attributable costs incurred subsequent to the feasibility study may be considered for capitalisation. Such costs are defined in FRS 15, paragraphs 9 to 11 and further guidance can be found in this Handbook at Chapter 5. The College should however be able to demonstrate that *in their opinion* the project is *more likely than not to go ahead* and in doing so should pay

particular attention to the following areas and their status **at the time the costs were incurred**:-

- Has **appropriate funding body consent** been obtained where the project is likely to exceed the limits shown in Chapter 5, paragraph 5.110.
- **Planning permission** – often the refurbishment or construction phase is dependent upon the College obtaining key planning permissions. The College should consider the likelihood that these will be granted and the impact on the project if they are not, before capitalising relevant costs.
- **Financing** – many capital projects involve a mixture of external borrowing and capital support from bodies such as (but not restricted to) the **LSC and its successor organisations. The LSC and its successor organisations** are often the major funding bodies in this respect and therefore the future viability of a project can be seen as dependent upon the College obtaining the appropriate level of **appropriate funding body** support. Colleges are informed in the 2006 Capital Handbook that they will be expected to increase their borrowing to reasonable levels before the **LSC and its successor organisations** will consider the capital grant application. Such levels depend on the financial health category of the College but will range from 15% to 40% of total income. The overriding stress is on affordability though and Colleges should therefore consider the impact on the project if the necessary level of intervention funding from **the LSC and its successor organisations** is not available and whether this could be reasonably replaced with other sources of finance.
- **Non financial criteria** – the Capital Handbook lists a range of other hurdle criteria to meet in the application, including sustainability, space utilisation, value for money and economy. The continuing achievement of these criteria should be kept under review when deciding whether to capitalise costs or otherwise.

6.113 Colleges should consider the use of additional narrative reporting where there are any issues with these at the balance sheet date so as to ensure all relevant information has been given to the readers of the accounts. The position is often not clear cut at the balance sheet date as to the appropriate treatment and Colleges should discuss the likely scenarios in advance with their financial statements auditors.

6.114 The College should also consider the eventual carrying value of the asset when capitalising associated costs. On final

occupation of the asset the College may find that the accumulated costs exceed the recoverable value of the asset and that an **impairment review** is necessary at that point.

Accounting treatment where expenditure includes demolition or the removal of substantial parts of the asset

6.115 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 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.

Carrying Value of existing assets within a capital development programme

6.116 A significant number of capital projects involve the demolition of existing property and the building of new property on the same site. Colleges should take into account that property that has been earmarked for demolition and where the project is deemed more likely than not to go ahead (as discussed above), will now have a shorter useful economic life than was the case before the strategy was implemented. The strict interpretation of this is that the relevant costs of a building with an unexpired life of say, 20 years, earmarked for demolition in two years time, should be written off over that shorter period ("accelerated depreciation"). The net book value of the building at the point that the project is deemed more likely than not to go ahead, should be depreciated over the remaining two years in this example. There is no provision within the accounting standards to make a prior year adjustment for the revision to the economic life of the asset. This is the **LSC and its successor organisations'** preferred approach for the majority of Colleges.

A short example will illustrate this:-

- Assume that a College inherited a building at 1 April 1993 with a DRC valuation of £1,500,000;
- Also assume that the College deemed a 50 year UEL for that building with depreciation commencing at 1st August 2003 at the rate of £30,000 p.a.;
- As at 31 July 2008 a property strategy is confirmed as being more likely than not to proceed and as a result the building will be vacated and demolished at 31 July 2010;

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- At 31 July 2008 the building will have a NBV of £1,050,000 after 15 years depreciation;
- This net book value would be written off over the remaining two years of the expected life, to July 2010, at the rate of £525,000 p.a. which is £495,000 higher than previously;
- In order to present a clearer view of the College's underlying results, the College may wish to disclose this **additional charge** (the "accelerated depreciation" element) separately. An illustrative example of this disclosure has been included within the Casterbridge College accounts in Chapter 4. It is not intended that all of the depreciation charge should be disclosed separately, only that element (for example as calculated at £495,000 above) which is additional to that previously calculated.

In many cases though, it is expected that there will be an equivalent release of the revaluation reserve through the Statement of Total Recognised Gains and Losses to match the increased depreciation charge.

The alternative accounting treatment included in the 2007/08 Handbook, whereby a College might decide to eliminate all of the net book value of an asset affected by the property strategy in one year as a form of accelerated depreciation, has not been carried over into later Handbooks. After representations from interested parties, this treatment has been agreed as not being fully compliant with FRS 15 and has been withdrawn. There is however no provision with UK GAAP to reverse this treatment for Colleges who chose to adopt it in 2007/08 and therefore any adjustments processed should be allowed to stand.

Colleges that are able to properly demonstrate that the indications of impairment found in FRS 11 (and reproduced at 5.100) may wish to then consider a formal impairment calculation. There are many difficulties associated with this next stage, primarily due to the inability to adequately identify an Income Generating Unit or the cash flows associated with it. As Colleges do not operate for profit, their break even position means that a meaningful impairment calculation is difficult to achieve. It may be possible to justify the use of the alternative accounting treatment in the 2007/08 handbook as a proxy for such calculations though. Taking the same scenario as above:

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- Assume that a College inherited a building at 1 April 1993 with a DRC valuation of £1,500,000;
- Also assume that the College deemed a 50 year UEL for that building with depreciation commencing at 1 August 2003;
- As at 31 July 2008 a property strategy is confirmed as being more likely than not to proceed and as a result the building will be vacated and demolished at 31 July 2010. The adjusted UEL would therefore be 16 years;
- At 31 July 2007 the building will have a NBV of £1,080,000 after 14 years depreciation;
- As a proxy for the Value in Use of the building the College could use the adjusted remaining UEL of two years which represents £187,500 (calculated as 2/16 of £1.5 million);
- The **impairment** to the carrying value is therefore £892,500, being £1,080,000 less £187,500;
- In the absence of subsequent revaluations or additions to that building, this amount would be charged against the original inherited asset revaluation reserve unless it is shown that the reduction in value is a result of a “clear consumption of economic benefits”;
- The depreciation charge in 2008 and 2009 will be £93,750 p.a.

Consideration of carrying value of Assets in the Course of Construction

- 6.117 Colleges should always review the carrying value of fixed assets at the year end and this principle applies equally well to Assets in the Course of Construction. As noted in 6.112 above Colleges should continually reassess the carrying value of an asset against its likely recoverable value. This principle is important when a project may be subject to delays or significant amendment to size or scope.
- 6.118 Project managers will be routinely reviewing the costs being incurred anyway and Colleges should ensure that any costs being carried forward have an enduring benefit to the project where there are changed circumstances that throw some doubt on their appropriateness. This aspect has been brought into focus by the current uncertainty regarding the availability of funding for

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capital projects both from within the sector and from financial institutions.

6.119 In the event that significant doubt is expressed about the likelihood of a project progressing in its original form (the key test in 6.110 above not being met such that the College cannot say that the project is more likely than not to proceed in that form) then the costs should be analysed for enduring benefit and those that do not meet the test, should be taken to the Income and Expenditure account. College auditors will be looking closely at the criteria for maintaining the costs as an asset and will want to see firm evidence of reviews in that respect.

Alternative treatments

6.120 If the College, on implementing FRS 15 for the first time, decided to adopt a policy of revaluation, then these issues may be resolved at the next review. However, for those Colleges who did not (the large majority), 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.

6.121 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.

Extracts from Financial Reporting Standard 15

Tangible Fixed Assets

Summary

- 6.122 *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.
- 6.123 *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

- 6.124 *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.
- 6.125 *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

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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.

6.126 *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.

6.127 *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
- their materiality in the context of the financial statements.

- 6.128 *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.

Financial Reporting Standard 17 *Retirement Benefits* – Full Implementation

Introduction

- 6.129 This paper provides guidance to Colleges on the most appropriate accounting treatment on dealing with FRS 17 *Retirement Benefits* in Colleges' financial statements.

Background

- 6.130 In November 2002 the ASB issued an amendment to FRS 17 extending the timetable for the mandatory full implementation of the accounting standard to accounting periods beginning on or after 1 January 2005 at the latest.
- 6.131 In Circular 04/04 *Accounts Direction to Further Education Colleges for 2003/04*, the LSC recommended that Colleges should not adopt the accounting standard early and fully implement FRS 17 in light of ongoing discussions and debate nationally in respect of this accounting standard. Instead Colleges should disclose, by way of a note to the accounts, what entries would be made in the financial statements if the FRS were fully implemented. These “transitional arrangements” would apply until notice was given otherwise by the HE/FE SORP Board.
- 6.132 In November 2004, the Technical Group of the HE/FE SORP Board agreed that all HE and FE institutions should fully implement the requirements of FRS 17 in their financial statements for all accounting periods commencing on or after 1 January 2005. This meant that the first year of full implementation in Colleges' accounts was the 2005/06 financial year.
- 6.133 As a result of the disclosures made in the 2005/06 financial statements, the 2006/07 financial statements contained no references to the implementation as those occurred in the year before the comparatives shown.
- 6.134 On 7 December 2006 the ASB published an amendment to FRS 17 which aligned the disclosures more closely with the

equivalent international standard, IAS 19. The amendment was effective for Colleges in 2007/08, though early adoption was encouraged.

Objectives of Financial Reporting Standard 17

6.135 The objectives of FRS 17 are to ensure that:

- financial statements reflect at fair value the assets and liabilities arising from an employer's retirement benefit obligations and any related funding
- the operating costs of providing retirement benefits to employees are recognised in the accounting period(s) in which the benefits are earned by the employees, and the related finance costs and any other changes in value of the assets and liabilities are recognised in the accounting periods in which they arise
- the financial statements contain adequate disclosure of the cost of providing retirement benefits and the related gains, losses, assets and liabilities.

6.136 FRS 17 is a complex accounting standard, but it is based on a simple principle that an organisation should account for retirement benefits when it is committed to give them, even if the actual giving will be many years into the future. FRS 17 is a better reflection of the economic reality of the relationship between an employer and the pension fund than the standard it replaces, SSAP 24 *Pension Costs*. Inclusion of the attributable share of the fund assets and liabilities does not, of course, mean that legal title has passed from the trustees to the employer. Instead it represents the employer's commitment to increase contributions to make up any shortfall in attributable net assets, or its ability to benefit (through reduced contributions) from a surplus in the scheme.

6.137 The important accounting distinction for pension schemes is whether they are "defined contribution" or "defined benefit".

Teachers' pension scheme

6.138 The HE/FE SORP Board has considered the treatment of the TPS. It has decided that even though the TPS is a defined benefit scheme and prima facie Colleges would be expected to comply with the requirements of FRS 17 *Retirement Benefits*, it would be not possible for the TPS to identify separately the College's share of the underlying assets and liabilities in the scheme on a consistent and reasonable basis. Therefore, the Board states that

the TPS should be treated as though it were a defined contribution scheme.

- 6.139 In the TPS, the College pays a contribution to central government reflecting benefits earned during the year. These contributions are not put aside into a separate fund, nor are additional contributions thereafter required by central government in relation to those benefits. The pensions are paid by central government. The government treats the pension scheme as an unfunded defined benefit scheme.

Local government pension scheme

- 6.140 On 2 April 2002 the Chartered Institute of Public Finance and Accountancy and the Local Authority (Scotland) Accounts Advisory Committee (LASAAC) Joint Committee published Update Bulletin 2 to *The Code of Practice on Local Authority Accounting in the United Kingdom 2000 – A Statement of Recommended Practice*. The Update Bulletin classifies the LGPS as a multi-employer scheme, where it is possible for individual employers to identify their share of assets and liabilities, and therefore it should be accounted for as a defined benefit scheme, in accordance with FRS 17.

Pooled valuations

- 6.141 Some LGPSs have indicated that they can only provide to the College a pooled valuation. If it is not possible for the actuary to identify the institution's share of the underlying assets and liabilities on a consistent and reasonable basis then paragraph 9(b) of FRS 17 allows such schemes to be accounted for as if they were a defined contribution scheme. Where this occurs, the **LSC and its successor organisations** would not expect the College's financial statements to be qualified through non-compliance with an accounting standard. The disclosure note to the accounts should be similarly worded to the note for teachers' pension schemes.
- 6.142 The **LSC and its successor organisations are** aware of the following schemes providing pooled valuations:
- Manchester (for small Colleges only)
 - Tyne and Wear
 - Croydon.

Disclosure requirements

6.143 The accounting treatment of fully implementing the standard in Colleges' financial statements is best described by Table 6.6.

Table 6.6: Accounting treatment of implementing the standard.

Income and expenditure account		Balance sheet	Statement of total recognised gains and losses
Staff costs – other pension	Pension finance income (or costs)		
Current service cost (capital cost of benefits earned in current period).	Interest cost (interest on the accrued pension liabilities).	Net pension asset / (liability)	Differences between the actual and expected return on scheme assets.
Past service costs (capital cost of benefit improvements).	Less: expected return on the assets held by the pension scheme.	Pension reserve	Experience changes affecting scheme liabilities.
Gains and losses on curtailments and settlements (for example, early retirements, bulk transfers from scheme) – except where FRS 3 para. 20 items.			Effect of changes in actuarial assumptions.

Income and expenditure presentation

- 6.144 FRS 17 introduced a new format heading “Pension finance income/ (costs)” into the income and expenditure account. The ASB received legal advice that this new heading was necessary and that it should be shown adjacent to, but separate from, the heading “Interest payable and similar charges”. The two components of the item “Pension finance income/ (costs)”, which are the “interest on pension scheme liabilities” and the “expected return on assets” should be disclosed separately in the notes (FRS 17 paragraph 84). This is typically achieved through the use of “analysis” tables within Note 32 to Casterbridge College with the net figure being shown in the Income and Expenditure account as appropriate (see below).
- 6.145 For the purposes of the Casterbridge accounts, the expected return on pension scheme assets and the interest on pension scheme liabilities should be netted off and the net figure should be included either within endowment and investment income, if a credit, or within interest payable, if a net debit. Each component should be identified within the pension note (Note 32 in Casterbridge) and the net figure included either in the “endowment and investment income” note (Note 5 in Casterbridge) or in the “interest and other finance costs” note (Note 9 in Casterbridge).
- 6.146 The additional FRS 17 charge for staff costs, being the difference between current service costs and the contributions paid, should be included as a single figure within the staff costs note, rather than apportioned across relevant department headings, to be consistent with the finance record.
- 6.147 Any contributions from employees should be set off against the current service cost (FRS 17 paragraph 51).

Early retirements

- 6.148 FRS 17’s definition of “retirement benefits” specifically **excludes** benefits that become payable as a result of the **early** termination of an employee's employment. Therefore, where employees made redundant are granted enhanced pension benefits (say, for early retirement) in lieu of, or in addition to, redundancy payments, the cost of the enhanced pension benefits are in effect treated as redundancy payments rather than past service costs. Such benefits might relate to the termination of an operation or fundamental reorganisation and be shown as FRS 3 paragraph 20 items outside operating profit.

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6.149 Colleges have in the past accounted for termination related pension entitlements as “Enhanced Pensions” (see below) and calculated a provision for the ongoing liability using the published tables (previously in LSC Circular 05/02) in accordance with FRS 12. The tables have an actuarial basis and in effect produce a similar result to that if it had been calculated under FRS 17 in most cases. Depending on the information flows between a College and its actuary, the implementation of FRS 17 on the balance sheet of a College resulted in certain elements (and not just the LGPS member related elements) of the provision being included within the total FRS 17 liability calculation and hence being released as Enhanced Pensions provisions as a prior period adjustment on implementation of the standard. Whilst this is strictly incorrect, there would be no significant overall balance sheet impact as the two provisions were calculated in a similar fashion. Therefore, where a College has already combined the enhanced pensions provision with the FRS 17 provision, and is impractical to obtain the information to analyse out the provisions, no adjustments are proposed to correct the position. The additional reporting disclosures found in FRS 17 (Revised) in respect of unfunded liabilities (of which Enhanced Pensions are a part) will identify this in the notes to the accounts.

Financial health implications of implementing Financial Reporting Standard 17

- 6.150 The LSC and its successor organisations take many factors into account in assessing a College’s financial health group, such as financial and non-financial factors, with the LSC and its successor organisations placing greater emphasis on the solvency of the College.
- 6.151 To assist Colleges in assessing their appropriate financial health group, the LSC developed a computed health group model. However, this model does not take account of “soft” factors such as management style, data performance, risk management, contingency planning and other intangible factors which may have an impact on a College’s financial health.
- 6.152 The LSC took the decision to add back the effect of implementing FRS 17 when assessing a College’s financial health.
- 6.153 Table 6.7 shows the effect of FRS 17 on the financial ratios used in the model and the action taken by the LSC and its successor organisations to negate the effect of the accounting standard.

Table 6.7: The effect of FRS 17 on the financial ratios

Financial ratio	Impact of FRS 17 on ratio	LSC action to negate effect of FRS 17
Cash generation	No	Not applicable
Cash days	No	Not applicable
Current ratio	No	Not applicable
Income and expenditure reserve	Yes	Ratio calculated on income and expenditure reserve less pension reserve
Operating position	Staff costs only	Ratio calculated on operating position less FRS 17 total operating charge
Total borrowing as a percentage of income	No	Not applicable

6.154 Colleges should ensure that where external agencies assess their financial position and that this does not add back the impact of the standard (certain banking covenants for example), they are able to mitigate the risks and can manage their results to meet any terms and conditions that might apply.

6.155 **The LSC and its successor organisations** have so far chosen to discount the effects of FRS 17 on calculating the automatic financial health score.

Enhanced pensions provisions

6.156 Unlike prepayment and accrual SSAP 24 provisions, the enhanced pension provision will not necessarily disappear under full implementation of FRS 17 and should instead be added on to the figures provided by the actuaries each year, as in most cases it will remain a valid provision. Care should be taken though that there is not any duplication of membership data between the two provisions, and Colleges should communicate with their actuaries accordingly.

6.157 The enhanced pensions spreadsheet provided each year calculates the FRS 17 charge. The FRS 17 charge will be as follows:

- balance at end of year – balance sheet, provision

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- retirement cost in year (if any) – income and expenditure account, operating costs
- payments in year – balance sheet, cash
- interest on provision – income and expenditure account, financing cost
- actuarial gain/(loss) – statement of recognised gains and losses.

Glossary to Financial Reporting Standard 17

Actuarial gains and losses

6.158 The changes in actuarial deficits or surpluses that arise because:

- events have not coincided with the actuarial assumptions made for the last valuation (experience gains and losses); or
- the actuarial assumptions have changed.

Current service costs

6.159 The increase in the present value of a defined benefit scheme's liabilities expected to arise from employee service in the current period.

Curtailments

6.160 An event that reduces the expected years of future service of present employees or reduces for a number of employees the accrual of defined benefits for some or all of their future service. For example, early termination of employees' services or termination or amendment of scheme terms affecting benefits accrued by future service.

Defined benefit scheme

6.161 A pension or other retirement benefit scheme other than a defined contribution scheme. Usually the scheme rules define the benefits independently of the contributions payable, and the benefits are not directly related to the investments of the scheme. The scheme may be funded or unfunded.

Defined contribution scheme

6.162 A pension or other retirement benefit scheme into which an employer pays regular contributions fixed as an amount or as a percentage of pay and will have no legal or constructive obligation to pay further contributions if the scheme does not have sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. An individual's benefits are determined by reference to contributions paid into

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the scheme in respect of that member, usually increased by an amount based on the investment return on those contributions.

Expected return on pension scheme assets

6.163 The average rate of return, including both income and changes in fair value but net of scheme expenses, expected over the remaining life of the related obligation on the actual assets held by the scheme.

Multi-employer scheme

6.164 A defined contribution scheme or a defined benefit scheme where more than one employer participates.

Past service costs

6.165 The increase in the present value of the scheme liabilities related to employee service in prior periods arising in the current period as a result of the introduction of, or improvement to, retirement benefits.

Pension finance income/(costs)

6.166 The total of the pension interest cost and the expected return on pension assets.

Pensions interest cost

6.167 The expected increase during the period in the present value of the scheme liabilities because the benefits are one period closer to settlement.

Retirement benefit

6.168 All forms of consideration given by an employer in exchange for services rendered by employees that are payable after the completion of employment.

Scheme liabilities

6.169 The liabilities of a defined benefit scheme for outgoings due after the valuation date.

Settlements

6.170 An irrevocable action that relieves the employer (or the defined benefit scheme) of the primary responsibility for a pension obligation and eliminates significant risks relating to the obligation and the assets used to effect the settlement. For example, the payment of a lump sum in exchange for surrender of rights, the purchase of an annuity to cover benefits, or the transfer of

scheme assets and liabilities relating to employees leaving the scheme.

Removal of SSAP 24 Provisions

Pension provisions in pooled schemes

- 6.171 It is possible that a College could be in a pooled pension scheme and be carrying a SSAP 24 provision for a shortfall in this scheme. It was stated in paragraph 6.139 that these Colleges would for FRS 17 purposes be treated as defined contribution schemes. However, the shortfall in the pension scheme needs to be addressed:
- a Where there is a SSAP 24 pension provision for 'strain on fund', for example, a specific amount calculated by the College using the pension scheme official spreadsheet and paid by the College to the scheme for early retirements of named employees.
 - b Where there is a pension provision for a fund deficit.
- 6.172 In the case of a) above, the College should continue to make a provision under the auspices of FRS 17 as it relates to past contributions payable that have yet to be settled.
- 6.173 In the case of b) above, the provision would be released to the Income and Expenditure Account.

Income recognition

- 6.174 Since the ASB issued Application Note G: Revenue Recognition, as an Amendment to FRS 5, 'Reporting the Substance of Transactions' (Application Note G') in November 2003, questions have arisen about the accounting for revenue from contracts to provide services, and the UITF was asked to provide guidance. In March 2005 it issued UITF Abstract 40 Revenue recognition and service contracts. The principles contained within both Application Note G and UITF 40 do not pose any great problems for Colleges but should require Colleges to examine closely the terms and conditions within any funding agreements to ensure that income is properly recognised in the correct accounting period.
- 6.175 The overriding consideration is whether the College has performed, or partially performed, its contractual obligations. If it has performed some, but not all, of its contractual obligations, it is required to recognise income to the extent that it has obtained the

right to consideration through its performance. Conversely, if the contractual obligations have not been met, then the income should not be recognised.

- 6.176 It is therefore important that Colleges clearly understand the terms and conditions contained within any contracts entered into and seek clarification from the funder where these are not clear.

New UK Exposure Drafts

Introduction

- 6.177 In July 2005, the Accounting Standards Board (ASB) issued four new Financial Reporting Exposure Drafts (FREDs) as part of its strategy for convergence with International Financial Reporting Standards (IFRS):-

- FRED 36 '*Business Combinations (IFRS 3) and Amendments to FRS 2 Accounting for Subsidiary Undertakings (parts of IAS 27 Consolidated and Separate Financial Statements)*'.
- FRED 37 '*Intangible Assets (IAS 38)*'.
- FRED 38 '*Impairment of Assets (IAS 36)*'.
- FRED 39 '*Amendments to FRS 12 Provisions, contingent liabilities and contingent assets and Amendments to FRS 17 Retirement benefits*'.

- 6.178 The ASB also issued FRED 40 *Heritage Assets* in December 2006, FRED 41 *Related Party Disclosures* in July 2007 and FRED 42 *Heritage Assets* in June 2008.

- 6.179 Colleges should note that these FREDs have been provided for information only. Therefore, no action is required for the time being.

- 6.180 The following information for FREDs 36 to 39 has been taken from the July 2005 issue of *Inside Track* (published by the ASB) and sets out the scope of each standard. Comments on the proposals were sought by the ASB by 28 October 2005. The information on FRED 40 was taken from the January 2007 issue of *Inside Track*, FRED 41 from the July 2007 issue and on FRED 42 from the July 2008 issue.

FRED 36 *Business Combinations (IFRS 3) and Amendments to FRS 2 Accounting for Subsidiary Undertakings (parts of IAS 27 Consolidated and Separate Financial Statements)*

- 6.181 The IASB issued IFRS 3 in March 2004 following completion of the first phase of its Business Combinations project. FRED 36

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is based on the Exposure Draft of Proposed Amendments to IFRS 3 issued by the IASB in June 2005 and the Exposure Draft of Proposed Amendments to IAS 27.

- 6.182 The main changes to existing accounting practices that would arise from adopting the proposals in FRED 36 are set out below. The ASB is concerned that certain aspects of the proposals may not improve the quality of information in financial statements.
- 6.183 Under current UK accounting practice the objective of acquisition accounting is to reflect the cost of the acquisition. To the extent to which it is not represented by identifiable assets and liabilities (measured at their fair value), goodwill arises and is reported in the financial statements. This exposure draft adopts a different perspective and requires the financial statements to reflect the fair value of the acquired business.
- 6.184 The proposals treat the group as a single economic entity ('entity concept') and any outside equity interest in a subsidiary is treated as part of the overall ownership interest in the group. As a consequence of this changes in a parent's ownership interest, that do not result in a change of control, are to be recognised as changes in equity. No gain or loss will be recognised in the profit and loss account. In the UK, to date, accounting has been based on the 'parent entity concept'. Under the parent entity concept the extent of non-controlling interests and transactions with non-controlling interests are separately identified in the primary financial statements.
- 6.185 It is proposed that goodwill is to be recognised in full; that is 100% of goodwill is recognised even if less than 100% is acquired. FRS 2 requires that goodwill arising on acquisition should only be recognised with respect to the part of the subsidiary undertaking that is attributable to the interest held by the parent entity.
- 6.186 Goodwill, after initial recognition, is to be measured at cost less impairment losses, and amortisation is not to be permitted. The IASB concluded that more useful information would be provided if goodwill was not amortised but subjected to a rigorous and operational impairment test. FRS 10 'Goodwill and Intangible Assets' seeks to charge goodwill to the profit and loss account only to the extent that the carrying value of goodwill is not supported by the current value of goodwill within the acquired business.

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6.187 Subsequent measurement of goodwill is a complex issue; neither annual impairment nor amortisation is likely to result in a conclusive value for the carrying amount of goodwill. The ASB is seeking views on whether the UK IFRS-based standard should be amended and an option introduced allowing amortisation of goodwill.

6.188 Costs incurred in connection with an acquisition are not to be accounted for as part of the cost of the investment.

FRED 37 *Definition of an Intangible Asset* and FRED 38 *Impairment Tests*

6.189 As part of the first phase of the Business Combinations project the IASB amended both IAS 38 'Intangible Assets' and IAS 36 'Impairment of Assets'. FREDs 37 and 38 propose the adoption of UK standards based on the current text of these standards.

6.190 The main differences between the proposed standards and current accounting practice are as follows:

FRED 37 Definition of an Intangible Asset

6.191 The IASB reconsidered the definition of an intangible asset and affirmed the view that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill.

6.192 IAS 38 does not define '*identifiable*' but states an intangible asset meets the identification criterion when it:

- is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract asset or liability; or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

6.193 This is in contrast to FRS 10 which defines identifiable assets as assets that are capable of being disposed of or discharged separately, without disposing of a business of the undertaking. The proposed Standard therefore extends the definition of an intangible asset to include those that are not separable.

FRED 38 Impairment Tests

6.194 To justify the carrying of goodwill without systematic amortisation it is clear that a robust test for impairment is required. The impairment test must provide confidence in its ability to identify reductions in the carrying amount of acquired

goodwill. There are two key differences between the impairment test set out in FRS 11 and that of IAS 36:

- a the FRS 11 test attempts to distinguish between acquired and internally generated goodwill and to recognise only impairment of the acquired part. The proposed Standard does not include such a test;
- b the FRS 11 impairment test includes a test to check the accuracy of impairment by comparing actual cash flows against those projected; IAS 36 does not contain a similar test.

FRED 39 Amendments to FRS 12 Provisions, contingent liabilities and contingent assets and Amendments to FRS 17 Retirement benefits

- 6.195 It is proposed that FRS 12 is renamed 'Non-financial Liabilities'. A non-financial liability is defined as a liability other than a financial liability as defined in FRS 25 'Financial Instruments: Disclosure and Presentation'. The IASB states that this amendment is to clarify that IAS 37 (and thereby FRS 12) should be applied to all non-financial liabilities that are not within the scope of other Standards.
- 6.196 The Exposure Draft no longer applies the terms 'contingent liabilities' and 'contingent assets'. Contractual rights and obligations can be divided into two types: 'conditional' and 'unconditional'. An entity recognises a liability relating to the unconditional obligation; uncertainty about the future event is reflected in the measurement of the liability. The term 'contingency' is used to refer to uncertainty about the amount required to settle the liability, rather than uncertainty as to whether a liability exists.
- 6.197 Under FRS 12, a provision is only recognised if it is probable that an outflow of economic resources would be required to settle the provision. When applying the amended definitions all unconditional obligations that meet the definition of a liability are considered for recognition. The draft Standard omits the probability criterion from recognition and moves it to measurement.
- 6.198 The amendments made to the recognition criterion, particularly the removal of the probability criterion, will give rise to a greater number of liabilities meeting the recognition criteria. These amendments place greater emphasis on satisfying the definition of a liability. The Exposure Draft notes that an essential characteristic of a liability is that the entity has a present obligation arising from a past event. The removal of the

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probability criterion from recognition will require all present obligations that meet the definition of a liability to be recognised.

6.199 What will change? - a simplified example

An entity is being sued for damages of £10 million. Legal proceedings have started, but the entity disputes liability. The entity estimates that it has a 20 per cent chance of losing the case. Under FRS 12, the entity would disclose a contingent liability in the notes to the accounts. Under the proposals in FRED 39, the entity has an unconditional obligation to stand ready to pay the damages if awarded. In this case, it would recognise a non-financial liability of £2 million.

6.200 The IASB is also proposing to amend the requirements relating to restructurings. The revised Standard states that a decision to restructure, even if accompanied with an announcement by management is not the requisite past event for the recognition of a liability. It would appear that this amendment will result in many restructurings that were previously recognised as 'single sum amounts' being recognised as a number of individual amounts when each cost meets the definition of a liability.

6.201 UK accounting standards currently include no specific requirements for accounting for termination benefits other than the general principles of FRS 12. It is proposed to introduce that section of IAS 19 'Employee Benefits' that define and set out the accounting requirements for termination benefits into FRS 17 (FRS 17 will be renamed 'Retirement and Termination Benefits').

6.202 Termination benefits may be either 'involuntary' (provided as a result of an entity's decision to terminate an employee's employment) or 'voluntary' (offered for a short period of time in exchange for an employee's decision to accept voluntary termination).

6.203 A liability and expense for 'voluntary' termination benefits shall be recognised when the employee accepts the entity's offer to those termination benefits.

6.204 A liability and expense for 'involuntary' termination benefits, except where provided in exchange for the employees future services, shall be recognised when the entity has a plan of termination that it has communicated to the employees and the plan meets the criteria specified in the Standard. Involuntary termination benefits provided in exchange for the employees future services shall be recognised over the period of service.

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FRED 40 *Heritage Assets*

- 6.205 In December 2006, the ASB published an exposure draft 'Accounting for Heritage Assets'. The aim is to improve the quality of the financial reporting of heritage assets for entities such as museums holding collections of art, antiques and books and also for entities that own and manage landscape or buildings for their environmental or historical qualities. The proposals in Financial Reporting Exposure Draft (FRED) 40 have been developed from a Discussion Paper 'Heritage Assets: Can Accounting Do Better?' which the ASB issued in January 2006.
- 6.206 The proposals apply only to entities that hold heritage assets that contribute to a principal objective of promoting knowledge and culture. These entities should report their heritage assets in accordance with new requirements, rather than the current requirements of FRS 15 'Tangible Fixed Assets'.
- 6.207 Specifically, the proposals will require entities, wherever practicable, to report collections of heritage assets at valuation in their annual accounts. Where it is not practicable to obtain a valuation, the collection should not be reported in the balance sheet. This is a change from the Discussion Paper, which proposed that the accounting policy should be applied for an entity's total holdings of heritage assets. Enhanced disclosures are required regardless of whether or not collections are reported in the balance sheet.
- 6.208 Illustrative disclosures, including details of the nature and scale of heritage assets held and policies for their acquisition, preservation, management and disposal are included in the FRED.
- 6.209 The proposals were intended to address criticisms of the current financial reporting requirements that result in most entities only recognising recently acquired heritage assets in the balance sheet at cost: figures which may bear little or no resemblance to the value of the entity's overall collection. Colleges should note that following feedback from interested parties, the ASB re-issued the exposure draft as FRED 42 (see 6.215 below).

FRED 41 *Related Party Disclosures*

- 6.210 FRED 41 contains proposals to replace the existing UK standard (FRS 8) with a Financial Reporting Standard based on International Accounting Standard (IAS) 24.
- 6.211 The proposals in the FRED are designed to ensure consistency between the requirements of accounting standards

and company law. In March 2007 the Government issued a consultation document 'Implementation of Directive 2006/46/ EC on Company Reporting - Amending the Accounting Directives' which will align the definition of a related party in UK company law with that in IAS 24. Without an amendment to FRS 8 a conflict would arise between that standard and the Companies Act requirement.

6.212 The proposals will lead to improved convergence between UK and International Financial Reporting Standards (IFRS) whilst avoiding any potential conflict between the requirements of financial reporting standards and company law. The FRED also proposes to:

- incorporate the IASB's proposals to amend IAS 24, as published in February 2007;
- provide disclosure exemptions for wholly owned subsidiaries in accordance with the DTI proposal for the UK implementation of Directive 2006/46/EC; and
- provide guidance on materiality, based on that set out in IAS 1 Presentation of Financial Statements.

6.213 The FRED also requires disclosure of transactions entered into by the [College] with related parties if they are material and have not been concluded under normal market conditions, as required by the Directive. The ASB notes that this is an addition to the disclosure requirements under IAS 24 and has asked both the Government and the European Commission to clarify whether this was the intention of the Directive. This proposal will be reviewed in the light of their responses.

6.214 It is anticipated that the changes proposed to UK company law above will become effective in 2009.

FRED 42 *Heritage Assets*

6.215 In June 2008, the ASB issued Financial Reporting Exposure Draft (FRED) 42 'Heritage Assets' which aims to improve the quality of the financial reporting of heritage assets. The proposed standard will apply not only to museums and galleries, but also to other entities that house historic collections of art, antiques and books, or that own or manage land or buildings with important environmental or historical qualities.

The main feature of the proposals is that enhanced disclosures should apply to all entities that hold heritage assets, regardless of whether these assets are reported in the balance sheet. These

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disclosures should provide readers with an understanding of the asset values being reported as well as the entity's policies for managing its total holding of heritage assets.

The proposals also require heritage assets to be reported in the balance sheet where information is available on cost or value. The ASB remains of the view that heritage assets are assets and that the best financial reporting is secured when they are reported as such in the balance sheet.

Accounting for heritage assets presents some very difficult and challenging issues and, having considered a number of alternative approaches, including those proposed in the Discussion Paper 'Heritage Assets: Can accounting do better?' (January 2006) and FRED 40 'Accounting for heritage assets' (December 2006), the ASB is not persuaded there is a better accounting solution than the current FRS 15 based requirements. The ASB does, however, expect the enhanced disclosures that are proposed in FRED 42 to significantly improve the financial reporting of heritage assets and thereby contribute to better financial management in this important sector.

Subsequent to the above the ASB has now issued a full Financial Reporting Standard (FRS 30 *Heritage Assets*) which utilises the majority of the text within FRED 42 unchanged. A fuller analysis is set out below at 6.229.

Further Guidance on the Exposure Drafts

- 6.216 For the time being the **LSC and its successor organisations** will not issue any further guidance to Colleges on these draft accounting standards as the accounting treatment might change by the time they get issued as accounting standards. If in the meantime Colleges wish to obtain further information on the FREDs they should refer to the [ASB's](#) website.

Urgent Issue Task Force (UITF) Abstracts

- 6.217 From time to time the ASB issues UITF Abstracts to deal with emerging issues that are not adequately dealt with in the existing standards and which are sufficiently pressing that they cannot wait for the full standard to be revised and reissued. On the whole the issues covered in the Abstracts are not relevant to the sector and are only referred to within this Handbook when they are relevant.

- 6.218 On 13 February 2008 the UITF published Abstract 45 and Information Sheet 83. Abstract 45 has the effect of implementing

into UK GAAP IFRIC Interpretation 6 – Liabilities arising from Participation in a Specific Market – Waste Electrical and Electronic Equipment.

- 6.219 The Abstract provides guidance on accounting for liabilities for waste management costs under the EU Directive on waste electrical and electronic equipment (the WEEE Directive). The Abstract considers the attribution of waste management costs where an individual producer's obligation arises from its participation in the market during a measurement period. The consensus is that the obligating event giving rise to a liability for waste management costs is participation in the market during a measurement period. .
- 6.220 The European Union's Directive on Waste Electrical and Electronic Equipment (WE&EE), which regulates the collection, treatment, recovery and environmentally sound disposal of waste equipment, gave rise to questions about when the liability for the decommissioning of WE&EE should be recognised. The Directive distinguishes between 'new' and 'historical' waste and between waste from private households and waste from sources other than private households. New waste relates to products sold after 13 August 2005. All household equipment sold before that date is deemed to give rise to historical waste for the purposes of the Directive.
- 6.221 On the 23 October 2008 the ASB issued UITF Abstract 46 (IFRIC 16) Hedges of a Net Investment in a Foreign Operation. Abstract 46 has the effect of implementing the International Accounting Standards Board's (IASB's) International Financial Reporting Interpretations Committee (IFRIC) Interpretation 16 'Hedges of a Net Investment in a Foreign Operation' in the UK and Republic of Ireland. Abstract 46 applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with FRS 26 *Financial Instruments: Recognition and Measurement*. As such it is not expected to have any direct relevance to the FE sector.

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

Introduction

- 6.222 The Accounting Standards Board (ASB) issued the *Statement of Principles for Financial Reporting* in December 1999.

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Although the Statement is of relevance to the financial statements of profit-orientated entities in both the private and public sectors, the ASB believes that the principles it sets out have wider application and, in May 2003, issued a discussion paper seeking comments on the application of those principles to public benefit entities. Comments received on the discussion paper were incorporated into an Exposure Draft *Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities* that was issued by the ASB on 11 August 2005. With certain points of clarification only, the [final document](#) was published by the ASB in June 2007.

Background to the Statement

- 6.223 The primary purpose of the Statement is to provide a coherent frame of reference to be used in the development of statements of recommended practice (SORPs), other specific guidance to the sector and to assist preparers of the financial statements and their auditors when faced with new or emerging issues.
- 6.224 The Statement is not an accounting standard, nor does it have a status, which is equivalent to an accounting standard. Where there is an inconsistency between the principles set out in the interpretation and a standard, such as SSAP 4 *Accounting for Government Grants*, the standard must be followed until it is replaced or revised. This is an issue that the ASB is considering further.
- 6.225 The principles in the Statement are however intended to be relevant to the financial statements of public benefit entities, such as Colleges.
- 6.226 Public Benefit Entities (PBEs) are reporting entities whose primary objective is to provide goods or services for the general public or social benefit and where risk capital has been provided with a view to supporting that primary objective rather than a view to a financial return to equity shareholders.
- 6.227 There are a number of approaches set out in the Interpretation which could, if applied to the financial statements of Colleges, have far reaching consequences including:
- Capital grants – these are suggested for recognition in the income statement as a gain immediately unless there are conditions, in which case they should be recognised when any conditions are substantially met or are virtually certain to be met (para 5.34)
 - Donation of services – with particular reference to those services that an entity might otherwise have purchased then the Statement

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proposes that the service should be recognised in the financial statements based on its value to the recipient – provided that the value can be reliably measured (para 4.50)

- Recognition of liabilities – the original draft included a desire to recognise liabilities under executory style contracts where there were non performance related commitments which was acknowledged as being inappropriate in the current context for PBEs. There remains continuing concerns about the interpretation of constructive obligations for PBEs and the ASB committed to consider these matters further. Depending on the results of those deliberations, Colleges could see additional liabilities being recognised in their accounts in future.
- Business combinations – the draft Interpretation took the view that the majority of combinations would be acquisitions not mergers and that where nil consideration was involved (as is the case for the combination of two or more Colleges) then the resulting gain should be taken to the income and expenditure account. The presumption of acquisitions has been removed but the accounting treatment of the gain has only been amended to acknowledge the gain as a gift of one business to another, with the same end result for the accounting treatment.

6.228 The LSC will continue to monitor developments in this area and inform Colleges as they arise.

New UK Financial Reporting Standards

6.229 The Accounts Direction Handbook for 2009/10 includes as far as they are applicable, all UK Financial Reporting Standards up to and including FRS 30 Heritage Assets.

6.230 In June 2009 the ASB published FRS 30 Heritage Assets. In developing the FRS, the ASB considered comments on the Discussion Paper and on the exposure drafts, FRED 40 and FRED 42. The new FRS should be applied in respect of accounting periods *beginning on or after 1 April 2010* and earlier application is encouraged. For the Further Education sector this would mean that the first full year of implementation would be 2010/11 though it should be noted that implementation will entail accumulating the additional disclosure information for 2009/10 as well in order to comply fully with the requirements.

6.231 The standard applies to all heritage assets that are held and maintained by an entity principally for their contribution to knowledge and culture. Assets that are used by a College in its

operations should be accounted for as operational assets in accordance with FRS 15 'Tangible fixed assets', notwithstanding historical or other heritage qualities.

6.232 The previous definitions of heritage assets set out in FRED 42 have been maintained and the objective of the FRS is to ensure that:

- *enhanced disclosures* apply to all heritage assets, regardless of whether they are reported in the balance sheet; and
- where information is available on cost or value, heritage assets are reported in the balance sheet.

6.233 These disclosures should provide readers with an understanding of the asset values being reported as well as the entity's policies for managing its total holding of heritage assets. The valuation rules within the standard are more relaxed than those found in other standards, with the express intent of encouraging entities to report heritage assets in the balance sheet. There will be the need to ensure that the accounting policies adopted for a College's holding of heritage assets are stated, including details of the measurement bases used.

6.234 The first time adoption of the standard will result in a prior period adjustment to income and expenditure reserves for that element relating to the value at donation, not previously recognised. Valuations changes relating to the assets subsequent to that date will be taken to revaluation reserves under the standard.

Charities Act 2006

6.235 The large majority of Colleges are exempt charities under the Charities Act 2006 as they were under the previous act. As such they are not required to include within their annual reporting, how they meet the "public benefit test" for their charitable activities. Any Colleges that are **registered** charities however, will have to make specific reference to this within their accounts, most likely within their OFR. Guidance on this matter is being developed by the Charities Commission and any Colleges that believe they are affected by this legislation should discuss it with their auditors and refer to the guidance on the relevant [Charities Commission](#) website.