Reclassification of Incorporated Colleges

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Reference: Communication Number 8

Summary: This communication provides initial guidance on the issues of VAT, insurance, borrowing, the balance sheet impact of transferring reserves to foundations, and capital accounting.

FAO: Principals, Chairs and Finance Directors of Scotland's colleges; College regional leads. Please note that the contents are largely technical and therefore of most interest to Finance Directors.

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Guidance note on VAT, insurance, borrowing, the balance sheet impact of transferring reserves to foundations, and capital accounting

Purpose

1. This note is designed to update you on the above issues that you will need to consider in preparing your accounts as at 31st March 2014 and beyond. It also identifies changes you will need to make to current practices to ensure you comply with government accounting requirements from 1st April 2014.

VAT

2. You have already been notified that there is no change to colleges' VAT status as a result of the ONS re-classification.

3. While there has been an agreement at national level, there is a requirement for your local HMRC office to be notified of the change in college status. We will separately forward to Finance Directors a copy of an exchange of e-mails between the Head of the Treasury and Banking Branch of the Scottish Government and HMRC which details the basis on which the ruling was given. The correspondence is marked restricted, however, Scottish Government is content that you can share this with your local tax office if needed.

4. Colleges' VAT return dates may also need to be changed to ensure they are coterminous with the financial year end.

Insurance

5. As a result of the reclassification of colleges as public sector bodies, there is a requirement to consider the implications arising from this on colleges' commercial insurance arrangements.

6. Under the Scottish Public Finance Manual (SPFM), public bodies are required to self-insure with the exception of Motor Third Party Insurance, Statutory Engineering Inspections, and where bodies are required to take out commercial insurance in order to undertake commercial contract work.

7. This would be a significant change to current practice and discussions are on-going to examine the implications that this change would have on college operations. It is hoped that a definitive answer can be provided to you by mid-November. However, given that colleges have renewed their commercial insurance until July 2014, there remains time for a discussion to take place.

Borrowing

Existing loans

8. Accounting for the repayment of existing loans within the resource budget falls into two parts: the repayment of the capital element of the loan and the cost of servicing the loan (interest, early repayment fees etc.).

9. The current working assumption, as stated in communication number 2, is that the interest cost of the loan will be charged to a college's income and expenditure account and counts against the resource budget. The repayment of the capital element does not count against the resource budget.

10. This is still under discussion with HM Treasury and you will be advised as soon as a decision is made.

11. Should colleges wish to use their reserves to repay the loans early they can do so. Colleges opting to settle loans early will need to demonstrate that this action provides value for money.

New Loans

12. Colleges should not enter into new loan arrangements after 1 April 2014 without the prior approval of the Scottish Funding Council.

13. Should a college take out a new loan, it will not have the resource budget available to spend the funds borrowed. The repayment of the capital element and the interest payment on the loan will count against the college resource budget. Taking out a loan without this cover will result inevitably result in a college overspending.

Balance Sheet Impact of Transferring Reserves to Arms-length Foundations

14. As you will be aware, college cash-backed income and expenditure reserves can be transferred to an arms-length foundation prior to 31 March 2014.

Implications for Colleges

15. The transfer of the reserves to the foundation could result in a number of colleges having a negative reserve total in their balance sheet, as a result of a negative pension reserve that is higher than their I & E reserve balance.

16. Should the size of the negative pension reserve be large enough, this may lead to some colleges having a negative balance sheet.

17. It should be noted that a number of public sector bodies have a negative balance sheet as a result of pension deficits. These organisations have been accepted by both the Scottish Government and Audit Scotland as going concerns.

18. The college position has been discussed with both the Scottish Government and Audit Scotland and both bodies are content that the position of colleges is no different than other public bodies. The college position does not give rise to either government or audit concern in respect of the impact of pension deficits in the accounts.

19. In order to explain the negative balance sheet position, colleges will need to adopt a statement similar to the one below in in the going concern section of their Accounting policies located in the 'Notes to the Accounts':

"(name of College) liabilities falling due in future years are in part met from income derived from commercial income, whose charges have been set to meet the expected costs attributable to them in (accounting year of accounts) including pension costs. The Board has no reason to expect this process to change in the future. To the extent that the pension deficit is not met from (College Name) other sources of income it may only be met by future grants from the Scottish Funding Council or its sponsoring department, Scottish Government Education and Lifelong Learning. This is because, under the normal conventions applying to parliamentary control over income and expenditure, such grants may not be paid in advance of need. The Board of (College name) has no reason to believe that either the Scottish Funding Council or the department's future sponsorship and future Ministerial approval will not be forthcoming or will only provide a reduced support to (College name). Given the above, it has accordingly been considered appropriate to adopt a going concern basis for the preparation of these financial statements."

20. This statement should be shared with your external auditors at the earliest opportunity so that any concerns they may have can be dealt with well in advance of your accounts being prepared.

Capital Accounting Post 1st April 2014

21. As a result of the ONS reclassification, the capital accounting requirements placed on colleges will change from 1st April 2014.

22. These changes will have a significant impact on the way colleges account for capital items. To ensure you get a heads up as early as possible on the issues involved, it is helpful to give you an early indication of what the changes will entail and the potential impact they will have on your accounts.

23. Some additional information is being requested from colleges to improve the accuracy of the budget allocation process in respect of some of the key changes noted below.

24. The key changes covered in this section of the paper are:

- Capital Expenditure Accounting and Control
- Depreciation Accounting
- Asset Valuation

Capital Expenditure Accounting and Control

25. As you will be aware, the draft Scottish budget for colleges included a grant for capital expenditure of £26.6 million for the 2014-15 year, additional capital expenditure above this level would require to be funded from capital receipts. Under the new accounting rules to be applied as a result of the reclassification of colleges as arms-length public bodies, capital grant is ring-fenced for capital use and cannot be used for revenue expenditure. This is a significant change from previous years where the capital maintenance grant could be used for either revenue (e.g. general building maintenance and the repayment of interest on debt) or capital expenditure.

26. From 1st April 2014, the capital grant can only be used to fund capital expenditure as defined by the SORP guidance. For ease of reference, the relevant part of the SORP is reproduced below.

FRS 15 (the SORP) defines expenditure that can be capitalised as being:

For assets brought into use for the first time:

"Costs, but only those costs, that are directly attributable to bringing the asset into working condition for its intended use." This can include the finance and other related costs of the asset. If finance costs are capitalised this needs to be applied consistently.

Subsequent expenditure on the asset should be capitalised where:

1. *The subsequent expenditure provides an increase in the expected future benefits to the institution from the existing tangible fixed asset beyond its previously assessed standard of performance.*
2. *A component of the fixed asset that has been treated separately for depreciation purposes and depreciated over its useful life is replaced or restored.*

Otherwise expenditure to maintain the asset i.e. routine repair and maintenance expenditure should be charged to the Income and Expenditure Account in the period it is incurred."

27. College retained capital receipts from the sale of Treasury funded non-current assets are also subject to the same capital accounting rules.

28. Any capital grant that will not be used in the financial year needs to be identified as early as possible and returned to the Funding Council (SFC) which will seek to ensure it is utilised elsewhere within the sector.

29. Before acquiring capital assets, colleges should as before ensure that the related running costs of the asset, including depreciation, can be met from within their budget (see section on depreciation below).

- **From 1st April 2014, a college will be required to use the capital grant received from SFC for capital items in accordance with the SORP (FRS 15). It cannot be used for revenue expenditure**

- **Unused capital grant will need to be returned to SFC for use elsewhere in the sector**

- **As the capital grant is ring-fenced, colleges will not be able to transfer any unused capital grant to the foundation as it would no longer form any part of the income and expenditure account surplus**

- **From 1st April 2014 colleges can continue to transfer revenue expenditure to capital expenditure**

How does this impact college accounts?

30. The impact of this change to capital accounting will mean that maintenance, interest charges and any other revenue costs that were previously met from the capital maintenance grant, will require to be met out of colleges' revenue expenditure. If this revenue expenditure continues to be charged to the Income and Expenditure Account at the historic level, with no additional

budget cover or other income generated, there would be an overspend, and the college would exceed its resource budget.

What is the size of the revenue shortfall?

31. Based on the August 2013 financial forecast returns (FFRs) it would appear that capital expenditure proposals across the sector for 2014-15 are £41 million, although this figure is subject to review. This is expected to be financed by SFC grant of £15.7 million with the remainder coming from college funds and disposals.

32. Under the pre 1st April 2014 regime, colleges would have expected to receive the full capital grant allocation of £26.6 million and based on the August FFR information would have used £15.7 million of this for capital expenditure and the balance of £10.9 million for revenue items.

33. After 1st April 2014, colleges will not be able to use the remaining £10.9 million for revenue items.

34. This £10.9 million represents the total pressure on sector revenue budgets, or put simply the level of overspend that will arise across the sector if no action is taken. Clearly colleges require to at least break even on income and expenditure and an overspend position is not sustainable.

How will this revenue shortfall be addressed?

35. In order to meet this shortfall, it is proposed to agree with Scottish Government a switch of capital funds to revenue on a recurrent basis. Initial indications are that Scottish Government would be supportive of this, but is dependent on the overall position of the Scottish Budget. Once this position is confirmed colleges will be advised.

What action is to be taken after addressing the revenue shortfall?

36. Once the shortfall has been addressed, the capital grant will comprise two components comprising a capital component which must be used as described above and a revenue component. SFC will then be in a position to allocate the two components to the sector, most likely on a formula basis as is done at present with the capital maintenance grant.

Depreciation Accounting

37. As you will be aware, HM Treasury has agreed to provide £50 million non-cash recurring 'budget cover' for depreciation costs for the sector. This does not mean that there is any extra grant available for the college sector. However, it is important because, without this agreement, the Scottish Government would have had to make real reductions in other parts of its budget to 'cover' incorporated colleges' depreciation charges.

38. An example, as shown in the simplified table below, may help explain how revenue resource budget, depreciation non-cash resource budget and cash payments are inter-related:

    The example assumes:

    - Grant Revenue is SFC income which is the same as the resource budget
    - The sector will break even on Income and Expenditure
    - Everything is received and paid, no accruals
    - No impact from deferred capital grants

39. It can be seen that the total income from SFC is £521.7 million and that this is matched by cash.

40. Column 1 (Resource Budget excluding Depreciation Resource Budget) shows the position if the £50 million non-cash resource cover was not provided to the sector. All other things being equal, colleges would need to utilise their revenue resource budget (grant) to meet their depreciation charge. The result of this would be that the sector would need to reduce their operational expenditure or increase other income by £50 million to ensure they stayed within their resource budget limit and achieve a break-even position. The sector would also have a cash surplus of £50 million, Column 2 (Cash). This would put colleges at a disadvantage when compared to their 2013-14 position.

41. To ensure that the sector is in the same financial position in 2014-15 as it was in 2013-14, the Scottish Government has provided a non-cash resource budget to cover depreciation of £50 million. (Column 3 (Resource Budget including Depreciation Resource Budget))

42. The £50 million non-cash depreciation budget ensures that the sector can use the full amount of the revenue resource (grant) it receives i.e. £521.7 million

as it does not now require to use the revenue resource budget or to generate additional income to cover the depreciation charge.

Resource Accounting v Cash Accounting

	Income & Expenditure Account	Cash	Income & Expenditure Account
	Resource Budget Excluding Depreciation Resource Budget		Resource Budget Including Depreciation Resource Budget
Income	£m	£m	£m
SFC Grant	521.7	521.7	521.7
College	165.4	165.4	165.4
Total	687.1	687.1	687.1
Expenditure			
Salaries & Supplies	637.1	637.1	687.1
Depreciation	50	0	50
Non Cash Resource	0	0	-50
Total	687.1	637.1	687.1
Surplus/(Deficit)	0	50	0

How does this impact college accounts?

43. **Annex 1** provides a very simple model, based on the same assumptions as stated above, on how resource accounting will impact a college accounts by comparing the position for 2013-14 and 2014-15.

44. In 2013-14, the college is outwith the public sector and therefore does not require to manage its expenditure within a resource budget. The £200,000 cash generated on operating activities is therefore available for colleges to spend.

45. In 2014-15, the college needs to manage within a resource budget. The cash received from SFC remains the same as 2013-14, £10 million, and this is matched by a resource budget.

46. If no other adjustments occurred, the college would generate a cash surplus, as it did in 2013-14. However, the main difference is that this cash surplus could not be spent by the college as it has no resource budget to support this spend. This would in effect mean the college would have a lower level of expenditure in 2014-15 than in 2013-14.

47. In order to put the college in the same financial position in 2014-15 as it had in 2013-14, the Scottish Government has allocated to the college a non-cash resource grant of £200,000. This means the college now has budget cover to use all the cash available to it.

Asset Valuation

48. Initial reviews of the FFRs indicate a depreciation charge for the sector of c£47 million, some £3 million less than the recurring £50 million non-cash resource budget. However, the depreciation charge from the FFRs may be understated.

49. The potential understatement arises from the fact that an analysis of 2011-12 financial statements highlighted 18 of the then 37 colleges with asset valuations based on historic cost. While it is acceptable that the assets can be held at cost, this has implications for the depreciation when the asset is replaced.

50. It is likely to be the case that colleges will require to undertake component accounting in 2015-16 to comply with IFRS. This will require colleges to assess the major components of a tangible fixed asset and, if they have significantly different useful lives, the components will require to be recognised and be depreciated separately.

Why is asset valuation important?

51. Colleges will be issued with a non-cash depreciation budget to cover their depreciation costs, those colleges which are depreciating on a historic cost basis will be allocated a lower non-cash budget cover than colleges that are depreciating on a revaluation basis.

52. When assets are replaced, those colleges that are depreciating on a historic cost basis will experience a significant step change increase in their depreciation costs due to the depreciation being charged on significantly higher asset replacement value. For those colleges which use a revaluation basis, any increase in depreciation is likely to be lower as a result of the requirement to carry out a full valuation every five years and an interim valuation in the third year following the full valuation.

53. It is entirely possible that when all colleges use the same basis of valuing their assets that the associated resultant depreciation will be higher than the £50 million non-cash resource budget. This has potential implication for colleges' revenue expenditure (see section above on depreciation).

54. If the sector depreciation charge is higher than the £50 million non-cash resource budget cover, then there are a number of options open to colleges:

- Raise the issue with SFC before the Scottish Government budget is set in January to seek a budget increase in respect of the non-cash budget cover; and/or

- Increase the useful life of the asset subject to agreement with your auditors.

What would be the impact on college financial statements?

Colleges with assets valued at historic cost in their financial statements

55. This example assumes that the £50 million non-cash depreciation cover is fully allocated to colleges and subsequently an asset requires replacement. The college will experience a higher level of depreciation due to the increased value of the replacement asset set against the asset replaced carried at historic cost. To meet this increased depreciation charge and achieve a balanced budget, the college would require to either increase its income or reduce its expenditure.

56. In order to reduce the impact of this, where colleges are actively considering revaluing their assets before 31 March 2014 they would receive an allocation of the non-cash depreciation budget.

57. Colleges will need to make their own decision on this as it will result in a change in accounting policy and a restatement of prior year accounts. However, this restatement may be required when IFRS is introduced in 2015-16 for component accounting. Therefore, if colleges opt to revalue, they should consider conducting the component assessment at the same time which would obviate the need to do this for the introduction of IFRS.

58. A further benefit may arise from the component analysis which could identify component parts of a larger asset that are fully depreciated and requiring replacement enabling the college to make plans for their replacement.

Colleges with re-valued assets in their financial statements

59. Colleges may wish to consider revaluing their tangible fixed assets if they are not re-valued on an annual basis to ensure that the base line level of the non-cash depreciation budget cover is allocated to take account of any component depreciation impacts. While the revaluation and

componentisation of tangible fixed assets will not be required until the introduction of IFRS, colleges which have not already done so may wish to consider the benefit of undertaking a revaluation of their assets on a component basis before 1st April 2014. By doing so colleges would ensure that the depreciation non-cash resource cover for their re-valued assets would be allocated in their 2014-15 budget baseline and they would not require a further revaluation of their assets when IFRS is introduced.

60. A further benefit may arise from the component analysis which could identify component parts of a larger asset that are fully depreciated and need replacement enabling the college to make plans for their replacement.

Non-profit distributing model

61. Impairment reviews should be undertaken by colleges which have or will have a signed contract by the year end under a Non Profit Distribution (NPD) funding arrangement. By realising any impairment or accelerated depreciation in the 2013-14 year, colleges will avoid this charge impacting in the 2014-15 accounts and counting against their non-cash depreciation resource limit, which may cause it to be exceeded with a potential reduction in revenue expenditure or requirement to increase income to ensure that the college breaks even.

Information request for all colleges

62. If you intend to undertake a revaluation can you please advise **Peter Ward (e-mail: pward@sfc.ac.uk; Tel: 0131 313 6667)** or **Andrew Millar (e-mail: amillar@sfc.ac.uk; Tel: 0131 313 6538)** as the outcome of any revaluation may impact on the depreciation budget allocated to the college and the affordability of the depreciation charge within the £50 million non-cash allocation. Could you also advise Peter or Andrew of the outcome of the revaluation in terms of the depreciation charge for the college and the new fixed asset values.

63. If you are undertaking an impairment review can you also advise Peter or Andrew in relation to the depreciation charge for the college and the new fixed asset values.

64. If you have any queries on the content of this communication, please contact **John Ford (e-mail: jford@sfc.ac.uk; Tel: 0131 313 6522)**.

Transition year

ANNEX 1

College X 13/14	**I and E**	**Cash**
	£000	**£000**
SFC Income	10000	10000
Other Income	5000	5000
Interest Receivable	500	500
Total Income	**15500**	**15500**
Staff Costs	12000	12000
Other Costs	3000	3000
Depreciation	200	0
Interest Payable	300	300
Total Expenditure	**15500**	**15300**
Surplus/Deficit	0	200

College X 14/15	**I and E**	**Cash**	**Resource**
	£000	**£000**	**£000**
SFC Income	10000	10000	10000
Other Income	5000	5000	5000
Interest Receivable	500	500	500
Total Income	**15500**	**15500**	**15500**
Staff Costs	12000	12000	12000
Other Costs	3000	3000	3000
Depreciation	200	0	200
Interest Payable	300	300	300
Total Expenditure	**15500**	**15300**	**15500**
Surplus/Deficit	0	200	0

Current position

	Cash	**Resource***
SFC income received	10000	-
Resource	-	-
	10000	**0**

2014-15 Position

	Cash	**Resource**
SFC income received (Cash)	10000	-
Cash resource allocated to college	-	10000
Non-Cash Resource Cover (Depreciation)	-	200
Total Cash/Resource expended	**10000**	**10200**

Cash generated on operating activities

	£000
Surplus	0
Add back : Depreciation (Non-cash)	200
Cash generated on operating activities	**200**

Cash generated on operating activities

	£000
Surplus	0
Add back : Depreciation (Non-cash)	200
Cash generated on operating activities	**200**

* Control does not apply till 2014-15