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Ministry of Defence

JSP 472
Financial Accounting & Reporting Manual

Part 2: Guidance

JSP 472 Pt 2 (V1.0 Jun 15)

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Foreword

This Part 2 JSP provides guidance in accordance with the policy set out in Part 1 of this JSP; the guidance is sponsored by the Defence Authority for Financial Accounting Policy. It provides policy-compliant business practices which should be considered best practice in the absence of any contradicting instruction. However, nothing in this document should discourage the application of sheer common sense.

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Preface

How to use this JSP

1. JSP 472 applicable for financial year 2015-16 explains the accounting policies which must be applied when preparing the Department's financial statements to ensure they comply with the requirements of International Accounting Standards (as interpreted/adapted by HM Treasury in its Financial Reporting Manual (FReM)). It also explains the approval and reporting requirements for losses and special payments and for certain classes of actual and contingent liabilities, as set out in Managing Public Money (MPM).

2. Its main uses are in the preparation of:

   a. the Annual Budget Cycles (ABC);

   b. in-year financial accounting and reporting;

   c. the Annual Report and Accounts (ARAc);

   d. the Whole of Government Accounts (WGA).

3. This JSP is structured in two parts:

   a. Part 1 - Directive. This provides direction that must be followed, in accordance with mandated policy.

   b. Part 2 - Guidance. This provides the guidance that will assist users in complying with the Directive.

Points of Contact

4. Points of contact for any policy advice on financial accounting; on losses and special payments; or on HM Treasury approval/Parliamentary reporting requirements for certain classes of actual and contingent liabilities are listed in Figure 1 below.

5. Any queries on this JSP should be directed to those individuals listed in Figure 1 below.

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Figure 1

	E-mail address	Telephone Number
FMPA A&TM Ahd Acctg Pol & TM (Accounting Policy)	HOCF-FMPA-A&TM-Ahd-ACCTPOL&TM	Int: 967984646 Ext:03067984646
FMPA A&TM Acctg Pol TM&TA (Accounting Policy)	HOCF-FMPA-A&TM-ACCPOL-TM&TA	Int: 9679 84640 Ext:030 679 84640
FMPA A&TM CFAT2 (Losses and special payments other than Special Severance Payments)	HOCF-FMPA-A&TM-CFAT2	Int: 9679 84636 Ext:030 679 84636
FMPA A&TM Ahd Fin Pol Governance (Special Severance Payments)	HOCF-FMPA-Ahd Governance	Int: 9621 86949 Ext: 0207 2186949
FMPA A&TM CFAT3 (RAC Usage Notes)	HOCF-FMPA-A&TM-CFAT3	Int: 9679 85709 Ext:030 679 85709

Scope

6. This JSP applies to all TLBs and Agencies which fall within the Annual Accounting and Reporting boundary.

7. Although Agencies are given some flexibility to tailor accounting policies to meet their own particular circumstances within their annual report and accounts, they must ensure that the end result is consistent with the policies contained within this JSP.

8. Other Departmental Financial Management System (DFMS) compliant packages must follow the policies and principles reflected in this JSP.

9. Expenditure on the Armed Forces Pension Scheme (AFPS) and the Armed Forces Compensation Scheme (AFCS) is defence expenditure for which the Accounting Officer is responsible to Parliament, even though it is not included within the Spending Review. Policies for the AFPS and AFCS are covered in this JSP.

Amendments and Updates to this JSP

10. The content of the JSP will be updated and a new version published at the beginning of each financial year. An amendments log will detail changes which have occurred since the previous version.

11. Where appropriate, amendments will be made to during the year. Changes will be recorded on an in-year amendments log.

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Amendment Log

12. This is the 2015-16 Version 1. The main amendments to the 2014/15 Financial Accounting and Reporting Manual reflected in this 2015/16 version are listed below (as Amendment Version 1). Any amendments arising during 2015/16 and applicable to 2015/16 are listed below as a further amendment with the relevant Version number.

Log	Amendment Version	Chapter	Summary of Change	Applicable FY
1	1	12	Amendments to the Policy on Losses and Special Payments.	2015-16
2	1	14	New chapter on RAC usage notes (formerly JSP 530).	2015-16

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Glossary of Abbreviations	
A-in-A	Appropriations-in-Aid
ADMT	Asset Data Management Team
AO	Accounting Officer
AP	Accounting Period
ARAc	Annual Report and Accounts
AUC	Assets Under Construction
BLB	Basic Level Budget or Budget Holder
BLBG	Basic Level Budget Grouping, a sub total of a number of BLBs all of which are within the same Management Grouping
BMP	Basic Material Price
CC	Current Cost
CDM	Chief of Defence Materiel
CFERs	Consolidated Fund Extra Receipts
COA	Chart of Accounts
COS	Contracted Out Services
CPR	Central Price Record
CRSP	Contract Repair Supply Procedure
CRSS	Contract Repair Support Inventories
CS	Capital Spares
DAO	Dear Accounting Officer (letter)
DBS	Defence Business Services
DEFCON	Defence Contract
DE&S	Defence Equipment and Support
DFMS	Departmental Financial Management System, a suite of applications through which the department plans, forecasts, accounts for and manages its finances
DG Fin	Director General Finance
DRC	Depreciated Replacement Cost
DIO	Defence Infrastructure Organisation
DRes	Director of Resources
DSA	Disposal Sales Authority
EOL	Effective Operational Life
EPP	Equipment Procurement Plan
ESP	Equipment Support Plan
FE	Fighting Equipment
FFR	Forces Fixed Rate
FMS	Financial Management System/Foreign Military Sales (determined by context)

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FReM	Financial Reporting Manual
GAD	Government Actuary's Department
GAR	General Accounting Rate
GFA	Government Furnished Asset
GFE	Government Furnished Equipment
GL	General Ledger
GRN	Goods Received Note
GRNI	Goods received not invoiced
HMRC	HM Revenue and Customs
HMT	HM Treasury
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
IMG	Inter-Management Grouping (transfer)
IPR	Intellectual Property Rights
IPSAS	International Public Sector Accounting Standards
IT	Information Technology (equipment)
IT & Comms	IT and Communications (equipment)
IYM	In-Year Management
JTTE	Jigs, Tools and Test Equipment
JSP	Joint Service Publication
LPC	Local Project Code, one of the 10 segments of the chart of Accounts used to record either TLB Project codes or Single Point Management Codes
MG	Management Grouping, a level in the department's organisational hierarchy at which Statements of Financial Position (formerly "Balance Sheets") are generated
MHCA	Modified Historical Cost Accounting
MOD	Ministry of Defence (The Department)
MOU	Memorandum of Understanding
MT	Motor Transport
NAO	National Audit Office
NATO	North Atlantic Treaty Organisation
NCA	Non Current Asset
NCAR	Non-Current Asset Register
NDPB	Non-Departmental Public Body
NIC	National Insurance Contribution
NLF	National Loans Fund
NRA	Net Recoverable Amount/Normal Retirement Age (determined by context)
NRV	Net Realisable Value
O2C	Order to Cash - The Department's receipts system
OMV	Open Market Value

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OMVEU	Open Market Value for Existing Use
OPG	Office of HM Paymaster General
P2P	The Department's Purchase Ordering System
PAO	Principal Accounting Officer/Principal Administrative Officer (determined by context)
PB&F	Planning, Budgeting and Forecasting, a suite of Cognos applications used to compile the Annual Budgeting Cycle and monthly forecasts of outturn
PDC	Public Dividend Capital
PEC	Programme Expenditure Code, signifying centrally managed expenditure, ie items which have not been delegated to Basic Level Budget holders
PES	Public Expenditure Survey
PFI	Private Finance Initiative
PLRs	Permanent Loan Records
PPE	Property, Plant and Equipment
PtP	The Department's Invoicing and Payment system
PUS	Permanent Under Secretary
RAC	Resource Account Code, the codes used across the department to record and classify financial transactions
RACE	Resource Account Code Establishment, an annual exercise to amend the list of Resource Account Codes
RCC	Resource Cost centre, a bespoke code used by Navy Command
RAF	Royal Air Force
RFA	Royal Fleet Auxiliary
RICS	Royal Institute of Chartered Surveyors
RMC	Raw Materials and Consumables
RN	Royal Navy
SCAPE	Superannuation Contribution Adjusted for Past Experience
SDS	Standing Data System, the centrally maintained database of organisational, accounting and Management Information codes used across all of the applications which from the Departmental Financial Management System
SIC	Standing Interpretations Committee
SLA	Service Level Agreement
SOCNE	Statement Of Comprehensive Net Expenditure
SOFP	Statement Of Financial Position
SPMC	Single Point Management Code, used to ensure expenditure is booked to central Programme Expenditure Codes or specified UINs
SPVA	Service Personnel Veterans Agency
SPWR	Special Purpose War Reserves
TLB	Top Level Budget, the level immediately below the Corporate Centre in the Department's Organisational hierarchy
UBE	Upkeep By Exchange

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UIN	Unit Identity Number one level below Basic Level Budget and the lowest centrally maintained level in the Department's organisational hierarchy
UING	A sub total of a number of Unit Identity Numbers all of which are within the same Basic Level Budget
VAT	Value Added Tax
WGA	Whole of Government Accounts
WMR	War Maintenance Reserves
WPS	Widow(er)s' Pension Scheme

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Glossary of Accounting Terms	
Accounts Direction	HM Treasury's statutory power of direction over the preparation of accounts.
Accounting Period (AP)	Used in-year to refer to the calendar month for which annual accounting information is prepared. Annual Report and Accounts are prepared for the year ending 31 March (AP 12). AP 6 and AP 9 are sometimes referred to as a 'hard close'.
Accounting bases	The methods developed for applying fundamental accounting concepts to financial transactions and items for the purpose of preparing financial statements, and in particular: for determining the accounting periods in which revenue and costs should be recognised in the SOCNE; and for determining the amounts at which material items should be stated in the SOFP.
Accounting Officer	Accounting Officers are appointed by HM Treasury. An Accounting Officer has the personal duty of signing the accounts described in his/her letter of appointment and, by virtue of that duty, the further duty of being a witness before the Public Accounts Committee (PAC).
Accounting policies	The specific accounting bases selected and consistently followed by an entity as being, in the opinion of the management, appropriate to its circumstances and best suited to give a true and fair view of its results and financial position.
Accounting standard	An authoritative statement of how particular types of transaction and other events should be reflected in financial statements. Compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.
Accounts Payable Ledger	The record of payables individual accounts and transactions.
Accounts Receivable Ledger	The record of receivables individual accounts and transactions.
Accrual	An accrual reflects the estimated value of goods and/or services received but not yet invoiced or paid.
Accruals Accounting	A method of accounting which records expenditure as it is incurred and income as it is earned during an accounting period.
Additional depreciation	Arises with the use of modified historical cost accounting and is the difference between depreciation charged in year at current replacement cost and the amount of depreciation charged in year on an historical basis.
Amortisation	The process of gradually extinguishing a liability, debt or capital expenditure on an intangible non-current asset over a period of time.
Annual Accounts	Details of the Departmental published accounts.
Appropriations-in-Aid (A-in-A)	Income received by a department which it is authorised to retain (rather than surrender to the Consolidated Fund) for finance related expenditure. Such income is voted by Parliament in Estimates and accounted for in the Annual Accounts.

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Asset	A resource currently controlled by the Department from which it expects to receive economic benefits.
Assets under construction (AUC)	The accumulated cost of NCAs which are in the process of being constructed.
Associate	An entity (other than a subsidiary) in which another entity (the investor) has a participating interest and exercises a significant influence over the entity's operating and financial policies.
Audit	The systematic examination of an entity's activities and status based primarily on investigation and analysis of its systems, controls and records.
Audit trail	The history of a transaction or other data, from its outset to its origin into financial statements.
Backlog depreciation	Represents the total of all prior year under-provisions for depreciation that have arisen due to the effect of changing prices on past consumption.
Bad debt	A debt which is either not collectable or there is specific evidence to indicate that the debt will not to be collected. A bad debt is written-off as a charge to the SOCNE or against an existing specific bad debt provision.
Budget	An annual sum of money allocated by Def Res for a particular purpose.
Budget Holder	The individual accountable for the use of resources delegated to him/her by the Accounting Officer and responsible to the next higher management level for the results achieved by their use.
Budget Manager	An individual who is accountable to a budget holder for the preparation of the costings, the preparation of the budget outturn reports and the provision of financial and budgetary advice.
Capital expenditure	Capital expenditure is incurred for the purpose of acquiring, producing, extending or improving NCAs.
Capital spares	Items of repairable materiel retained for the purpose of replacing parts of an asset (sections, assemblies, sub-assemblies, modules or components thereof) undergoing repair, refurbishment, maintenance, servicing, modification, enhancement or conversion.
Capitalisation threshold	The value above which it is mandatory to capitalise an NCA.
Carrying amount	The historical or current cost of an NCA less any accumulated depreciation, amortisation or impairment.
Comptroller and Auditor General (C&AG)	Head of the National Audit Office which audits Government departments' accounts and reports on them to Parliament. The C&AG is appointed by the Crown and is directly responsible to Parliament for all matters relating to the collection, handling and disposal of public monies.

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Consolidation	Aggregating data from subordinate organisations.
Consolidated Fund	The Government's central fund (an account with the Bank of England known as the Exchequer Account) into which the product of taxation and other public revenues and receipts are paid and from which Government expenditure is met.
Consolidated Fund Extra Receipts (CFERs)	Receipts realised in excess of amounts authorised as Appropriations in Aid of the supply Estimates, or of kinds which HM Treasury does not allow Departments to use. Such receipts are surrendered to the Consolidated Fund as Extra Receipts.
Constructive obligation	A constructive obligation is one that derives from a department's actions where, by an established pattern of past practice, published policies or a sufficiently specific current statement, the department has indicated to other parties that it will accept certain responsibilities and created a valid expectation that it will discharge those responsibilities.
Consumables	Items of materiel that are consumed or which are otherwise regarded as consumed on issue.
Contingent asset	A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the Department's control.
Contingent liability	A contingent liability is: a possible obligation, legal or constructive, that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the Department's control <u>or</u> a present obligation, legal or constructive, that arises from past events but is not recognised because either: it is unlikely that economic benefits will need to be transferred to settle the obligation <u>or</u> the amount of the obligation cannot be measured with sufficient accuracy.
Control Account	A ledger account which collects the sum of the postings into the individual accounts which it controls. The balance on the control account should equal the sum of the balances on the individual accounts, which are maintained as subsidiary records.
Cost Centre	The lowest unit in a budgetary chain to which cost can be attributed - for example, a production or service location, specific task, specific activity or item(s) of equipment.
Credit note	A document prepared by a seller notifying the purchaser that the account is being reduced by a stated amount - for example, because of an allowance, return of goods or cancellation.
Current assets	Inventories, receivables within one year, prepayments, bank balances, cash and cash equivalents.
Current liabilities	Liabilities which fall due for payment within one year. They include that part of long-term loans due for repayment within one year.
Current prices	Prices prevailing at the time.

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Customer - Supplier Agreements	The principle method of formally establishing relationships between Budget Holders in their role as either customers or suppliers. They govern the provision of goods or services from one budgetary area to another and specify the quality, quantity and time standards suppliers must meet.
Depreciation	The measure of the wearing out, consumption or other loss of value of a non-current asset whether arising from use, passage of time or obsolescence through technological and market changes.
Development cost	The cost of use of scientific or technical knowledge in order to produce new or substantially improved materials, devices, products or services; to install new processes or systems prior to the commencement of production or application; or to improve substantially those already produced or installed.
DG Finance	The senior official in a department responsible to the Accounting Officer(s) for the overall management and co-ordination of the Department's financial activities, including relations with HM Treasury, for general financial questions and for ensuring that proper standards of financial administration and control are maintained. Authorities delegated to the Department by HM Treasury are channelled through DG Fin and, acting on behalf of the AOs, delegates as appropriate.
Direct cost	A cost which it is possible to identify directly to a particular activity or product.
Entity	An economic unit that has a separate, distinct identity.
Equity accounting	The method of accounting that brings the financial assets into its investor's financial statements initially at its cost and identifying any goodwill arising. The carrying amount of the financial assets is adjusted in each period by the investor's share of the results of its investee less any amortisation or write-off for goodwill, the investor's share of any relevant gains or losses, and any other changes in the investee's net assets including distributions to its owners - for example, by dividend. The investor's share of its investee's results is recognised in its profit and loss account. The investor's Statement of Cash Flows includes the cash flows between the investor and its investee, for example, relating to dividends and loans.
Exceptional items	Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individually, or, if of a similar type in aggregate, are disclosed by virtue of their size or incidence so as to present a true and fair view of the accounts.
Finance Lease	A lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee.
Financial accounting	The classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation, by means of a SOCNE, SOFP and Statement of Cash Flows, during and at the end of an accounting period.
Financial statements	Those statements forming the basis of the published accounts of an organisation.

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Financial year	The Parliamentary accounting year beginning on 1 April and ending on the following 31 March, being the period covered by the financial statements.
Firm price contract	A contract with an agreed price which is not subject to variation.
Financial asset	Mainly an asset that is cash; an equity instrument of another entity; or a contractual right to receive cash or another financial asset from another entity.
Fixed price contract	A contract with an agreed price which may be subject to variation.
Foreseeable loss	An assessment of the costs which are not recoverable under specified contract conditions, reflecting the loss attributable to that part of the work completed at the accounting period end.
General Fund	Total assets less liabilities to the extent not represented by other reserves.
General Ledger	The accounts in which all financial transactions are shown, either in detail or in summary.
Golden shares	Shares retained in businesses which have been privatised, but in which the Department wishes to retain a regulatory interest of reserve.
Gross carrying amount	The historical or current cost of a NCA or inventory item before any adjustment for depreciation or provision.
Gross equity accounting	The gross equity method of accounting is similar to the equity accounting method. In addition it requires that the investor’s share of the aggregate gross assets and liabilities underlying the net equity financial assets are to be shown on the face of the SOFP. In the SOCNE the investor’s share of the investee’s turnover must be given.
Guided weapons, missiles and bombs (GWMB)	Explodable munitions (excluding conventional explosive devices, for example, mines, grenades, cartridges; depth, demolition and detonation charges, mortars, bullets and other expendable ammunition; but including torpedoes and rockets where appropriate) which are maintained (repaired or serviced) by replacement of repairable parts (sections, assemblies, sub-assemblies, modules or components thereof), and which incorporate guidance mechanisms. ‘Maintained’ in this context specifically excludes routine refurbishment of ammunition and other conventional explosive devices.
Grant	An amount of expenditure approved by Parliament following the submission of Supply Estimates. Unspent balances must be surrendered at the end of the financial year. May also be a payment to an individual or a body, in the public or private sector, for which no goods or services are received in return.
Grant-in-Aid	A grant from voted monies to a particular organisation or body.
Historical cost	The original acquisition cost of an asset.

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International Financial Reporting Standard (IFRS)	One of a suite of international accounting standards applied to the Annual Report and Accounts.
Imprest account	A sum of public money advanced for official purposes, and the formal statement of receipts and expenditure of those monies, supported by the relevant vouchers. An imprest can also be a sum of money advanced by an Other Government Department or a Foreign Government, which is held by the Department and against which the Department has drawing rights to enable it to offset invoices presented to the customer.
Income	A gross inflow of economic benefits during the period which result in an increase in Taxpayers' Equity.
Indexation	A method of arriving at an approximation of current values by application of an index number.
Intangible assets	Non-financial NCAs that do not have physical substance but are identifiable and controlled by the entity through custody or legal rights.
Intellectual Property Rights	Legal rights covering ownership of invention, designs, processes, techniques, copyright material, technical information, know-how, trade names, trade secrets and drawings/specifications.
Internal audit	Independent appraisal function within an organisation to examine and evaluate its activities as a service to the organisation.
Joint Business Agreement	A formal bi-lateral agreement between service customers and suppliers which identifies and regulates mutual obligations and/or relationships, but which is not legally enforceable.
Joint control	It is the contractually agreed sharing of control over an economic activity and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).
Joint venture	A contractual arrangement whereby two or more parties undertake an economic activity that is subject to control.
Lease	A contract between a lessor and a lessee for the hire of a specific asset.
Legal obligation	An obligation that derives from a contract (explicitly or implicitly), legislation or other operation of law.
Liability	An obligation, legal or constructive, to transfer economic benefits as a result of past transactions or events.
Long term contract work in progress	The cost to date of a long term contract falling within the definition of work in progress, net of foreseeable losses and progress payments received and receivable on account.
Management Accounting	The preparation and presentation of accounting information in such a way as to assist management in the formulation of policies and in the planning and control of the activities of the undertaking.
Management Grouping (MG)	A Management Grouping (MG) is an entity (within the Departmental boundary) which has its own General Ledger and SOFP.

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Materiality	Materiality is a concept that considers the relative significance or importance of an event or accounting entry in relation to information to be included, accurately stated and separately disclosed where appropriate in the accounts of a reporting entity. Events or accounting entries (or groups thereof) are material if through their omission, non-disclosure or misstatement a reader of the accounts could be misled. The level of significance may be considered in the context of the accounts as a whole or of individual items within them.
Materiel	A generic term which covers equipment, stores, supplies and spares.
Memorandum of Understanding (MOU)	The main form of document used by the Department to record detailed arrangements between Governments' international defence co-operation.
Modified Historical Cost Accounting	Under this convention, non-current assets and inventories are reflected at current values, which are calculated by the use of indices and periodically through formal revaluation.
Net present value	The difference between the sum of the projected discounted cash inflows and outflows attributable to a capital financial asset or other long-term project.
Net realisable value	The estimated disposal sale value of an item of materiel not expected to be used or sold in the ordinary course of business. The estimated disposal sale value may be nil or scrap in appropriate circumstances, and will be net of any costs incidental to the sale, for example, agent's fees, to the extent that these are identifiable to individual items or sales contracts and are deducted from the sales proceeds on a net receipt basis (separately charged disposal costs are reflected in the surplus/deficit on disposal of inventories account).
Non-current Asset Register (NCAR)	A record of individual property, plant, equipment and intangible NCAs.
Obsolescence	The loss of value of a non-current asset or inventories item due to advances in technology or changes in market conditions for its product.
Onerous contract	A contract entered into with another party under which the unavoidable costs of fulfilling the terms of the contract exceed the revenue or value of the equipment or services supplied under the contract, and where the other party would have to be compensated if the terms of the contract were not fulfilled.
Operating lease	A lease other than a finance lease.
Opportunity cost	The cost of a resource in terms of its best alternative use.
Ordinary activities	Any activities which are undertaken by a reporting entity as part of its business and such related activities in which the reporting entity engages in furtherance of, incidental to, or arising from, these activities.
Overheads	The aggregate of indirect materials cost, indirect labour cost and indirect expenses.

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Post Statement of Financial Position Event	An event which occurs between the Statement of Financial Position date and the date on which the Annual Report and Accounts are approved.
Prepayment	Amounts paid in advance of benefits to be received.
Principal Accounting Officer (PAO)	The Permanent Secretary of a department is appointed as its Principal Accounting Officer (PAO). The appointment reflects the fact that under the Minister the PAO has personal responsibility for the overall organisation and for department-wide procedures in financial and other matters.
Prior period errors	Material errors applicable to prior periods.
Progress payment	A payment made to a contractor based on his own statement of expenditure incurred under the contract and not necessarily related to the attainment of a defined stage of work.
Provision	A liability in respect of which the amount or timing of the expenditure that will be undertaken is uncertain.
Public bank accounts	Accounts opened by departments and non-departmental public bodies to hold public monies and subject to the provisions of the Exchequer and Audit Departments Act 1866. OPG accounts are not public bank accounts for the purposes of the 1866 Act.
Public Dividend Capital	A form of long term finance for certain public sector bodies, on which the Department is paid dividends rather than interest.
Public monies	Monies that in law are the property of departments, non-departmental public bodies and other central government bodies, whether the monies come from the Exchequer or from sources such as fees and charges or asset sales.
Qualitative factors	Factors which are relevant to a decision but which are not expressed numerically.
Quantitative factors	Factors which are relevant to a decision and which are expressed numerically.
Receivable	A person or entity which owes money.
Receivables note	A document prepared by a seller notifying the purchaser that the account is being reduced by a stated amount, e.g. because of an allowance, return of goods or cancellation.(Under IFRS this is called a Receivables Note but it is accepted that the term ‘Credit Note’ might still be used in practice)
Reserves	Retained surpluses and deficits.
Residual value	The remaining value of an asset at the end of its useful life (typically scrap value).
Resource Accounting Code	The resource accounting code identifies the nature of transactions in terms of their type - i.e. expenditure, income, asset or liability.
Revaluation	The updating of an existing asset valuation through either an actual or indexed reassessment.

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Significant influence	The investor is actively involved and is influential in the direction of its investee through its participation in policy decisions covering aspects of policy relevant to the investor, including decisions on strategic interests such as: the expansion or contraction of the business, participation in other entities or changes in products, markets and activities of its investee; and determining the balance between dividend and reinvestment.
Special shares	See Golden shares.
Stage payment	A payment due to a contractor under the terms of a contract for the satisfactory completion of a predetermined stage of work.
Statement of Cash Flows	A statement listing the inflows and outflows of cash and cash equivalents for a period.
Statement of Comprehensive Net Expenditure	This is the Public Sector's equivalent of a commercial organisation's Profit and Loss Account.
Statement of Financial Position	A statement of the financial position of an entity at a given date, disclosing the assets, liabilities and accumulated funds such as taxpayers' equity and reserves, prepared to give a true and fair view of the financial state of the entity at that date.
Stewardship	The responsibility of agents to act in the best interests of their principals.
Stocktaking	The process whereby all items of materiel in an inventories location are physically checked (counted, measured or weighed), by actual or estimated means, and immediately compared with appropriate accounting records.
Supplier	An organisation providing services on behalf of customers.
Tangible asset	An asset which has a physical identity.
Taxpayers' Equity	The taxpayers' interest in the Department, comprising the general fund and the revaluation reserve.
Trading Funds	To improve commercial operation and public accountability, the Government Trading Funds Act 1973 enables certain services of the Crown, whose operation consists of or includes trading with other Government Departments or anyone else, to be financed with public money by means of a Trading Fund rather than by annual votes and appropriations.
War maintenance reserves (WMR)	Strategic inventories amassed in peacetime to meet the increase in military requirements consequent on an outbreak of war. WMR inventories are held to provide the interim support essential to sustaining operations until re-supply can be effected.
Working capital	The capital available for conducting the day-to-day operations of an organisation – i.e. normally the excess of current assets over current liabilities.
Write down	A reduction in the recorded value of an asset to reflect its recoverable amount or net realisable value.
Write-off (losses)	The final and authorised book-keeping stage in dealing with a loss which needs to be noted in the Appropriation Account and also the Annual Report and Accounts.

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1 Basis of the Annual Accounts

Introduction

1. This chapter expands on the directive in Part 1 Chapter 1 by providing further detail in setting out the illustrative Primary Statements, the extant IFRS with their adaptations and interpretations, key accounting concepts, the consolidation methodology and the process for IMG transfers. RAC usage notes guidance is given in Part 2 Chapter 14.

Illustrative Financial Statements

2. Illustrative primary financial statements are set out in Figures 1 and 2 below.

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Figure 1

Statement of Comprehensive Net Expenditure
for the year ended 31 March XX

	£000	£000
Administration Costs		
Gross administration costs	**X**	
Operating income	(X)	
Net administration costs before interest		**X**
Net interest payable	X	
Net administration costs	**X**	
Programme Costs		
Gross programme cost		**X**
Operating income		(X)
Net programme cost before interest		**X**
Net interest payable		X
Net programme cost		**X**
Net operating cost		**X**
Other Comprehensive Net Expenditure		
Items that will not be reclassified to net operating costs:		
Net gain/(loss) on revaluation of Property Plant and Equipment	X	
Net gain/(loss) on revaluation of Intangibles	X	
Items that may be reclassified subsequently to net operating costs		
Net gain/(loss) on revaluation of Available for Sale Financial Assets	X	
Total Net Comprehensive Expenditure for the year ended 31 March XX		**X**

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Figure 2

Statement of Financial Position
As at 31 March XX

	£000
Non-current assets	
Intangible assets	X
Property, plant and equipment	X
Financial assets	X
Receivables due after more than one year	X
Total non-current assets	**X**
Current assets	
Financial assets held for sale	X
Non-current assets classified as held for sale	X
Inventories	X
Trade and other receivables	X
Financial assets	X
Cash and cash equivalents	X
Total current assets	**X**
Total assets	**X**
Current liabilities	
Trade and other payables	(X)
Financial liabilities	(X)
Total current liabilities	(X)
Non-current assets plus net current assets/liabilities	**X**
Non-current liabilities	
Provisions for liabilities and charges	(X)
Other payables	(X)
Total non-current liabilities	
Assets less liabilities	
Taxpayers' equity	
General fund	X
Revaluation reserve	X
Total taxpayers' equity	**X**

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Summary of IFRS Adaptations and Interpretations

3. The extant International Financial Reporting Standards (IFRS) with their adaptations and interpretations is set out in Figure 3 below.

Figure 3

International Standard/ Interpretation	Applied in Full	Interpreted for public sector	Adapted for public sector
IAS 1 Presentation of Financial Statements	●	●	
IAS 2 Inventories		●	
IAS 7 Statement of Cash Flows	●		
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors	●		
IAS 10 Events after the Reporting Period	●	●	
IAS 11 Construction contracts	●		
IAS 12 Income Taxes	●		
IAS 16 Property, plant and equipment		●	●
IAS 17 Leases	●		
IAS 18 Revenue	●		
IAS 19 Employee Benefits		●	●
IAS 20 Accounting for government grants and disclosure of government assistance	●	●	
IAS 21 The effects of changes in foreign exchange rates	●	●	
IAS 23 Borrowing Costs	●	●	
IAS 24 Related party disclosures	●	●	
IAS 26 Accounting and Reporting by Retirement Benefit Plans		●	●
IAS 27 Consolidated and Separate Financial Statements			●
IAS 28 Investments in associates			●
IAS 29 Financial reporting in hyper-inflationary economies	●	●	●
IAS 32 Financial Instruments: Presentation	●	●	
IAS 33 Earnings per share	●		
IAS 34 Interim Financial Reporting	●		●
IAS 36 Impairment of Assets		●	
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	●	●	

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IAS 38 Intangible Assets	●	●	
IAS 39 Financial Instruments: Measurement, Recognition and Derecognition	●	●	
IAS 40 Investment Property	●	●	
IAS 41 Agriculture	●		
IFRS 1 First time adoption of IFRS	●	●	
IFRS 2 Share based payments	●		
IFRS 3 Business combinations	●		
IFRS 4 Insurance contracts	●		
IFRS 5 Non-current Assets Held for Resale and discontinued operations	●	●	
IFRS 6 Exploration for and evaluation of mineral resources	●		
IFRS 7 Financial Instruments: Disclosures	●		
IFRS 8 Operating Segments (was IAS 14 Segmental reporting)	●		
IFRS 10 Consolidated Financial Statements			●
IFRS 11 Joint Arrangements			●
IFRS 12 Disclosures of Interests in Other Entities			●
IFRS 13 Fair Value Measurement			●
SIC 7 Introduction of the Euro	●		
SIC 10 Government assistance – No specific relation to Operating Activities	●	●	
SIC-12 Consolidation – Special Purposes Entities			●
SIC-13 Jointly Controlled Entities – Non-Monetary Contributions by Venturers			●
SIC 15 Operating Leases - Incentives	●		
SIC 21 Income Taxes – Recovery of Non-Depreciable Assets	●		
SIC 25 Income Taxes – Changes in the Tax status of an Entity or its Shareholders	●		
SIC 27 Evaluating the Substance of Transactions			
Involving the Legal form of a Lease	●		
SIC 29 Service Concession Arrangements: Disclosures	●		
SIC 31 Revenue – Barter Transactions Involving Advertising Services	●		
SIC 32 Intangible Assets – Web Site Costs	●	●	
IFRIC 1 Changes in decommissioning, restoration and similar liabilities	●		
IFRIC 2 Members' shares in co-operative entities and similar instruments	●		

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IFRIC 4 Determining whether an arrangement contains a Lease	●		
IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds			●
IFRIC 6 Liabilities Arising from Participating in a Specific Market-Waste Electrical and Electronic Equipment	●		
IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies	●		
IFRIC 8 Scope of IFRS 2	●		
IFRIC 9 Re-assessment of embedded derivatives	●		
IFRIC 10 Interim Financial Reporting and Impairments	●		
IFRIC 11 IFRS 2 – Group and Treasury Share Transactions	●	●	
IFRIC 12 Service Concession Arrangements	●		
IFRIC 13 Customer Loyalty Programmes	●		
IFRIC 14 IAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	●		
IFRIC 15 Agreements for the Construction of Real Estate	●		
IFRIC 16 Hedges of a Net Investment in a Foreign Operation	●		
IFRIC 17 Distribution of Non-Cash Assets to Owners	●		
IFRIC 18 Transfer of Assets from Customers	●		
IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments	●		
FRS 30 Heritage Assets	Follows the principles of the FRS.		

Key Concepts

4. The International Accounting Standard's Board (IASB) Conceptual Framework ('the Framework') identifies two concepts as playing a pervasive role in financial statements and hence in the selection of accounting policies.

<u>Going Concern</u>

5. The ARAc are normally prepared on the assumption that the Department is a going concern and will continue in operational existence for the foreseeable future. Hence it is assumed that the Department has neither the intention nor the need to liquidate or materially curtail the scale of its operations. However, if such an intention or need exists, they may have to be prepared on a different basis, in which case this must be disclosed.

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6. Where an entity (for example, an Agency) is providing a service and the entity ceases to exist but the service continues to be provided by a different organisation using the same assets and incurring the same liabilities, the going concern concept should be applied.

Accruals

7. Accounts, except for cash flow information, should be prepared on an accruals basis. This requires the non-cash effects of transactions and other events to be reflected in the accounts during the year in which they occur and not in the year in which the cash is received or paid.

Selection of Accounting Policies

8. When judging the appropriateness of accounting policies, the following two constraints should be borne in mind:

a. the need to balance the objectives described in Part 2 Chapter 1 paragraphs 10 to 18;

b. the need to balance the cost of providing the information with the likely benefit of such information to the users of the accounts.

9. The notes to the ARAc must give a description of the accounting policies adopted for dealing with items which are judged material in relation to the ARAc.

Objectives

10. The Framework sets out the objectives which should be used to judge the appropriateness of individual accounting policies to particular circumstances.

Relevance

11. Accounts provide information on an entity's financial performance and position and this helps users to assess management stewardship and make economic decisions.

12. Financial information is relevant if it has the ability to influence economic decisions.

Reliability

13. Financial information is reliable if it faithfully represents what it either purports to represent or could reasonably be expected to represent. Information is reliable when the substance of transactions and other events that have taken place are free from bias (i.e. it is neutral), free from material error, is complete and, under conditions of uncertainty, has been prudently prepared.

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14. Where the demands of neutrality and prudence compete, they are reconciled by finding a balance that ensures that the deliberate and systematic understatement of assets and gains and the overstatement of liabilities and losses do not occur.

Comparability

15. Information increases its usefulness when it can be compared with similar information for another period or point in time and against similar information from other entities. Such comparability is usually achieved through a combination of consistency and disclosure.

Understandability

16. Information provided in the ARAc must be capable of being understood by users with a reasonable knowledge of the public sector and its economic activities and financial practices. Users should be willing to apply reasonable diligence to studying the information provided.

Estimation Techniques

17. An accounting policy will specify the basis on which an item should be measured. Where there is uncertainty over the monetary amount corresponding to that basis, it will be obtained by using an estimation technique such as depreciation. The ARAc accounting policy note should describe the key areas of estimation uncertainty and the assumptions underpinning those estimates.

18. A change to an estimation technique should not be accounted for as a prior period adjustment unless it represents the correction of a material error.

Consolidation Methodology

19. The consolidation process at each management level involves:

a. collection and verification of data from subordinate organisations;

b. reconciliation of TLB assets;

c. processing of agreed adjustments to subordinate organisation data;

d. reporting, as prescribed by instructions issued by CFAT;

e. exporting data to higher level organisations.

20. The Department does not consolidate the results of its Trading Funds which are outside the Departmental boundary. The Armed Forces Pension & Compensation Schemes are also treated as falling outside the Departmental boundary. However, any

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expenditure which the Department incurs arising from, or in support of, these activities is reflected in the Annual Accounts.

21. Consolidation policies apply throughout the Department including to entities which operate non-DFMS compliant systems but which are still required to provide data to the central consolidation process.

22. It is essential that a proper audit trail is maintained throughout the consolidation process. Accounting reports, schedules, reconciliations and journal entries reports should be prepared at the 'hard close' and at year end. These should be available for review and sign-off by the Senior Finance Officer and Agency Chief Executive. These reports should also be made available for the year-end audit.

23. The 'hard close' periods and the year-end accounts consolidation methodology consist of a tiered and upward exercise. The formal consolidation levels are at TLB and Departmental level. TLBs should submit their accounts to CFAT through the Annual Accounts Excel workbook. Supplementary information is also required.

24. The ARAc Instructions provide guidance on consolidation adjustments.

25. Examples of consolidation adjustments include:

a. effects of immediate policy changes;

b. material omissions/reclassifications;

c. information not known or received within the consolidation timetable and of a material nature.

26. Due consideration must always be given to the security implications of consolidation processes. The security classification of accounting data may change on consolidation.

27. Management review of the financial data at each consolidation stage is an important aspect of the consolidation process.

Inter-TLB Transfers (GL010s)

28. For Inter-TLB transfers, both parties must agree the transaction. The responsibilities are as follows:

a. the initiating TLB is responsible for the transfer procedure, for providing appropriate data to the receiving TLB and for obtaining the appropriate authority;

b. the receiving TLB is responsible for agreeing the transfer and for obtaining the appropriate authority;

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c. DBS/FMPA CFAT are responsible for ensuring that the transfer is authorised and for uploading both sides of the transfer into the Primary ledger;

d. FMPA CFAT is responsible for the monthly running of the Inter-TLB variance report by source. Given that the security rules applied to the GMG range of RA codes will prevent manual journals from causing any Inter-TLB imbalance, the relevant system operator will be informed of imbalances and CFAT will monitor their resolution;

e. FMPA CFAT is responsible, at the year end, for actioning the clear down to zero of the Inter-TLB current account balances to the General Fund;

f. DBS FAADMT is responsible for ensuring that, for Non- Current Asset (NCA) transfers, the relevant paper work is completed and for actioning the changes to the Non-Current Asset Register

29. Inter-TLB transfers should only be used for the transfer of SOFP balances. The Inter-TLB process cannot be used to transfer SOCNE balances between TLBs. SOCNE balances posted through the electronic feeders and manual supply systems should be transferred through the cash and inventory feeder/manual supply system owner that generated the original transaction.

30. There are exceptions, agreed by Defence Resources, to this overriding policy, which are:

a. inventory fuel consumption transfers (RA codes PB, PK and PM);

b. NCA impairment charges to the SOCNE (RA codes MA to MW);

c. Learning Skills Council Funding (RA code RNA010);

d. International Collaboration Projects (RA code QDB001);

e. Crown reimbursement of food charges (RA codes RLB013, PAA001, PAA002);

f. transfer entries that miss the mid-March cut off (through the EBT process, see Part 2 Chapter 1 paragraph 31(e)).

31. The key steps of the Inter-TLB transfer process are:

a. when the annual budget is set, where there is an organisational change that requires balances to be transferred to another TLB or on other occasions where the need for a transfer arises, the initiating TLB identifies the input costs requiring transfer and agrees these with the receiving TLB. Only when both parties are in agreement can a transfer take place;

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b. when the cost is incurred, the initiating TLB processes the cost in accordance with the agreement and obtains approval from its TLB Authoriser. If the transfer relates to an NCA, an Asset Delivery Schedule/Asset Change Notification form will need to be validated with the DBS Fin-FAADMT-NCA team;

c. the receiving TLB approves the transfer and obtains approval from its designated TLB Authoriser;

d. when both TLB designated Authorisers have approved the journal it is sent to DBS (by midday on the last WD of the AP in which it should be posted) or to FMPA CFAT who will process the journal into the Primary ledger;

e. where a business need requires a transfer that conflicts with this policy, Defence Resources approval will be required. Once approval is obtained an Extraordinary Business Transaction (EBT) template will be used and this will need to be endorsed by TLB Chief Accountants;

f. detailed desk instructions on this process are available on the Finance Hub IYM page of the Defence Intranet.

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2 Income

1. This chapter expands on the directive in Part 1 Chapter 2 by providing further detail on when revenue should be recognised and measured.

Recognition

Sale of Good/Equipment

2. Revenue from the sale of goods/equipment should be recognised when all the following conditions have been satisfied:

a. the Department has transferred the significant risks and rewards of ownership of the goods to the buyer;

b. the Department retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

c. the amount of revenue can be measured reliably;

d. it is probable that the economic benefits associated with the transaction will flow to the Department; and

e. the costs incurred or to be incurred in respect of the transaction can be measured reliably.

3. If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

a. when the Department retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

b. when the receipt of income from a particular sale is contingent on the purchaser's own sale of goods generating the required income;

c. when the goods are sold subject to significant installation;

d. when the buyer has the right to rescind the purchase for a reason stated in the contract and the Department is uncertain about the probability of return.

Provision of Services

4. When the outcome of a transaction involving the provision of services can be

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estimated reliably, income should be recognised by reference to the stage of completion of the transaction at the period end. The outcome can be estimated reliably when all of the following conditions are satisfied:

a. the amount of income can be measured reliably;

b. it is probable that the economic benefits associated with the transaction will flow to the Department;

c. the stage of completion of the transaction and the costs to complete the transaction can be measured reliably.

5. Income is recognised in accordance with Part 1 Chapter 2 paragraph 8.

6. The Department is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

a. each party's enforceable rights;

b. the payment to be exchanged;

c. the manner and terms of settlement.

7. The stage of completion of a transaction can be determined by a variety of methods depending on the nature of the transaction and may include:

a. surveys of work performed;

b. services performed to date as a percentage of total services to be performed;

c. the proportion that costs incurred to date bear to the estimated total costs of the transaction.

8. For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, income is recognised on a straight line basis over the specified period unless some other method better represents the stage of completion.

9. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, income should be recognised only to the extent of the expenses recognised that are recoverable. This will often be the case during the early stages of a transaction.

10. When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recoverable, income is not recognised and the costs incurred are recognised as an expense.

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Measurement

11. In most cases, the consideration is in the form of cash or cash equivalents (i.e. short term arrangements readily convertible to known amounts of cash). The amount of income is the cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, when the Department receives income over a period of time and does not charge interest to the buyer or the rate of interest is below a market rate of interest. In such an arrangement, all future receipts which are material should be discounted and FMPA A&TM must be consulted. The 'interest' element is recognised as interest income.

12. When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates income. However, where goods or services exchanged are of a different nature, the exchange is regarded as a transaction that generates income. The income is measured as the difference between the fair value of the goods or services exchanged. When the fair value of the goods or services received cannot be measured reliably, the income is measured at the fair value of the goods or services given up and adjusted by the amount of cash or cash equivalents transferred.

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3 Expenditure

1. There is no guidance on accounting for expenditure. Refer to Part 1 – Directive.

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4 Intangible Non-Current Assets

Purpose

1. This chapter expands on the directive in Part 1 Chapter 4 by providing further detail on: costs to be capitalised; research and development costs; transfer of development costs on project completion; how to account for the cost of software which is either purchased by the Department or developed in house; Carbon Reduction Commitment Energy Efficiency Scheme (and Similar Schemes).

Costs to be Capitalised

2. All costs directly attributable to creating and producing an intangible NCA for its intended purpose should be capitalised. Examples of directly attributable costs are:

a. costs of materials and services consumed in generating the intangible asset (less any trade discounts and rebates);

b. if appropriate, costs of employee benefits (as defined in IAS 19) incurred in generating the intangible asset;

c. fees to register a legal right;

d. amortisation of patents and licences that are used to generate the intangible asset;

e. costs of testing whether the asset is functioning properly;

f. import duties and non-recoverable VAT.

3. The following are not components of the cost of internally generated intangible assets:

a. selling, administrative and other general overhead expenditure unless this expenditure is directly attributable;

b. identified efficiencies and initial operating losses incurred before the asset achieves its planned performance;

c. expenditure on staff training (for example, on the use of new software).

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Research and Development Costs

4. The accounting treatment depends on whether expenditure is defined as research expenditure or development expenditure:

a. research expenditure is defined as original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Examples of research activities include:

i. activities aimed at obtaining new knowledge;

ii. the search for, evaluation and final selection of the application of research findings or other knowledge;

iii. the search for alternative materials, devices, products, processes, systems or services;

iv. the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

b. development expenditure is the application of research findings or other knowledge to a plan or a design for producing new or substantially improved material, devices, products, processes, systems or services before commencement of production or use. Examples of development activities include:

i. the design, construction and testing of pre-production or pre-use prototypes and models;

ii. the design of tools, jigs, moulds and dies involving new technology;

iii. the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production;

iv. the design construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Transfer of development costs on project completion

Development Costs Incurred in Relation to Non-Current Assets on the NCAR

5. As DE&S is likely to manage the majority of projects that will incur development expenditure, the following text assumes that DE&S PTs are the project managers.

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Determining the Amount of Development Costs to Transfer

6. DE&S should account for all capitalised development costs, as incurred, as an intangible asset, recording the costs against an appropriate project number.

7. Capitalised development costs are transferred to the agreed receiving TLB on first delivery into beneficial use of the major asset type under production. This is termed the 'cut off' position.

8. On project completion or on completion of the development of the baseline capability for a project which employs an Incremental Acquisition (IA) strategy, development costs should be accrued to arrive at a final (i.e. 'cut–off') figure for transfer to the agreed receiving TLB.

9. Any residual costs or credits, except those which represent material omissions, should be written off in year as development costs and not transferred to the agreed 'receiving' TLB. A material omission is defined as £5M or 5% (if lower) of the total development costs already transferred.

10. Where a material omission does come to light, the additional tranche of development costs should be transferred to the agreed receiving TLB.

11. For projects which employ an IA strategy, expenditure incurred on developing an asset enhancement or upgrading a capability after the initial baseline capability has been delivered should be treated as relating to the next asset delivery. Similarly, any development costs incurred during a mid-life upgrade should be transferred to the agreed receiving TLB as an intangible asset when the asset is accepted back into service.

12. The amount to be included in the agreed receiving TLBs accounts as an intangible asset is obtained from the latest version of the Asset Delivery Schedule (ADS) (i.e. the one which is issued immediately before the development cost transfer) and is used for the In Year Management and/or Annual Budget Cycle process**.** The relevant Project Manager should advise the agreed receiving TLB of the planned asset life so that the development costs can be amortised over the same period.

Accounting for Development Costs after the Transfer

13. The TLB that has received the development costs must account for the development costs as an intangible NCA on an 'asset class' basis and must record the data in the NCAR. For audit and control purposes, the TLB that has received the development costs will need to ensure that the development costs for each 'asset class' can be traced back to the associated underlying asset.

14. The TLB that has received the development costs should amortise the development costs for each asset class on a straight line basis over the planned operational life of the whole 'asset class', irrespective of whether the assets have physically entered service. As a result, this receiving TLB may start to amortise development costs ahead of the period in

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which the associated NCA comes into service. The receiving TLB must not directly relate the amortisation of development costs to individual assets received into service.

15. The DBS FAADMT is responsible for maintaining the capitalised development costs on an NCAR and for performing the accounting functions.

16. The capitalised development expenditure that is directly linked to a specific tangible NCA should be impaired only where the tangible NCA becomes impaired. If a whole class/group of NCAs is to be withdrawn earlier than was previously planned, the carrying amount of the associated development costs must be written off to the SOCNE on the same basis as the carrying amount of the underlying asset class/group is written off. For example, where a whole class/group of NCA is withdrawn, the associated capitalised development costs must immediately be written off to the SOCNE. If the whole class is not withdrawn, development costs cannot be written off until the final asset is taken out of service. Similarly, any impairment should be charged only where the entire class/group is impaired and will be proportionate to the impairment of the group of tangible NCAs. For example, development expenditure related to a class/group of aircraft will be impaired only where the entire class/group of aircraft is impaired and not if less than the whole class/group is impaired.

17. Capitalised development costs that are directly linked to a class of asset should only be impaired if the whole class of the associated NCA is impaired. The magnitude of the impairment must be in the same proportion as that applied to the underlying asset class. In this context, impairment includes a reduction in the carrying amount of an asset that has been destroyed, lost, scrapped, damaged beyond economic repair or used for a different purpose.

18. If a decision is taken to shorten the NCA's remaining service life, then the carrying amount of the development cost balance should be accounted for by accelerating the amortisation of the asset's remaining (i.e. shorter) useful economic life.

19. An extension to the underlying NCA's life will also affect the life of any associated development cost. This should be accounted for through a reduced annual amortisation charge over the remaining (i.e. longer) useful economic life.

Development Costs Incurred in Relation to Non-Current Assets Held on the Supply Systems

20. Costs may be incurred on developing NCAs that will subsequently be accounted for within the Departmental supply systems. Such items are referred to as capital spares and Guided Weapons, Missiles and Bombs (GWMB).

<u>Capital Spares</u>

21. Capital spares are generally developed, procured and utilised to support a specific NCA project and have the same economic life as the related NCA. Capital spares development costs should be added to (in fact they are often indistinct from) the

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development costs relating to the associated NCA. The same accounting treatment is applied as is used for NCAs. See Part 2 Chapter 4 paragraphs 5 to 19.

22. Expenditure on developing enhancements should be collected by the PT managing the enhancement project and transferred to the agreed receiving TLB for capitalisation. Costs which fail the capitalisation criteria set out in Part 1 Chapter 4 paragraph 35, plus any associated in service support costs, should be expensed by the PT, as incurred.

Guided Weapons, Missiles and Bombs

23. GWMB items are accounted for until used by DE&S. Any associated development expenditure is capitalised by DE&S as an intangible asset and amortised over the useful economic life of the associated asset. They are accounted for in the same way as NCAs. See Part 2 Chapter 4 paragraphs 5 to 19.

Development Costs Incurred in Relation to Raw Materials and Consumables

Raw Materials and Consumables

24. One-off development costs which are incidental to acquisition, relate to a single batch production of Raw Materials and Consumables (RMC) specific items and are identifiable against a single purchase contract should be incorporated within the Basic Material Price (BMP) for each item. As such, they will be capitalised within the value of each RMC item and charged to the SOCNE on issue or consumption.

25. Where development costs relate to an RMC item that will be produced in more than one batch and utilised for a period in excess of one year and the costs meet the capitalisation criteria set out in Part 1 Chapter 4 paragraph 35, they should be recorded on an NCAR as an intangible NCA.

26. Capitalised development costs should initially be accounted for in the same way as those relating to an NCA. See Part 2 Chapter 4 paragraphs 5 to 19.

27. On first delivery of the RMC item, the agreed receiving TLB will be notified of the value of the development costs to be included in the Annual Accounts and also the life, which is to be used as the amortisation period for the associated development costs.

28. If an item of RMC is enhanced or modified or if an increased capability is delivered under a project employing an IA strategy, any additional or subsequent development costs associated with its above baseline enhancement or increase in capability should be accounted for as relating to the next delivery and transferred to the agreed receiving TLB accordingly.

29. All transfers of development costs (except those included in the BMP) are to be accounted for as intangible assets.

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30. The TLB that has received the development costs, with the assistance of the DBS FAADMT, must account for development costs on particular RMC items separately in an NCAR and include the intangible asset within its SOFP. For audit and control purposes the TLB that has received the development costs should ensure that it is possible to map development costs to the RMC items to which they relate.

31. When development costs for RMC items are transferred to the agreed receiving TLB, a clear indication of the planned period over which they will be consumed or used must be given. The development costs should then be amortised on a straight line basis over this period. However, if the planned period changes, the life of the associated development cost asset should be revised accordingly.

32. Where RMC consumption ceases permanently, the carrying amount of the associated development cost should immediately be written off to the SOCNE. Other changes to the planned consumption or usage period should be accounted for prospectively through adjusting the annual amortisation charge to match the remaining useful economic life of the RMC item.

Software Costs

Recording Software Costs as a Separate Non-Current Asset

33. TLBs should use their judgement to determine whether an asset that incorporates both tangible and intangible elements should be treated as a tangible Non-Current Asset (NCA) or as an intangible NCA. For example, computer software for a computer-controlled machine tool that cannot operate without it forms an integral part of the related hardware and should be treated as a tangible NCA. The same treatment applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

34. Guidance on whether VAT is recoverable for a particular software cost should be sought from the FMPA VAT Policy Team.

Software Procured for Internal Departmental Use

35. Software which the Department will use for internal business can be procured as follows:

a. it is written/developed by the Department's own staff;

b. it is purchased from an outside body;

c. it is written by consultants/programmers employed by the Department;

d. it is acquired for use under licence;

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e. it is procured under PPP/PFI arrangements.

36. Costs relating to procurement methods a. to c. should be capitalised as intangible Assets Under Construction (AUC) if the requirements set out in Part 2 Chapter 4 paragraph 39 are met and, on completion, as intangible NCAs. Purchases that do not involve stage payments (i.e. a single payment is made for the software on delivery) will not need to go through AUC. Such costs should be capitalised as an intangible NCA. Although some software projects may involve a mixture of these procurement methods it should not affect the accounting treatment.

37. Software licences confer the right to use software developed by third parties. Where the Department has the right to use software under a licence and this use contributes to the provision of services or other Departmental outputs for a period in excess of one year, then the cost of the licence should be capitalised as an intangible NCA. This intangible asset should be amortised over the shorter of its useful life or the licence period. Annual software licences do not meet the criteria set for capitalisation as an NCA and should be expensed to the SOCNE in the period(s) to which they relate.

38. Software may be procured under a PPP/PFI contract. The decision on whether or not to record software obtained under such a contract as an NCA will depend on the nature of the contract and whether it is assessed to be ‘on’ or ‘off’ the Department’s Statement of Financial Position (SOFP).

Inclusion of Software Costs in Assets Under Construction Balances

39. Software costs incurred whilst a software development project is ongoing (i.e. stage payments) should only be capitalised and treated as an intangible AUC if the following criteria are met:

a. the development expenditure relating to the project is separately identifiable and can be measured reliably;

b. adequate technical, financial and other resources are available to enable project completion and implementation of results;

c. it is intended that the project will result in an asset or service that will eventually be brought into use to generate probable future economic benefits;

d. the project is technically feasible.

40. On completion, the accumulated costs of the software project (reflected in the AUC balance) should be reclassified to an appropriate intangible NCA category and recorded on the Non-Current Asset Register (NCAR).

41. Costs incurred during a software purchase or development project but which are not directly attributable to bringing an asset into working condition for its intended use within the Department should be expensed to the SOCNE.

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42. If a project is abandoned prior to completion, any associated costs held as an AUC balance should immediately be written off to the SOCNE.

Software Purchased or Developed for Inclusion in Goods and Services Provided to Customers Outside the Department

43. Software costs which the Department incurs on a product or service which is to be supplied to a body outside the Department should be capitalised as an intangible NCA if either meets the criteria at Part 2 Chapter 4 paragraph 39 are met and the Department intends to sell either of them.

Asset Lives, Depreciation and Amortisation

44. Any capitalised software costs should be amortised over their useful life. However, capitalised software which is included in goods and services provided to customers outside the Department should be amortised over the period in which the related product or service is sold or provided for use.

45. In some cases, the useful life of a software asset may differ from that of the hardware into which it is loaded, in which case each asset should be recorded separately within the NCAR to ensure that an appropriate depreciation/amortisation charge is applied.

46. When deciding whether or not to separately capitalise the elements of an IT project, a balance needs to be struck between the need to calculate the depreciation charge very precisely and the resultant administrative burden (as it may be that separate capitalisation has no material effect on the accounts). The final decision will need to satisfy the NAO. The valuation of each asset must be clearly identifiable and directly attributable to it.

47. The useful life of assets should be reviewed annually and revised as necessary. Any change to the useful life should be accounted for prospectively through depreciation or amortisation over the remaining useful economic life of the asset.

Maintenance and Enhancement

48. After an asset is brought into use, further expenditure may be incurred.

49. All expenditure incurred on the repair and maintenance of software to maintain it at its previously assessed standard of performance must be expensed to the SOCNE.

50. However, if it is probable that future economic benefits associated with the item will flow to the Department and the cost can be measured reliably, the expenditure should be capitalised and the carrying amount of the replaced part derecognised. If it is not practicable for TLBs to determine the carrying amount of the replaced part, the cost of the new part may be used as a proxy.

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Revaluation

51. Software recorded as AUC or an intangible NCA should be held at its Depreciated Replacement Cost (DRC) in the SOFP and re-valued through the application of price indices.

52. On the rare occasions that an active (homogeneous) market exists, the software costs should be valued at fair value at the reporting period date. Also, in rare cases where the software is income-generating, the software should be valued at the lower of DRC (i.e. using indices) and value in use. Where there is no value in use, it should be held at DRC.

Carbon Reduction Commitment Energy Efficiency Scheme (and Similar Schemes)

53. The MOD participates in both the Carbon Reduction Commitment Energy Efficiency Scheme (the CRC Scheme) and the EU Emissions Trading Scheme (ETS).

Carbon Reduction Commitment Energy Efficiency Scheme

54. As a result of the Climate Change Act in November 2008, the CRC Scheme became operational in 2011/12. The CRC Scheme is administered by the Environment Agency.

55. Participation in the CRC Scheme gives rise to a liability relating to emissions made. The liability is recognised for the obligation to deliver allowances to the CRC Registry equal to the emissions made. Purchased allowances give rise to an asset.

56. The CRC Scheme assets are classified as either current or non-current intangible assets depending upon their expected useful life e.g. if held for the purpose of trading, as a current asset. The asset, whether classified as a current or as an intangible (current or non current) asset shall be measured initially at cost.

57. Scheme assets in respect of allowances shall be revalued at fair value where there is evidence of an active market. Until there is evidence of an active market, scheme assets in respect of allowances shall be measured at cost, as a proxy for fair value.

58. During 2012/13, the Department was purchasing the emissions permits retrospectively and was therefore charging them to the SOCNE.

EU Greenhouse Gas Emission Allowances

59. In January 2005 the EU Emissions Trading Scheme (ETS) commenced operation as the largest world-wide, multi-country, multi-sector greenhouse gas emission trading scheme. It is based on Directive 2003/87/EC which came into force on 25 October 2003 and requires EU member state governments to set a maximum emission limit for all establishments participating in the scheme.

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60. The EU ETS is administered in England and Wales by the Department for Environment, Food and Rural Affairs (DEFRA). Establishments participating in the EU ETS are set maximum emissions limits for each year, receiving tradable emission allowances equal to their limits at the start of each year.

61. At the end of each year, participants surrender allowances equal to their level of emissions for that year. If the actual level breaches their limit, participants have to purchase additional allowances at the prevailing market price to cover the shortfall.

62. Conversely, if the actual levels of emissions are lower than their limit, the participants may sell the surplus allowances at the prevailing market price or, in certain circumstances, carry them forward to future years.

63. Any participants who do not deliver sufficient allowances at year-end will not only have to buy additional allowances to match their actual level of emissions but will also be fined by DEFRA. Compliance checks to validate actual levels of emissions will be conducted annually.

64. The CRC Scheme/ETS should be accounted for in accordance with Part 2 Chapter 4 paragraphs 55 to 57. However, for materiality reasons, the Department does not fully comply with the ETS accounting requirements. Instead, the Department reflects purchases and sales of allowances as an expense or income in the SOCNE. All other costs associated with the scheme, such as fines and compliance checking, are charged to the SOCNE.

65. The NAO has previously been satisfied that this departure is unlikely to have a material impact on the Annual Accounts. However, the NAO will need to confirm this each year by reviewing the calculations and underlying assumptions used to form the materiality judgement.

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5 Tangible Non-Current Assets

Purpose

1. This chapter expands on the directive in Part 1 Chapter 5 by providing further detail on:

   a. Categorisation of tangible Non-Current Assets (NCAs);

   b. Property and Non-Property NCA disposals;

   c. Assets under Construction (AUC);

   d. capital spares and Guided Weapons, Missiles and Bombs (GWMB);

   e. ancillary, composite and grouped assets;

   f. containers;

   g. Government Furnished Assets (GFA);

   h. Non-Current Asset non-financial data standards;

   i. Public Private Partnership (PPP) arrangements including the Private Finance Initiative (PFI) contracts.

Categorisation

2. Tangible NCAs, including those held under a finance lease, are analysed into major categories. The major categories, and factors to be considered in their categorisation, are listed below.

Land, Buildings and Dwellings

3. The following should be taken into account when categorising land, buildings and dwellings:

   a. land and buildings are separately disclosed between land, buildings (excluding dwellings) and dwellings;

   b. land comprises any land holdings and land which underlies buildings. Land underlying or associated with dwellings should be separately disclosed;

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c. dwellings are defined as buildings used entirely or primarily as residences, including any associated structures such as garages and parking areas. Any underlying and associated land, such as gardens and yards, should be separately disclosed;

d. buildings, excluding dwellings, comprise offices; warehouses; hospitals; barracks; hangars; runways; farms; and multi-storey car parks etc. As noted above, any underlying and associated land should be disclosed separately;

e. the land and buildings category constitutes the Defence Estate;

f. land and buildings are separately valued;

g. leasehold improvements to building assets are included within this category if the improvements meet the recognition criteria described in Part 1 Chapter 5 paragraph 69.

h. the split of land and buildings into the revised categories should be on a 'site' basis - i.e. apportionments should not be made for non-specific assets such as car parks and football pitches.

i. a 'site' will be determined as dwellings if the majority of the site by value is used for dwellings. It follows that a 'site' will be classified as non-dwelling if the majority of the site by value is not used for dwellings.

j. separately identified infrastructure assets in the NCAR should to be treated as non-dwelling. Undeveloped land should be classified as non-dwelling.

Single Use Military Equipment

4. SUME is defined as:

a. military equipment for which there is no equivalent civilian role. It covers weapons and vehicles, as well as the equipment which supports and delivers them - for example, warships, submarines, fighter aircraft, tanks, missile carriers and launchers.

b. SUME does not yield a production service as the assets and the associated equipment are used to destroy rather than to produce;

c. SUME includes assets at front line units; at training establishments; held in storage; held in reserve; or undergoing repair;

d. assets that are not SUME in their own right but are held purely to support a SUME platform and have no other use to the Department should also be classed as SUME.

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Transport Equipment

5. Transport equipment is defined as equipment for moving people and/or objects - for example, lorries, trains, ambulances and aircraft. All non-SUME vehicles are included in this category.

Plant and Machinery

6. Plant and machinery includes NCAs classified as non-current or moveable equipment used to repair, maintain or support Departmental assets or for administrative purposes.

7. Expenditure on furniture items purchased for immediate issue should be expensed to the SOCNE as incurred and not recorded on an NCAR. If furniture is purchased for future use, it should be accounted for within the raw materials and consumables category

IT and Communications Equipment

8. IT and communications equipment includes all IT systems hardware including mainframe computers; stand-alone personal computers (PCs); non-SUME communication and satellite systems; dedicated peripherals; networks and cabling.

9. The following features determine the categorisation of IT and comms equipment:

a. all software (excluding the operating system) which is both owned and obtained under licence by the Department either for business use (or used in connection with a product or service which is to be supplied to a body outside the Department) should be classified as an intangible asset. See Part 1 Chapter 4;

b. the cost of the operating system should be capitalised as an NCA, as part of the cost of the hardware;

c. where an item of IT equipment is part of a network, it is grouped together with other networked items, where appropriate, to form a single composite NCA. See Part 2 Chapter 5 paragraph 113.

Assets Under Construction

10. Assets Under Construction (AUC):

a. represent the accumulated costs of NCAs which are under construction and often relate to projects where stage payments are contractually payable. For example, major works projects and equipment procurement projects;

b. are categorised and disclosed as either AUC (SUME) or AUC (Other).

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11. Subsequent expenditure on NCAs (for example, enhancement and Major Refit and Overall (MRO) projects) should be treated as AUC if costs are accumulated during the project and the enhancement/MRO meets the capitalisation criteria. See Part 1 Chapter 5 paragraph 69.

Capital Spares

12. Capital spares balances are disclosed within the appropriate SUME, transport or plant and machinery NCA category. Management of capital spares is conducted through the Departmental supply system or by a contractual relationship with industry partners.

13. Capital spares and ancillary items are defined as repairable items with a life greater than one year, which are retained for the purpose of replacing parts of an asset (such as sections, assemblies, sub-assemblies, modules or components thereof) which are undergoing repair, refurbishment, maintenance, servicing, modification, enhancement or conversion. For example, helicopter gearboxes and vehicle engines. Capital spares should be categorised as shown in Part 1 Chapter 7, Figures 2 to 10.

14. Ancillary items of equipment may meet either NCA (other than capital spares) or capital spares categorisation criteria, depending on their location and function in relation to the principal item of SUME. For example, a radio set could be an NCA in its own right, or a capital spare; or it could be embodied in a unit of SUME such as a vehicle. When a particular ancillary item has been nominated as a capital spare, the same classification should be consistently applied to all subsequent items.

15. The generic capital valuation of SUME may include ancillary equipment. A single categorisation, determined by the relevant supply authority (i.e. the project, commodity or equipment support manager (normally a PT)), is applied to individual items as either an NCA (other than a capital spare) or a capital spare but not both. The principal use of such items and the related accounting and control procedures are taken into account when making the decision. Where necessary, advice on categorisation can be obtained from the DE&S IAET.

16. Capital spares are often referred to as rotables or repairables (but note that not all repairable items are categorised as capital spares) and are accounted for as pooled assets. The movements in the pools follow the standard activities of issue, return and processing for re-issue (normally via a repair loop) in accordance with an Upkeep By Exchange (UBE) regime.

17. Capital spares balances and movements on the gross carrying amount, depreciation and the carrying amount are included under the appropriate SUME, transport or plant & machinery NCA categories in the Annual Accounts.

Guided Weapons, Missiles and Bombs

18. GWMB are disclosed within the SUME category and are controlled and managed through the Departmental supply system.

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19. GWMB are defined as explodable munitions which incorporate guidance mechanisms. They exclude conventional explosive devices, such as mines, grenades, cartridges, depth, demolition and detonation charges, mortars, bullets and other expendable ammunition but include torpedoes and rockets which are maintained (i.e. repaired or serviced) by replacing their repairable parts (i.e. sections, assemblies, sub-assemblies, modules or components thereof).

20. In this context 'maintained' specifically excludes routine refurbishment of ammunition and other conventional explosive devices.

21. GWMB are issued as complete munitions, even if they are held in parts for safety reasons and are categorised as shown in Part 2 Chapter 7, Figures 1 to 9. Parts which are held as spares are not categorised as GWMB.

22. Assembled GWMB are accounted for as pooled assets and are recorded separately. Asset balances and movements (excluding associated capital spares) for gross valuations, depreciation and carrying amount, are included within SUME in the Annual Accounts.

23. Where it is not possible to readily segregate assembled assets and associated capital spares into separate pools - for example, because the assets are not separately registered when in an assembled state - disclosure requirements are met by assessing the number of assets that could be put into a ready state.

Disposals

Disposals of Property Non-Current Assets

24. Once a property asset meets the criteria for classification as a held for sale asset, it is removed from the Departmental NCAR and recorded on the GL as a current asset until disposal. DIO values the asset in accordance with Part 1 Chapter 5 paragraph 135. Where the fair value less costs to sell is higher than its carrying amount, no adjustment should be made to its value. The subsequent surplus on disposal is recognised in the SOCNE.

25. DIO continues to review property assets identified for disposal to ensure their values retain a true and fair view of the lower of their carrying amount and their fair value less costs to sell. Any further reduction in the value of an asset arising from a subsequent revaluation should be accounted for in accordance with Part 1 Chapter 5 paragraph 135.

26. DIO should recognise a gain for any subsequent increases in value prior to disposal up to the associated cumulative impairment loss previously recognised in the SOCNE. The impairment may have occurred whilst the asset was either classified as held for sale or in use.

27. Once the property has been disposed of, DIO should record the proceeds in the NCA Proceeds of Sale Account (RAA range). At the same time, the property's carrying amount should be transferred to the NBV of NCAs (RAB range). Any cost of removal or disposal should be charged to the NCA Cost of Removal (RAD range). Any remaining

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Revaluation Reserve balances which relate to the particular property item should be released to the General Fund.

28. If a decision is taken to demolish a building, DIO eliminates the gross carrying amount and accumulated depreciation from the NCAR and transfers them to the Surplus/Deficit on Disposal of NCA Account. As there are no sales proceeds to receive, the carrying amount will represent the deficit on disposal. This deficit on disposal is recorded as a charge to the SOCNE.

Disposals of Plant and Equipment Non-Current Assets

Disposals Through the Disposal Sales Authority (DSA)

29. Except for local sales (see Part 2 Chapter 5 paragraphs 37 and 38), sales of assets declared for disposal are accounted for as described below once the user/custodian TLB ceases to have management control over the asset.

30. The plant and equipment asset balances are reflected in the accounts of the appropriate DE&S budgetary area at a value adjusted for any impairment, with any subsequent surplus/deficit on disposal reported in its SOCNE/reserve balances, as appropriate.

31. Establishing fair value less costs to sell requires an element of judgement. Estimated sales values are informed by equipment/commodity managers, finance staff with PR and/or FOO estimates together with receipt profiles from the DSA for major surplus platforms.

32. Where sales receipts from assets are not separately identifiable, the gross carrying amount and accumulated depreciation must be removed from the NCAR (after any adjustment to fair value less costs to sell). The gross carrying amount, accumulated depreciation and reserves balances are then reflected in the accounts of the appropriate DE&S budgetary area. The gross carrying amount and accumulated depreciation balances are posted to Assets Declared for Disposal (ADD) - Non-Current-Asset Disposal with Non-Specific Receipts Account. The RAC used is DMA003. Subsequent sales receipts are posted to the Proceeds of Assets from the ADD account.

33. Where it is not possible to match sales receipts against specific NCAs' carrying amounts, the surplus or deficit is derived by using an estimate of the carrying amount that needs to be transferred from the ADD - Non-Current Asset Disposal with Non-Specific Receipts Account (to the carrying amount of assets from the ADD account) to be offset against the sale proceeds. The basis of this estimate takes into account past experience of the delay between declaring an asset for disposal and the actual sale. Any balance in the Revaluation Reserve associated with assets disposed of should be released to the General Fund.

34. Assets to be disposed of, for which sales receipts are separately identifiable and material, continue to be accounted for as NCAs until their disposal (although no further

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depreciation should be charged and they should be separately disclosed within current assets in the SOFP).

35. On disposal, the asset is removed from the NCAR. The gross carrying amount and accumulated depreciation balances (after any final adjustment to fair value less costs to sell) and the reserves balances are reflected in the accounts of the appropriate DE&S budgetary area. The gross carrying amount and accumulated depreciation balances are posted to the NBV of the NCA Sold Account. The RAC used is DMA004. Receipts are recorded in the SUME/Non-SUME NCA Proceeds of Sale Account and the surplus or deficit calculated. Any cost of removal or disposal is charged to the NCA Cost of Removal (RAD range). Any balance in the Revaluation Reserve associated with assets disposed of is released to the General Fund.

36. Where sales receipts are separately identifiable but are expected to be very low or nil, the NCA is written off in the accounts of the appropriate TLB when it is identified for disposal.

Local Disposals

37. Local disposals may only take place after written delegated authority has been received from the DSA.

38. Detailed guidance on local sales procedures is provided in JSP 886.

Specific Accounting Requirements

39. Specific aspects of NCA accounting requirements are explained below.

Assets Under Construction

40. AUC are not entered onto an NCAR but are usually tracked, on a project basis, via project account coding within the PT's General Ledger. They are included within NCAs on the SOFP. It is usual for contract costs to already reflect current costs and if this is the case, AUC balances are already at fair value. Therefore, indexation should not be applied to AUC where contract costs already include price inflation. The rationale for indexing or not indexing AUC must be retained to ensure that there is robust documentation available to auditors.

41. From the outset all projects should be recorded in an appropriate asset delivery schedule. The PTs must provide the agreed receiving TLB with the expected delivery dates over the life of the procurement project together with data for calculating and reporting deliveries.

42. AUC normally represent the accumulated costs of NCAs being constructed and will mainly be projects where stage payments are paid - for example, major works projects and equipment procurement projects.

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43. Accumulated costs, for example stage payments, should only be capitalised and treated as AUC if, at the time they are incurred, they meet the recognition criteria in Part 1 Chapter 5 paragraph 9.

44. Costs incurred on an NCA procurement project that are not directly attributable to bringing the asset into working condition for its intended use within the Department should be immediately expensed to the SOCNE, even if these costs are incremental to the project.

45. If a project is abandoned prior to completion, any associated costs held against AUC (including any revalued amounts) should be written off immediately to the SOCNE as abortive capital expenditure (MKD000) in the accounts of the TLB managing the project. If a proportion of the assets are saleable, their carrying amount should be impaired to their recoverable amount (and charged to the net operating section of the SOCNE). The value of the saleable assets should be transferred to the NBV of NCA sold (RAB range) and set off against the proceeds on sale.

46. On completion of the project, or on delivery of an NCA with phased deliveries, the costs should be transferred to the agreed receiving TLB and entered on the NCAR. When the asset is capitalised from AUC, a review of the fair value of the asset should be made, as it may not be assumed that the historic cost includes all adjustments for inflation to equal fair value. If necessary, the appropriate revaluation action should be taken. All decisions on revaluation to fair value after capitalisation should be documented and held as audit evidence. The receiving TLB must be given all the information needed to record the asset.

47. Once entered onto the NCAR, the NCA should be depreciated over its estimated useful economic life in the same way as for any other NCA.

Capital Spares and Guided Weapons, Missiles and Bombs

48. Part 2 Chapter 5 paragraphs 49 to 86 cover the accounting policies applicable to both capital spares and GWMB. Additional accounting policies relating specifically to capital spares and GWMB are set out in Part 2 Chapter 5 paragraphs 87 to 111 respectively. Part 1 Chapter 7 paragraph 85 contains the accounting treatment for Contracting for Availability contracts (sometimes referred to as Contractor Logistic Support contracts).

49. Capital spares pools and asset pools for GWMB are accounted for by a single owner throughout their life (normally a PT in DE&S or JFC). Movements in the pool are not reflected by a transfer in ownership, unless the item is permanently transferred to the asset pool of another owner - for example, where a transfer across service boundaries takes place. If this happens, the gross carrying amount, the accumulated provision or depreciation and the associated element of the reserves are individually transferred.

<u>Receipts</u>

50. Receipts are accounted for by the owner on the appropriate supply system at the point of acquisition when:

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a. legal title transfers from a third party;

b. internally manufactured items are brought on charge;

c. items are returned;

d. transfer of items takes place between TLBs; and

e. spares are cannibalised or salvaged from other assets.

51. When items are received in non-Departmental locations, they are accounted for by the Department from the point at which the custodian first notifies the Department. However the act of receipting materiel on to the supply system automatically brings the item on charge.

52. Where items are purchased on behalf of another owner, an appropriate inter-management grouping transfer is made by the supplying TLB to the receiving TLB to reflect the receipt of items in the owner's SOFP.

53. Where there is a difference (which should be rare) between the recorded value of an item being returned and that recorded in the receiving account, the difference (adjusted upwards) is reported in the inventories Revaluation Reserve account in the receiving MG's accounts.

54. Revaluation adjustments may also be necessary when the cannibalised spares control account is cleared after an asset is restored - i.e. issues are made for replacement of cannibalised spares.

55. The appropriate price to use is determined by reference to the Central Pricing Record which is maintained on the Integrated Stock Ownership and Pricing System (ISOPS).

Cost of Purchase

56. Cost is defined as the cost of purchases, costs of conversion and other costs incurred in bringing capital spares and GWMB to their present location and condition. The cost of purchase, net of trade discounts or other rebates and subsidies, includes the addition of packaging, carriage, customs duties, and other expenses incidental to acquisition if they can be identified to individual items or are specified in individual purchase contracts. The cost of purchase specifically excludes the notional price percentage additions which were formally applied in the calculation of Basic Material Price (BMP), which is VAT exclusive, and likewise those used to recover Departmental overheads

57. Cost is referred to as BMP plus VAT where appropriate and applies to both purchases and manufactured items.

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Cost of Conversion

58. Cost of conversion comprises direct materials, labour and expenses and other attributable overheads (including irrecoverable VAT). Cost of conversion is represented by the invoiced cost where work has been carried out by an external contractor.

59. Cost of conversion applies to a change in valuation of items which have undergone material modification, enhancement or conversion. However, it is not applied to items undergoing scheduled repair, maintenance, refurbishment or servicing, where the items have merely been restored to a fully serviceable condition.

Valuation

60. Capital spares and GWMB are valued at current cost or historical cost if not materially different. Where capital spares and GWMB balances are not material in value or the items are consumed and replaced at frequent intervals, it is acceptable to value them at historical cost. This will be sufficiently close to their value to the business and is therefore unlikely to result in any material difference from current cost. Individual assessments of materiality are made by the relevant TLB owner.

61. Current cost is the expenditure which would be incurred in manufacturing or acquiring an item of materiel at a current date. It represents the cumulative revaluation of items using the latest cost of acquisition or indexation and applies to items expected to be used or sold in the ordinary course of business.

62. Where appropriate, capital spares and GWMB should be impaired to their recoverable amount. This general principle is interpreted for Departmental purposes as:

a. current cost unless, exceptionally, historical cost applies, where items are expected to be used in the ordinary course of business; or

b. recoverable amount (fair value less costs to sell) in circumstances where such valuation is appropriate. For example, damaged items or where items are not expected to be used or sold in the ordinary course of business.

Revaluation

63. Revaluation to current cost is undertaken on an individual item basis and at least annually. It occurs through price supersession, indexation or some other current assessment. Appropriate Revaluation Reserves are maintained. To ensure that valuation is consistent across the Department, reference is made to the Central Pricing Record maintained on ISOPS. Only one price per individual item is recorded on a price record at any one time.

64. If appropriate, periodic revaluation at more frequent intervals than once a year is undertaken, for example, where prices for certain items are subject to short-term material fluctuation.

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65. Price supersession (price update) takes place when the relevant item is purchased or acquired. Periodic revaluation is carried out on fixed or effective dates - for example, on contract revision. For an item that has been purchased or acquired since the last price update or periodic revaluation, the latest re-provisioning price (either at the time of ordering, if the price is known or when subsequently invoiced) should replace the existing price record. However, this should not be done if using this price distorts the total value of such items, as might be the case with one-off purchases to meet critical supply shortages.

66. Where no price supersession has occurred, periodic revaluation is made through indexation, reference to price lists or revised contracts, or through a professional valuation. Items subject to recurring indexation are revalidated against current price lists or, in the absence of price lists, by a professional valuation assessment every five years.

67. Price changes used for a contract revision are taken into account during periodic revaluation provided that the contract is in force at that time. Periodic revaluation may be also be undertaken at the effective date of the contract. Price supersession will take place at the point at which an item is next acquired, unless this has been preceded by periodic revaluation in accordance with the revised contract.

68. Where price supersession is deemed inappropriate - for example, for one-off buys or due to short term currency fluctuations, the difference between the total cost of the items purchased and the total cost calculated using the existing price is reported as a purchase price variance. The balance on the purchase price variance account is released in full to the SOCNE at the accounting period end, subject to any outstanding price investigations, in which case the variances are carried forward. Where material, purchase price variances are reported as exceptional items.

69. Revaluation of internally manufactured items, which include raw materials and other costs of conversion, may require more complex methodologies - for example, weighted indexation.

70. Contract embodiment items manufactured or purchased by a contractor are revalued where current cost is deemed to be materially different from historical cost. When items are declared obsolete, revaluation is suspended. Where the cost of an item includes irrecoverable VAT, a change in the rate of VAT is taken into account during revaluation.

Inventories Revaluation Reserve

71. The Inventories Revaluation Reserve is used for the revaluation of all capital spares, GWMB and RMC (see Part 1 Chapter 6) rather than the NCA Revaluation Reserve. The balance on the Revaluation Reserve reflects the unrealised elements of the cumulative revaluation adjustments. When the items are issued for use or, in the case of RMC (see Part 1 Chapter 7), for consumption, sale, write-off, disposal or a permanent diminution in value has occurred (for example, to fair value less costs to sell /net realisable value) any associated Revaluation Reserve balance is realised and transferred to the General Fund.

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72. The release of a Revaluation Reserve balance to the General Fund should be calculated to a maximum of ‘one’ (i.e. the balance of the reserve should never show a debit balance) as shown below:

$$\frac{\text{in-year downward movements in value*}}{\text{opening balance value (excluding provisions)}} \times \text{balance on revaluation}$$

* comprises: consumption of RMC, write-offs, disposals, sales, write-downs and transfers (where the amounts relating to transferred items are not separately identifiable).

Issues and Items in Transit

73. Issues are accounted for on the appropriate supply system by the owner at the point of issue. DE&S hold the balance on their SOFP.

74. Issues are made at Basic Material Price (BMP) plus VAT where appropriate.

75. Sales (including repayment and prepayment issues) are priced at BMP with an addition to reflect recovery of applicable overheads (as set out in JSP 462. The difference is reported in the SOCNE as a surplus on disposal.

Physical Verification

76. PTs are responsible for physically verifying assets.

77. PTs should satisfy themselves that the custodians are carrying out appropriate physical verification procedures.

78. JSP 886 explains stocktaking policy and procedures.

79. Where practicable, full in-year continuous, and full end of year stocktaking is to be undertaken.

80. All NCAs on the supply system are subject to physical verification.

81. Where discrepancies are found, the accounting records should not be adjusted until the appropriate investigations have been completed.

Disposals

82. Capital spares and GWMB declared for disposal should be valued at the lower of their carrying amount and their fair value less costs to sell.

83. The policy at Part 2 Chapter 5 paragraph 95 will usually mean that they are valued at their estimated disposal proceeds less costs to sell - for example, agent’s fees.

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84. Items declared for disposal whose sales receipts (either collected by the Disposal Services Authority or generated from local sales) are anticipated to be separately identifiable are transferred to the Inventories Declared for Disposal account and evidence of the transfer retained.

85. Receipts are matched against the value of the items disposed of and any associated surplus or deficit on disposal is calculated and reported at TLB level, net of direct costs incurred in the sale.

86. Items declared for disposal, in accordance with JSP 886, Volume 2, Part 6, whose sales receipts (either collected by the Disposal Sales Authority or generated from local sales) are not anticipated to be separately identifiable are transferred to the Assets Declared for Disposal (Inventories) account. The receipts (Proceeds from the Sale of Inventories) are offset against the balance on this account (Value of Inventories Disposed) on a succession basis consistent with cyclical sales patterns. For example, current month receipts are offset against asset disposal postings in a specified prior month, consistent with the average lead time between declaration for disposal and sales receipts. Any associated surplus or deficit on disposal is calculated and reported at TLB level, net of direct costs incurred in the sale.

Capital Spares

87. Part 2 Chapter 5 paragraphs 49 to 86 cover accounting policies which apply to both capital spares and GWMB. Those which relate solely to capital spares are set out below.

88. Capital spares pools are established and identified to the prime equipment(s) they support. Items embodied in existing assets, or awaiting embodiment on a non-replacement basis (unless brought on charge to satisfy materiel accounting controls), are excluded from the pools. Items due in from repair (contract work items) and returns relating to replacement issues (repairable returns) are included.

89. Each pool is depreciated in order to write down its gross carrying amount less its estimated residual value over the life of the items, consistent with the estimated useful economic life of the prime equipment(s) supported. The accumulated depreciation is adjusted to take account of excess and obsolete items. Decisions on pooling and assigning a useful economic life are taken by the pool owners - for example, the relevant project, commodity or equipment support manager (normally a PT).

90. Where appropriate, pools are relifed to account for additions, transfers, write-offs and disposals (i.e. assets retired from the pool). Depreciation is calculated prospectively over the remaining life of the pool (i.e. the accumulated depreciation charged in prior years is not adjusted):

a. when the composition of the pool is permanently reduced, either as a result of a decision to meet changing military requirements or due to write-off of items as a result of a physical loss;

b. when the composition of the pool is permanently increased, either as a result of a decision to meet changing military requirements or due to write-on of items

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previously written-off and subsequently recovered or not having been previously recorded as received;

c. following impairment of the pool value as a result of the reduction in service potential of items in the pool;

91. Valuation of individual items is not generally applied owing to the pooled nature of capital spares and the accounting complications which would arise in respect of items below the threshold.

92. At the point at which the accumulated depreciation reduces the value of the pool to its fair value less costs to sell (i.e. the capital spares pool is fully depreciated) any further depreciation is only required to offset the continuing revaluation to current cost, until the items in the pool are declared obsolete.

93. Capital spares recorded on the supply system are revalued at least annually by using indices, price supersession, making reference to price lists, revised contract prices or through a professional valuation. Depreciation charges are adjusted to take account of the revaluation.

94. Backlog depreciation adjustments are made to account for prior period charges as a result of revaluation and are taken to the NCA Revaluation Reserve.

95. When capital spares are declared obsolete, written-off or disposed of (i.e. retired from the pool), the associated accumulated depreciation is released to offset the write-down.

Capital Spares in the Repair Loop

96. A repairable item is one which, if it were to break, is capable of being repaired and it is intended that it will be restored to its required condition, i.e. made fully serviceable after repair, refurbishment, maintenance, servicing, modification, enhancement or conversion. (NB. An item might subsequently prove to be too expensive to repair, at which point it would be disposed of.)

97. Capital spares are processed for re-issue via a repair loop. This is normally in accordance with an upkeep by exchange (UBE) process, whereby an item of materiel is issued from inventory system holdings to replace an identical but normally unserviceable item which is returned.

98. Capital spares issued for repair are accounted for by the owner - i.e. the relevant project, commodity or equipment support manager (normally a PT).

99. Repair costs are charged to the SOCNE as incurred. Costs incurred in modifying, enhancing or converting items capital spares, which increase their value, are attributed to those items and the BMPs of the items changed. Concurrently, the items are re-referenced (given a new NATO stock number).

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100. At the accounting period end, the following reconciliations are performed and particular attention paid to transactions relating to capital spares in the repair loop:

a. throughput reconciliation of opening to closing balances

b. control reconciliation of account closing balances with inventory system closing balances.

c. costs awaiting invoice are accrued in respect of capital spares that have been returned from repair at the reporting period date.

Guided Weapons Missiles and Bombs

101. Part 2 Chapter 5 paragraphs 49 to 86 cover accounting policies which apply to both capital spares and GWMB. Those which relate solely to GWMB are set out below.

102. Assembled GWMB (excluding associated capital spares) are progressively depreciated to residual value over the estimated useful economic life of the items. Where appropriate, this will be consistent with the estimated useful economic life of the associated weapon system.

103. Missiles fired to destruction are fully depreciated and charged to the SOCNE to recognise the fact that the pool size has reduced. Because of the pooled basis on which the depreciation is calculated, its validity should be reconfirmed each year to ensure that it adequately reflects the nature, timing and size of movements which are projected to occur.

104. Where GWMB are used to destruction or fired, they should be charged to the SOCNE of the relevant PT.

105. Where GWMB are fired but recovered for further use (for example, telemetry or test missile firings) they should be reclassified from GWMB SUME to capital spares to enable them to be processed through the standard repair procedures. The value of any missile subsequently found to be beyond economic repair should be written off to the NCA Write-Off account.

Cannibalisation

106. Where spares are removed from a scrapped asset prior to disposal, they are brought on charge to the appropriate account at their existing recorded value. The value of the asset is impaired by the value of the spares removed. Where appropriate, a further adjustment is made to write the asset off to its scrap value. The value of the spares which have been removed is credited to the SOCNE by adjusting depreciation.

107. If an asset is temporarily cannibalised to provide spares support and they are brought on charge to the appropriate account prior to issue, a balancing entry is made to a cannibalised spares control account. This is cleared when the asset is restored.

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Transfers

108. Capital spares and GWMB asset pools are accounted for by a single owner throughout their life.

109. Movements in the pool are not reflected by a transfer in ownership, unless an item is permanently transferred to the asset pool of another owner.

110. The gross carrying amount, accumulated provision or depreciation and the reserves element are transferred individually.

111. The following headings should be used to account for GWMB (excluding capital spares):

a. depreciation should be charged to ‘GWMB Provisions’;

b. usage of GWMB - i.e. the firing of GWMB to destruction - should be charged to ‘GWMB Additional Depreciation for Firings Used to Destruction’;

c. write-offs should be charged to ‘NCA Write-Offs’;

d. where it will not be possible to match the receipts from the sale of GWMB to individual items, balances are mapped to ‘Non-Current Assets Declared for Disposal with Non-Specific Receipts’.

Ancillary, Composite and Grouped Assets

112. Ancillary items are discrete NCAs which are integral to the support of a main NCA and can be pooled. They cover items such as an engine trolley or an oscilloscope used to repair electronic equipment so may not necessarily be embodied.

113. Composite items comprise a number of separate items which do not warrant capitalisation in their own right but due to their interdependence and accumulated value are registered as a single NCA.

114. Grouped items are generically similar items whose individual values do not warrant capitalisation but, due to their total value, are grouped and capitalised. The £25,000 capitalisation threshold also applies to grouped assets.

115. Ancillary, composite and grouped NCAs are capitalised within the relevant principal NCA category.

116. For ancillary items included ‘on board’ other NCAs, a separate NCAR entry is made and referenced to the main NCA through a ‘parent-child’ relationship. An example of this is a SUME asset containing a communications system which could be removed and redeployed either as a standalone NCA or within some other NCA.

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117. Composite items are included as part of the main item of equipment to which they are fitted and are registered as a single NCA. For example, IT networks and the systems which are an integral part of SUME and cannot be removed and used in isolation.

118. Grouped items are registered as a single group NCA, where the omission of the NCAs would cause a material understatement of the TLB's SOFP. Typical examples of grouped assets are firearms and stand-alone PCs, where their use is extensive and core to the organisation's successful operation. If an individual NCA exceeds the capitalisation threshold it is registered separately.

119. Grouped assets should be accounted for as follows:

a. individual components of grouped items are recorded separately on the NCAR under one main asset record. Each component of the group is allocated to the same asset category. The NCAR either contains one entry describing the group or alternatively all items of the group are listed. Where it is impractical to list components separately, a full audit trail of items within the group is maintained;

b. the cost of additions to groups should be capitalised as part of the value of the group;

c. groups should be revalued;

d. any addition to the group is given an economic life, which ends in the same accounting period as the rest of the group. Depreciation is charged on grouped assets, in line with the useful economic life of the group;

e. if significant changes are made to the group (for example, many new additions) the whole grouped asset should be re-lifed to reflect its changed composition. Alternatively, if a significant number of new assets are purchased, a new group may be formed.

120. Cabling for new IT and Comms systems should be capitalised as a separate composite IT asset based on the cost of purchase and installation and depreciated over the planned operational life of the asset. Upgrades to existing cable infrastructure are deemed to be maintaining operational capability and should be expensed. If existing underground ducting is used for a new IT and comms installation, this should not be included in the capitalised asset valuation but may need to be revalued and relifed in accordance with any revised usage.

Containers

121. A container is a receptacle which is specifically designed to transport or store items.

122. The term container may relate to small wooden crates used for the permanent storage of sensitive equipment; large metal containers used for shipping materiel overseas; or to specialised containers incorporating technical and electronic devices used

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for the carriage and storage of explosive or other dangerous products. All empty containers are returned for inspection, repair or refurbishment, re-use or disposal.

123. Where a container is regarded as packaging; is identifiable to individual items or specified in individual purchase contracts; and is included in the cost of purchase, no separate accounting is required. The price recorded for the individual item includes the cost of the associated container.

124. Containers not treated as packaging but identified separately within individual purchase contracts or acquired under a specific purchase contract, are accounted for as RMC items (see Part 1 Chapter 7 paragraph 93) or grouped NCAs, depending on the nature, quantity and value of the items concerned. Grouped NCA pools are created for each container type (and sub-type).

125. Containers are classified into three generic types, i.e. Special To Content (STC) containers; ammunition boxes; packed fuel containers.

126. With the exception of STC containers, which should be accounted for at all times, accounting for containers is restricted to items which are empty and held on a supply system awaiting re-use or, subject to materiality, have been issued to contractors to be repaired or refurbished.

127. Containers issued to contractors for repair or refurbishment are accounted for as a CWI. All accountable containers are subject to physical verification.

STC containers

128. STC containers are specialised containers and are regarded as essential assets in their own right.

129. They should be accounted for, whether empty or filled, as grouped NCAs and depreciated over the life of the pool, unless this is so long that the annual depreciation charge is immaterial. In such circumstances, the pool should not be depreciated but reviewed for impairment at the end of each financial year.

130. Containers which meet the Departmental capitalisation threshold are capitalised individually as NCAs, for example, specialised ISO containers.

Ammunition Boxes

131. Ammunition boxes are returned, where appropriate, for re-use. They undergo routine inspection and repair or refurbishment. As grouped NCAs, the pools of empty containers are depreciated over their life, unless this is so long that the annual depreciation charge is immaterial, in which case the pools should not be depreciated but reviewed for impairment at the end of each financial year.

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Packed Fuel Containers

132. Empty containers are recorded as individual RMC items. See Part 1 Chapter 7 paragraph 94.

Government Furnished Assets (GFA)

Scope

133. In the context of Departmental materiel accounting, JSP 886 uses the term 'inventory' when referring to capital spares, Guided Weapons Missiles and Bombs (GWMB) and Raw Materials and Consumables (RMC). However, for financial accounting purposes, capital spares and GWMB are categorised as Non-Current Assets (NCAs) and RMC as inventories. Therefore, where this annex refers to 'inventory' or 'materiel', the terms apply solely to the materiel accounting concept of capital spares, GWMB and RMC.

134. For the purpose of this Part 2 Chapter 5 paragraphs 135 to 208, the owner of Government Furnished Assets (GFA) within the Department is referred to as the Authority.

Categories

Government Furnished Assets (GFA)

135. GFA is a generic term used to describe Authority funded and owned intangible and tangible NCAs (which include capital spares and GWMB); RMC; facilities; and personnel supplied to industry in support of Defence contracts.

136. GFA covers Government Furnished Equipment (GFE), Government Furnished Facilities (GFF); Government Furnished Information (GFI); and Government Furnished Resources (GFR); and is synonymous with the term Assets in Industry (AiI).

137. GFA can be provided to Industry engaged in the delivery of new or modified assets or to support in-service equipment support programmes. GFA can be deployed within Defence contractor premises and in Defence contractor designated areas in Authority premises in both UK and overseas locations.

138. GFA can be issued to, or retained by Trading Funds and by contractors to support Public/Private Partnership (PPP), collaborative projects and, in exceptional circumstances, the Private Finance Initiative (PFI) contracts. It can also be held to support specific logistic supply schemes - for example, Contractor Logistic Support (CLS) contracts. The term 'contractor' is used generically throughout this annex to cover all entities in receipt of GFA, as contractors' precise legal status will vary.

139. The Defence Internal Audit (DIA) is responsible for auditing the stewardship of GFE with the Department and Industry.

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140. Defence Business Service (DBS) is the custodian of the Assets in Industry (AiI) database and is responsible for providing the management information (MI) to Project Teams (PT). PTs are however responsible for ensuring that their contractors comply with DEFCON 694 and provide timely and accurate data in respect of GFE balances and transactions

Government Furnished Facilities (GFF)

141. GFF includes purpose built services or amenities consisting of property and associated infrastructure, which serve a specific function and are provided to a contractor to support the delivery of a Defence contract - for example, training and trials facilities.

Government Furnished Information (GFI)

142. GFI includes data, books, software, drawings and Intellectual Property Rights (IPR) supplied in accordance with, or generated as a result of, a Defence contract.

143. IPR includes concessions, patents, licences, copyrights, trademarks, databases and similar rights and assets, and are included within intangible NCAs.

Government Furnished Resources (GFR)

144. GFR covers Authority funded personnel who are needed to perform tasks to support a Defence contract - for example, tests or trials.

Government Furnished Equipment (GFE)

145. GFE is an item of Authority owned materiel provided to a contractor in support of a Defence contract to assist with research or the development, manufacture, production, construction, repair, refurbishment, maintenance, servicing, modification, enhancement or conversion, of facilities, equipment or RMC other than a repair contract where items will be in a repair loop.

146. The contract conditions determine whether an item is to be treated as GFE, since Authority owned items may be physically located in contractor operated environments under purely custodial arrangements - i.e. they have not been provided to the contractor to support a Defence contract.

147. Jigs, Tools and Test Equipment (JTTE) are materiel which is generally supplied to a contractor as special to type GFE. JTTE comprise jigs, tools, patterns, moulds, dies, manufacturing gauges, test equipment and any associated fixtures, fittings and software. JTTE are generally procured for specific projects;

148. Items are normally procured/supplied in accordance with standard conditions of contract: DEFCON 23 (DC23) for Special Jigs, Tooling and Test Equipment (JTTE), and DEFCON 611 (DC611) for Issued Property. The DEFCONs specify the requirements for records of items supplied to be maintained by the contractor, either through a commercial

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Asset Register (DEFCON 23) or a Public Store Account (DEFCON 611) respectively. The items, which should be classified as either NCAs or RMC for accounting purposes, range from piece part spares, through assemblies of varying complexity (including capital spares), complete equipment and platforms, to special JTTE.

149. JTTE can be procured as JTTE under DEFCON 23 arrangements or supplied as Issued Property (which is synonymous with the term loan) under DEFCON 611 arrangements. As each category has its own specific accounting treatments, this annex makes a clear distinction between JTTE procured under DEFCON 23 and JTTE supplied as Issued Property.

Special Jigs, Tooling and Test Equipment

150. JTTE for Current Project Delivery (CPD) are typically procured under DEFCON 23 to support projects engaged in development, manufacture, production, construction, modification, enhancement or conversion. Decisions on the future use of the JTTE – i.e. for Future Project Delivery (FPD) or In-Service Support (ISS) are not made until project completion. Where the JTTE is required for FPD or ISS then the items will be treated as Issued Property and as a Contract Support Item.

151. In the legal and materiel accounting context, JTTE can become Issued Property once the Authority assumes legal title, which can occur at various points during a contract. For the purposes of this annex, JTTE are assumed not to become Issued Property until project completion. This is primarily because, irrespective of their legal status and materiel accounting requirements, the value of the items will only be attributed to the project account (see Part 2 Chapter 5 paragraph 150) up to that point in time.

152. Although JTTE held by the contractor under DEFCON 23 terms are recorded on commercial asset registers to enable them to be physically controlled until returned or otherwise disposed of, they will not be recorded on the Authority's NCAR until project completion. It is therefore of fundamental importance that the Authority accounts for them financially regardless of whether legal title has passed and irrespective of the attached DEFCON status. Care must therefore be taken to avoid double accounting of assets charged to project accounts.

Other GFE Categories

153. A simplified GFE category structure has now been adopted and the terms are explained in Part 2 Chapter 5 paragraphs 154 to 157. Where appropriate, former GFE category definitions are cross-referenced to the revised rationalised terms.

<u>Contract Work Item (CWI)</u>

154. A CWI is an item of materiel which is being worked on in accordance with a contract issued by the Authority. It is an item of materiel temporarily issued to a contractor, without charge and for a specified period upon which it is returned. It is typically issued for the purpose of enabling repair, refurbishment, maintenance, servicing, modification, enhancement or conversion (for example – an engine), or for the purposes of inspection or packing. It is subject to physical return in a specified condition. CWI was formerly referred to as a contract loan item.

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Contract Support Item (CSI)

155. CSI is an item of materiel provided in support of a contractor's contractual obligation on a CWI. It is an item of materiel provided to a contractor for a particular purpose and specified period (for example – power supply), with or without charge. It is subject to return in the same condition as issued, fair wear and tear excepted. If the item needs to be replaced, the original item should be written off and the new asset written on. The charge may be based on a hire or rental levy (which may be payable in advance or require a deposit). The permanent issue of a CSI - i.e. where the item will not be returned and is issued for an unspecified period - is only permitted in exceptional circumstances. CSI are sometimes referred to as Issued Property.

Contract Embodiment Item (CEI)

156. CEI is an item of materiel embodied in a CWI or an article of new build in accordance with a contract issued by the Authority (also referred to as Issued Property). It is an item of materiel provided to a contractor, normally without charge, for incorporation into an asset under manufacture, production, construction, repair, refurbishment, maintenance, servicing, modification, enhancement or conversion (for example – a gearbox). Items may be issued as new acquisitions with no NATO Stock Numbers (NSN), or from existing inventory holdings. A feature of CEI is the contractor's direct custodial responsibility for the item prior to embodiment. Issues for CEI are only to be made in accordance with the agreed scales laid down within the contract. Issues above the scales laid down should be on Repayment terms.

Contract Work Arising (CWA)

157. An item of materiel removed from a CWI or other MOD owned asset in accordance with a contract (issued by the Authority) for incorporation into another item of materiel or for the retention as a NCA or inventory in its own risght. A check should be made to ensure that those items which have been removed remain intact - e.g. an engine removed from the hull of a ship and placed on the dock could have been cannibalised.

Ownership

Ownership Test

158. For GFA to be included in the SOFP, the Authority must be able to demonstrate that it has a legitimate ownership interest in the assets and is able to identify them to an appropriate owner. Where the contractor is deemed to hold sole custodial responsibility and title is deemed to have been conferred on the Authority, the ownership of commercially managed assets will include items held in support of PPP, PFI, CLS, collaborative and Trading Fund agreements. These arrangements should be reviewed to establish whether they should be reported on the Authority's SOFP in accordance with IFRIC 12, IFRIC 4 and/or IAS 17 as applied in this JSP.

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Authority Ownership

159. Authority ownership of assets is recognised at the point of acquisition and only when legal title is deemed to have transferred from a third party. Where items are paid for by the Authority - for example, on completion of the manufacture of an item by the contractor and before legal title has passed - the cost is a legitimate charge to a project account in advance of formal ownership. This is in line with the assumption that items are only assumed to be Authority owned Issued Property at the end of the project (see Part 2 Chapter 5 paragraph 151).

Joint Ownership

160. Where the Authority has a joint ownership in assets (for example, through collaborative projects) only the element which represents the Authority's ownership interest is included in the Statement of Financial Position (SOFP) of the appropriate TLB/Inventories holder. Ownership or part ownership is based on the relevant legal and business arrangements set out in the appropriate formal agreement. It reflects the basis on which, in principle, the assets would be distributed if the agreements were dissolved and the rights conferred on the Authority exercised. Ownership accounting or reporting should therefore be established on a contract by contract basis.

Jigs, Tooling and Test Equipment (DEFCON 23) AUC

161. For the purposes of this annex, ownership of JTTE is deemed to vest in the DE&S Project Team (PT) responsible for Current Project Delivery (CPD), Future Project Delivery (FPD) or In Service Support (ISS), or it may be assigned to another body who is temporarily responsible for holding the assets pending their use in a future project. Although these PT descriptions are referred to separately in the following paragraphs, in practice the PT responsible for the project may cover one or more of the above responsibilities. Therefore a transfer of ownership between PTs may not always be relevant.

GFE (DEFCON 611) NCA and inventories

162. Items issued to contractors do not involve the transfer of title to a third party and therefore Authority ownership is retained throughout the period of issue. Financial management of NCAs is vested in the relevant TLB. Financial management of inventories is vested in the responsible Inventories Holder. Ownership and accounting responsibilities for the Issued Property remain with the PT for which the items are being used – i.e. the contract owner with the exception of CSI loans where accounting responsibility remains with the equipment owning PT, normally the Single Item Owner.

Orphan Assets

163. Any assets loaned to industry which cannot be identified to an owner should be allocated to a proxy owner by the relevant TLB and the appropriate management action taken.

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Government Furnished Facilities

164. Ownership of GFF is deemed to vest in the PT responsible for the project for which the facilities have been provided, as new, to the contractor. In the case of an existing facility, which is in use with an owning TLB before it is re-assigned for use by the contractor, ownership is retained by the existing owner if it is not appropriate to formally transfer the associated assets to the project.

Government Furnished Information

165. Ownership of GFI is deemed to vest in the PT responsible for the project for which the information has been supplied or generated.

Government Furnished Resources

166. As contractors' personnel are not treated as assets on the SOFP, ownership is not applicable.

Accounting

Government Furnished Equipment

167. The accounting treatments for GFE make a clear distinction between special JTTE held under DEFCON 23 terms (Part 2 Chapter 5 paragraphs 171 to 179) and Issued Property (Part 2 Chapter 5 paragraphs 180 to 198) under the various schemes. The accounting treatment is generally governed by ownership considerations and the terms under which materiel is held by contractors (DEFCON 23 or DEFCON 611).

168. Where a contractor is the custodian of MOD owned materiel, the PT with contract responsibilities is to ensure that the contractor complies with DEFCON 694 (Accounting for Property of the Authority) and provides timely and accurate data in respect of GFE balances and transactions.

169. Items issued between entities which are within the Departmental accounting boundary are accounted for in accordance with the relevant materiel accounting regulations, and where appropriate, Chapter 5 of this JSP.

170. The accounting treatment for GFE issues and for their retention and disposal at the end of a contract is set out in the following paragraphs.

Special Jigs, Tooling and Test Equipment

JTTE procured for Current Project Delivery (DEFCON 23)

171. JTTE procured by contractors to support current projects, (see Part 2 Chapter 5 paragraphs 189 and 190), should be charged to the appropriate project account operated

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by the DE&S PT responsible for current project delivery. Subject to the application of the NCA capitalisation rules, project costs are capitalised as development costs or AUC, pending transfer through the asset delivery schedule (ADS), or otherwise, following project completion. Where capitalisation is inappropriate, project costs are charged directly to the SOCNE.

172. On project completion, all JTTE charged to the project account are initially assumed to have a nil (i.e. fully depreciated) value, as all items charged to the project account are absorbed into the development or production costs of the assets delivered (intangible and tangible NCAs respectively). Hence, a value is only attributed at the end of the project if it is relevant to the items future use or disposal. The valuation should be applied on a group asset basis against a current contract or the platform.

173. The value is to be determined by the PT owner responsible for retention and further use or disposal action. In practice, the PT may need to consult more widely across the acquisition community to determine a supportable value to attribute, taking account of items treated as grouped assets. Subject to the application of standard NCA capitalisation criteria and valuation policies, the accounting actions described in the following paragraphs should be taken.

JTTE to be Retained for In-Service Support (DEFCON 611)

174. Items are grouped and valued at fair value - i.e depreciated replacement cost (DRC) and assigned an estimated useful economic life. They are recorded on the Authority's NCAR and their value reflected on the SOFP. Items include those to be held in reserve, which can be, if fully codified, recorded on DE&S supply system inventories. Items held on the NCAR are subsequently re-valued and depreciated in accordance with standard NCA accounting policies.

JTTE to be Retained for Future Project Delivery (DEFCON 611)

175. Items are grouped and valued at fair value (DRC) and are charged to the appropriate project account operated by the DE&S PT responsible for FPD (FPD PT). Subject to meeting the NCA capitalisation rules, they are capitalised as development costs or AUC, pending transfer through the asset delivery schedule (ADS), or otherwise, following project completion. The items, although recorded as legally Issued Property, are transferred direct to the appropriate project account.

176. Where a project account for future project support does not exist, items are valued at fair value (DRC) together with an estimated useful economic life, and are entered temporarily onto the Authority's NCAR with the value held on the SOFP, including those items to be held in reserve. Items held on the NCAR are subsequently re-valued and depreciated in accordance with standard NCA accounting policies.

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JTTE Identified as no Longer Required and for Disposal

177. Items are issued for disposal from the appropriate project account operated by the CPD PT and are accounted for in accordance with standard NCA disposal accounting policies.

JTTE to be Retained by the Contractor for Commercial Purposes (DEFCON 611)

178. Items no longer required would ordinarily be disposed of. In exceptional cases, the contractor, in accordance with the principles in JSP 462, may retain them for solely commercial purposes even though title still vests in the Authority. In such cases, the items are valued based on the income stream which will be generated through future commercial exploitation levy receipts. They are given an estimated useful economic life, entered on the Authority's NCAR and the value reflected on the SOFP. Items held on the NCAR are subsequently re-valued and depreciated in accordance with standard NCA accounting policies.

Accounting Adjustments

179. Where there is a balance on the project account, adjustments resulting from the actions set out in Part 2 Chapter 5 paragraph 174 of this chapter are made to the amount capitalised as development costs or AUC. Otherwise the adjustment is made to the revaluation reserve.

Contract Embodiment Items (DEFCON 611)

New Build/Major Refits (AUC)

180. All CEIs provided to contractors for subsequent embodiment should be charged to the project account operated by the appropriate PT

181. This accounting treatment recognises that a CEI issue represents an item of materiel which is intended to be incorporated into an asset and will not be subject to return in its singular state. Contractors are required to confirm that items have either been embodied or are awaiting incorporation, by identifying the items within their reported GFA balances which were issued to them as CEIs. These items are excluded from NCA or RMC balances, unless material in value, in which case an adjustment is made to the project costs (development costs or AUC) and the items are reported in the SOFP (i.e. there would be a misstatement of the accounts if assets awaiting embodiment were included in project costs where they still existed as materiel balances in their own right).

182. Any items remaining unincorporated on project completion are valued and recorded as NCAs or RMC in the Authority's NCAR or inventory records in accordance with the general principles set out in Part 2 Chapter 5 paragraphs 174 to 178.

183. It is the responsibility of each TLB to have a process whereby contractors are accountable for physical verification of CEI holdings and for recording and accounting for

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CEIs on non-Departmental systems, including all receipts, issues, transfers, disposals and losses.

184. It is the responsibility of each TLB CEI sponsor to ensure contractors provide valuations for items purchased or manufactured on the Authority's behalf, consistent with Authority valuation and revaluation policy. Evidence to verify valuations, for example, purchase orders, is retained by contractors and periodically audited by Departmental auditors. A record of the associated acquisition cost is made concurrently with the TLB's authorisation for purchase or manufacture.

185. It is necessary to differentiate between CEIs issued to a specific production or enhancement task (principally capital spares), and items issued in support of on-going repair contracts (generally RMC) because of the different control procedures that apply to each.

Embodiment of Capital Spares

New Manufacture/Modification

186. Capital spares awaiting embodiment on a non-replacement basis are ordinarily excluded from capital spares pools and charged to the appropriate project account when purchased in accordance with the guidance given in Part 2 Chapter 5 paragraph 180 of this chapter. As such, capital spares purchased for embodiment do not generally form part of a pool unless they remain unincorporated at the end of a project, at which point they will be subsumed within the appropriate capital spare pool(s). It is only necessary to adjust project costs to recognise capital spares awaiting embodiment where a material balance is involved.

187. Capital spares with the same NSN included in a pool may be subsequently issued for embodiment on a non-replacement basis - for example, for the production of new assets or in the enhancement of existing assets. The issue is made on CEI terms and any depreciation is released back to the SOCNE of the pool owning PT. It effectively represents the transfer of a capital spare to the project account operated by the CPD PT, which on completion of the project and subject to the application of NCA capitalisation rules, will be capitalised within development costs or AUC, pending transfer through the asset delivery schedule (ADS) or otherwise following project completion. Where the project costs are not capitalised the value of the embodied item will be charged to the SOCNE as permanent diminution (in the case of RMC items this will be inventories consumption).

Repair

188. Capital spares, with the same NSN, included in a pool may be subsequently issued for embodiment on a replacement basis. The issue is made on CEI terms and any depreciation is released back to the SOCNE of the pool owning PT. It effectively represents the transfer of a capital spare to the project account operated by the CPD PT. The subsequent return of the replaced capital spare into the pool will attract catch up depreciation in accordance with normal write on procedures.

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Contract Work Items (CWIs) and Contract Support Items (CSIs)

189. CWIs and CSIs NCAs (capital spares and GWMB) issued to contractors to support current projects continue to be recorded in the Authority's NCAR and held on the Authority's SOFP. In the case of capital spares, GWMB and RMC items issued from TLBs other than DE&S, the owning TLB is responsible for holding the balances on its SOFP. This accounting treatment recognises that the issued item of materiel is subject to return in its singular state. Appropriate records are maintained detailing the current location and associated custodial responsibilities in accordance with Departmental Materiel Accounting Regulations.

190. If an item is issued to an internal customer - i.e. an entity within the Departmental accounting boundary, it is not treated as an internal loan and therefore not covered within the term GFA. In this context Trading Funds are to be regarded as external customers. CWI and CSI issues are to be regarded as internal loans and are not subject to transfer of depreciation.

Contract Work Arisings (DEFCON 611)

191. The value of an existing item is adjusted in accordance with the rules on impairment of NCAs or RMC write-down. In the case of items removed and subsequently identified for disposal, they should be valued at the lower of their carrying amount and their fair value less costs to sell (NCAs) or NRV (RMC). Items removed and used in support of current projects are charged to the appropriate project account at fair value (DRC) or CRC respectively.

Issued Property Records

192. Records of CWI and CSI issues should be maintained and returns monitored during and at the end of specified issue periods. It should be noted that the Authority's NCAR only records NCAs held by contractors under CWI or CSI terms where their value meets the Departmental capitalisation threshold and also that a single NCAR entry may cover a number of grouped assets recorded individually in the contractor asset registers.

193. Records include transfers to sub-contractors, write-offs and issues for disposal. However, items issued to the Disposal Sales Authority should not normally be treated as Issued Property. Items passed for disposal are removed from the inventories/asset records at the point of transfer (not the point of sale) and must be accounted for under normal disposal accounting policies. Separate contractor returns for items held pending sale are required to support the balances.

194. Records of items issued to contractors or Trading Funds in the capital spares repair loop (CWIs) are to be maintained and returns monitored against anticipated repair completion dates. Items issued internally are also subject to returns monitoring. All dues-in from internal (repairable returns) or external (CWIs) sources at the reporting period date are accounted for within account and inventory balances.

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195. Records of CSIs that have been provided to contractors or customers are maintained and returns monitored during, and at the end of, specified periods. Overdue returns are hastened and the records cleared on receipt of the returned item. All CSIs at the reporting period date are accounted for in account and inventory system balances.

Asset Transfers

196. Assets can be provided to contractors by transferring completed assets from other projects, or as directly procured items by PTs - for example, items supplied by the US Department of Defence under Foreign Military Sales (FMS) arrangements. Costs are transferred as development costs or AUC from one project and added to the development costs or AUC of another project or alternatively they are charged direct to the appropriate project account. The transfer is effected, as appropriate, through the ADS process, by inter-MG transfer, or by manual journal for projects relating to PTs within the same MG.

Collaborative Projects

197. Collaborative projects are usually regarded as joint arrangements. The Authority is deemed to hold an interest (on a long-term basis) in a project which is controlled jointly with other parties under a contractual arrangement. Each party accounts solely for its share of the assets used to deliver the project.

198. Subject to title (ownership interest) being established, items of materiel provided to contractors under collaborative projects are accounted for in accordance with the general policies set out in this annex.

Liability for Loss, Damage or Faults

199. If an asset provided to a contractor is lost, damaged or subject to a repair fault and liability is disclaimed or repair under specific or standard contract conditions, then the owning PT or MG is responsible for the costs associated with replacement. The costs will not be transferred to project costs as described in Part 2 Chapter 5 paragraph 190.

200. Where liability is upheld, then the DBS will notify the appropriate PT in order that appropriate charges can be raised for the recovery of costs. Recoveries are credited to the appropriate project account or SOCNE.

Missile Test Firings

201. Where missiles are used to destruction in test firings in support of project assessments, these are accounted for by the PT owner responsible for accounting for the missile pool in accordance with standard missile accounting policies. Missiles recovered from test firings are repaired and also accounted for in accordance with standard rules.

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Government Furnished Facilities

202. All GFF provided to contractors to support current projects, except for facilities not transferred from an existing owner, should be charged to the appropriate project account operated by the appropriate PT (normally a CPD PT). Subject to the application of NCA capitalisation rules, project costs should be capitalised as development costs or AUC, pending transfer through the ADS or alternatively on completion of the project.

203. In the case of an existing facility which is not transferred from an existing owner, any costs associated with the enhancement or provision of additional capability to the facility are charged to the appropriate project account and included in the overall project costs or, where the criteria for NCA capitalisation are met, they are capitalised as enhancements to the existing assets.

204. On project completion, all items remaining in use or to be disposed of are accounted for in accordance with the general principles set out in Part 2 Chapter 5 paragraphs 174 to 179.

Government Furnished Information

205. Provided that an appropriate acquisition cost can be attributed, provision of GFI to contractors is accounted for in accordance with the rules set out in Part 2 Chapter 5 paragraph 202.

206. Following project completion, it is unlikely that the majority of information supplied will be material in value and therefore no accounting action is necessary. The majority of IPR is generated by commercial contractors and normally the Authority secures ‘freedom of use’ for the time that the asset is in service. Consequently, any element for IPR will invariably be included within the overall project development costs and as such be indistinguishable from the overall capitalised asset value. As the IPR cannot be sold to a third party, it is not appropriate to identify it separately.

207. However, in cases where the Authority concurrently or subsequently, receives the right to a Commercial Exploitation Levy, a market value for the IPR may be readily ascertainable, in which case it should be recognised as an intangible asset, subject to the application of the £25,000 capitalisation threshold. Purchased IPR should be capitalised at cost.

Government Furnished Resources

208. Authority funded personnel engaged on a temporary or fixed term-basis as a direct result of a requirement to perform specific tasks in support of a Defence contract, are deemed to be directly attributable to that project and should be charged to the appropriate project account operated by the appropriate PT (normally a CPD PT). Subject to the application of the NCA capitalisation rules, project costs are capitalised as development costs or AUC, pending transfer through the asset delivery schedule (ADS) or alternatively following project completion.

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Non-Current Asset Non-Financial Data Standards

209. The following non-financial data standards are used to identify non-current assets.

Non-Current Asset Non-Financial Data Standard	Use
ASSET NUMBER	Unique asset reference number that identifies individual assets held within the department's asset registers. The first four characters denote the owner and actual register that the assets are held in and the remaining six characters are simply sequential numbers.
DESCRIPTION	A brief description of asset that enables correct identification for future verification and valuation exercises.
TAG NUMBER	A compulsory, unique reference number for all property and land assets. The tag number is the unique asset reference that the defence infrastructure organisation (DIO) uses within its defence property gazetteer (DPG) database. As this is not linked directly to the accounting asset register, is recoded within the asset registers to create a link between the two systems. The format of the tag number is defined as per DIO's SPEC024 requirement. The first four characters denote the establishment, the next two characters the actual land parcel and the remaining six characters the actual building reference.
PARENT/CHILD LINK	Subsequent enhancements/extensions to assets after initial capitalisation are capitalised as separate assets in their own right, but linked to the parent asset through the use of the parent/child link.
SERIAL NUMBER/UNIQUE IDENTIFIER	For equipment assets (i.e. non estate assets) a record of the vehicle registration number, tail number (for aircraft/helicopters), pennant number (ships) or other unique serial number. For property and land assets, in addition to the tag number, a record of either the land parcel unique identifier (lpuid) or built structure unique identifier (bsuid) as recorded within DIO's DPG.
CATEGORY	A four segment asset category code (major, minor, sub cat 1 and sub cat 2) to ensure that assets are recorded, indexed and accounted for in accordance with departmental and HMT requirements.
STATUS	To identify all heritage assets held by the department.
FINANCED	To identify the ownership of the assets held, i.e. either owned, donated, Private Finance Initiative (PFI) or leased.
IN SERVICE DATE	A record of the date the asset(s) entered service.
LIFE	A record of the expected in-service life of the asset(s).
OUT OF SERVICE DATE	Calculated from the in service date and life entered.

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UNITS	A record of the number of assets held. the majority of assets are held as individual assets (vehicles, buildings, aircraft etc), but other are held as grouped assets with the number of individual items held recorded against the one grouped asset (radios, rifles, desktop computers etc).
LOCATION UIN	A record of the asset's physical location uin (unit identification number) to aid future verification and costing exercises.
ESTATE MAINTENANCE ARRANGEMENT	A record of any Regional Prime Contractor (RPC) arrangements or PFI contracts.
PLATFORM	A two segment asset platform code (major and minor) used to group common platform assets together to provide quality management information on asset holdings. typical platforms would include Typhoon, T45 destroyer, Chinook etc.

Accounting for Public Private Partnership (PPP) Arrangements including Private Finance Initiative (PFI) Contracts

Scope

210. PPP/PFI contracts generally involve the private sector designing, building, financing and operating a property in order to provide a contracted service.

211. In this context, the term 'property' refers to any asset provided under the PPP/PFI contract, i.e. not simply to land and building assets.

212. This annex provides guidance on the scenarios most likely to arise. However, as they are not exhaustive and each PPP/PFI contract may have some particular features which are not addressed in any of the scenarios, each contract will need to be assessed on its own merits to determine its exact accounting treatment.

213. The accounting decision about which party has the property as an asset on its Statement of Financial Position (SOFP) should also be made on a case by case basis. Although provisional judgements can be made throughout the procurement process, they can only be finalised immediately prior to contract signature when the actual terms and conditions of the contract are certain.

214. Non-Current Assets (NCAs) which are on the SOFP are subject to revaluation in the same way as non-PPP/PFI assets. However, for ease in demonstrating the accounting transactions, the effect of revaluation has been ignored throughout this annex.

215. VAT paid to the PPP/PFI contractor may be recoverable and guidance on this can be sought from the FMPA VAT team.

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Main Features of a PPP/PFI Contract

216. The main features of a PPP/PFI contract are as follows:

a. the Private Sector Operator (PSO) provides services to the Department. The Department normally pays for these services on a monthly basis through a single unitary payment covering all aspects of the service. The payment is linked to factors such as availability, performance and usage;

b. a property is normally required in order to provide the service – for example, buildings or military equipment. The property is legally by owned or leased to the PSO, who designs, builds, finances and operates it;

c. the contract will specify arrangements for the property at the end of the contract term. These arrangements may include options available to both the PSO and the Department. Legal title to the property may pass to the Department through payment of its fair value or for a fixed or nominal fee. Alternatively or in addition, there may be a provision to re-tender the PPP/PFI contract to a new PSO and for the property to transfer. Another possibility is that the PSO may retain legal title to the asset at the end of the contract term.

Reporting PPP/PFI Transactions

217. All NCAs are reported on the SOFP of the relevant TLB. Although the PPP/PFI contract may be managed in a different TLB, this will not prevent the NCA value being allocated to the relevant and managed as any other conventionally procured asset.

218. For 'on' SOFP PPP/PFIs, the TLB managing the PPP/PFI contract (usually the sponsor of the project) remains responsible for all accounting entries, including transferring the opening gross carrying amount of the asset to the relevant TLB at the point at which it needs to be reported. This TLB will then have the asset in its segment of the Non-Current Asset Register (NCAR).

219. The liability will remain on the books of the TLB managing the PPP/PFI contract and will be reduced by contract payments. In addition, that TLB will account for the PPP/PFI finance costs, service charge and, where applicable, retain any residual interest in the asset. This means that all costs associated with the PPP/PFI unitary charge will be accounted for in one TLB, which has the advantage of avoiding the nugatory effort of transferring costs relating to the unitary charge between TLBs.

220. The management authority responsible for achieving Investment Approval Board Main Gate approval for the acquisition will need to ensure that for proposed 'on' SOFP PPP/PFI contracts, both the TLB who will report the assets on its SOFP and the TLB that will receive the unitary charge from any PPP/PFI arrangement are fully consulted during the course of the IAB submission.

221. Where an Agency satisfies the ownership criteria for the PPP/PFI asset, the relevant TLB 'communicates' the NCA values at year end so that the Agency can report it

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on its SOFP. The relevant TLB also communicates the depreciation cost charged to its Statement of Comprehensive Net Expenditure (SOCNE).

222. 'Off' SOFP deals do not result in an asset being reported on the Department's SOFP. However, where existing Departmental assets are passed to the PSO as part of the contract, there will be a SOFP implication in circumstances where it is appropriate to create a prepayment.

223. In these circumstances the prepayment should be accounted for by the TLB/Agency (including disclosing the contract in the commitments section of the accounts) that receives the unitary charge and manages the contract. The prepayment will then be charged to its SOCNE and added to the unitary charge.

224. When ownership of a PPP/PFI deal is transferred from one TLB to another, full details of the separate cost elements must be passed over from the exporting body along with the contract paperwork.

Accounting for a PPP/PFI Transaction

225. FMPA A&TM must be consulted and agree the accounting treatment for all service concession arrangements. Figure 1 (at Annex B) summarises the accounting decisions for PPP/PFI arrangements.

226. NCAs subject to PPP/PFI contracts should be recognised as NCAs on the Department's SOFP when the contract falls within the scope of IFRIC 12.

Determining When Contracts are Within the Scope of IFRIC 12

227. To be within the scope of IFRIC 12, the service concession arrangement must contractually oblige the PSO to provide the services relating to the infrastructure to the public on behalf of the Department. Contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract fall outside the scope of IFRIC 12, as do arrangements that do not involve the delivery of services to the public.

228. Generic examples of infrastructure which provide public services include: roads; bridges; tunnels; prisons; hospitals; airports; water distribution facilities; telecommunication networks; permanent installations for military etc. operations; and NCAs used for administrative purposes in delivering services to the public. However, each PPP/PFI arrangement must be assessed on its own merits to establish whether the arrangement creates infrastructure in the sense of IFRIC 12. In the widest sense, infrastructure comprises the Department's strategic assets (or groups of assets) and the means by which the Department carries out its business. Therefore, all the Department's service concession agreements are, in principle, capable of being infrastructure. For example, assets such as vehicle fleets could validly be regarded as infrastructure given their size and their role in delivering the Department's outputs.

229. There may be rare cases where some assets of a PPP/PFI contract meet the definition of infrastructure and some do not, in which case a split SOFP treatment (i.e.

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some assets ‘on’ the Department’s SOFP and some ‘off’ the Department’s SOFP) may be required.

230. Where there is infrastructure, whether previously owned by the PSO or the Department, or constructed or acquired from a third party for the purpose of the service concession arrangement and the Department controls:

a. or regulates which services the operator must provide with the infrastructure, to whom it must provide them and at what price; and

b. through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement (or there is no residual interest);

then, from the Department’s perspective, the PPP arrangement or PPP/PFI contract is a service concession within the meaning of IFRIC 12.

231. Where the infrastructure asset is used for its entire life, and there is little or no residual interest, the arrangement falls within the scope of IFRIC 12, if the Department controls or regulates the services as described in the first condition. Significant residual interest will exist where the Department is contractually required to purchase the infrastructure asset at the end of the term of the arrangement.

232. In determining the applicability of the first condition, non-substantive features (such as price capping that would apply only in remote circumstances) should be ignored and the substance of the arrangement considered.

233. The residual interest in the infrastructure is the estimated fair value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement. Where the Department has the option to purchase the asset, at whatever price, it will mean that the Department has control of the residual interest. The overall residual value should also be taken into account when reviewing the substance of the agreement.

234. IFRIC 12 applies to:

a. arrangements where the infrastructure is used for its entire useful life;

b. infrastructure that the operator constructs or acquires from a third party; and

c. infrastructure that the Department provides to the operator for the purpose of the concession.

How to Account for a PPP/PFI Contract within the Scope of IFRIC 12

235. The Department should recognise the infrastructure as an NCA and value it in the same way as other NCAs of that generic type. The asset will be recognised when:

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a. it is probable that future economic benefits associated with the asset will flow to the Department; and

b. the cost of the asset can be measured reliably.

236. The Department should consider the asset recognition criteria above, together with the specific terms and conditions of the binding arrangement, when determining whether to recognise the service concession asset during the period in which the asset is constructed or developed. If the asset recognition criteria have been met, an Asset Under Construction service concession asset and associated liability should be recognised. If not and the Department makes contributions to the PSO in advance of the asset coming into use, the Department should account for those payments as prepayments.

237. The asset will be measured in one of two ways:

a. where the contract is separable between the service element, the interest charge and the infrastructure asset (see Part 2 Chapter 5 paragraph 238), the asset will initially be measured by following the guidance in IAS 17 (as stated in Part Chapter 5 paragraphs 243 to 260), with the service element and the interest charge recognised as incurred over the term of the concession arrangement. The liability should be reduced as payments against it are made. The subsequent measurement of the asset should follow normal NCA accounting for that particular asset category; or

b. where there is a unitary payment stream that includes infrastructure and service elements that cannot be separated, the various elements will be separated using estimation techniques as set out in Part 2 Chapter 5 paragraphs 239 and 240.

238. The Department should separate out the service, interest and infrastructure elements. A contract may be separable in a variety of circumstances including, but not limited to, the following:

a. the contract identifies an element of the payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services;

b. different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract; or

c. different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the Department in such a way that the part of the payment relating specifically to that service can be identified.

239. In situations where it is not possible to separate the contract due to commercial reality, the service element of the payments must be estimated. This could be achieved by obtaining information from the PSO or by using the fair value approach, i.e. the fair value

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of the asset determines the amount to be recorded as an asset with an offsetting liability. The total unitary payment is then divided into three: the service charge element; repayment of the capital element of the contract obligation; and the interest on it (using the interest rate implicit in the contract).

240. For both existing and new contracts, where it is not practicable to determine the interest rate implicit in the contract, the Department should use the cost of capital nominal rate calculated using the inflation rates given in table 16 of the Treasury's Pocket Data Bank.

Accounting for PPP/PFI Transactions that are not within the Scope of IFRIC 12

241. Where PPP and PFI contracts do not fall within the scope of IFRIC 12, the arrangement should be assessed to establish whether it contains a lease under IFRIC 4. If it does contain a lease, IAS 17 should be applied to determine whether it is a finance or an operating lease and accounted for accordingly. Where the arrangement does not contain a lease, the expenditure should be recognised as it falls due.

242. The accounting requirements of IAS 17 have wider applicability than simply to agreements which take the legal form of leases. Arrangements that do not take the legal form of a lease but which, under IFRIC 4, give the Department the right to control the use of the underlying asset in return for a payment or series of payments may be deemed to contain a lease if the following criteria are met:

a. fulfilment of the arrangement depends on a specific asset or assets. The asset need not be explicitly identified by the contractual provisions of the arrangement. Rather it may be implicitly specified because it is not economically feasible or practical for the supplier to fulfil the arrangement by using alternative assets;

b. the arrangement conveys a right to control the use of the underlying asset, which is the case if any of the following conditions are met:

i. the Department has the ability or right to operate the asset or to direct others to operate the asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset;

ii. the Department has the ability or right to control physical access to the asset while obtaining more than an insignificant amount of the output or other utility of the asset;

iii. there is only a remote possibility that parties other than the Department will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the Department will pay for the output is neither contractually fixed per unit of output nor equal to the current market price at the time of delivery.

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243. If an arrangement contains a lease, the Department should apply IAS 17 to the lease element of the arrangement to determine whether the lease is a finance lease or an operating lease.

244. A finance lease is one which transfers substantially all the risks and rewards of ownership of an asset to the lessee. Examples of situations that individually or in combination will normally lead to a lease being classified as a finance lease are:

a. the present value of minimum lease payments is equal to substantially all the fair value of the leased asset;

b. the lease term is for the majority of the leased asset's economic life, even if ownership is not transferred;

c. ownership is transferred to the lessee by the end of the lease term;

d. a bargain purchase option is provided for in the arrangement so that it is reasonably certain, at the inception of the lease, that the option will be exercised;

e. the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

245. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

a. if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

b. gains or losses from fluctuations in the fair value of the residual value fall to the lessee (for example, by means of a rebate equalling most of the sales proceeds at the end of the lease);

c. the lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent.

246. An operating lease is a lease other than a finance lease. An operating lease does not transfer substantially all the risks and rewards of ownership.

247. At the inception of the lease, the land and buildings element of a lease of land and buildings should be considered separately, for the purposes of lease classification.

248. At the inception of the lease, IAS 17 requires the land and buildings elements of a lease to be considered separately to enable them to be classified in their own right. The buildings element and the land element are classified as either a finance or an operating lease when measured against the situations and indicators of a finance lease described in Part 1 Chapter 5 paragraphs 183 and 184. In applying these situations and indicators to

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the land element, an important consideration is that land normally has an indefinite economic life.

249. Where leases of buildings are for only a small part of the useful life of the building and the lessee does not obtain the economic benefits of ownership arising, for example, from any increase in value, they should be accounted for as operating leases.

250. NCAs held by the Department as a lessee under a finance lease are capitalised as NCAs and depreciated over the shorter of the lease term or their estimated useful economic life. However, if there is reasonable certainty that the Department will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset.

251. At the inception of the lease, the NCA's value is equal to its fair value or, if lower, to the present value of the minimum lease payments, which is derived by discounting them at the interest rate implicit in the lease.

252. The minimum lease payments are the payments over the lease term that the Department is or can be required to make, excluding contingent rent, together with any costs guaranteed by the Department or by a party related to the Department.

253. If the Department has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date on which the option becomes exercisable and it is reasonably certain at the inception of the lease that the Department will exercise the option, the minimum lease payments comprise:

a. the minimum payments payable over the lease term to the expected date of exercise of this purchase option; and

b. the payment required to exercise the purchase option.

254. The lease term is the non-cancellable period for which the Department has contracted to lease the asset together with any further terms for which the Department has the option to continue to lease it, with or without further payment, when at the inception of the lease it is reasonably certain that the Department will exercise the option. For example, the Department is reasonably certain to continue with a lease after a break clause.

255. An 'obligation under finance lease' liability should also be created. This represents the capital element of the future lease payments. At the inception of the lease, this is the present value of the minimum lease payments, discounted at the interest rate implicit in the lease (and should equal the related NCA entry).

256. In order to classify and account for a lease of land and buildings, the minimum lease payments are allocated between the land and building elements in proportion to the relative fair values of the leasehold interests in the land element and the buildings element respectively at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

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257. Payments made under finance leases are apportioned, in accordance with the leasing agreement, between reductions in the 'obligation under finance lease' liability and finance charges which are charged to the SOCNE.

258. Expenditure under operating leases is charged directly to the SOCNE in the period in which it is incurred.

259. In some cases, separating the payments for the lease from payments for other elements within the arrangement will require the Department to use an estimation technique. For example, the Department may estimate the lease payments by reference to a lease agreement for a comparable asset that contains no other elements. Alternatively, it may estimate the payments for the other elements in the arrangement by reference to comparable agreements and then deduct these payments from the total payments under the arrangement.

260. If the Department concludes that it is impracticable to separate the payments reliably, it should:

a. in the case of a finance lease, recognise an asset and a liability at an amount equal to the fair value of the underlying asset. Subsequently, the liability should be reduced as payments are made and an imputed finance charge on the liability recognised using an appropriate rate of interest. This rate of interest must be agreed with FMPA A&TM;

b. in the case of an operating lease, treat all payments under the arrangement as lease payments, but:

i. disclose these payments separately from the minimum lease payments of other arrangements that do not include non-lease element payments and;

ii. state that the disclosed payments also include payments for non-lease elements in the arrangement.

How to Account for a PPP/PFI Contract Outside the Scope of IFRIC 12 and IFRIC 4

261. Where the PPP/PFI contract is outside the scope of IFRIC 12 and does not contain a lease under IFRIC 4, the Department recognises the expenditure in the SOCNE as it falls due.

262. There may, nevertheless, be other assets or liabilities that require recognition – for example, contributions (where the Department transfers an asset to the PSO) or where the Department acquires the residual element of the asset at the end of the PPP/PFI contract. Further details on how to account for these assets and liabilities are set out below.

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How to Account for Non-Current Assets Transferred to a Private Sector Operator as part of a PPP/PFI Transaction

263. For some PPP/PFI projects, which can be 'on' or 'off' the SOFP, the Department may own assets which are currently used to provide the service. Rather than disposing of these assets and then requiring the PSO to provide new ones (the cost of which would be recovered through the unitary charge) best value for money can be achieved by transferring these Departmental assets to the PSO for either a cash payment; a reduction in the unitary charge; or a combination of the two. The following describes the accounting effects for non-current asset transfers for both 'on' and 'off' SOFP scenarios.

The Assets Subject to the PPP/PFI Contract are Determined to be 'Off' the Department's Statement of Financial Position

Cash Receipt from the Sale of Assets

264. The accounting transactions will be the same as for any non-PPP/PFI disposal of NCAs, i.e. recognising the cash received and any profit or loss on disposal (if applicable).

Reduction in Unitary Charge

265. Where the 'consideration' received by the Department is in the form of reduced unitary payments, the sales value (the cash amount that the asset could have been sold for at the date the contract was entered into) is set up as a prepayment. This prepayment is then reduced (charged to the SOCNE) over the course of the contract as the benefits of the prepaid element are utilised.

266. A prepayment should only be created to the extent that the transfer gives rise to a future benefit (i.e. a lower unitary payment). The charging (unwinding) of the prepayment to the SOCNE has the effect of increasing the PPP/PFI unitary charge. The rationale for this is that if the Departmental assets were not transferred and the PSO had to fund the purchase of new assets to fulfil the service requirements, then the unitary charge would be higher. Some assets might be transferred to the PSO but not give rise to future benefits. In this case, the carrying amount of the assets should be written off immediately. An example of this would be the transfer of a building which was not going to be used, i.e. transferring to the PSO who was responsible for its demolition.

The Assets Subject to the PPP/PFI Contract are Determined to be 'On' the Department's Statement of Financial Position

Cash Receipt from the Sale of Assets

267. As the assets remain on the Department's SOFP, in substance no disposal has taken place. Hence the assets simply remain on the Department's SOFP, albeit their remaining economic life should be reviewed.

268. The accounting transactions are to debit cash and credit PFI payables.

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Reduction in Unitary Charge

269. In substance no disposal has taken place and the assets remain on the Department's SOFP. As such, no further accounting entries are required for the transferred assets.

How to Account for PPP/PFI Transactions Resulting in the Department Having a Residual Interest in the Asset(s) at the End of the Contract

270. In some PPP/PFI transactions, all or part of an asset either transferred to the PSO or procured as part of the PPP/PFI contract will pass to the Department at the end of the contract. The contract may specify that the transaction will be carried out at fair value at the date of transfer or it may specify an amount (including zero) which may or may not equal the expected fair value of the residual element estimated at the start of the contract.

The Assets Subject to the PPP/PFI Contract are Determined to be 'Off' the Department's Statement of Financial Position

271. Where the asset transfers at fair value, no accounting is required until the date of transfer, as this represents future capital expenditure for the Department.

272. Where the contract assigns a non-fair value to the asset, and this is less than the expected fair value of the asset at the end of the contract, it will be necessary to build up, as Assets Under Construction (AUC), the differential value over the term of the contract. This is to ensure that proper allocations of payments are made between the cost of services under the contract and the acquisition of the residual interest in the asset. AUC will be debited with a corresponding credit to the unitary charge. At the end of the contract the accumulated balance, together with any final payment, should exactly match the originally estimated fair value of the residual. If, during the life of the contract, expectations change so that the expected value of the residual interest rises or falls, further adjustments will be necessary. See Annex A to this chapter for the accounting entries.

273. Where the contract assigns a non-fair value to the asset, and this is greater than the expected fair value of the asset at the end of the contract, it will be necessary to build up, annually (or monthly as appropriate), as a provision, the differential value over the term of the contract. This is to ensure that proper allocations of payments are made between the cost of services under the contract and the acquisition of the residual interest. The accounting transactions are to debit the unitary charge and credit the provision. Where material, the provision should be discounted. At the end of the contract, the provision is released and the asset is brought onto the SOFP. If, during the life of the contract, expectations change so that the expected value of the residual interest rises or falls then further adjustments will be necessary. See Annex A for the accounting entries.

The Assets Subject to the PPP/PFI Contract are Determined to be 'On' the Department's Statement of Financial Position

274. Where the Department has a contractual obligation to make a payment to obtain

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legal title to assets that are already accounted for as ‘on’ the Department’s SOFP, then the residual interest rules are not relevant, although the amount to be paid should be set up as either a long-term liability or a provision. The accounting entries for this are to debit the SOCNE and credit long term liabilities or provisions.

275. Provisions should be created when there is uncertainty over the amount that will eventually be paid. However, if the actual payment to be made at the end of the contract is stated in the contract, there should be sufficient certainty to create a liability. However, if the contract terms were such as ‘fair value plus/minus 10%’ then a provision is likely to be required.

276. The above two paragraphs provide an indication of the likely accounting treatment. However, the treatment will depend on the particular circumstances of the contract.

Refinancing of Contracts

277. Refinancing gains can arise when a PSO changes the financing of the project during the project’s life. Where the change increases or accelerates gains to investors or reduces their commitments to the project, these effects are referred to as refinancing gains. Such gains can be treated in one of three ways, depending on the manner by which the refinancing gains are taken. These are:

a. one off cash payments. This cash lump sum received should be treated as borrowing from the PSO. Hence a liability (payable) should be established. The liability would be released to the SOCNE to reduce the unitary charge over the period in which the benefit of the refinancing is expected to be received;

b. a reduced unitary charge over the remaining contract period;

c. an increased scope in services which will have no financial accounting impact (assuming that the unitary charge stays the same).

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ANNEX A TO CHAPTER 5

ACCOUNTING FOR RESIDUAL INTERESTS

A1. To aid understanding, all calculations ignore the impact of revaluation and the unwinding of any discounts for items which are shown at their discounted value.

Scenario

A2. The asset in a PPP/PFI contract is deemed to be 'off' the Department's SOFP but will transfer to the Department at the end of a 25 year PPP/PFI contract with an expected residual value (estimated at the start of the contract) of £2m.

A3. The worked examples that follow use this scenario, but with differing variables.

Worked Example 1 - asset purchased in year 25 for £1m

Variant 1a - but expected year 25 fair value reduces to zero
Variant 1b - but expected year 25 fair value increases to £5m

Worked Example 2 - asset purchased in year 25 for £2m

Variant 2a - but expected year 25 fair value reduces to zero
Variant 2b - but expected year 25 fair value increases to £5m

Worked Example 3 - asset purchased in year 25 for £3m

Variant 3a - but expected year 25 fair value reduces to zero
Variant 3b - but expected year 25 fair value increases to £5m

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Worked Example 1 – The Department Agrees in the Contract to Acquire the Residual Asset for £1m at the End of the Contract

A4. The Department will pay £1m for the asset that it believes will be worth £2m at the end of the contract. Therefore, it is necessary to recognise this additional £1m by building up the excess residual value over the course of the contract.

Accounting Treatment

A5. Capitalise £40,000 of the unitary charge per year (£1m/25 years) for 25 years, representing the residual interest. At the end of the contract the cash payment of £1m is added to the residual interest asset to give an amount for the repurchased asset of £2m.

Journal Entries

Years 1-25 (one journal each year for 25 years):

Dr	Assets Under Construction	£40,000 (x 25)	=	£1,000,000
Cr	SOCNE (PFI Contract RAC)	£40,000 (x 25)	=	£1,000,000

Year 25:

Dr	Non-Current Assets	£1,000,000
Cr	Cash	£1,000,000

Worked Example 1a – But What If After 5 years the Expected Residual Value Falls to Zero?

A6. The Department will be purchasing an asset for £1m at the end of the contract that, for the first 5 years, it believes will be worth £2m. This excess should be built up for the first 5 years per Worked Example 1.

A7. However, at the 5 year point it is believed that the asset will have no value at the end of the contract but the Department is still committed to paying £1m for it. The Department should immediately write off the residual interest built up to date.

Accounting Treatment

A8. Record an expense immediately to write off the residual asset built up so far ((£1m/25 years) x 5= £200,000). Record as an expense and as a provision the Net Present Value of the remaining 'payments' to be made plus the £1m year 25 payment (£800,000 + £1,000,000). This represents the obligation to pay for something that is expected to be worth nothing at the end of the contract. When the 'payments' are actually made they will be charged against the provision thus reducing its value to nil at the end of the contract.

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Journal Entries

Years 1-5 (one journal each year for 5 years):

Dr	Assets Under Construction	£40,000 (x 5)	=	£200,000
Cr	SOCNE (PFI Contract RAC)	£40,000 (x 5)	=	£200,000

Year 5

Dr	SOCNE	£200,000
Cr	Assets Under Construction	£200,000
Dr	SOCNE	£1,800,000
Cr	Provisions	£1,800,000

Years 6-25 (one journal each year for the remaining 20 years):

Dr	Provisions	£40,000 (x20)	=	£800,000
Cr	SOCNE	£40,000 (x20)	=	£800,000

Year 25

Dr	Provisions	£1,000,000
Cr	Cash	£1,000,000

Worked Example 1b – But What If After 5 years the Expected Residual Value Increases to £5m?

A9. The Department will be purchasing an asset for £1m at the end of the contract that, for the first 5 years, it believes will be worth £2m. This excess should be built up for the first 5 years as per Worked Example 1.

A10. However, at the 5-year point it is believed that the asset will have increased in value to £5m by the end of the contract but the Department will still only pay £1m for it.

Accounting Treatment

A11. This higher expected residual value should be reflected in the accounts by increasing the value of the build up of the asset. The higher expected value now placed on the asset at the 25 year point should be credited to the Revaluation Reserve and released to the General Fund over the period during which the asset is in use following its transfer back into Departmental ownership.

Journal Entries

Years 1-5 (one journal each year for 5 years):

Dr	Assets Under Construction	£40,000 (x5)	=	£200,000

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Cr SOCNE (PFI Contract RAC)	£40,000 (x5)	=	£200,000

Years 6-25 (one journal each year for the remaining 20 years):

Dr Assets Under Construction	£190,000 (x20)	=	£3,800,000
Cr SOCNE	£40,000 (x20)	=	£800,000
Cr Revaluation Reserve	£150,000 (x20)	=	£3,000,000

Year 25

Dr Assets Under Construction	£1,000,000
Cr Cash	£1,000,000

Worked Example 2 – The Department Agrees in the Contract to Acquire the Residual Asset for £2m at the End of the Contract

A12. The Department will pay £2m for the asset that it believes will be worth £2m at the end of the contract. Therefore, there is no residual interest to be built up.

Accounting Treatment

A13. No action is required until year 25 when the asset purchase is recognised.

Journal Entry

Year 25

Dr Non-Current Assets	£2,000,000
Cr Cash	£2,000,000

Worked Example 2a – But What If After 5 years the Expected Residual Value Falls to Zero?

A14. The Department will be purchasing an asset for £2m at the end of the contract that, for the first 5 years, it believes will be worth £2m. So, for the first 5 years no action is required.

A15. However, at the 5-year point it is believed that the asset will have no value at the end of the contract, but the Department is still committed to paying £2m for it.

Accounting Treatment

A16. Record an expense and a provision immediately for the NPV of £2m which represents an obligation to pay for something that is expected to be worth nothing at the end of the contract. The provision will be cleared when the £2m payment is made in year 25.

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Journal Entries

Year 5

Dr SOCNE £2,000,000
Cr Provision £2,000,000

Year 25

Dr Provision £2,000,000
Cr Cash £2,000,000

Worked Example 2b – But What If After 5 years the Expected Residual Value Increases to £5m?

A17. The Department will be purchasing an asset for £2m at the end of the contract that, for the first 5 years, it believes will be worth £2m. So, for the first 5 years no action is required.

A18. However, at the 5-year point it is believed that the asset will have increased in value to £5m by the end of the contract. The Department will still only pay £2m for it.

Accounting Treatment

A19. This higher expected residual value should be reflected in the accounts by increasing the value of the build up of the asset. The higher expected value now placed on the asset at the 25 year point should be credited to the Revaluation Reserve.

Journal Entries

Years 6 – 25 (one journal each year for the remaining 20 years):

Dr Assets Under Construction £150,000 (x20) = £3,000,000
Cr Revaluation Reserve £150,000 (x20) = £3,000,000

Year 25

Dr Non-Current Assets £2,000,000
Cr Cash £2,000,000

Worked Example 3 – Department Agrees in the Contract to Acquire the Residual Asset for £3m at the End of the Contract

A20. The Department will pay £3m for the asset which it believes will be worth £2m at the end of the contract. Therefore, it is necessary to recognise this additional expense of £1m by building up an additional expense and a provision over the course of the contract.

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Accounting Treatment

A21. Record an additional expense of £40,000 per year ((£3m-£2m)/25 years), together with a corresponding provision, representing the residual interest. At the end of the contract the cash payment of £3m will clear the provision of £1m to give an amount for the repurchased asset of £2m.

Journal Entries

Years 1-25 (one journal each year for 25 years):

Dr	SOCNE – PFI contract RAC	£40,000 (x 25)	=	1,000,000
Cr	Provision	£40,000 (x 25)	=	1,000,000

Year 25

Dr	Non-Current Assets	2,000,000
Dr	Provision	1,000,000
Cr	Cash	3,000,000

Worked Example 3a – But What If After 5 years the Expected Residual Value Falls to Zero?

A22. The Department will be purchasing an asset for £3m at the end of the contract that, for the first 5 years, it believes will be worth £2m. So, it is necessary to recognise this additional expense over the contract period as per Worked Example 3.

A23. However, at the 5-year point it is believed that the asset will have no value at the end of the contract. The Department is still committed to paying £3m for it.

Accounting Treatment

A24. Record an expense and a provision immediately for the NPV of £2m. The remaining amount of £1m is still built up over the life of the contract to give a final provision of £3m. At the end of the contract the cash payment of £3m will clear the liability.

Journal Entries

Years 1-25 (one journal each year for 25 years):

Dr	SOCNE – PFI contract RAC	£40,000 (x 25)	=	1,000,000
Cr	Provision	£40,000 (x25)	=	1,000,000

Year 5

Dr	SOCNE	2,000,000

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Cr Provision 2,000,000

Year 25

Dr Provision 3,000,000
Cr Cash 3,000,000

Worked Example 3b – But What If After 5 years the Expected Residual Value Increases to £5m?

A25. The Department will be purchasing an asset for £3m at the end of the contract that, for the first 5 years, it believes will be worth £2m. This excess should be built up for the first 5 years as per Worked Example 3.

A26. However, at the 5-year point it is believed that the asset will have increased in value to £5m by the end of the contract. The Department will still only pay £3m for it.

Accounting Treatment

A27. This higher expected residual value should be reflected in the accounts by increasing the value of the build up of the asset. The higher expected value now placed on the asset at the 25 year point should be credited to the Revaluation Reserve.

Journal Entries

Years 1 – 5 (one journal each year for 5 years):

Dr SOCNE £40,000 (x5) = £200,000
Cr Provision £40,000 (x5) = £200,000

Year 5

Dr Provision £200,000
Cr SOCNE £200,000

Years 6 –25 (one journal each year for the remaining 20 years):

Dr Assets Under Construction ((£5m-3m)/20)) (x20) = £2,000,000
Cr Revaluation Reserve £100,000 (x20) = £2,000,000

Year 25

Dr Non-Current Assets £3,000,000
Cr Cash £3,000,000

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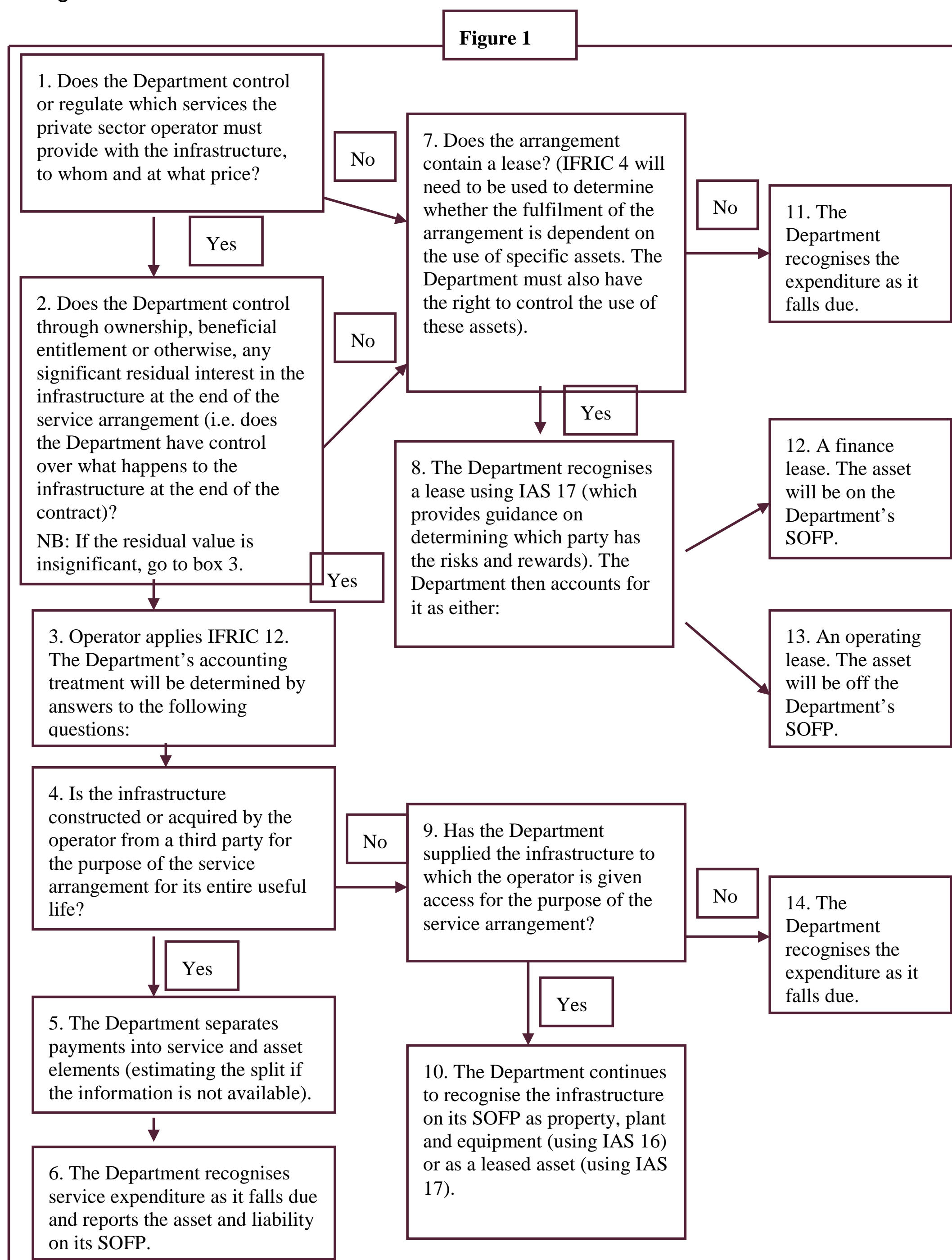
ACCOUNTING FOR PPP/PFI ARRANGEMENTS

B1. Figure 1 below summarises the accounting decisions required for PPP/PFI arrangements.



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6 Cash and Cash Equivalents

1. There is no guidance on accounting for cash and cash equivalents. Refer to Part 1 – Directive.

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7 Inventories (Raw Materials and Consumables)

1. This chapter expands on the directive in Part 1 Chapter 7 by providing further detail on:

a. categorisation;

b. materiality in relation to ownership and categories.

Categorisation

2. Raw materials are purchased for conversion and incorporation into NCAs. Consumables are not repairable and consist of items such as ammunition, fuel and support items (for example - hand tools). The inventory category analysis is shown in Figure 1 below.

Figure 1	Capital Spares (refer to Part 1 Chapter 5)	Raw Materials and Consumables
Armaments	✓	✓
Clothing and Textiles		✓
Engineering and Technical	✓	✓
General	✓	✓
Guided Weapons, Missiles and Bombs	✓	✓
Medical, Dental and Veterinary	✓	✓
Oil, Fuel and Lubricants		✓
Strategic Weapon System	✓	✓

3. Coverage of each inventory group, under the generic inventory system item descriptions, is shown in Figures 2 to 9 below.

Figure 2	Armaments
Ammunition	Bombs
Chemical and Biological Defence Stores	Decoys
Demolition Stores and Detonators	Depth Charges
Drill, Trials and Practice Weapons	Explosives
Fuzes	Grenades
Guns and Gun Systems	Illuminants

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Figure 2 Armaments	
Markers	Mine Countermeasure and Disposal Stores
Mines	Mortars
Non-Explosive Weapons	Personal Protective Equipment and Survival Gear
Power Cartridges	Propulsion Fuels
Pyrotechnics and Flares	Remote Control Mine Disposal Systems
Rockets	Small Arms
Sonobuoys	Targets
Tracers	Torpedoes

Figure 3 Clothing and Textiles	
Flying Clothing	Protective Clothing and Footwear
Special Purpose Clothing	Uniform Clothing
Badges, Medals and Ceremonial Items	Textiles

Figure 4 Engineering and Technical	
Aircraft Equipment and Rigs	Airframes and Rotor Blades
Aero Engines	Aviation Stores
Avionics and Equipment	Administrative Vehicles
Fighting Vehicles	Load Carrying Vehicles
Locomotives and Railway Inventory	Military Vehicles
Specialist Vehicles	Calibration Equipment
Compressed Air Systems and Equipment	Cranes and Lifting Equipment
Diving Equipment	Educational and Training Technology Equipment
Electricity Supply Systems and Equipment	Engines
Fire Detection and Control Equipment	Fuel Distribution Systems and Storage Tanks
Galley and Canteen Equipment	Generating Plant and Equipment
Heating Systems and Equipment	Hydraulic Systems and Equipment
Laboratory and Research Equipment	Laundry Equipment
Lighting Systems and Equipment	Maintenance Equipment and Jigs

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Figure 4 Engineering and Technical	
Mechanical Handling Equipment	Navigational Beacons
Production Equipment	Servicing Equipment
Simulators and Training Rigs	Specialised Equipment
Storage Plant and Racking Systems	Survey and Test Equipment and Rigs
Ventilation and Air Conditioning Systems and Equipment	Workshop Plant and Machinery
Water Distillation and Demineralisation Systems and Equipment	Other Plant, Machinery and Equipment
Alarm and Warning Systems	Closed Circuit Television Systems
Command and Control Systems	Communication and Cryptographic Equipment
Computer Hardware and Peripherals	Electrical Test Equipment
Electronics and Equipment	Software Management Systems
Identification Devices	Information Technology Systems
Instrumentation	Navigation Equipment
Night Vision Equipment	Public Address Systems
Radar Equipment	Radios and Aerials
Security Systems	Sonar Equipment
Surveillance Equipment	Switches, Cables and Terminals
Telecommunications Equipment	Telephone Exchanges and Switchboards
Video Recording Systems	Gun Mountings and Weapon Carriage Systems
Weapon Release, Discharge and Launch Systems	

Figure 5 General	
Batteries and Chargers	Cabling
Chemicals	Cordage
Electrical Equipment and Appliances	Electrical Cabling and Fittings
Energetic Materials	Gases
Glass	Household and Husbandry Goods
Inflatable Boats	ISO Containers
Musical Instruments	Packaging Materials
Paints	Photographic Equipment
Sports Equipment	Steel and Other Metals
Structural Materials	Timber

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Tools	Cooking and Catering Equipment, Utensils and Crockery
Domestic Equipment and Appliances	Household and Office Furniture
Gardening Equipment	Audio Visual Equipment and Media
Binding and Storage Media	Commercial Books and Publications
Computer Consumables	Computer Stationery
Drawing Equipment	Graphics Materials
HMSO Books and Publications	Office Equipment
Paper and Paper Products	Photographic Media and Materials
Printed Forms and Other Printed Information Media	Printing Inks
Dry Food/Provisions	Fresh Food/Provisions
Frozen Food/Provisions	Hexamine Cookers
Operational Ration Packs (ORP) and Specialist Rations	ORP Componentry
Animal Food and Bedding	

Figure 6 **Guided Weapons, Missiles and Bombs**

Guided Weapons	Guided Missiles
Guided Bombs	

Figure 7 **Medical, Dental and Veterinary**

Blood and Blood Products	Drugs and Dressings
Medical, Surgical and Laboratory Equipment and Instruments	Prosthetics and Surgical Items
X-Ray Film and Paper	

Figure 8 **Oil, Fuel and Lubricants**

Antifreeze and Marker Fluids	Aviation Fuel (AVCAT, AVGAS, AVTUR)
Diesel (Dieso UK/Dieso MT)	Diesel Oil (Dieso/Marine Gas Oil)
Furnace Fuel Oil	Gasoline
Greases	Kerosene
Lubricants	Lubricating Oils
Petroleum (MT Gas/UL Gas)	Solid Fuel

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Figure 9 Strategic Weapon System	
Trident	

Materiality

4. Guidance on materiality in relation to ownership and how to treat various categories of RMC is summarised in Figure 10 below.

Figure 10

Materiality Guidance for RMC

Description	Bulk Holding (assessed as material) - Current Asset	Ready-Use Holding (assessed as immaterial) - Expensed
Victualling Stores (food and related items)	• Overseas locations buffer stores. • Stores (re-issue load) held on-board Royal Fleet Auxiliaries.	• Stores held for immediate consumption which are discarded after the recognised expiry date.
Operational Ration Packs	• Packs held at recognised stores holding points.	• Stores held for immediate operational or training use which are consumed or discarded after their recognised expiry date.
Medical, Dental and Veterinary Stores	• Stores held within the Medical and General Supplies PT supply chain. • Stores held by other holding agencies and medical centres to meet scaled requirements.	• Stores held in dispensaries within hospitals, dental surgeries and medical centres for immediate consumption and discarded after recognised expiry date. Disclose as bulk holdings where the level of write-off for shelf-lifed items is exceptionally high.
Clothing and Textiles	• Stores held within the Defence Clothing PT supply chain. • Stores (re-issue load) held on-board RFAs. • Stores held at other principal holding locations (excluding loan clothing).	• Items held for immediate use and issued as replacements on a new for old basis.

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Figure 10

Materiality Guidance for RMC

Description	**Bulk Holding (assessed as material) - Current Asset**	**Ready-Use Holding (assessed as immaterial) - Expensed**
Accommodation Stores (principally furniture and domestic/gardening equipment)	• Stores held within DE&S supply chain. • Stores consisting principally of new/unissued items not awaiting immediate issue. Issued items recorded on loan records are excluded. Items re-circulated for repair or refurbishment and re-issue are accounted for as returns.	• Stores consisting principally of previously issued/refurbished items or new/unissued items awaiting immediate issue (in-year). Issued items accounted for as articles in use may be held on loan from DE&S inventory feeder systems.
Stationery and IT Consumables	• Forms and publications held by Joint Support Chain Services (JSCS) where assessed as material to individual sponsors at TLB level. • Overseas locations buffer stores.	• Items held for immediate use (consumed or disposed of after supersession date).
Oil, Fuel and Lubricants	• Stores held within DE&S supply chains. • Stores held in other bulk fuel installations and pipelines. • Other local stores holdings, e.g. MT fuel held at service pump points.	• RMC held for immediate use. • Operating fuel issued to vessels, aircraft, vehicles, etc (including fuel held on delivery tankers awaiting immediate issue). • Domestic fuel held for immediate use. Note: in this context operating fuel and domestic fuel are regarded as being in the process of being consumed.

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8 Liabilities

Purpose

1. This chapter expands on the directive in Part 1 Chapter 8 by providing further detail and examples on how to account for:

a. accruals and deferred income;

b. provisions.

ACCRUALS AND DEFERRED INCOME

Acquisition of Goods

2. An accrual for a 'one-off' acquisition of goods is normally triggered by a Goods Received Note (GRN). Once an invoice has been received from the supplier, the accrual is 'reversed out' and replaced by a payable transaction. The value of the accrual will normally reflect the agreed contract price and therefore equal the settlement value.

Example 1

3. A TLB arranges to purchase a laptop computer with a contract price of £2K (including irrecoverable VAT). The TLB receives the laptop (with the associated red copy of the MOD Form 640) in AP01 and signs and returns the brown copy of the MOD Form 640 to the supplier. The supplier sends the brown MOD Form 640 with an accompanying DAB10 to DBS in AP02 and payment is made in AP03. The value of the laptop computer is below the capitalisation threshold and is therefore expensed to the Statement of Comprehensive Net Expenditure (SOCNE). See Figure 1 below for the accounting entries.

Figure 1

		£K	
AP01	Dr. SOCNE (NNA010) Cr. Accruals A/c (GBA020)	2 2	Create accrual on receipt of laptop computer and red MOD 640.
AP02	Dr. Accruals A/C (GBA020) Cr. SOCNE (NNA010) Dr. SOCNE (NNA010) Cr. Payables A/C (GAA000)	2 2 2 2	Reverse accrual and create creditor when DAB 10 invoice received by DBS in AP02.
AP03	Dr. Payables A/C (GAA000) Cr. Cash A/C	2 2	Payment by DBS clears the payables balance.

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4. For long-term contracts, the payments may not be due until a certain stage of work has been completed. Each month project and other managers of major or long term contracts should assess the value of work completed, taking account of all stage or progress payments.

Example 2

5. A TLB starts to procure a new piece of fighting equipment at the beginning of AP01, using a prime contractor to manage the supply of components and sub-contractors. Milestone payments are made to the prime contractor on completion of a defined work package. The value is accrued on the basis of work completed under the terms of the contract. Therefore, each month the relevant project manager accrues for contractually agreed activities which have been completed but for which the prime contractor has not yet been paid. The first milestone payment of £90 million (excluding recoverable VAT) is to be released to the prime contractor on successful construction and integration of specified electronic components. It is anticipated that this work package will take 3 months to complete with the related activities spread evenly across this period. At the end of AP01, the project manager establishes that the prime contractor is on track to complete the work package specified under the first milestone payment by AP03. He therefore accrues for it on the basis that one third, by value, of the activities leading to the milestone payment has been completed. See Figure 2 below for the accounting entries.

Figure 2

		£m	
AP01	Dr. Assets Under Construction (BWD007)	30	Create accrual for work performed as at AP01 (i.e. 1/3 of £90m).
	Cr. Capital Accruals A/C (GBA010)	30	

Acquisition of Services

6. The Department contracts for a range of different services, from the provision of utilities to consultancy services to training courses. The time lag between delivery and payment can vary significantly. Electricity invoices are generally received up to 3 months after consumption of the electricity, which means that a degree of estimation may be needed to calculate the accrual using, for example, past consumption patterns.

Example 3

7. A TLB pays a gas bill on a quarterly basis in arrears. The invoice for this quarter, received in AP10, was £20K (including irrecoverable VAT). Using historical trends, the BLB has accrued for the cost of gas in the quarter AP07 to AP09. See Figure 3 below for the accounting entries.

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Figure 3

		£K	
AP07	Dr. SOCNE (NAB000) Cr. Accruals A/C (GBA020)	5 5	Create accrual.
AP08	Dr. SOCNE (NAB000) Cr. Accruals A/C (GBA020)	7 7	Create accrual.
AP09	Dr. SOCNE (NAB000) Cr. Accruals A/C (GBA020)	6 6	Create accrual.
AP10	Dr: Accruals A/C (GBA020) Cr. SOCNE (NAB000) Dr. SOCNE (NAB000) Cr. Payables A/C (GAA000)	18 18 20 20	Reverse cumulative AP7-9 accrual. Create payable.

Example 4

8. A TLB engages the services of a professional training company to train 100 of its finance staff. The training is carried out over 10 courses, with each course lasting 5 days. The training commences in AP01 and is fully completed in AP03. The company invoices the TLB at a firm price of £50K (excluding recoverable VAT) on completion of the training in AP03. In AP01 a total of 3 courses were completed, 4 were completed in AP02 and the remaining courses completed in AP03. See Figure 4 below for the accounting entries.

Figure 4

		£K	
AP01	Dr. SOCNE (NGB002) Cr. Accruals A/C (GBA020)	15 15	Create accrual to reflect 30% of courses completed in AP01.
AP02	Dr. SOCNE (NGB000) Cr. Accruals A/C (GBA020)	20 20	Create accrual to reflect 40% of courses completed in AP02.
AP03	Dr. Accruals A/C (GBA020) Cr. SOCNE (NGB000) Dr. SOCNE (NGB002) Cr. Payables A/C (GAA000)	35 35 50 50	Reverse cumulative AP01 accrual. Create payable.

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Accruing for Deferred Income and Interest Payable

9. The requirement to accrue for transactions in the period in which they occur extends beyond the receipt of goods and services to cover transactions such as:

a. deferred income;

b. interest payable.

10. Deferred income relates to cash received in advance of the period in which the goods and services which generate the income are provided by the Department. In accordance with the accruals principle, the income should be deferred to the period in which the goods and services are provided rather than when the monies are received. Any output VAT crystallising on the income should be excluded from the amount to be deferred/accrued to future periods.

Example 5

11. At AP01 a TLB rents out one of its spare workshops to a contractor for a commercial rent of £9K per quarter (excluding output VAT). As part of the rental agreement the contractor is required to pay the TLB quarterly in advance commencing at AP01. See Figure 5 below for the accounting entries.

	Figure 5	£K	
AP01	Dr. Cash A/C immediately Cr. SOCNE (RMB002) Dr. SOCNE (RMB002) Cr. Deferred Income A/C (GGA001)	9 9 6 6	Cash received from contractor and credited to SOCNE as income. Accrual created to reflect part-deferral of the rental income to AP02 and AP03.
AP02	Dr. Deferred Income A/C (GGA001) Cr. SOCNE (RMB002)	3 3	Income released from Deferred Income A/C to SOCNE to reflect rental earned in AP02.
AP03	Dr. Deferred Income A/C (GGA001) Cr. SOCNE (RMB002)	3 3	Income released from Deferred Income A/C to SOCNE to reflect rental earned in AP03.

12. Interest payable on loans also needs to be accrued for, if the cash payment is made in a different Accounting Period from that in which the interest is due. By applying the

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principles of accruals accounting, the Department recognises the interest charge in the period in which it is due/payable, not when the actual cash payment is made.

Accruals – Areas of Former Bad Practice

13. A review of accruals accounting within the Department identified a number of areas where the accounting was incorrect. Areas where mistakes sometimes occur (and the effect on the Annual Accounts) are described below:

a. long term projects. Some parts of the Department have, in the past, not fully accrued for the value of work achieved but have recognised costs only when milestone payment points are successfully reached, or not accrued at all. Such practices would have resulted in a misreporting of expenditure during a project;

b. reversal of accruals. There have been instances of accruals not being reversed out of the Annual Accounts after the invoice has been paid, leading to a double-counting of expenditure;

c. incorrect coding. There have been instances where accruals have been posted to the incorrect Resource Account Code;

d. incorrect materiality thresholds for accruing expenditure. Some materiality thresholds are set too low, leading to unnecessary effort whilst other thresholds are set too high with the effect that accruals balances may be understated;

e. inappropriate accruals estimations. Where broad-brush approaches are used to estimate the value of accruals, the potential for error may be increased;

f. audit trails. Inadequate audit trails to support accruals balances will prevent effective management review, delay NAO audits and could potentially lead to a qualification of the Annual Accounts.

g. the provision of financial management information (FMI) by contractors has, in the past, often been inadequate to support balances in the Department's Accounts and this has been particularly the case in supporting accruals calculations. DEFCON 647 (effective September 2013) sets a mandated minimum level of FMI and is applied to all contracts with a value of over £5M, unless an exemption has been agreed. Finance personnel should work with commercial colleagues to ensure that that the DEFCON provides the appropriate level of FMI that will support the calculation of accruals and provide sufficient audit evidence.

Accruals – Correct Accounting Treatment

14. To reinforce understanding, the correct accruals accounting treatment is explained below:

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a. long term projects. The value of work achieved should be accrued for. If costs are only recognised when milestone payment points are reached, the Annual Accounts will be understated;

b. reversing of accruals. Accruals must be reversed out of the Annual Accounts once the invoice has been paid, otherwise expenditure will be duplicated and the Annual Accounts will be overstated;

c. correct coding. Accrued expenditure must be correctly coded otherwise one part of the Annual Accounts will be overstated and another understated;

d. appropriate materiality thresholds for accruing expenditure. Materiality thresholds need to be set at an appropriate level. If it is too low, it will result in spurious effort and if too high, the Annual Accounts will be understated;

e. inappropriate accruals estimations. Broad-brush approaches to estimating the value of accruals must be used with caution, as they increase the potential for error.

Audit Trails

15. To avoid a potential qualification of the Annual Accounts, clear audit trails must be maintained to enable management to review balances and ensure that NAO can complete its audit within the planned timeframe. The financial reporting processes for determining the accruals and the judgements being applied should be recorded.

ACCOUNTING FOR PROVISIONS

Accounting Entries for Nuclear and Non-Nuclear Provisions

16. The examples below show the accounting entries for nuclear provisions. The accounting entries for non-nuclear provisions follow the same policy but require non-nuclear RACs to be used. The 2.2% discount rate used in the following examples is for illustrative purposes only. When calculating actual provision, the rate(s) provided by CFAT must be used.

Creating Provisions and On-Going Entries

17. The entries for creating a provision to recognise a nuclear provision which does not have a capitalised asset provision are:

	(i) DR	(i) CR
Provision in the SOFP (J*A***)	(ii)	(ii) X
SOCNE (NW****)	(iii) X	(iii)

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18. The entries to create a provision to recognise a nuclear provision which does have an associated capitalised asset provision are:

	(i) DR	(i) CR
Provision in the SOFP (J*A500)	(ii)	(ii) X
Capitalised asset provision gross cost in the SOFP	(iii) X	(iii)

19. The entries to depreciate the capitalised asset provision over the life of the associated asset are:

	(i) DR	(i) CR
SOCNE – depreciation charge (M*****)	(ii) X	(ii)
Capitalised asset provision in the SOFP (accumulated depreciation)	(iii)	(iii) X

20. The entries to unwind the discount are:

	(i) DR	(i) CR
Provision in the SOFP(J*A300)	(ii)	(ii) X
SOCNE (TMB002)	(iii) X	(iii)

21. The entries to apply inflation where there is no associated capitalised asset provision are:

	(i) DR	(i) CR
Provision in the SOFP (J*A100)	(ii)	(ii) X
SOCNE (NW****)	(iii) X	(iii)

22. The entries to apply inflation where there is an associated capitalised asset provision are:

	(i) DR	(i) CR
Provision in the SOFP (J*A500)	(ii)	(ii) X
Capitalised Asset Provision in the SOFP	(iii) X	(iii)

Changes in Assumptions/Estimates/Prices

23. Inflation adjustments must be made before adjusting for changes in assumptions and/or estimates.

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24. Where there is no capitalised asset provision or it has been fully depreciated, the accounting entries are:

	(i) DR	(i) CR
For an increase	(ii)	(ii)
Provision in the SOFP (J*A100)	(iii)	(iii) X
SOCNE (NW****)	(iv) X	(iv)
	(v)	(v)
For a decrease:	(vi)	(vi)
Provision in the SOFP (J*A200)	(vii) X	(vii)
SOCNE (NW****)	(viii)	(viii) X

25. If there is a capitalised asset provision which has been fully depreciated, the accounting entries are:

	(i) DR	(i) CR
Provision in the SOFP (J*A***)	(ii)	(ii) X
SOCNE (NW****)	(iii) X	(iii)

26. If the capitalised asset provision has not been fully depreciated, the accounting entries are:

	(i) DR	(i) CR
Provision in the SOFP(J*A***)	(ii)	(ii) X
Capitalised Asset Provision in the SOFP	(iii) X	(iii)

Explanation of the Discount Factor and the Time Value of Money

27. A provision should reflect the 'best estimate of the expenditure required to settle the present obligation at the reporting period'. This can be achieved by:

a. expressing cashflows in current prices (i.e. excluding inflation) and discounting them using a real rate (that excludes the effects of inflation); or

b. expressing cashflows in expected future prices (i.e. including inflation) and discounting them using a nominal rate (a rate that includes inflation).

28. In practice, both of the above options should arrive at the same Net Present Value (NPV). However, because the discount(s) rate prescribed by HM Treasury is a real rate, the Department needs to express its cash flows at current prices. HM Treasury prescribes three discount rates based on the time boundary of the cashflows. Refer to CFAT for the rate to use.

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29. The 'real' rate is the fixed rate of return from government investments and represents the 'real return' that could be generated were a sum to be invested. The real rate plus inflation is effectively the nominal rate.

30. Ignoring the impact of inflation, in the example of a nuclear liability of £10m due in 10 years time, a sum of £8.04m could be invested today, with an indicative rate of return of 2.2%, which would be worth the £10m required in 10 years time. **The 2.2% discount rate used in the following examples is for illustrative purposes only. When calculating actual provision, the rate(s) provided by CFAT must be used.**

Example

31. It is estimated that there is an obligation to pay £1,000 in current prices, at the end of each of the next three years. Alternatively, there is an obligation to pay £1,020, £1,040 and £1,061 respectively, if inflation is taken into account (the amount that will be paid).

32. Inflation is constant at 2.0%. The 'real' discount factor is calculated as $1/(1+0.022)^n$, where 'n' is the year of the cashflow.

Calculating the NPV Using the 'Real' Rate

33. The cash flows must first be expressed in 'current prices'. This may require the effects of inflation to be eliminated if inflation is included in the estimates e.g. £1,040 / 1.02 in Year 2 = £1,000.

34. The cash flows must also be adjusted for risk. Assuming, for example, that the estimate received from the contractor is £900 in Year 1 in current prices, but with a 25% probability that it will increase by £400. The cash flow is determined as £900 + 25% of £400 i.e. £1,000.

35. Risk is included within the cash flows and a risk-free discount factor applied.

	Cash Flows £		
	Yr 1	Yr 2	Yr 3
Cash flows at current prices	1,000	1,000	1,000
Real discount factor (at 2.2%)	0.978	0.957	0.937
NPV	978	957	937

36. The total NPV and value of the provision at Yr 0 is therefore £2,872. (£978+£957+£937)

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Calculating the NPV Using a 'Nominal' Rate

37. The nominal rate includes the effects of inflation. As such, the indicative nominal discount rate is 2.2% real rate +2.0% inflation = 4.2%.

38. The cash flows are expressed in future prices, i.e. including the effect of inflation.

	Cash Flows £		
	Yr 1	Yr 2	Yr 3
Cash flows at future prices (including 2.0% inflation)	1,020	1,040	1,061
Nominal discount factor 4.2% (2+2.2%)	0.959	0.921	0.884
Carrying Amount	978	957	937

39. The total carrying amount and value of the provision at Yr 0 (i.e now) is therefore £2,872 (£978+£957+£937).

Illustration of Unwinding the Discount Factor and Applying Inflation Where There is No Capitalised Asset Provision

40. This example continues from that at Part 2 Chapter 8 paragraphs 31 to 39. The objective of unwinding the discount factor and applying inflation is to adjust the provision to the value at which it will be settled.

41. Having established the provision at Yr 0, the value needs to be adjusted annually. In this example it is assumed that apart from revalorisation (i.e. the effect of one year's worth of unwinding the discount and applying inflation) there are no changes to either the assumptions or to the value of the provision. The cash flows are expressed in current prices, as per Departmental policy, and there is no associated capitalised asset provision.

42. The impact of the unwinding of the discount is disclosed in the financial statements under the Resource Account Code TMB*** and reported as interest in the Annual Accounts. The impact of the adjustment for inflation is disclosed in the financial statements under NW**** and reported within other operating costs.

43. Using the real rate and current prices the increase in the provision each year is made up of the indicative discount factor (2.2%) and inflation factor (2.0%). The estimated cash outflow has an NPV of £2,872.

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Provision in the SOFP	Yr 0 £	Yr 1 £	Yr 2 £	Yr 3 £
Opening provision balance		2,872	1,974	1,018
Unwinding of discount at 2.2% (op bal*2.2%)		64	44	22
Inflation (op bal+discount*2.0%)		58	40	21
Cash spend in year		(1,020)	(1,040)	(1,061)
Closing provision balance	2,872	1,974	1,018	0
SOCNE				
TMB*** 'Interest on the unwinding of the discount' NW**** 'Provision expenditure' – i.e. inflation adjustment		64 58	44 40	22 21
NW**** 'Provision expenditure' – i.e. creation of provision	2,872			
Total charge to the SOCNE	2,872	122	84	43

44. Note that the total value charged to the SOCNE over the period of £3,121 equates to the total amount settled. If the 'real' discount factor alone were unwound, it would create the liability values at Year 0 at current prices (today's prices) and not the actual amounts to be settled. The amounts to be settled based on the example above are £1,020 in Yr 1, £1,040 in Yr 2 and £1,061 in Yr 3.

Changes in the Inflation Rate

45. The rate of inflation applicable to the liability may change over the life of the provision. In the following example, the rate of inflation is 2% in Years 1 and 2, and 4% in Year 3. As such, the amounts expected to be paid, including inflation are:

a. year 1 £1,020 (£1,000 current price, with 2% inflation);

b. year 2 £1,040 (£1,000 current price, with 2% inflation over two years); and

c. year 3 £1,082 (£1,000 current price, with 2% inflation over 2 years and 4% in Year 3).

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SOFP: Provisions balance	Yr 0 £	Yr 1 £	Yr 2 £	Yr 3 £
Opening provision balance		2,872	1,974	1,018
Unwinding of discount at 2.2% (op bal*2.2%)		64	44	22
Inflation (op bal+discount*2.0% or 4% Yr 3)		58	40	42
Cash spend in year		(1,020)	(1,040)	(1,082)
Closing provision balance	2,872	1,974	1,018	0
SOCNE				
TMB*** 'Interest on unwinding of discount' NW**** 'Provision expenditure' i.e. inflation adjustment		64 58	44 40	22 42
NW**** 'Provision expenditure' – i.e. Creation of provision	2,872			
Total Charge to the SOCNE	2,872	122	84	64

46. The total charged to the SOCNE over the period (£3,142) equates to the value settled.

47. As the inflation rate changes annually, the new rate should be assessed each year to ensure that the cash flows reflect the amount that will need to be settled. When the contractor submits a revised estimate, the inflation rate included by the contractor should be used, subject to this being acceptable. Where no better information is available or the contractor does not provide a revised estimate, the inflation rate used in the most recent Annual Budget Cycle should be used.

Illustration of Accounting for Changes in the Value of the Provision Where There is No Capitalised Asset Provision

48. The carrying value of a provision may be adjusted for three main reasons (excluding settlement and transfers):

a. revalorisation, i.e. the unwinding of discount and application of inflation;

b. changes in assumptions or previous estimates;

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c. release of a provision which is no longer required.

Revalorisation: Unwinding the Discount Factor and the Application of Inflation

49. This is covered in Part 2 Chapter 8 paragraphs 40 to 47.

Change in Assumptions/Previous Estimates

50. An annual assessment of the provision is required, to ensure that the carrying amount remains the 'best estimate' of the liability at the SOFP date. As a result, particularly as the provision moves closer to the settlement date and costs become more certain, the estimate of the cash outflow will be likely to change. This could reflect better knowledge or a change in the assumptions on which the provision is based - for example, a revised out-of-service date or a change in de-commissioning techniques.

51. Where the provision has not been capitalised, the change in the estimated cash outflow is taken as an adjustment through the SOCNE.

52. The example is continued from that described in Part 2 Chapter 8 paragraphs 40 to 47.

53. In Year 0 (i.e. now), the cash outflows are expected to be £1,000 annually for three years. The provision is therefore initially created at the NPV of £2,872. However, at the end of Year 2, the cash outflow in Year 3 is re-assessed. £2,600 rather than the previously estimated £1,082 will be paid.

54. In order to calculate the impact of this re-assessment, the change in the discounted cash flow at Year 2 will need to be calculated by:

a. calculating the difference in cash outflows for Year 3 in current prices at the end of Year 2;

b. discounting the difference to reflect the discounted adjustment at the end of Year 2.

	Original assessment	Revised estimate in Year 2	Difference
Cash outflow in Year 3, in future prices (amount to be settled)	£1,082	£2,600	£1,518
Cash outflow for Year 3, in current prices, at end of Year 2 (e.g. £2,600/1.04 inflation)	£1,040	£2,500	£1,460
Discounted cash outflow for Year 3, at end of Year 2 (e.g. £2,500*0.9785)	£1,018	£2,446	£1,428

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55. The provisions balance should unwind as follows:

	Yr 0 £	Yr 1 £	Yr 2 £	Yr 3 £
SOFP: Provisions balance				
Opening provision balance		2,872	1,974	2,446
Unwinding of discount at 2.2% (op bal*2.2%)		64	44	54
Inflation (op bal+discount*2.0% or 4% Yr 3)		58	40	100
Increase in estimated cash flow	2,872		1,428	
Cash spend in year		(1,020)	(1,040)	(2,600)
Closing provision balance	2,872	1,974	2,446	0
SOCNE:				
TMB*** 'Interest on unwinding of discount' NW**** 'Provision expenditure' Inflation adjustment		64 58	44 40	54 100
NW**** 'Provision expenditure' Creation of provision	2,872			
NW**** 'Provision expenditure' Revised estimate			1,428	
Total charge to the SOCNE	2,872	122	1,512	154

56. The adjustment to the discounted value of the provision should be reflected as a credit to the provision in the SOFP, and a debit to the SOCNE as NW****. The transaction will be reported in the 'increase to Statement of Comprehensive Net Expenditure' line of the Annual Accounts tables.

57. Where there is a reduction in the estimated cash outflow, this is treated in the same way as an increase. A credit entry will be posted through the SOCNE to NW****. This would be reported as a 'release to SOCNE' in the Annual Accounts tables, as it effectively represents the release of provision no longer required.

58. In both cases, the total charged through the SOCNE over the period should equate to the amounts actually settled.

Releasing a Provision Which is No Longer Required

59. Where a liability is settled, the amount actually paid may be less than the value provided. In this case, the remaining un-utilised provision will need to be released to the

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SOCNE. Following the example above, assume now that the amount actually settled in Year 3 is £2,550 in real terms, instead of the revised estimate of £2,600.

	Yr 0 £	Yr 1 £	Yr 2 £	Yr 3 £
Provision in the SOFP:				
Opening provision balance		2,872	1,974	2,446
Unwinding of discount at 2.2% (op bal*2.2%)		64	44	54
Inflation (op bal+discount*2.0% or 4% Yr 3)		58	40	100
Increase in estimated cash flow	2,872		1,428	
Release of provision				(50)
Cash spend in year		(1,020)	(1,040)	(2,550)
Closing provision balance	2,872	1,974	2,446	0
SOCNE:				
TMB*** 'Interest on unwinding of discount' NW**** 'Provision expenditure' Inflation adjustment		64 58	44 40	54 100
NW**** 'Provision expenditure' Creation of provision	2,872			
NW**** 'Provision expenditure' Revised estimates			1,428	(50)
Total charge to the SOCNE	2,872	122	1,512	104

60. Again, the total amount taken through the SOCNE in the period (£4,610) is the amount actually settled. Release of the provision is reported as 'release to Statement of Comprehensive Net Expenditure' in the Annual Accounts tables and posted to NW****.

Illustration of Accounting for Changes in the Value of the Provision where the Provision is Capitalised

61. Adjustments for price changes, i.e. revisions in estimated cash flows and inflation should be capitalised, but unwinding of the discount must always be taken to the SOCNE. There is no materiality threshold in order to ensure that the inflation adjustments are capitalised.

62. With the exception of when the provision is first created, the carrying amount of the capitalised asset will never equate or remain in line with the provision value. This is due to two reasons:

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a. the cost of unwinding the discount is expensed each year and not added to the capitalised provision value; and

b. the capitalised provision value reduces each year as depreciation is written off.

63. An example of a capitalised provision is provided below. The details are taken from Part 2 Chapter 8 paragraphs 50 to 60. Assume in this case, that the provision has been capitalised in Year 0 (for example, the end of a financial year-now), and that there are no subsequent adjustments.

64. An indicative discount factor of 2.2% applies. Inflation is 2% in Years 1 and 2, and 4% in Year 3. Cash outflows of £1,000 per annum are anticipated, at Year 0 current prices.

	Yr 0 £	Yr 1 £	Yr 2 £	Yr 3 £
Provision in the SOFP:				
Opening provision balance		2,872	1,974	1,018
Unwinding of discount at 2.2% (op bal*2.2%)		64	44	22
Inflation (op bal+discount*2.0% or 4% Yr 3)		58	40	42
Cash spend in year		(1,020)	(1,040)	(1,082)
Closing provision balance	2,872	1,974	1,018	0
Non-Current Asset (SOFP):				
Gross carry amount	2,872	2,872	2930	2,970
Capitalised inflation		58	40	42
Depreciation in-year		(977)	(1003)	(1,032)
Accumulated depreciation		(977)	(1,980)	(3,012)
Carrying amount		1,953	990	0
SOCNE				
TMB*** 'Interest on unwinding of discount'		64	44	22
Depreciation		977	1003	1,032
Total SOCNE	0	1,041	1,047	1,054

Change in Assumptions/Previous Estimates, Including a Material Change

65. These would also be capitalised along with the inflation adjustment and corrections to previous estimates. A monthly (and a more comprehensive year-end) assessment of the

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provision is required, to ensure that the carrying value remains the 'best estimate' of the liability at the SOFP date. The change in provision value should be added to the associated asset and depreciated over the remaining years of the useful life of the asset.

66. The example is followed through from above.

67. Assume in this case, that the original estimates of cash outflows at current prices of £1,000 per annum for three years are re-assessed at the end of Year 2. It is found that the estimated cash outflow in Year 3 is now going to be £2,500 in Year 0 current prices, due to a major change in the basis on which the decommissioning will occur. The value in Year 3 prices would be £2,705 (£2,500*1.02*1.02*1.04).

68. To calculate the revised discounted provision value at the end of YR2:

	Year 3
Cash outflows - actual	£2,705
Cash outflow - current prices Yr2	£2,601
Discount factor	0.9785
NPV	£2,545

69. The revised total provision value in Year 2 would now have been £2,545 compared to £1,018, an increase of £1,527.

70. The full treatment over the three years will be as follows:

	Yr 0 £	Yr 1 £	Yr 2 £	Yr 3 £
Provision in the SOFP:				
Opening provision balance		2,872	1,974	2,545
Unwinding of discount at 2.2% (op bal*2.2%)		64	44	56
Inflation (op bal+discount*2.0% or 4% Yr 3)		58	40	104
Increase to non-current assets			1,527	
Cash spend in year		(1,020)	(1,040)	(2,705)
Closing provision balance	2,872	1,974	2,545	0
Non-Current Asset (SOFP):				
Gross carrying amount	2,872	2,872	2,872+58+1527	4,497
Capitalised inflation		58	40	104
Depreciation in-year		(977)	(1003+764)	(1857)
Accumulated depreciation		(977)	(2,744)	(4,601)

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Carrying amount		1,953	1,753	0
SOCNE:				
TMB*** 'Interest on unwinding of discount'		64	44	56
Depreciation		977	1,003+764	1857
Total SOCNE	0	1,041	1,811	1,913

71. Note that the total value charged to the SOCNE over the period of £4,765 equates to the total amount settled.

72. The same principles apply where a decrease in the provision occurs although advice should be sought from FMPA A&TM if this produces a negative value for the capitalised provision.

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9 Pension Schemes

Purpose

1. This chapter expands on the directive in Part 1 Chapter 9 by providing further detail on:

a. Civilian Pension Schemes; and

b. The Armed Forces Pension Scheme (AFPS).

Section 1 – Civilian Pension Schemes

Multi-Employer Defined Benefit Schemes

2. Where the Department participates in a civilian personnel multi-employer defined benefit scheme such as the PCSPS, it must disclose:

a. the nature of the scheme (i.e. that it is a defined benefit scheme);

b. the date of the latest full actuarial valuation on which the amounts in the financial statements have been based;

c. the contribution made for the respective accounting period and any agreed contribution rates for future years;

d. for schemes in which the age profile of the active membership is increasing significantly, that under the projected unit method the current service cost will increase as the members of the scheme approach retirement.

3. Where the Department is unable to identify its share of the underlying assets and liabilities on a consistent and reasonable basis, it must disclose:

a. the fact that it is a defined benefit scheme in which its share of the underlying assets and liabilities cannot be identified;

b. any available information about the existence of the surplus or deficit and the implications of that surplus or deficit for the Department (as shown on the relevant pension scheme statement).

4. For defined pension schemes in which the Department is able to identify its share of the underlying assets and liabilities, it must disclose each of the main assumptions used at the beginning of the period and the reporting date. Amounts should be disclosed as separate figures not combined or netted off.

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5. The main financial assumptions should include:

   a. the inflation rate;

   b. the rate of increase in salaries;

   c. the rate of increase for pensions in payment and deferred pensions; and

   d. the rate used to discount scheme liabilities.

6. For funded schemes, see the FReM Chapter 9 for the latest requirements, but as a guide, the fair value of the assets held by the pension scheme at the beginning and end of the year should be analysed into the following classes and disclosed together with the expected rate of return for each class for the subsequent period:

   a. equities:

   b. bonds; and

   c. other (sub-analysed if material).

7. The following information should be disclosed (without comparatives for the previous period):

   a. the current service cost;

   b. any past service cost;

   c. gains and losses on any settlements and curtailments;

   d. the interest cost; and

   e. for funded schemes, the expected return on assets in the scheme.

8. Refer to the FReM for the latest requirements, but a s a guide, the following information is also required (without comparatives for the previous period):

   a. for funded schemes, the difference between the expected and actual return on assets expressed as (i) an amount and (ii) a percentage of the scheme assets at the reporting period date;

   b. the experience gains and losses (i.e. events that have not coincided with the actuarial assumptions made for the last valuation) on the scheme liabilities as (i) an amount and (ii) a percentage of the present value of the scheme liabilities at the reporting period date;

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c. the effects of changes in the demographic and financial assumptions underlying the present value of the scheme liabilities as an amount;

d. the total actuarial gain or loss expressed as (i) an amount and (ii) a percentage of the present value of the scheme liabilities at the reporting period date;

e. the fair value of the scheme assets (if any). The present value of the scheme liabilities based on the accounting assumptions and the resulting surplus or deficit should be disclosed in a note to the financial statements (including comparatives for the previous period). An analysis of the movements during the period in the surplus or deficit in the scheme should be given.

9. Furthermore, disclosure should also be made of the number and total additional accrued pension liabilities payable by the pension scheme for individuals who retired early on ill-health grounds during the year.

10. Disclosure may be made in total, separately for each scheme or in such groupings as are considered to be most useful. If the disclosure is in total for a number of schemes, the assumptions should be given in the form of weighted averages or of relatively narrow ranges, with any outside the range disclosed separately.

Section 2 – Armed Forces Pension Scheme (AFPS)

Benefits Payable

11. Pension benefits are treated as payable only from the time that the pension Scheme itself has formally accepted liability and are accounted for on an accruals basis. Where, at the reporting period date, there is a significant volume of benefit claims still to be resolved, this should be disclosed in the narrative.

12. Pension Scheme statements should only recognise as a payable, pensions that are payable at the year-end but which have not been paid out until after the reporting period date. If a pensioner has not cashed an issued payable order at the reporting period date, that does not constitute a payable. Any bank balances shown in the Statement of Financial Position should treat such payable orders as if they had been presented at the reporting period date.

13. The Statement of Financial Position does not include the pension Schemes liabilities to pay pensions or other such benefits which arise in the accounting periods after the reporting period date.

Payments to those Retiring

14. If a retiring member has no choice over the allocation of benefits awarded between the value of a lump sum then an accrual should be made based on the date of retirement for any amounts due but not paid until after the reporting period date.

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15. Early departure costs arising from termination of employment through redundancy, severance or early retirement fall to the departmental vote/Supply Estimate and not to the Scheme itself. These additional costs arise from:

a. the payment of annual compensation payments;

b. pension payments before the employee's retiring age;

c. lump sum compensation payments;

d. the enhancement element of the superannuation lump sum;

e. redundancy payments;

f. the cost to the Exchequer of bringing forward payment of the superannuation lump sum.

Tax

16. Income tax is accrued on a daily basis and all tax due as at month end is paid to HMRC by the nineteenth working day of the following month.

Statement of Financial Position

Provision for Pension Scheme Liabilities

17. Liabilities to pay pensions and other benefits in the future (as advised by the Scheme actuaries) should be recognised in the Scheme's SOFP. The liability will not include benefits provided directly by employers. Scheme liabilities should be measured on an actuarial basis using the projected unit method. The assumptions underlying the valuation should be mutually compatible and lead to the best estimate of the future cash flows that will arise in order to meet the Scheme liabilities.

18. Scheme liabilities, expressed at current year prices, are discounted using an assumed long-term real rate of return, based on the returns from AA corporate bonds, as advised by the Government Actuary's Department (GAD). The rate will be reviewed annually by the GAD and promulgated by HMT. The rate is set based on yields at 30 November each year and then reviewed again at 31 March to see if yields have changed significantly between November and March. The rate is changed only if there has been a significant change.

19. Full actuarial valuations by a professionally qualified Actuary should be obtained for a defined benefit Scheme at intervals not exceeding four years. The Actuary should review the most recent actuarial valuation at the reporting period date and update it to reflect current conditions.

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20. Gains and losses arising on the initial recognition of items in the primary statements should be dealt with as a prior period adjustment.

Statement of Comprehensive Net Expenditure

Income

Employers' Normal Contributions

21. The Department's normal contributions (SCAPE payments) should be accounted for on an accruals basis as they fall due in accordance with the recommendations of the Scheme Actuary. The Scheme statements should recognise as a receivable any amounts due at the year end but not received from the Department until after the reporting period date.

Employers' Special Contributions

22. Where the Department makes special contributions, they should be accounted for either in accordance with the agreement under which they are being paid or, in the absence of such an agreement, on an accruals basis.

Employees' Normal Contributions

23. Employees' normal contributions exclude amounts for the purchase of added years and Additional Voluntary Contributions (or AVCs).

24. Employees' normal contributions and amounts for the purchase of added years should be accounted for on an accruals basis as they are deducted from salaries and disclosed separately by way of a note. Pension Scheme statements should recognise a receivable for any amounts due at the year end but not received until after the reporting period date.

25. The AFPS is free to its members and as such the Scheme receives no Employee normal contributions.

Transfers In

26. Transfers in to the Scheme are accounted for on a cash basis. However, the accruals basis may be appropriate if the pension Scheme has formally accepted a liability – for example, in the case of a group transfer, before monies have actually been received. In such a situation, the accrual should be based on the terms of the group transfer agreement.

27. Any material transfers that have been agreed but not settled at the reporting period date, or which are still under negotiation, should be disclosed in a note to the financial statements.

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Additional Voluntary Contributions

28. Additional Voluntary Contributions (AVCs) are deducted from employees' salaries and are paid over directly by employers to the approved AVC providers. AVCs do not include employees' normal contributions for the purchase of added years.

29. AVC transactions should not be recorded in the main pension Scheme statements (for example, revenue account and SOFP). Instead, they should be recorded by way of a note to the Scheme statements.

Other Income

30. Other income should be accounted for on an accruals basis.

31. Any miscellaneous income relating to recovering the costs of providing individual or pension Scheme information should normally be treated as Departmental income (subject to any Vote or running cost considerations) and should not be shown as other income of the Scheme.

Expenditure

Current Service Cost

32. The current service cost is the increase in the present value of the Scheme liabilities arising from the current members' service in the current period and is recognised in the Statement of Comprehensive Net Expenditure. The cost should be based on the discount rate used to discount the Scheme liability.

Past Service Costs

33. Past service costs are increases 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.

34. Past service costs should be recognised in the Statement of Comprehensive Net Expenditure on a straight line basis over the period in which the increase in benefits vests. Where the benefits vest immediately, the past service cost should also be recognised immediately.

Interest Cost

35. The interest cost is the increase during the period in the present value of the Scheme liabilities because the benefits are one period closer to settlement. The interest cost should be based on the discount rate used to discount the Scheme liability. For example, using an illustrative hypothetical discount rate of 2.8 per cent real, with inflation at an illustrative 2.5 per cent, the interest cost would be determined by applying 5.30 per cent to the value of the Scheme liabilities at the beginning of the year, and to one half of

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the movement in the liabilities during the year (excluding the interest charge and the actuarial gains and losses) assuming that the increase or decrease accrues during the year.

Other Increases in Scheme Liabilities

36. Increases in Scheme liabilities arising from income receivable by the Scheme, for example, transfers in and the purchase of added years, should be accounted for at the same time as the associated income.

Other Payments

37. Other payments should be accounted for on an accruals basis.

Administration Costs

38. The costs of administering the Scheme should fall on the principal operating department, MOD, and should not be included in the Scheme statements.

Ex Gratia Costs

39. Any ex-gratia costs charged to the Scheme should be accounted for on an accruals basis. Where there is any doubt as to whether a particular cost should be borne by the Scheme or a department/agency, Treasury guidance should be sought.

Other Movements on the Pension Scheme Liability

Transfers Out

40. Following a change in pension legislation transfers out of the Scheme will only be allowed under certain circumstances, to protect the public sector pension Schemes from increasing volumes of withdrawals after 6th April 2015. The same rules apply for transfers out as transfers in.

Pensions Payable

41. Pension benefits payable should be accounted for on an accruals basis. Pension benefits are treated as payable only from the time that the pension Scheme has formally accepted liability. Where, at the reporting period date, there is a significant volume of benefit claims still to be resolved, then this fact should be disclosed by way of a narrative note to the Scheme statements.

42. Where pensions are payable at the year end but have not been paid out until after the reporting period date, the Scheme should transfer an appropriate amount from the pension Scheme liability to payables.

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43. For example, where payments are made to individuals throughout a month, it will be necessary to accrue for pensions due from the previous payment date to 31 March. Thus, if a pensioner is paid in arrears on the tenth day of every month, the Scheme statement should include an accrual for the period from 11 March to 31 March.

44. Payable orders which have been issued but not cashed at the reporting period date should be included in bank balances recorded on the Statement of Financial Position, as if they had been presented at the reporting period date. This is consistent with the cash measurement criteria.

Payments to Leavers

45. If a member leaving the pension scheme before normal retirement age is only entitled to a refund of contributions, an appropriate amount should be transferred from the pension scheme liability to payables based on the date of leaving.

46. However, if a member leaving the pension Scheme before normal retirement age is entitled either to a refund of contributions or to a deferred pension, an accurate accrual cannot be made until such time as that option has been exercised. In such circumstances, the transaction should normally be accounted for on a cash basis.

47. The AFPS is a non-contributory pension Scheme; therefore no refund of contributions will be made to members on leaving the Scheme.

Payments to Those Retiring

48. If a member retiring has no choice over the split of benefits between the value of the lump sum and the annual pension, then a transfer from the pension scheme liability to payables should be made, based on the date of retirement, for any amounts due at the reporting period date but not paid over until after that date.

49. However, if a member retiring has a choice over the split of benefits between the value of the lump sum and the annual pension, then an accurate accrual cannot be made until such time as that option has been exercised. In such circumstances, the transaction should normally be accounted for on a cash basis.

Statement of Other Net Comprehensive Expenditure

Actuarial Gains and Losses

50. Changes in the pension Scheme liability can arise because:

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

b. the actuarial assumptions have changed.

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51. Actuarial gains and losses arising from any new valuation and from updating the latest actuarial valuation to reflect conditions at the Statement of Financial Position date should be recognised in the Statement of Comprehensive Net Expenditure for the year.

Commutation

52. Commutation is the means by which a capital sum can be raised by an individual in return for giving up a proportion of the pension entitlement.

53. Two forms of commutation exist for Service personnel:

a. life commutation, (which is only available to those serving prior to 31 March 1978) where part of the pension is given up for life;

b. resettlement commutation, where a prescribed amount is given up until age 55 when the pension is fully restored. The capital sum for resettlement commutation is met by the AFPS through the normal Spending Review process.

54. Commutation payments are treated as prepayments of the accrued pensions liability. Thus when a payment is made, there is a corresponding reduction in the accrued liability.

Transfer of Superannuation Rights

55. Scheme members may opt to transfer their rights to future benefits to a personal pension plan or to another approved occupational pension scheme. However, from the 6th April 2015 transfers to private defined contribution schemes will not be allowed.

56. When an application to transfer out of the AFPS is received, the amount of accrued benefit is actuarially assessed. If the transfer is approved and takes place, the liability towards the pensioner is, effectively, removed. Equally, if a transfer into the Scheme is approved, the AFPS will assume a liability for future superannuation.

57. Transfers are to be accounted for on a cash basis.

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10 Financial Instruments

Purpose

1. This chapter expands on the directive in Part 1 Chapter 10 by providing further detail and examples on how to account for:

   a. embedded derivatives;

   b. other Departmental investments – for example, in Trading Funds;

   c. receivables, loans and prepayments;

   d. liabilities (excluding provisions);

   e. financial guarantee contracts.

2. Annex A, Annex B and Annex C explain how to:

   a. determine whether an embedded derivative is closely related to its host contract;

   b. value an embedded derivative;

   c. account for the Department's foreign currency forward contracts.

Scope

3. This chapter covers the recognition and measurement of all the Department's financial assets and liabilities, including investments, foreign currency forward contracts, receivables and payables.

Required Accounting

4. IAS 32, IAS 39, IFRS 7 and IFRIC 9 accounting requirements are detailed below.

Derivatives

5. The Department enters into contracts for the express purpose of procuring goods and services and has no practice of settling its contracts net in cash (i.e. making or receiving a cash payment either with the supplier or a third party, prior to delivery of the goods and services based on the change in the value of the contract). These contracts to procure goods and services are not treated as derivatives and in accordance with IAS 39 are outside the scope of the standard. However, the Department does enter into derivative contracts as detailed in the paragraph below.

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6. The $US and € forward contracts purchased on behalf of the Department by the Bank of England are derivatives and are classified as held for trading. As such, the foreign currency forward contracts are measured at their fair value on the Department's Statement of Financial Position (SOFP) with movements in their fair value taken to the Statement of Comprehensive Net Expenditure (SOCNE). The accounting requirements are covered in Annex C.

7. The Department also enters into fuel fixed price swap instruments which should be defined and accounted for as derivatives. The same accounting principles should be applied as those used to account for the foreign currency forward contracts. The fuel fixed price swap instruments are contracts whereby the Department enters into a fixed price swap for fuel and then either has to make or receive a payment based on the market price of the fuel at the time the contract matures. The fair value of the derivative is measured as the difference between the contract price and the market value of the fuel at the date of the valuation. Once each contract is settled, it is removed from the SOFP.

Embedded Derivatives

8. An embedded derivative is a feature within a contract whereby the associated cash flows behave in a similar fashion to a stand-alone derivative.

9. An embedded derivative should be separated from its host contract and accounted for as a derivative when all of the following conditions are met:

a. the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract; and

b. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c. the entire instrument is not already measured at fair value with changes in fair value recognised in the profit and loss account/SOCNE.

10. The Department has various types of contract pricing arrangements for purchasing goods and services which include embedded derivatives, such that the cash flows of the combined contract vary in a similar way to a standalone derivative. Due to the complex nature of embedded derivatives and the difficulties in defining them, it is not possible to produce an exhaustive list. However, some examples of potential embedded derivatives are described below:

a. certain long term fixed price contracts, including PFI deals, which are inflation-indexed using either variable output or input based indices. These contractual arrangements are known as Variation Of Price (VOP);

b. an arrangement in which the Department uses an Exchange Rate Variation (ERV) against a fixed price sterling contract for goods and services originally priced in a foreign currency;

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c. the Department's non-PFI leases (principally land and buildings leases overseas), which may either be at firm prices or uplifted to market rents through the use of inflation indices;

d. an arrangement in which the contractor is permitted to recover costs against the Department if certain conditions are met;

e. performance related payments such as gainshares, benchmarking, internal rate of return payments and value for money clauses;

f. revenue sharing;

g. compensation payments;

h. take or pay contracts;

i. penalties for selling assets subject to sale and leaseback arrangements;

j. interest on late payments;

k. termination clauses in PPP/PFI contracts.

11. In the examples above, and for any contract which may contain an embedded derivative where the whole contract is not already at fair value (which will be very rare), it is necessary to assess whether the embedded derivative is closely related to the host contract. Where it is not, the embedded derivative must be separated from the host contract and accounted for as a stand alone derivative by valuing it at its fair value. Determining whether an embedded derivative is closely related should be done on a case by case basis. IAS 39 does not define closely related. See Annex A to this chapter for examples of when an embedded derivative is likely to be closely related.

12. Assessing whether an embedded derivative needs to be separated from its host contract and accounted for as a derivative should be done when the Department first becomes party to the contract. The assessment should be carried out by both finance and commercial staff to ensure that the accounting requirements are understood. Due to the difficulties in defining embedded derivatives, all clauses in a contract should be considered for their potential impact on the value of the cash flows. Subsequent re-assessment is prohibited unless there is a change in the terms of the contract which results in significantly modified cash flows.

13. If a separable embedded derivative needs to be valued, advice should be sought from the FMPA A&TM. A basic example is provided at Annex B to this chapter. The general principle is that the embedded derivative should be recognised at fair value on the SOFP, with changes recognised in the SOCNE. The initial determination of fair value should, wherever possible, be made in an active liquid market with reference to quoted market prices. If an active liquid market is not available, the embedded derivative should be valued according to its nature by using:

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a. optional derivatives. Option pricing models, such as the Black-Scholes or Binomial Lattice model;

b. non-optional derivatives. Non-optional derivatives, likely to be representative of applicable Departmental contracts, should be at fair value using discounted cashflow analysis using an appropriate yield curve.

14. If an embedded derivative is separated and valued, the following RACs should be used:

SOFP		**SOCNE**	
RAC	**Description**	**RAC**	**Description**
CBA	Non-current asset embedded derivative	MKG	Embedded derivative cash payment
EQA	Current asset embedded derivative	MKG	Fair value gain/loss on embedded derivatives
GEL	Current liability embedded derivative		
JHA	Non-current liability embedded derivative		

15. If TLBs consider that they have a contract which contains an embedded derivative but are unsure of the accounting treatment they should seek advice from FMPA A&TM.

Other Investments

16. The Department's investments in Trading Funds comprise Public Dividend Capital (PDC) and loans. The PDC should not be disclosed as a financial instrument in the accounts but instead should be carried at historical cost less any impairment. The loans should be disclosed as a financial instrument.

17. Should the Department have any future investments (shareholdings), such as it previously had in QinetiQ, they should be classified as Available For Sale financial assets. The shares should be carried on the Department's SOFP at fair (market) value with any fair value revaluations (increases and decreases in value) taken to the Revaluation Reserve.

18. Where there is objective evidence that the value of an asset is impaired and the cumulative loss has been recognised directly in the Revaluation Reserve, the loss should be removed and recognised in the net operating cost section of the SOCNE, even though the financial asset has not been derecognised. Impairment losses recognised in the net operating cost section of the SOCNE for an investment in an equity instrument classified as available for sale should not be reversed through the SOCNE. FMPA A&TM should be consulted for further direction.

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19. On disposal/sale of all or part of the shares, any associated Revaluation Reserve balances should be recycled through the net operating cost section of the SOCNE (RA Code: RAF 000) as either a gain or a loss.

20. In accordance with HM Treasury instructions, the Department's investment in special or 'Golden' shares should not be recognised on the SOFP.

21. The Department holds non-cumulative irredeemable preference shares in a trade association. As distributions are at the discretion of the trade association, the preference shares should be treated as equity instruments in accordance with IAS 32 and classified as Available for Sale financial assets under IAS 39. As the shares cannot be traded and a reliable fair value is not available, the shares are measured at historic cost adjusted for impairment. The shares may be recovered by the trade association at 1p per share, as laid down in its Articles of Association, should the Department cede its membership. The shares should therefore be reported on the Department's SOFP at the (impaired) cost of 1p/share.

22. The Department has a 100% interest in the non-preferential shares of a company which ceased trading in 1991. Following settlement of outstanding contracts, the company will be liquidated. The Department's interest in the company represents an equity instrument, classified as an Available for Sale financial asset for which a reliable fair value is not available. In accordance with the provisions of IAS 39, the shares should be measured at historic cost, adjusted for impairment (i.e. nil).

Receivables, Loans and Prepayments

23. All receivables, including trade receivables, staff loans and advances should be classified as Loans and Receivables assets. They should be measured at fair value initially and subsequently on a discounted cost basis. This means that for those receivables and loans carrying no market rate of interest (or a subsidised rate) the nominal value of the receivable or loan will be different from its discounted present value. However, where the time value of money is not material, receivables may be carried at a cost valuation.

24. With the agreement of NAO, the Department's routine receivables (all current trade receivables which are typically short-term in nature) will continue to be measured at cost after allowing for bad debts. This is on the basis that the discounting effect would be immaterial.

25. Any future non-interest bearing long-term receivable balances will need to be discounted, if they are material, using the higher of the rate intrinsic to the financial instrument and the discount rate set by HM Treasury (2.2%).

26. Before creating a bad debt provision, each receivable should be reviewed for specific indications that the debtor will be unable or unwilling to settle all or part of the debt. General provisions to cover a range of bad and doubtful debts are prohibited.

27. It may be possible for the Department's long-term interest free staff loans to be carried at cost on materiality grounds. However, where the value is not considered

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material (and hence the loans are not discounted), this will have to be justified to the NAO at each reporting period. It should be noted that the value was considered material at the IFRS opening SOFP reporting date.

28. Prepayments for goods and services are not defined as financial instruments (because they are not settled in cash) and should therefore continue to be reported on the basis of amounts paid net of goods and services received. The Department's prepayments, with the exception of one specific prepayment which relates to an escrow account, are all provided in exchange for goods and services and it is anticipated that this will continue to be the case in the future. The escrow account prepayment is in effect a bank balance and is therefore already stated at fair value.

Liabilities (Excluding Provisions)

29. Under IAS 39, liabilities covering trade payables, accruals, PFI payables, loans and deferred income should be classified as Other Liabilities. They should initially be measured at fair value and subsequently at discounted cost. This means that for financial liabilities which carry no market rate of interest (or a subsidised rate) their nominal value will differ from their discounted present value. However, where the time value of money is not material, such liabilities may be carried at a cost valuation.

30. The NAO has agreed that the Department's short-term (i.e. falling due within one year) payables and accruals including trade, VAT and social security payables, will continue to be measured at cost on the basis that the discounting effect would not be material.

31. The SOFP value of the payables and loans for which the Department is obliged to pay a market rate of interest, including interest charges on PFI liabilities and NLF loans, is also unaffected. This is because the carrying amounts are already measured in accordance with IAS 39 measurement principles - i.e. the present value of the stream of future cash payments, discounted at the appropriate loan/ PFI contract interest rate.

32. Any non-interest bearing (or less than a market rate of interest) loans and long-term liabilities should, if material, be discounted to net present values. The rate to use when discounting such loans and liabilities to a net present value is the higher of the rate intrinsic to the financial instrument and the discount rate set by HM Treasury (2.2%).

Financial Guarantee Contracts

33. Provisions which arise under financial guarantee contracts (i.e. contracts which require the Department to reimburse its suppliers for a loss incurred because a specified debtor fails to make a due payment) fall within the scope of IAS 39. All other types of provisions are covered by IAS 37.

34. The Department only has a small number of arrangements with third parties which fall within the definition of a financial guarantee contract. Their accounting treatment is covered in Part 1 Directive Chapter 10.

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ANNEX A TO CHAPTER 10

DETERMINING WHEN EMBEDDED DERIVATIVES ARE CLOSELY RELATED TO THE HOST CONTRACT

A1. **Index Multiples**. As a guide, where an index multiple is ≥ 2-times the base index (also described as being leveraged) it is unlikely to be closely related. For example:

a. the Department has a 10-year contract with Company Y (UK-based) for it to service major assemblies. The contract contains an embedded clause that requires annual payments to be adjusted for 2-times the change in the UK's CPI.

Whilst the UK CPI is economically close to the contracting parties, the embedded inflation indexed payment would be accounted for separately because the rate of inflation is leveraged at 2 or more times CPI; it is not closely related to the base index itself;

b. the Department leases property in the UK from a UK company with a lease term of 10 years payable in Sterling. Embedded within the lease is a provision requiring payments to be adjusted annually by the UK's CPI.

The embedded derivative will not be accounted for separately as the inflation adjustment is not leveraged and is, therefore, closely related. The embedded derivative would be separated if the adjustment exceeded twice the CPI;

c. the Department benefits from or is penalised from saving or using additional units of energy (U) beyond a certain threshold multiplied by the average unit cost of that energy (AvUC) in relation to the following formula:

Gainshare/Painshare = 0.5U x 2AvUC(£).

The arrangement fulfils the definition of a derivative in that it requires no initial net investment, is settled at a future date, and its value changes in response to a change in a commodity price. It requires separation because whilst the general economic characteristics of the index are closely related to the parties (a commodity price denominated in £ Sterling), the multiple of that relationship (2 times) explicit in the contract recognizes that the inherent risk being carried needs to be disclosed separately.

A2. **Index Relationship**. An index must demonstrate a risk or economic relationship to its host contract. For example:

a. the Department contracts to buy spares from a UK company for a fixed amount, plus or minus an indexation feature linked to movements in the FTSE 100. The embedded derivative based on the FTSE 100 would need to be separated from the host contract as there is no relationship between the purchase and the inflation feature; they are not closely related;

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b. where the inherent economic characteristics of a derivative's index are not obviously 'closely related' to one or more of the contracting parties, the embedded derivative may require separation. For example, the Department benefits or is penalised from saving or using additional units of energy (U) beyond a certain threshold multiplied by the average unit cost of that energy (AvUC) and the relationship between the Department and a UK-based gas supplier was contracted as:

GainShare/PainShare = 1U x AvUC($).

In this instance, the denomination of the GS/PS cashflow in US$ may indicate a degree of economic difference that changes the risk relationship inherent in the contract and therefore requires review. It may be demonstrated that US$ is the only recognized exchange mechanism for this utility price and despite it not being the home currency of either party is sufficient to demonstrate a closely related economic relationship. However, it is also possible that the contract has been written to hedge foreign exchange risk and this would, therefore, warrant separation as an embedded derivative.

A situation may also arise, and is occasionally the case with gas supply in particular, that there is no universally adopted index for its supply. In these situations, a 'basket' of similar products with available price indices (primarily relating to oil products) may be used. Whether or not this is deemed to be sufficiently closely related will require review and endorsement of that opinion by the NAO.

Situations may also arise in gainshare arrangements where the 'reward' is free additional supplies of the product being purchased in the host contract. Whilst this 'non-financial variable' is likely to be specific to one or more of the contracting parties, it is strongly recommended that this is reviewed and the opinion endorsed by the NAO before the contract is let as a separable embedded derivative may exist.

A3. **Functional Currency**. A foreign currency embedded derivative in a host contract is closely related provided it is not leveraged, does not contain an option feature and requires payments denominated in one of the following currencies:

a. the functional currency of any substantial party to the contract;

b. the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US$ for crude oil transactions); or

c. a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (for example, a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

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For example:

i. the Department has a 7-year contract with a Canadian company to supply suspension systems for wheeled vehicles, payable in Canadian Dollars and increased annually by the Canadian RPI.

The foreign currency feature is an embedded derivative. However, as payment is made in the functional currency of one of the contracting parties and inflation is related to the economic environment of one of the parties to the contract, separation is not required;

ii. the Department leases property in Germany from a German company. The lease payments are denominated in Sterling. The functional currency of the German company is the Euro and the functional currency of the Defence Infrastructure Organisation is Sterling.

The provision to pay in Sterling would not require separate accounting because Sterling is the currency of the primary economic environment of the Department, who is a substantial party to the lease; the relationship is close. Similarly, if the lease payments were to be made in Euros, the derivative would not require separation.

Separation due to not being closely related would be necessary if: the lease payments were to be made in a currency which is not the functional currency of either party or; is not routinely denominated in lease transactions around the world (e.g. oil would be) or; is not a commonly used currency in the economic environment of where the transaction occurred such as US$;

iii. the Department leases a property in Cyprus with a lease term of 10-years. The lease payments are denominated in Cypriot Pounds. Embedded in the lease is a provision that requires the lease payment to be adjusted every two years for the change in the UK's CPI.

The embedded inflation indexed payment would be accounted for separately. Although the rate of inflation is not leveraged, the inflation index is in a different economic environment from the Department's and is therefore not closely related.

A4. **Cap or Floor**. An embedded cap or floor on the rate of an instrument, where the cap or floor is not leveraged, is closely related to the host debt contract provided the cap is at or above the market rate and the floor is at or below the market rate when the instrument is issued. The assessment as to whether an embedded cap or floor is closely related to a host contract is made at contract let and is not subsequently revised. For example:

a. the Department enters into a contract to purchase fuel in 12-months at the market price of fuel at the point of purchase. Embedded in the contract is a cap that

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puts an upper limit on the price payable. The cap is set above the current price for fuel at inception (out-of-the-money).

The cap is closely related to the host purchase contract so will not be separated. The cap is closely related to the host contract for the life of the contract, irrespective of whether fuel prices rise so that the cap becomes less than the market price (in-the-money);

b. Company X issues $1M variable rate debt with a 5-year maturity. The variable rate is indexed to LIBOR, which is 4.5% at the date of issue. Embedded in the debt is a provision that caps the variable rate at 10%.

The cap would not be accounted for separately because the cap is both related to interest rates and above the market rate when the debt is issued; the cap is considered to be closely related to the host instrument.

A5. **Term**. Three scenarios are envisaged.

a. **Extension**. Where the term of the contract is extendable and there is no concurrent adjustment to the approximate current market rate of interest at the time of the extension, the embedded term extension option is not closely related to the host debt contract. For the reset to market rates to be closely related the term must result in a reset of both current interest rates and current credit spread for the issuer.

b. **Early termination**. Contractual provisions that allow either party to terminate the contract early and accelerate the repayment of the outstanding principal, either in whole or in part, are often embedded derivatives. Examples of such provisions include: call options of the issuer; put options of the holder; or prepayment features. These embedded derivatives are not closely related to the host contract unless the exercise price is approximately equal to the contract's amortised cost on each exercise date.

c. **Termination Clauses in PPP/PFI Contracts**. An example being that the Department can terminate the PFI contract if the private sector operator fails to meet certain performance standards. These do not require recognition unless it is probable that the relevant clauses will be invoked.

For example:

i. company X issues $10M in debt at par with an 8% coupon and maturity of five years. However, if LIBOR increases by 250 basis points or more during the term of the debt, the issuer of the bonds has the option to extend the maturity for an additional 3 years. If the issuer exercises its option to extend the maturity, the coupon will be reset to the current market rate for a company with a similar credit rating.

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The embedded derivative is closely related and would not be accounted for separately from the host contract. Whilst it significantly extends the maturity of the debt instrument, the coupon will be reset to the current market rate for a company with a similar credit rating;

ii. Company X issues $10M in debt with an 8% coupon and a maturity of five years. However, if LIBOR increases by 200 basis points within any one year, the maturity of the bonds will be extended for another 3-years at the stated coupon rate.

The embedded derivative is not closely related and would be accounted for separately from the host contract. The term is extended but the coupon does not reset to the current market rate at each renewal date and it is considered to be reasonably possible that LIBOR could increase 200 basis points in a year.

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EXAMPLE OF HOW TO VALUE AND ACCOUNT FOR EMBEDDED DERIVATIVES

B1. During 2013-14 the Department enters a contract for the provision of munitions. As part of the contract the contractor will procure 1000 tonnes of steel for £1000. Included in the contract is a clause which states that the procurement cost of the steel will be indexed according to the price of wheat which is a separable embedded derivative. At contract signature date the price of wheat is £1 per tonne. The embedded derivative should be accounted for as follows:

31 March 2014 (first time recognition)

Market Price of Wheat = £0.50 per tonne (50% decrease)
Indexed Actual Price of Contract = 1000 x 50% = £500
Difference between Contracted Price and Actual Price = £500
The separable derivative has, therefore, a fair value of £500

<u>Statement of Financial Position</u>
Dr Non-current asset embedded derivatives £500

<u>Statement of Comprehensive Net Expenditure</u>
Cr Fair value gain on embedded derivatives £500

31 March 2013 (Revaluation)

Market Price of Wheat = £0.30 per tonne (40% decrease)
Indexed Actual Price of Contract = 500 x 60% = £300
The separable derivative has, therefore, a fair value of £700 (an increase of £200 over its previously stated value in the Statement of Financial Position).

<u>Statement of Financial Position</u>
Dr Non-current asset embedded derivatives £200

<u>Statement of Comprehensive Net Expenditure</u>
Cr Fair value gain on embedded derivatives £200

31 March 2016 (Contract Completion)

Market Price of Wheat = £1.20 per tonne (400% increase)
Indexed Actual Price of Contract = 300 x 400% = £1200
Difference between Contracted Price and Actual Price = £200

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The separable derivative is, therefore, a fair value liability of £200 (a decrease of £900 over its previously stated value in the Statement of Financial Position).

Step 1 - Revaluation
Statement of Comprehensive Net Expenditure
Dr Fair value loss on embedded derivatives £900

Statement of Financial Position
Cr Embedded derivatives £900

Step 2 – Clearance of embedded derivative liability (i.e. pay the contract).

Statement of Comprehensive Net Expenditure
Dr Steel purchases £1,000

Statement of Financial Position
Dr Embedded derivative £200
Cr Cash £1,200

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ANNEX C TO CHAPTER 10

FOREIGN CURRENCY FORWARD CONTRACTS

Scope

C1. The policy contained in this annex is to be implemented by FMPA-A&TM-ACCPOL Treasury Accountant (FMPA TA).

Properties of the Department's Foreign Currency Forward Contracts

C2. To eliminate the majority of its exchange rate risk and also to provide greater certainty for planning purposes, the Department purchases foreign currency forward contracts denominated in its major trading currencies, US$ and €.

C3. The forward contracts are placed through the Bank of England on a phased basis to reflect TLBs' projected US$ and € cash flows. The Department only pays for the contract when it matures, at which point the contract is settled. A contract will include the number of units of each currency, the fixed exchange rate and its maturity date.

Accounting Treatment

C4. The foreign currency forward contracts are financial instruments, which are sub-classified as derivatives. They are recognised at fair (i.e. market) value on the SOFP. Subsequent changes in their fair value are charged/credited to the SOCNE.

C5. The fair value of the forward foreign currency contracts, at any point in time, will be the spot rate compared to the rate inherent in the contract. Given that the Department has an obligation to take up the forward contracts, the valuation could give rise to either a financial asset or a financial liability on the SOFP.

C6. A foreign currency forward contract will give rise to:

a. a financial asset where the fair value of an unsettled foreign currency forward contract is positive;

b. a financial liability where the fair value of an unsettled foreign currency forward contract is negative;

c. a charge or credit to the SOCNE to reflect the movements in the fair value of each of the Department's unsettled foreign currency forward contracts.

C7. The fair value of the Department's individual contracts is established by FMPA TA. For audit purposes, FMPA TA should maintain separate 'off-line' records of the individual contract valuations.

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C8. The Department's forward contracts only have a fair value until their point of settlement, after which they are removed from the Department's SOFP. A forward contract should be valued immediately prior to settlement, as this will eliminate any financial asset or financial liability.

C9. When settling the contract, FMPA TA will translate the US$ and € values stated in the contract, at the specified contract rate. Any differences arising between the actual cost of the forward contract and the spot rate will have already been charged/credited to the SOCNE on valuation (using the MKE000 RAC).

Accounting Transactions

C10. The following accounting entries should be made in the FMPA TM MG set of books:

a. on initial recognition, FMPA TA records the fair (market) value of each of its unsettled foreign currency forward contracts. The valuation of each contract is recognised in the accounts as follows:

i. if the fair value of the contract is positive, then the financial asset is created by debiting CBA000 with a corresponding credit to the SOCNE (MKE000);

ii. if the fair value of the contract is negative, then a financial liability is created by crediting GEL000 with a corresponding debit to the SOCNE (MKE000);

b. the new valuations should be grouped and totalled between those which have a positive value (i.e. a financial asset) and those which have a negative value (i.e. a financial liability). The financial asset and liability accounts (CBA000 and GEL000 respectively) should be adjusted to the new positive and negative values, with a corresponding charge to the SOCNE (MKE000).

C11. FMPA TA is to seek valuations at APs 9 and 12 of all the foreign currency forward contracts that have not yet been settled. In addition, a valuation of the contract should be carried out immediately prior to the contract being settled.

C12. The adjustments made to the financial asset and liability accounts described in Part 2 Chapter 10 paragraph C10.b. should represent settled contracts that have been derecognised (i.e. they have matured); new contracts that have been recognised; and variations to the value of existing contracts arising from movements in the spot rate.

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11 Specific Disclosures

Purpose

1. This chapter expands on the directive in Part 1 Chapter 11 by providing further detail and examples on how to account for:

a. the definition of a related party;

b. examples of adjusting and non-adjusting post reporting period events;

c. financial commitments.

Definition of a Related Party

2. Two parties are defined as being related if:

a. one has direct or indirect control over the other (i.e. one party has the power to govern the financial and operating policies of the other such that it obtains benefits from its activities);

b. the parties are subject to common control from the same source;

c. one party has significant influence over the other entity.

3. The following will always be regarded as related parties of the reporting entity:

a. the ultimate and intermediate parent undertakings, subsidiary undertakings and fellow subsidiary undertakings;

b. associates and joint ventures;

c. key management personnel of the reporting entity and the directors of the ultimate and intermediate parent undertakings;

d. members of the close family of any individual who is a related party;

e. pension funds for the benefit of the employees of the reporting entity or of any entity that is a related party of the reporting entity. Contributions to a pension fund need not be disclosed;

f. entities (for example, companies and partnerships) controlled by any individual who is a related party.

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4. The following definitions should be noted when applying the related party disclosures to the Annual Accounts:

a. key management personnel are those with authority and responsibility for planning, directing and controlling the activities of the entity directly or indirectly, including any director (executive or otherwise);

b. directors, who are to be interpreted as:

i. the Ministers who were responsible for the Department during the year;

ii. the person occupying the position of permanent head of the Department;

iii. personnel appointed to the Defence Board (including advisory and non-executive members) who have authority or responsibility for directing or controlling the major activities of the entity during the year. This means those who influence the decisions of the entity as a whole rather than the decisions of individual directorates or sections within the Department;

c. close family members of the above include the domestic partner, spouse, parent, child (minor or adult), children of the domestic partner or any other dependants of the individual or domestic partner.

Adjusting Post Reporting Period Events

5. Adjusting events are those that provide further evidence of conditions that existed at the reporting period date. The Annual Accounts are only adjusted for material events.

6. Examples of adjusting events include:

a. subsequently establishing a purchase price for items bought or the sales proceeds of assets sold before the period-end;

b. a valuation that provides evidence of a permanent diminution in value which occurred prior to the period end;

c. the receipt of sales proceeds after the reporting period end or other evidence of the net realisable value of inventories;

d. re-negotiated amounts owed by debtors or a debtor becoming insolvent after the period-end;

e. amounts received or receivable in respect of claims that were in the course of negotiation at the reporting period date, or the settlement of litigation relating to events which occurred prior to the reporting period date;

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f. receipt of information providing evidence of a permanent diminution in the value of a financial asset;

g. errors showing that the Annual Accounts were incorrect at the period end.

Non-Adjusting Post Reporting Period Events

7. Non-adjusting events are those which did not exist at the reporting period date and therefore do not require the Annual Accounts to be adjusted. However, they are disclosed in the Annual Accounts if sufficiently material to affect users' understanding of the Department's financial position.

8. Examples of non-adjusting events include:

a. purchases and sales of non-current assets (NCAs);

b. destruction of NCAs or inventories as a result of a catastrophe, such as a fire or flood;

c. opening new or extending existing facilities;

d. closing or reorganising a significant part of Departmental activities if this was not anticipated at the period-end;

e. a decline in the value of property or financial assets held as NCAs, where there is evidence that the decline occurred after the period-end;

f. changes in rates of foreign exchange (post period-end);

g. improvement or worsening of pension benefits;

h. dividends declared by non-Trading Fund entities.

Financial Commitments

9. Examples of commitments that need to be disclosed include:

a. commitments as a lessee under operating leasing agreements (see Part 2 Chapter 11 paragraph 10);

b. finance lease commitments existing at the reporting period date where inception occurs after that date;

c. purchase commitments in excess of normal requirements;

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d. lending commitments or guarantees for future loans to third parties;

e. guarantees and warranties;

f. legal commitments, such as EC Directives;

g. commitments under Contracting For Availability/Contractor Logistic Support (CFA/CLS) contracts (see Part 2 Chapter 11 paragraph 11).

10. For operating leases, payments which the Department is committed to make in the following year, in the second to fifth years inclusive, and over five years from the reporting period date should be disclosed. The amounts are analysed between leases of land, buildings and other leases.

11. Obligations under CFA/CLS contracts where the assets are not reported on the Statement of Financial Position (SOFP) should be analysed and disclosed between payments which the TLB is committed to make in the first year, in the second to fifth years inclusive, and over five years from the reporting period date.

12. Separate disclosure of commitments within the above categories is required if they are undertaken on behalf of, or for the benefit of, other related entities outside the Departmental boundary.

13. Part 1 Chapter 9 explains pension disclosure requirements.

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12 Losses and Special Payments

Introduction

1. This chapter gives guidance on the classifying, managing, writing-off and reporting losses and special payments. It should be noted that throughout this chapter 'write off' is used in the context of Parliamentary reporting, and is taken to mean that the case is no longer being pursued and will be closed i.e. written off, it does not necessarily refer to the accounting treatment.

Classification of Losses and Special Payments

Losses

Type A Losses – Cash and Bookkeeping

2. In addition to physical loss of cash, other examples include, a claim for a refund of an overpayment which fails or a loss arising from a failure to make adequate charges for the use of public property or services.

3. Where a bookkeeping loss includes a balance which is written off because it cannot be supported due to, for example, an asset whose existence cannot be verified or traced, the loss is reportable and is to be disclosed in the losses note. However, if an error has resulted in two entries being made for the same asset, which can be proved, the resultant write-off is not a reportable loss, although an audit trail should be retained.

4. Exchange rate losses where currency has been exchanged back at a less than favourable rate are reportable. Losses as a result of accounting revaluations e.g. using the Government Accounting Rate (GAR), or movements in the FOREX programme are not reportable losses.

5. Where a loss is wholly or partly met by payments by the person responsible, by a payment from an insurance company, other non-public source or recovered under statutory or other specific powers, only the net loss is reportable.

6. Recovery of an overpayment of pay or allowances that fails is a Type A(iv) loss. If the Department decides not to pursue the overpayment then it is a claim waived Type D.

Type B Losses – Losses of Accountable Stores

7. Stores losses cover loss and damage to Departmentally owned equipment and materiel. Although not reportable to Parliament the following examples of stores losses are still to be accounted for in accordance with Defence Materiel Accounting policy (see JSP 886 Volume 4 Part 6):

a. losses arising from direct contact with or as a consequence of enemy activity;

b. losses arising from authorised tests, experiments or practice firings in which destruction, loss or damage may be expected;

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However paragraph 8 must also be considered before deciding whether a loss is reportable.

8. Any stores loss occurring through the circumstances described below is reportable to Parliament. Where the loss is:-

a. proven or suspected fraud;

b. theft;

c. arson or sabotage;

d. any other deliberate act (including repairable damage caused maliciously to buildings, stores etc even where a legal claim is not possible).

e. a loss by fire (other than arson);

f. a loss by weather damage or by accidents beyond the control of any responsible person;

g. by negligence or errors of judgement on the part of Departmental personnel in the performance of their duty;

h. a loss arising from deterioration in stores caused by some defect in administration or Departmental error, such as over provisioning and failure to rotate inventories correctly.

9. Where NCA values are adjusted to reflect complete destruction, damage beyond economic repair, demolition, scrapping, obsolescence or an excess supply of assets (non-current or otherwise), this is not a loss provided that the adjustment is made as a consequence of normal Departmental business. The definition of depreciation encapsulates use', 'obsolescence', 'reduction in life' and 'wearing out' of an asset.

10. Loss of, damage to, or deterioration of Departmental stores held by a contractor will usually generate a claim against the contractor under the terms of the contract. If a valid claim or any part of it is not enforced, the loss is regarded as a claim abandoned. Stores issued to contractors on embodiment, contract or ordinary loan which are condemned by the appropriate Quality Assurance authority as 'damaged' or 'defective', but where liability does not rest with the contractor, are written off as a stores loss if it is not possible to make a claim against the original supplier.

11. Loss of, or damage to, materiel in transit will normally be the subject of claims against the carrier, and should be dealt with according to instructions given in stores accounting regulations in JSP 886.

12. Any loss recoverable from a third party, which is waived under a knock for knock agreement, should be noted as a stores loss.

Type C Losses – Fruitless Payments and Constructive Losses

13. A payment which cannot be avoided because the recipient is entitled to it, even though the Department will not receive anything of use in return, should be classified as either a fruitless payment or a constructive loss.

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Fruitless Payments

14. A fruitless payment is a payment which should have been avoided. For example:

a. unused bookings for travel or hotel accommodation that were not cancelled to prevent charges being incurred;

b. failure to cancel unwanted goods or services early enough to avoid having to pay for them;

c. Culpable damage to vehicles;

d. Fines and interest charges imposed by HMRC;

e. the cost of rectifying design faults which were caused by a lack of diligence or defective professional practices;

f. costs arising from a failure to allow for foreseeable changes in circumstances i.e. poor planning.

15. Many degrees of error can give rise to a fruitless payment. The criterion is not whether the error is considered serious enough to warrant disciplinary action, but whether the Department was at fault in incurring or not avoiding, liability to make the payment. The recipient's legal entitlement to the money prevents the expenditure from being classified as a special payment.

Constructive Losses

16. A constructive loss is closely associated with procurement. It occurs where, for example, stores or services which are correctly ordered, delivered and paid for under the terms of the contract become surplus to requirements or suffer a reduction in utility following a change in policy.

17. By its nature, some development expenditure may not lead to the intended or desired outcome for reasons not foreseeable at the outset. In such circumstances, HM Treasury (HMT) has agreed that the expenditure should not be treated as a constructive loss. Expenditure on a project which has been approved prior to Main Gate by the Departmental Investment Approvals Board (or its equivalent or successor) is not to be treated as a loss unless, there is evidence of a lack of diligence or defective professional practice; in these cases the expenditure is to be treated as a fruitless payment.

18. If a project is cancelled or significantly changed after Main Gate approval, all expenditure (including any incurred pre-Main Gate) should be treated as a constructive loss. Where assets are sold, the value of the loss is calculated, as the difference between the value of the asset and the sales receipt.

19. Equipment and/or land and building assets that have entered into service may be withdrawn from service immediately, withdrawn earlier than planned or remain in service at a reduced capability as a result of a change in the strategic or regulatory environment. The loss should be first reported in the financial year in which the decision is made and not left until the last item is withdrawn from service.

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Type D Losses – Claims Waived or Abandoned

20. Waive or abandonment of a claim occurs where a decision is taken not to present or pursue a claim which could be or has been legitimately made.

21. Examples of claims waived or abandoned include:

a. a reduction in the rate of interest on a loan;

b. bad debts written off;

c. claims which are actually made but then reduced in negotiations or for policy reasons;

d. those where there has been a failure to make a claim or to pursue it to finality - for example, owing to procedural delays which allow the Limitations Acts to be invoked;

e. those which arise from actual or believed contractual or other legal obligations which are not met (whether or not pursued) - for example, under default or liquidated damages clauses of contracts;

f. those which are reduced by compositions in insolvency cases or in out-of-court settlements, other than reductions arising from corrections of facts;

g. those which are dropped on legal advice, or because the amount of liabilities could not be determined.

22. Waivers or remission of tax are not losses. HMRC has special rules about remissions of tax and HMT should be consulted (through HOCF-FMPA-A&TM-CFAT2) for the correct treatment when a case arises

23. The policy on losses associated with International Courtesy Rules is contained in JSP 462 – Financial Management and Charging Policy Manual

24. Where more than one Government Department is involved, each Department should record the extent of its interest in its own records but without any attempt to achieve spurious accuracy. Claims waived or abandoned between Government Departments are not recorded in the ARAc, as they are domestic matters.

Special Payments

Type E1 – Special Payments to Contractors

Extra-Contractual Payments

25. An extra-contractual payment may arise from a claim made against the Department by a contractor. Although not legally due under the contract, the legal advice is to settle if the claim is likely to be upheld by the courts. A payment may be extra-contractual even where there is some doubt about whether the Department is liable - for example, where the contract provides for arbitration but, on legal advice, a settlement is reached without it. However, a payment made as a result of an arbitration award is contractual and therefore not a special payment.

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Ex-Gratia Payments

26. An ex-gratia payment goes beyond statutory cover, legal liability or administrative rules and is usually made outside a binding contract - for example, on the grounds of hardship.

27. Whether or not to make an ex-gratia payment is largely a financial or political decision. However, the commercial officer should take legal advice and consult the relevant finance officer before starting to administer the claim. Ex-gratia payments should not exceed the amount of the total loss on the contract; must be supported by strong evidence; and be defensible should PUS be called to account.

Type E2 – Ex-Gratia Payments other than to Contractors

28. Ex-gratia payments other than to contractors are payments which go beyond administrative rules or for which there is no statutory cover or legal liability. Reasons for this type of ex-gratia payment vary widely but include;

a. payments made to meet hardship caused through official failure or delay.

b. out of court settlements to avoid legal action on grounds of official inadequacy.

A claim which is statute-barred but where, after considering the claimant's representations, it is decided not to invoke the Limitation Acts (because there are records to prove that payment would have been valid if it had been brought within the required timeframe) must be dealt with as an ex- gratia payment.

29. Any ex-gratia payments to individuals for stress and inconvenience will always be novel and contentious, irrespective of whether MOD has made similar payments before, and require HMT approval.

Financial Remedy Schemes For Ex-Gratia Payments

30. Financial remedies for individual cases are normally ex-gratia payments. Where a pattern develops, and a number of cases raising similar points need to be dealt with, it may be appropriate to develop an extra-statutory scheme. If such a scheme is likely to persist, the Department should consider whether to bring forward legislation to set it on a statutory footing.

31. The Department must consult HMT before finalising schemes to pay remedies. In addition, proposed schemes drawn up in response to a Parliamentary and Health Service Ombudsman recommendation following an investigation require Cabinet Office approval.

32. Great care should be taken in designing financial compensation schemes since they may set expensive precedents.

33. Where financial remedies are identified as the right approach to service failure, they should be fair, reasonable and proportionate to the damage suffered by those complaining. Financial remedies should not allow recipients to gain a financial advantage over what would have happened if there had not been a service failure.

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34. If a compensation payment includes an element to cover the fact that the complainant has had to wait for his/her award, it should be calculated at simple interest. The interest rate applied should be appropriate to the circumstances and defensible. Rates worth considering are those used by HMRC on tax repayments and the rate used in court settlements.

Type E3 – Compensation Payments

35. Compensation payments are payments, outside statutory schemes or contracts, to provide redress for personal injuries (except for payments under the Civil Service Injury Benefits Scheme), traffic accidents, damage to property etc, suffered by civil servants or others. Compensation for stress, inconvenience etc are Type E2.

Type E4 – Extra-Statutory Payments and Extra-Regulatory Payments

36. Extra-statutory payments and extra-regulatory payments are payments made within the broad intention of the statute or regulation but which go beyond a strict interpretation of its terms.

Type E5 – Special Severance Payments

37. Special severance payments made to employees, contractors and others who leave employment in public service, whether by resigning, being dismissed or as the result of termination of contract go beyond normal statutory or contractual requirements. The payments are directly related to the reason the person left employment in public service. They are only permitted on an exceptional basis and always require HMT approval. Legal advice that a particular severance payment appears to offer good value for money for the Department may not be conclusive, as it may not be based on wider public interest.

38. To obtain HMT approval, the pro-forma ‘HM Treasury approval for special severance payments’ (Appendix 01 to JSP 472 Part 2) must be completed in full and include the approval of the DRes,. The pro-forma should be submitted to HOCF-FMPA-Ahd-Governance who will review it on behalf of PUS as Accounting Officer. If satisfied that the proforma has been correctly completed and the proposed payment is defensible and represents value for money, the HOCF-FMPA-Ahd-Governance will forward it to HMT for approval. (Please note that this proforma can only be used for a special severance payment).

39. As a TLB cannot make an offer of a special severance payment until the requisite approval from HMT is in place, sufficient time must be built into the process to allow HOCF-FMPA-Ahd-Governance and HMT **a minimum of 15 working days** to progress the issue. Under no circumstances may a special severance payment be offered, either spoken or written, until HMT approval is in place.

40. Most SSPs are accompanied by a settlement agreement and should this agreement contain a confidentiality clause then Ministerial approval will be required. TLBs should run this approval in parallel to the financial approval. Guidance on this approval process can be found on the Defence Intranet – Personnel/Civilian/Conduct and Behaviour/Concerns and Whistleblowing.

41. TLBs should note that HMT adopts a sceptical approach to proposals for special severance payments and that approval of one case does not necessarily set a precedent for another. Therefore, even if the cost of defeating an apparently frivolous or vexatious appeal will exceed the cost of the proposed settlement, a decision may still be taken to invoke formal

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proceedings. In doing so, the Department will be keen to demonstrate that it does not reward failure and that it is prudent in its use of public funds.

42. A special severance payment should not be used as a soft option, for example, to avoid management action, disciplinary processes, unwelcome publicity or damage to its reputation. If the Department were to have to seek retrospective Treasury approval for special severance payments, there should be no automatic assumption that it would be given.

43. When dealing with special severance payments, particular care should be taken to:

a. avoid unnecessary delays which may lead to a higher severance payment than is merited;

b. avoid offering the individual concerned consultancy work after severance, unless best value for money can be demonstrated;

c. make it clear that although content maybe of a sensitive nature, it must be of sufficient detail to ensure that severance transactions remain open to adequate scrutiny, if called for, by the NAO and the Public Accounts Committee (PAC);

d. ensure special severance payments to senior staff are transparent and negotiated and avoid conflicts of interest.

44. Retention payments to staff are designed to encourage staff to delay their departures and may form part of a special severance case. These are always contentious and hence always require HMT approval. HMT will always be sceptical of whether they are necessary and will require a business case for any such proposals. This business case should be supported by market evidence, together with an evaluation of the risks and costs of alternative options so that the proposal can be understood against alternative management approaches.

Management and Control of Losses and Special Payments

Write-Off Approval

45. By exception, the NAO will allow cases to be closed before the value of the loss is 100% certain, although permission will only be granted on a case by case basis after judging the case on its merits. TLBs should note, however, that the case may need to be reopened if the estimated write-off value proves to be materially incorrect.

46. An officer must never write off a loss or make a special payment if they have been involved in the circumstances which have given rise to it.

47. The net value of the loss decides the level at which it should be written off - i.e. the gross value of the loss less expected cash recoveries.

48. Every loss must be thoroughly investigated. A full and factual record of all losses which have been written off under delegated authority should be maintained. Before approving any write-off (or, in cases beyond the Department's delegation requesting HMT approval) the authorising officer must be clear:

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a. about the nature of the case; the amount involved; and the circumstances in which the loss arose; and its causes, including any relevant information from police reports;

b. about his/her personal responsibility and, if there is any suspicion of theft, fraud, arson, sabotage, malicious damage or gross carelessness, whether prosecution is proposed and, if not, why not;

c. that disciplinary action, if appropriate, has been taken;

d. that monetary recoveries, if appropriate, have been made from those responsible for the loss;

e. about whether the investigation shows any defects in existing procedures or systems of control and, if these have emerged, whether appropriate remedies have been applied or devised;

f. that all other management areas involved have been consulted and that records have been annotated to this effect, including any planned remedial action.

Recording Losses and Special Payments

49. The losses register should record losses as they occur, irrespective of whether they are closed or advance notifications. The losses register should be kept up to date so that information on the status of losses is readily available. Advance notification cases should be closed as soon as possible.

50. The supporting evidence is regarded as a financial record and while financial records are normally required to be kept for seven years, the actual timetable for destroying main ledgers and supporting records should be agreed with the NAO.

Supporting Write-Off and Special Payments Cases

51. When losses or special payments cases are submitted to TLBs, the supporting casework should include a copy of the proforma reproduced in Appendix 02 to JSP 472 Part 2. Additional guidance for its completion follows:

a. The description should be brief and written in terms that a layman can understand as this will be published in the ARAc (if separate disclosure is required);

b. If the date the loss occurred is not known the date of discovery should be used.;

c. The value of the loss should include all costs incurred to date and, if applicable, future costs or estimate if actual costs are not known;

d. whether prosecution or disciplinary action was appropriate and practicable and, if so, what action has been taken. A certificate should be included to show that any appropriate court martial or other disciplinary action has been taken. If prosecution was practicable but not undertaken, the reasons and authority for not having done so should be provided;

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e. The schedule recording key dates in progressing the case could include,. the date on which the loss was first identified, dates when cross-referred to other branches for comment.

HM Treasury Approval to Write Off Losses

52. Where losses exceed the Department's delegated authority, the Department will need to obtain HMT authority, through FMPA, to write them off. In order to approve a write-off case, HMT requires the following facts, as a minimum:

a. the nature of the case; the amount involved; and the circumstances in which it arose;

b. the reasons for the proposed write-off, including any legal advice;

c. whether fraud (suspected or proven) is involved;

d. whether the case resulted from dereliction of duty;

e. whether failure of supervision is involved;

f. whether appropriate legal and/or disciplinary action has been taken against those involved, including supervisors, and if not, why not;

g. whether those primarily involved will be required to bear any part of the loss;

h. whether the investigation has shown any defects in the existing systems of control and if so, what action will be taken.

i. Lessons learned.

HM Treasury Approval to Make Special Severance Payments

53. The Department does not have delegation to make severance payments so must always seek advance approval from HMT using the special severance pro-forma at Appendix 01 JSP 472 Part 2. The submission to HMT must explain:

a. the circumstances of the case;

b. the amount involved and how this has been calculated;

c. any scope for reference to a tribunal, with its potential consequences, including the legal assessment of the organisation's chances of winning or losing the case;

d. the management procedures followed;

e. the value for money offered by the possible settlement;

f. any non-financial considerations;

g. whether the case could have a wider impact - for example, potentially exposing the Department to further tribunal cases.

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54. It is important to note that as the Department is not legally liable to make a special payment, any proposal must clearly demonstrate that the payment is in the public interest and represents value for money.

55. Requests for special severance payments should allow 15 working days for HOCF-FMPA-Ahd-Governance and HMT to complete the approvals process because to miss or defer a prescheduled judicial hearing could generate additional legal costs.

Ministerial Approval of Confidentiality Clauses in Settlement Agreements

56. The Cabinet Office have issued guidance on the use of settlement agreements, special severance payments and confidentiality clauses on the termination of employment. The guidance sets out the requirement for Ministerial approval for the use of confidentiality clauses in settlement agreements.

57. This is not a financial approval and the process to obtain such approvals is governed by People Civ HR. The Cabinet Office Guidance and Civ HR implementation guidance for TLBs can be found on the Defence Intranet – Personnel/Civilian/Conduct and Behaviour/Concerns and Whistleblowing.

Loss Connected with Cross-Department Transactions

58. Where one government department supplies goods or services through a supplier to another Government Department, any associated loss or special payment will be borne by the customer department and reported in the customer department's annual accounts.

59. The supplying Department is responsible for the efficiency and economy of the service it provides and for preventing fraud. The customer department answers only for the policy behind the transactions and is not expected to check the supplying department's output or procedures.

60. It is normally appropriate for the supplying department to deal with the investigation and write off losses borne by the supplier. It must keep the customer department fully informed and, in cases which require HMT approval, the submission should not be made until after it has consulted the customer department.

61. If the loss is in any way attributable to the action or inaction of the customer department, the customer department will also conduct an investigation, and any necessary reference to HMT will be made jointly or by the customer department. These proceedings will be observed by the Department as either customer or supplier in interdepartmental transactions.

Valuation of Losses and Special Payments for Write-Off and Reporting Purposes

62. For reporting purposes, the value of losses and special payments should be based on the most appropriate method that will meet audit requirements after taking in to consideration the points below:

a. the value usually reflects a precise sum which will include (where applicable) VAT,

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customs dues, excise duty and European Community (EC) levies. Where the value can only be estimated, the amount is to be rounded to the nearest £100;

b. if a review of balances, for example Assets Under Construction balances or inventory records, results in both a loss and a surplus the value of the reportable loss is the loss element only and not the net result.

c. the value of constructive losses should include: the net book vale of the asset, accelerated depreciation charge, asset impairment charge, disposal costs and redundancy costs.

d. the valuation of non-current assets should be requested from ADMT.

e. waived and abandoned claims relating to unsatisfactory contract performance should always reflect the total un-recovered loss suffered by the Department. Where offsetting benefits are received in lieu of cash as part of a negotiated settlement, the write-off should not be reduced by the value of such benefits, although reference should be made to them in the accompanying note to the accounts;

f. the value of stores losses depends on the type and conditions of the items lost. This will be assessed as the value of the materiel immediately before the loss in accordance with the guidance set out in JSP 886, which also contains details of specific valuations to be applied:

i. new and serviceable items held in store and non-inventory items e.g. mobile ‘phones – current replacement cost;

ii. serviceable stores in use (not covered by the clothing, textiles and repairable equipment listed at f.iii below) – 75% of current replacement cost;

iii. clothing and textiles part-worn and all repairable equipment – 50% of current

iv. replacement cost (except Defence Accommodation Stores which are to be assessed in accordance with JSP 384 Part 1 Chapter 13);

v. stores classified as surplus or scrap before discovery of the loss – disposal value either known or estimated;

vi. items produced for sale – current selling price;

vii. where it is not possible to determine the material condition at the time of the loss, the price of a serviceable item should be used;

viii. where estimates have to be used, time and effort should not be wasted in trying to achieve unnecessary precision.

g. Losses should be reported on an accruals basis even if they may be reduced by subsequent recoveries.

Recoveries

63. When the main facts of a case are known and have been thoroughly investigated, the

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write-off should not be delayed on the grounds of any potential recoveries The amount to be written off is the value of the expected loss, less any cash recoveries which have either been agreed or for which there is a firm expectation that they will be received.

64. Action to write off the balance should be taken immediately, although this does not mean recovery attempts should cease. The loss may also be reduced by the value of benefits which have been, or will be, transferred to other projects.

65. If after the case has been closed, recovery action fails, a new case must be opened for the failed recoveries.

66. Where it is agreed that recovery can be affected through a series of instalments, a default on any particular instalment forms an additional loss for write-off, unless the default is made good within the financial year in which it occurs. This applies even if the recovery period is extended to take account of the amount defaulted.

67. If, after all possible means of recovery have been exhausted, a debt (or part of a debt) remains un-recovered or if it is deemed that the cost of pursuing recovery cannot be justified, the DBS I&R, (if they have not received a financial delegation from the TLB concerned), should seek approval to write off the debt by submitting a case to the TLB officer holding the appropriate write-off delegation.

Reporting Losses and Special Payments

68. Losses and special payments are reported in the ARAc under two sections:

a. Closed Cases. These are cases where all the case work has been finalised and the cases have been formally signed off. Individual losses of £300,000 or above are separately noted;

b. Advance Notifications. The Department must bring cases exceeding £300,000 to Parliament's attention at the earliest opportunity. These are cases where formal sign-off cannot take place until all the work necessary to establish the validity and the exact amount of the loss has been concluded. The amounts stated under advance notification are the best estimates and may change when the case is finally closed. The advance notification section also includes cases brought forward from the previous year which remain outstanding.

69. HOCF FMPA A&TM CFAT2 should be consulted immediately if a particularly serious loss has occurred, as a decision will need to be taken about whether Parliament needs to be notified ahead of the publication of the next ARAc.

70. Unless there is a compelling case to withhold the information from Parliament for example, on the grounds of security or commercial negotiation (which should be discussed with HOCF FMPA A&TM CFAT2), the Department should declare the loss or special payment by means of an advance notification.

71. When reporting losses and special payments to CFAT, TLBs must ensure they have included the losses and special payments of agencies and Arms Length Bodies within their boundary.

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72. CFAT requires information on losses and special payments to be submitted at APs 6, 9 and 12, in accordance with the ARAc instructions and templates. Case files are not required as part of the ARAc submission.

73. Reporting of Special Severance Payments to the Cabinet Office is undertaken centrally by HOCF-FMPA-Ahd-Governance.

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APPENDIX 1 TO CHAPTER 12

For a non-PDF version please contact HOCF-FMPA-AHD-Governance: Telephone 020 7218 6949

PROTECT – STAFF (when completed)

Request to HM Treasury to make a Special Severance Payment

A Special Severance payment is a proposed settlement to an individual who has brought a claim against the MOD **in connection with the reason for their departure**.

A request to make a Special Severance payment must be submitted on this pro-forma to **HM Treasury** (HMT) **via HOCF-FMPA-Ahd-Governance for approval** as the MOD does not have any delegation in this area.

The pro-forma **must be accompanied by a copy of legal opinion relevant to the case. The application of legal privilege to this advice should be made clear in any correspondence.**

The pro-forma will only be considered for approval **if all fields have been completed, except those with an *asterisk which are optional.**

Please use plain English explain clearly any legal/technical terms or acronyms that have been used. This template will be sent to HM Treasury and therefore it is to your advantage to make the case readable and clear to an extenral audience.

A minimum of **15 working days in total** is required by HOCF-FMPA-Ahd-Governance and HMT to address any issues arising and to complete the approvals process.

MOD TLB plus a contact name:		
Claimant's name and TLB case reference if available:		
Date case is submitted:		
Date decision is needed and why:		

Claimant's details.		
Age:	Length of service:	Current salary:
Contractual notice period:	Civilian grade/military rank:	Full/fixed/part-time etc:
*Trade union member:	*Other relevant details:	

Events leading to the claim. Please provide a **brief** account, including dates, of the sequence of events that resulted in the officer serving a claim on the MOD. The account must be factual and without bias.
Events leading to the claim.

MOD policy, rules and guidance. During the events leading up to the claim, please explain which of the MOD policy, rules and guidance procedures were correctly applied, incorrectly applied or were overlooked.
MOD policy rules and guidance.

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Proceedings.

This section should explain the current status of proceedings agaInst the MOD.

The legal prognosis should be summarised and include:

- Advice on the prospects of MOD success, noting that it is unlikely An SSP request will be sent to HMT if the MOD prospects of success are greater than 50%
- Detail of the legal advice that supports the estimate of success
- What other options have been or could be explored to settle the dispute.

Proceedings.

Public Scrutiny of Agreements and Approval for the use of a Confidentiality Clause in any Settlement Agreement

This section of the form seeks to ensure that the form of the agreement will not prevent current or future protected disclosures (commonly known as whistle blowing), as this is unlawful and that the necessary Ministerial approvals are underway to allow a confidentiality clause to be included in any settlement agreement.

Please confirm that the final agreement will not preclude public scrutiny: (YES/NO)

Please confirm that a Confidentiality Clause will be included in any Settlement Agreement: (YES/NO)
If YES

Please confirm that Ministerial Approval is being sought for the use of the Confidentiality Clause through People CivHR: (YES/NO)

Value for money (vfm) consideration with reference to the legal advice.

Value for money is not a conclusive reason for approval of an SSP request. However, it is part of the consideration undertaken by HMT.

The VFM case should be built up in the sections below:

The potential cost of losing the case:

Commonly the claimant will have provided a schedule of loss. This is NOT the potential cost of losing the case but rather the starting point for your legal advice to assess the likely outcome of the case were it to proceed to ET and the claimant wins.

The other major cost will be legal fees. Fees already spent should be noted but the estimate of future fees, were the case to proceed to an ET, is the relevant cost for this section given that they could be avoided by agreeing a settlement.

Staff time and disruption of attending any ET are not relevant and should not be included in the cost.

The Special Severance Payment approval amount requested:

HMT will not agree to a range and must be presented with a not to exceed figure to agree

The approval amount should reflect each side’s risk of losing at the ET i.e. if there is some prospect of MOD success then it is not acceptable to request approval for the estimated ET outcome above.

The Approval amount requested should not in any way result in the claimant “sharing” in legal fees that the Department has avoided by agreeing a settlement. HMT will not approve the request in these circumstances.

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Explain why the proposed Special Severance payment offers the best value for money (VFM) in the round.
In this section wider VFM arguments can be deployed e.g. effect on staff morale, achievement of business objectives.
Details of the Director of Resources (DRes). Please state the name and title of the DRes and confirm that they are satisfied that a Special Severance payment is defensible, appropriate and affordable.
This section should make a positive assertion that theTLB DRes is aware of the details of the case and approves the approach to Treasury. This is important because a proportion of SSPs will be approved personally by PUS and PUS will wish to be assured that the TLB D Res has considered the case.
Wider impact and potential precedents. Explain whether this case might have an impact on or set a precedent for other existing or future cases, both within your own organisation and for other public sector bodies.
This section is particularly important given that cases which may have wider applicability will be approved by PUS personally
Other relevant information.
Lessons learned from this case. Explain lessons learned and how management systems and processes have been/will be improved to avoid the future occurrence of similar cases.
The lessons learnt and the subsequent improvements.
HOCF-FMPA-Ahd-Governance Use Only Please confirm that PUS as the MOD Accounting Officer is aware of and satisfied with the proposed settlement.
FOR HMT USE:
Approval given by: **Date:**
Advice taken from (TOA/ WPP):
Rationale for approval and any conditions:

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APPENDIX 2 TO CHAPTER 12

Write-off/special payment case checklist

A copy of this pro-forma should be completed and included in the papers supporting the write-off case/special payment.

Information Required:	**Included? Yes/No**
The TLB and UIN	
Description of the loss/special payment	
Category of loss or special payment; o using the full definition; o or the cause of the loss (if not evident from the category description)	
Date/period of the loss discovery or special payment made/to be made	
Gross value of loss/special payment	
Amount of recovery made or expected.	
Explanation if full recovery has not been/will not be made	
Net value of the loss	
Value of benefits that have or will be transferred to other projects.	
Have any monies been charged to a control account?	
Name of control account (if applicable)	
The value	
The date cleared	
The RAC used	
The RAC to which the loss or special payment has been charged.	
Has any prosecution or disciplinary action taken place?	
Lessons learnt?	
New procedures or preventative action taken to avoid recurrence	
Has Director Resources (DRes) been notified?	
Evidence required:	
Copy of approving officer's letter of delegation enclosed in file	
Has this loss already been reported to CFAT?	
Has the TLB Chief Accountant been notified?	
Has a draft note suitable for inclusion in the Annual Report and Accounts been provided?	
Has written documentary evidence been provided to prove the calculated value of the loss, including agreement by DRes?	
Special Payment: Has evidence that proves payment has been made been included?	
Has a schedule recording the progress of key dates been included in the case?	
Has a Press Brief been provided?	

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13 Liabilities – HM Treasury and Parliamentary Reporting Requirements

1. There is no guidance on accounting for liabilities – HM Treasury and Parliamentary Reporting Requirements. Refer to Part 1 – Directive.

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14 Resource Account Code Usage Notes

Introduction

1. Resource Account Codes (RACs) are the principal 'input based' account codes for the Departmental Financial Management System (DFMS). RACs distinguish income from expenditure and assets from liabilities in accordance with International Financial Reporting Standards (IFRS). Any questions on this chapter should be directed to FMPA CFAT who are responsible for its content.

2. RACs are used extensively in both internal and external financial reporting and Management Information. Their uses include but are not limited to:

   a. Production of the Annual Resource and Accounts (ARAc);

   b. External Reporting (Resource Estimates, Whole of Government Accounts, etc);

   c. In-Year Management;

   d. Planning & Budgeting.

3. The RAC is hierarchically structured into four levels known as:

   a. Resources (Level 1)

   b. Resource Categories (Level 2)

   c. Transactions (Level 3)

   d. The RAC (Level 4).

4. Each RAC is a 6 character Alpha Numeric code structured as follows:

A	AA	AAA	AAAxxx
Level 1	Level 2	Level 3	Level 4

5. The last three characters are usually numeric but for Inter-Top Level Budget (ITLB) codes, an Alpha Numeric TLB identifier is used.

Relationship of RAC to Organisations

6. In most cases, there is no relationship between the RAC and the organisation structure. The exceptions are ITLB codes which are of two types:

   a. Non-Cash Inter-TLB RACs- GMGxxx (where xxx is the TLB Code)

   b. Cash Inter-TLB RACs - GMAxxx (where xxx is the TLB Code)

7. Each TLB has these two ITLB Accounts. The codes are created automatically by the Chart of Accounts Team (and the automated rules within the Standing Data System)

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whenever a new TLB is created. This means there is no need to apply for them through the Resource Account Code Establishment exercise.

The Chart of Accounts

8. The Chart of Accounts is maintained for the Department by Defence Business Services in an application known as the Standing Data System. A number of extracts from this system are published monthly as a series of files (which can be found here. Select the period and then the file containing the information you require.)

The Six Segments

9. Resource Account Codes are one of the six segments of the Department's Chart of Accounts. The full set of segments are:

a. **Top Level Budget (TLB)**. An entity within the Departmental boundary which has its own Statement of Financial Position;

b. **Unit Identification Number (UIN)**. A 6 character alpha numeric code (in the form AnnnnA) which is the lowest level of the centrally maintained organisation structure.

c. **Resource Account Code (RAC)**. The principal input based account code for the Financial Management systems & processes. Annex A provides current Departmental Policy for the transactions to be booked to each code.

d. **Local Project Code.** The principal uses of segment 9 are for Equipment Procurement and Support Project Codes ('P9s' and 'S9s') and Single Point Management Codes (SPMCs) both of which are described in more detail in Chapter 5.

e. **Spare Segment 1.** This segment is not currently in use

f. **Spare Segment 2.** This segment is not currently in use

Value Added Tax

10. In addition to the above, there are a number of VAT Codes which identify whether a transaction attracts COSVAT, Formula VAT and so on.

The Standing Data System (SDS)

11. Standing Data refers to the Organisational, Accounting and management information codes applied to financial transactions, effectively the data listed above.

12. The Departmental Financial Management System (DFMS) comprises multiple applications including:

a. Oracle Financials

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b. PB and F

c. P2P

d. Feeders and Interfaces

13. For these systems to work together, they must use the same set of Standing Data. To ensure this, the Department's Chart of Accounts is held in a centrally managed system – the Standing Data System (SDS).

14. The SDS is the authoritative source of standing data used by all of the MODs financial systems. It comprises:

a. Centrally managed Chart of Accounts segments;

b. Logical names of Management Groupings for the routing of information between DFMS systems and applications and for promulgation of standing data;

c. Other standing data, which is common to MOD financial systems and applications e.g. VAT Codes, but does not form part of the Chart of Accounts.

15. Defence Business Services manage the SDS and will:

a. Provide a change control process to ensure the SDS is kept up to date.

b. Provide information (in the form of standing data and/or reports) at regular intervals to DFMS systems and individuals who require it and prescribe the interval (usually accounting period) when it is to be used.

c. Provide information (in the form of standing data and /or reports) at regular intervals or on an ad hoc basis to non-DFMS systems and individuals who need it for information or compliance purposes.

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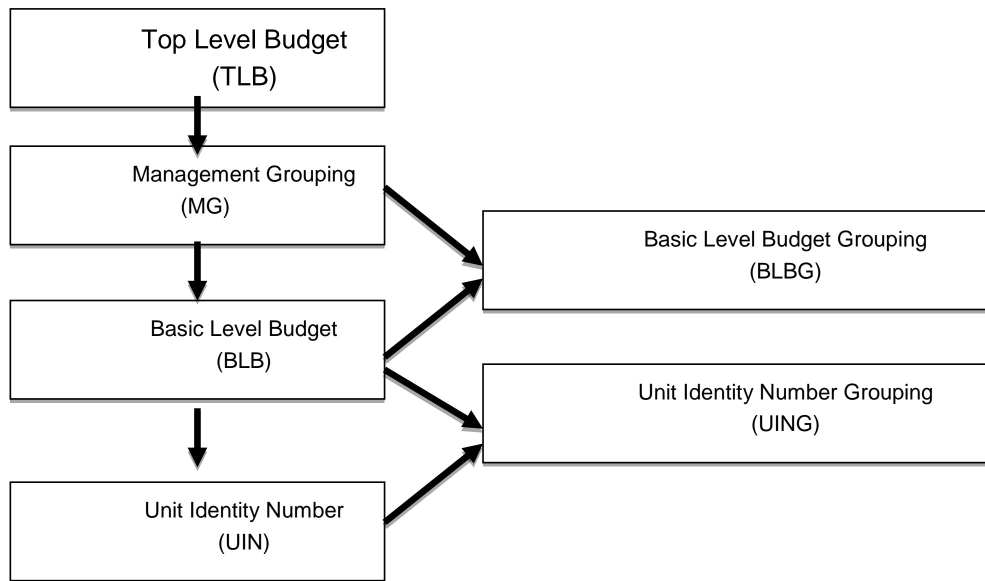
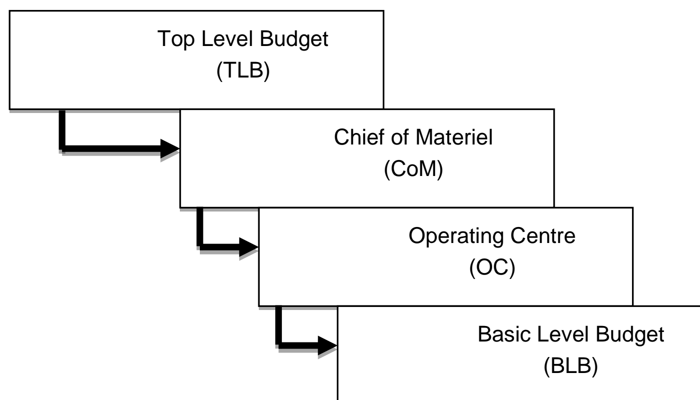
Organisational Structure

16. The generic organisational structure for the Department is:



17. Navy Command TLB have an organisation structure which includes a TLB, an MG and a BLB but day to day management of expenses is achieved through a hierarchy of 2* organisations, Lead Resource Control Centres and Resource Control Centres.

18. Defence Equipment and Support have a different reporting structure which comprises:



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19. The applications within the DFMS use the following:

Planning

a. For all organisations within the MoD the PB&F planning models use the TLB, MG, BLB Grouping and BLB layers of the organisation and can consolidate at Corporate HQ level.

b. The different constructs in DE&S and Navy Command are catered for by using Alternative Hierarchies which allow data to be reported against different structures than the main organisational hierarchy.

In Year Management

c. The Oracle AO system uses the TLB and UIN layers. MG, BLB, BLB groupings are embedded sub totals within the list of UINs and are held on SDS.

d. The DE&S construct is not available on Oracle Financials.

e. Navy Command maintain their structure offline for use in Oracle.

f. PB&F Forecasting models use all layers from TLB to UIN Grouping while AO Reporting also includes UINs. DE&S and Navy constructs are available for reporting using the Alternative Hierarchies model.

Organisation Change

20. Re-organisation, particularly at MG level and above, has a significant impact on the DFMS. The Change Control process is managed annually by the DBS Chart of Accounts team.

21. The objective of the annual re-organisation exercise is to identify every TLB's structure for the coming financial year and to reconfigure the SDS so that it can update all the DFMS applications in time for the new financial year. Each year TLB Chief Accountants appoint a representative to act as a TLB focal point with the Chart of Accounts team.

22. If you are one of those appointed by your TLB Chief Accountant then ideally, you will agree the new structures the start of the Annual Budget Cycle, one year in advance of the In-Year processes. This will allow your finance staff to prepare their plans in the same structure they will be implemented in year.

23. You will be asked to agree different levels of the organisation at different times. These dates are derived from the lead time required to prepare the DFMS, taking into account your need to obtain formal approval for organisation change.

24. You will be asked to confirm the different levels of their structures to the following deadlines:

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Organisation element	Deadline
TLB structure fixed for IYM	Mid November 2014
MG structure fixed for IYM (2* for Fleet)	Mid November 2014
BLBG structure fixed for IYM (Lead RCC for Fleet)	Mid January 2015
BLB structure fixed for IYM (RCC for Fleet)	Mid January 2015
UING structure fixed for IYM	Mid January 2015
UIN structure fixed for IYM	Mid March 2015
Local Project Codes (LPC), including P9s, S9s and Control Accounts fixed for AP 1	Mid March 2015

25. UIN and LPC codes can be changed each month during the financial year, in accordance with the SDS timetable for revisions for each Accounting Period.

26. Before deleting a UIN, you must consider whether any type 3 LPCs (see next section) are linked to it. If they are, you should ask the relevant authority (the Chart of Accounts team for PECs, or the Control Accounts team for control accounts) to move the LPC to a different UIN or, if appropriate, to delete the LPC as well.

Organisation Structure 2015/16

27. The latest version of the structure, together with lists of UINs belonging to each BLB, can be found here. Click on the period in which you are interested and then the 'Capital Organisational Hierarchy' link.

Resource Account Code Establishment (RACE) Exercise

Background

28. Resource Account Codes are reviewed annually. Changes to RACs are based stakeholders' requests. Change is managed by the RACE exercise.

Objective

29. The RACE exercise is designed to support both corporate and local business needs. Proposals for change are scrutinised to ensure they add value by:

a. Providing internal stakeholders with clearer or more detailed information or

b. Satisfying a statutory or HM Treasury reporting requirement.

Representation

30. All TLBs and the Corporate Centre participate in the exercise. Hd FMPA decides which requests should be recommended to the Finance Management Executive for approval.

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Authorisation

31. If you want to add, delete or amend a Resource Account Code you will need your TLB Chief Accountant to endorse the change. This gives the RACE team assurance that all the consequences of your proposal have been considered.

Timing

32. The RACE exercise starts in April and concludes in September. There is a period of development and testing before formal release in time for use from 1st April the following year.

Other Financial Codes

Local Project Codes (LPC) and Single Point Management Codes (SPMC)

33. Local Project Codes are 10 character, centrally managed codes. They provide visibility of programme/project costs within the Departmental Financial Management System and ensure relevant transactions are reported to the appropriate project manager, programme manager or control account holder.

34. There are two types of LPC:

a. **Type 2: Management / Project Information LPCs.** These are used to monitor resource consumption by project. They are centrally maintained on the DFMS SDS. There are 3 types:

i. P9 and S9 codes used by DE&S, JFC and HOCS.

ii. Z *alpha* codes used by TLBs

iii. Z *numeric* codes used by Defence Infrastructure Organisation

b. **Type 3: Single Point Management Codes (SPMCs).** These are used for programme expenditure codes and control accounts that are also supported by the Cash Feeder System Interfaces and centrally maintained on the SDS. SPMCs are linked to an 'owning' UIN. This means all expenditure which contains an SPMC in the LPC field will be booked to the default UIN for that SPMC as held on the SDS. Any other UIN on the transaction input will be copied to the Destination UIN field in Oracle where it is held purely for information. Use of the correct SPMC is essential to the task of reconciling control accounts.

35. SPMCs (and their 'owning' UINs) are of two types:

a. Programme Expenditure Codes (PECs).

b. Payables, Receivables and Cash/Bank Control Accounts (for further information see Part 1 of this JSP and JSP 891).

36. In summary the use of LPCs is as follows:

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a. DE&S Procurement and Support costs – use Type 2.

b. Other TLB project costs – use Type 2.

c. Booking to a Payable/Receivable or Cash Control Account – use type 3.

d. Recording costs against a centrally maintained Programme Expenditure Code – use type 3.

37. All type 2 and type 3 LPCs are centrally maintained on the SDS. The SDS files are on the MOD Intranet here and are updated monthly.

38. If a financial feeder systems encounters a transaction containing an LPC it doesn't recognise, the system will overwrite the LPC field with blank spaces so that it can continue to process.

Attribution of LPCs

39. LPC codes are applied at source. This means you write or type them onto the document that generates the transaction e.g. BX164 or DAB1. In the case of contract transactions, you need to ensure LPC codes are recorded on the contract's DEFFORM 57. This form is completed by Commercial Staff based on information passed to them by the financial authority.

Summary of LPC Prefixes

LPC Type	Prefix	Remainder	Rules	Change Control
Type 2	Za	'a' is to equal the first character of the TLB code. The remaining 8 characters are at TLB discretion.	Generically these can be created/disabled & renamed during the year but TLBs are at liberty to issue local instructions if required. Not linked to a UIN.	All requests for new codes to be sent to TLB LPC Focal Point who will raise an SDS Form 050 and forward it to DBS FDMT SDS Team (address on form).
Type 2 – DE&S P9 and S9 Project Codes	P9 or S9	8 numerical characters form the remainder of the P9/S9 code. Used by DE&S, JFC and HOCS. e.g. P900005100 – T45 SHIP	Can be created, disabled & renamed during financial year. Not linked to a UIN. Although JFC and HOCS also own LPCs, this process is controlled by DE&S and all requests for change should go through them.	All requests for new codes to be sent to DE&S LPC Focal Point who will raise a SDS Form 050a and forward it to DBS FDMT SDS Team (address on form).

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LPC Type	Prefix	Remainder	Rules	Change Control
Type 2 – DE Zn Project code	Zn	Where 'n' is a number. Reserved for Defence Infrastructure Organisation.	Can be created, disable & renamed during financial year. Not linked to a UIN. Controlled by DIO.	All requests for new codes to be sent to DIO LPC Focal Point who will raise a SDS Form 050 and forward it to DBS FDMT SDS Team (address on form).
Type 3 – SPMC – Centrally Maintained Budget/ Prog Exp Code(PEC)	ZZP	The 7-character suffix will comprise the Category A, B or C IAC that was used in the legacy financial systems. e.g. ZZP1G21121 – Purchase of Food (Controlled Centrally)	Can be inserted during financial year. Can't be disabled/renamed during financial year. Linked to a UIN. Relationship to UIN can be changed during financial year.	PEC Request Form raised by TLB LPC Focal Point. Forward to DBS CoA Team (address on form).
Type 3 – SPMC – Control Account Codes	ZZZa	The 'a' will identify the category of control account where: 'G' is Debtor/Creditor Control Account; 'S' is Cash & Bank Control Account; 'F' is Flight Sub-Imprest Account (FSI); and 'A' is Exercise or Operational Imprest Control Account (EOI). The remaining 6 characters will comprise the actual control account code. e.g. ZZZG81A951 – RET FUNDS	Can be created during financial year (MoD F1190). All but FSIs & EOIs can be disabled during financial year (MoD F1192). Can be renamed/amended during financial year (MoD F1193). Linked to a UIN. Relationship to UIN can be changed during financial year.	Forms should be raised by the account holder and passed through MG and then TLB Control Acct. Focal Point. Control Accounts Are governed by JSP 891.

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Control and maintenance of LPCs

40. Type 2 Codes are managed by your TLB focal point. Codes can be created, amended or deleted at any time during the financial year subject to any restrictions imposed by your TLB. Your focal point is responsible for notifying the DBS SDS Team of changes, by completing SDS Form 050.

41. The Chart of Accounts team is responsible for maintaining the Type 3 PECs. Your TLB focal point is responsible for notifying the Chart of Accounts team of any changes. The Chart of Accounts team will validate the request and submit SDS Forms to the DBS FDMT SDS Team. PECs can be created or amended (so long as they remain within the same TLB-MG) at any time throughout the financial year but can only be deleted in AP0.

42. DFM-FMPA-A&TM-TA-Banking1 are responsible for the policy and management of Payable, Receivable and Cash/ Bank Control Accounts (see JSP 891). They are responsible for allocating and maintaining codes for these control accounts.

Value Added Tax Code

43. VAT is not a segment in the Chart of Accounts but VAT Codes must be applied to all financial transactions.

44. Although The Ministry of Defence is a government department, we must charge VAT at an appropriate rate on any supplies we provide to customers. We also pay VAT on any goods and services we purchase. Like most public bodies we can recover VAT paid on Contracted Out Services and a small amount of VAT (determined by a formula) to reflect our pure business transactions. It is important, therefore, to correctly code transactions so that we can both fulfil our statutory requirements and recover all the VAT to which we are entitled.

Usage Notes

45. Annex A to this chapter contains the RAC usage notes.