MINISTRY OF DEFENCE

Ministry of Defence

JSP 472

Financial Accounting and Reporting Manual

PREFACE

P.1. This manual sets out the accounting policy and treatments to be applied by the Department in preparing its accounts. In addition, it sets out the Treasury and Parliamentary approval and reporting requirements for Losses, Special Payments and Liabilities. However, Finance Officers must ensure that they hold the appropriate level of financial delegation. JSP 462, Chapter 3 sets out delegation policy.

P.2. Any queries on this manual should be directed to the MOD Accounting Policy Team. All Intranet links within this document are subject to **MOD personnel access only**.

Amendment Log

P.3. The main amendments to the 2010/11 Financial Accounting and Reporting Manual reflected in this 2011/12 version are listed below. Any amendments arising during 2011/12 and applicable to 2011/12 are listed with the date of amendment.

Log	Date of amendment	Chapter	Summary of Change	Applicable Date
1	1 April 11	Whole Manual	Increase in the Departmental non-current asset capitalisation threshold from £10,000 to £25,000.	2010/11
2	1 April 11	1	New reporting requirements for the Statement of Parliamentary Supply.	2011/12
3	1 April 11	1	Revised definition of the Departmental boundary.	2011/12
4	1 April 11	2	Inclusion of a new chapter covering accounting for income.	2011/12
5	1 April 11	3	Inclusion of a new chapter covering accounting for expenditure (also incorporating accounting for foreign exchange transactions).	2011/12
6	1 April 11	5	Confirmation that the Department is currently not applying IFRIC 4.	2011/12
7	1 April 11	5	A change in the accounting policy for property leases whereby the land element of land and buildings leases must now be assessed against the situations and indicators of a finance lease.	2010/11
8	1 April 11	5	Changes in the accounting policy for donated and grant funded assets.	2011/12
9	1 April 11	5	Amendments to the definition of Single Use Military Equipment and Transport Equipment.	2011/12
10	1 April 11	5	Reinforcement of the need to	2011/12

Log	Date of amendment	Chapter	Summary of Change	Applicable Date
			document assumptions in estimating impairments and useful economic lives and to review these assumptions each year.	
11	1 April 11	7	Clarification that as the Department is not currently applying IFRIC 4, Contracting For Availability contracts should continue to be accounted for under UK GAAP.	2011/12
12	1 April 11	7	Reinforcement of the need to document assumptions in estimating RMC provisions and to review these assumptions each year.	2011/12
13	1 April 11	8	Reinforcement of the need to document assumptions in calculating provisions and to review the assumptions each year.	2011/12
14	1 April 11	12	Clarification that additional costs of withdrawing equipment/property assets from service earlier than planned should be treated as a constructive loss.	2011/12
15	1 April 11	12	Clarification that any ex-gratia payments to individuals for stress and inconvenience are novel and contentious and require HM Treasury approval regardless of value.	2011/12
16	1 April 11	12	Inclusion of a new section which reinforces the requirement for HM Treasury approval to be in place before any special severance payments, including retention payments, are made.	2011/12
17	1 April 11	12	Clarification of the process to state that in order to meet HMT requirements, all proposed submissions to HMT for approval to write off losses and special payments must first be sent to the MOD Accounting Policy Team for review before being sent to HMT.	2011/12
18	1 April 11	12	Amendment to the process to state that if any loss relates to an Urgent Operational Requirement (UOR), the loss submission must be sent to SecEC-Ops for review.	2011/12
19	1 April 11	13	Additional clarification on the process for Parliamentary reportable liabilities.	2011/12
20	19 August 11	Annex 8	First time inclusion of NCA non-	2011/12

Log	Date of amendment	Chapter	Summary of Change	Applicable Date
			financial data standards.	
21	1 October 11	1	New section on segmental reporting.	2011/12
22	1 October 11	5	Policy for abandoned assets.	2011/12
23	1 October 11	5	New section covering the policy on accounting for retention payments.	2011/12
24	1 October 11	7	Clarification of the definition of consumable items.	2011/12
25	1 October 11	9	The discount rates to be used for the Gibraltar and Cyprus pension schemes.	2011/12
26	1 October 11	13	A change to the Treasury delegation and additional information on DEFCONs 76, 611, 612 and 614	2011/12
27	1 October 11	13	New section on determining when contractor's limits of liabilities are notifiable.	2011/12
28	1 October 11	13	New paragraph stating that liabilities associated with the acceptance of charitable donations are notifiable.	2011/12
29	1 October 11	13	Amendments to the Annual Accounts disclosures.	2011/12
29	1 October 11	13	Amendments to the Annual Accounts disclosures.	2011/12
30	15 November 11	13	Paragraph 13.40 temporarily withdrawn as under review	2011/12
31	16 November 11	13	Paragraphs 13.7, 13.19 and 13.43 have been amended to include further clarification.	2011/12
32	16 November 11	13	Further guidance to be provided ahead of the issue of the AP9 Annual Accounts Instructions	2011/12
33	31 January 12	10	Inclusion of text to cover the policy in the unlikely event that IFRIC 19, 'Extinguishing Financial Liabilities with Equity Instruments' would apply.	2011/12
34	31 January 12	1	Updated to state the inclusion of Sustainability Reports in the Annual Report and Accounts.	2011/12
35	31 January 12	1	Amended to state that the Governance Statement has replaced the Statement of Internal Control.	2011/12
36	31 January 12	1	Inclusion of the requirement to disclose the ratio of the median remuneration of the MOD's staff and the mid-point of the banded remuneration of the highest paid director.	2011/12

Log	Date of amendment	Chapter	Summary of Change	Applicable Date
37	31 January 12	7	Updated for Land environment policy for RMC issues at the year end.	2011/12

Introduction

P.4. JSP 472 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 which are 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).

P.5. The use of key points and policy detail is designed to meet awareness and practitioner needs respectively.

General Responsibilities

P.6. This section describes general responsibilities within the Department.

The Secretary of State for Defence

P.7. The Secretary of State for Defence is accountable to Parliament for the policies, actions and conduct of the Department.

The Permanent Under Secretary of State and other Accounting Officers

P.8. The Permanent Under Secretary of State (PUS) is responsible to the Secretary of State for the management of the Department. As the Principal Accounting Officer (PAO) and permanent head of the Department, PUS has responsibility for the overall organisation of the Department, including the management of public funds and the allocation of resources.

P.9. PUS is supported by the Accounting Officers of the Departmental Trading Fund Agencies.

P.10. The Chief Executives of on-vote Agencies have responsibilities which are analogous to those of Accounting Officers. The Head of the Finance Function within an on-vote Agency is responsible to the Agency Chief Executive and is also responsible for ensuring that the accounting policies applied by the Agency are consistent with those of the Department.

Director General Finance

P.11. Director General Finance (DG Fin) is accountable to PUS and is responsible for ensuring effective financial management throughout the Department.

MOD Accounting Policy Team

P.12. The MOD Accounting Policy Team is responsible for:

a. providing advice on financial accounting policy; on losses and special payments policy; and on HM Treasury approval and Parliamentary reporting requirements for certain classes of actual and contingent liabilities;

b. reflecting policy changes in this manual and for ensuring that it is kept up to date;

c. agreeing Departmental accounting policy with HM Treasury and the National Audit Office (NAO) in conjunction with Hd FMPA and for disseminating it within the Department.

TLBs

P.13. TLBs are responsible for ensuring that accounting policy is applied consistently.

Points of Contact

P.14. 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.

Figure 1

	E-mail address	**Telephone Number**
Rosemary Reay	DFM-FMPA-A&TM-Ahd-ACCTAXPOL (Reay, Rosemary Mrs)	9355 82759
Phil Inward	DFM-FMPA-A&TM-ACCPOL1 (Inward, Philip Mr)	9355 85341
Linda Hughes	DFM-FMPA-A&TM-ACCPOL2 (Hughes, Linda Mrs)	9355 85341

Purpose and Scope of this Manual

Purpose

P.15. JSP 472 details the policy which is to be applied by the Department and its reporting entities within the following areas:

a. financial accounting;

b. losses and special payments;

c. HMT approval and Parliamentary reporting requirements for certain classes of actual and contingent liabilities.

Scope

P.16. This manual applies to all TLBs and Agencies which fall within the Departmental resource accounting boundary.

P.17. 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 manual.

P.18. Other Departmental Financial Management System (DFMS) compliant packages must follow the policies and principles reflected in this manual.

P.19 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 manual.

Terminology

P.20. The term ‘Accounting Period’ (AP) is used to refer to the calendar month for which resource accounting information is prepared.

P.21. Statutory Resource Accounts are prepared for the year ending 31 March. Throughout this manual, the terms ‘accounting period’ or ‘annual accounting period’ have been used to describe the accounting period ending on 31 March. The Resource Accounts are often prepared for audit at AP 6 and AP 9. This is termed a ‘hard close’.

Use of the Manual

P.22. The manual is designed to be applied by all personnel engaged in the preparation of resource accounting information.

P.23. Its main uses are in the preparation of:

a. the Planning Round;

b. in-year financial accounting and reporting information;

c. the Consolidated Departmental Resource Accounts;

d. the Central Government Accounts;

e. the Whole of Government Accounts.

Amendments and Updates to the Manual

P.24. The content of the manual 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.

P.25. Where appropriate, amendments will be made to the current version during the year. Changes will be recorded on an in-year amendments log.

Further Information

List of Senior Finance Officers

P.26. A list of Senior Finance Officers can be found in Chapter 12, Losses and Special Payments, paragraph 12.141.

Additional Sources of Information

P.27. The additional sources of information are listed below:

a. the MOD VAT Handbook;

b. the Chart of Accounts (COA) and Usage Notes;

c. the Annual Accounts Instructions;

d. the In-Year Management Instructions;

e. JSP 462;

f. JSP 886;

g. JSP 891;

h. the Government Financial Reporting Manual (FReM);

i. Managing Public Money.

Contents

CHAPTER 5 – TANGIBLE NON-CURRENT ASSETS

CHAPTER 6 – CASH AND CASH EQUIVALENTS

Glossary of Abbreviations

A-in-A	Appropriations-in-Aid
AAC	Asset Accounting Centre
AO	Accounting Officer
AUC	Assets Under Construction
BLB	Basic Level Budget or Budget Holder
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)
DEFCON	Defence Contract
DE&S	Defence Equipment and Support
DFMS	Departmental Financial Management System
DG Fin	Director General Finance
DRC	Depreciated Replacement Cost
DIO	Defence Infrastructure Organisation
DSA	Disposal Services Authority
EC	European Community
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)
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
MG	Management Grouping
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
NCAM	Non-Current Asset Manager
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
OMV	Open Market Value
OMVEU	Open Market Value for Existing Use
OPG	Office of HM Paymaster General
PAO	Principal Accounting Officer/Principal Administrative Officer (determined by context)
PB&F	Planning, Budgeting and Forecasting
PDC	Public Dividend Capital
PES	Public Expenditure Survey
PFI	Private Finance Initiative
PLRs	Permanent Loan Records
PPPA	People, Pay and Pensions Agency
PR	Planning Round
PPE	Property, Plant and Equipment
PUS	Permanent Under Secretary
RAC	Resource Account code

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
SFO	Senior Finance Officer
SIC	Standing Interpretations Committee
SLA	Service Level Agreement
SOCNE	Statement Of Comprehensive Net Expenditure
SOFP	Statement Of Financial Position
SPVA	Service Personnel Veterans Agency
SPWR	Special Purpose War Reserves
TLB	Top Level Budget or Budget Holder
UBE	Upkeep By Exchange
UIN	Unit Identity Number
VAT	Value Added Tax
WGA	Whole of Government Accounts
WMR	War Maintenance Reserves
WPS	Widow(er)s' Pension Scheme

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 resource accounting information is prepared. Statutory Resource Accounts are prepared for the year ending 31 March.
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	A resource for which benefit has been received but payment has yet to be made.
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.
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.
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 or 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 or 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, 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.
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.
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	An asset that is characterised by its ability to provide economic or strategic benefits in the form of capital appreciation, or other benefits to the investing entity such as those obtained through trading relationships.
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.
HM Paymaster General	Usually a Minister without Departmental duties. The functions of the Paymaster General's Office are therefore carried out by his Deputy, the Assistant Paymaster General, who is a permanent civil servant. He is in effect the banker for most of the spending Departments and keeps an account showing the amount granted by Parliament for each Vote, the issues received from the Consolidated Fund on account of that grant and the payments made from the Vote on the authority of the Department concerned. The accounts are held by HM Paymaster General at the Bank of England.
Historical cost	The original acquisition cost of an asset.
International Financial Reporting Standard (IFRS)	One of a suite of international accounting standards applied to the Departmental Resource 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	See 'Appropriations in Aid'.
Indexation	A method of arriving at an approximation of current values by application of an index number.
Indirect cost	See 'overhead'.
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.
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 Managers	DE&S NCAM is responsible for equipment NCAs. DE is responsible for property NCAs.
Non-current Asset Register (NCAR)	A record of individual property, plant, equipment and intangible NCAs.
Non-current cost	A cost which is incurred for an accounting period, and which, within certain output limits, tends to be unaffected by fluctuations in the levels of activity.
Notional cost	A hypothetical cost used in the accounts to represent expenditure for which no cash has transferred.
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.
Offset agreements	Agreements, usually international, which offset the costs of one commodity or service against receipts due from another commodity or service.
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.
Payable	A person or an entity to whom money is owed as a consequence of the receipt of goods or services in advance of payment.
Payable Order	The principal method of payment by Government Departments. It is basically a cheque, which tells the payee that HM Paymaster General will pay the sum shown on presentation of the Order through a bank within a stated period. Payable Orders can only be presented at HM Paymaster General's Office by a bank.
Post Statement of Financial Position Event	An event which occurs between the Statement of Financial Position date and the date on which the Resource 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 economic life (typically scrap value).

Resource Accounting	Resource Accounting comprises a set of accruals accounting techniques for reporting on central government expenditure and a framework for analysing expenditure by organisational aims and objectives - where possible, relating these to outputs.
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 re-assessment.
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 (SOCNE)	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.
Sub-Accountant	An officer entrusted by an Accounting Officer with the duty of receiving monies on his behalf and making payment out of imprest or other monies advanced for this purpose, and whose record of transactions is separately recorded in the central books of the Department.
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 Resource Accounts.

CHAPTER 1: BASIS OF THE ANNUAL ACCOUNTS

Introduction

1.1. This chapter sets out the accounting policies and principles to be applied when preparing the Departmental Annual Accounts. It also explains the main elements of the Annual Accounts; the Departmental boundary; the consolidation process; and the policy on Inter-Management Grouping (IMG) transfers.

Key Points

1.2. The Annual Accounts should give a true and fair view of the financial affairs of the Department and of the entities within its accounting boundary by applying accounting policies which provide relevant, reliable and comparable information.

1.3. The comparative figures and opening reserves of the Annual Accounts should be adjusted for material changes applicable to prior periods arising from changes in accounting policies and the correction of material errors.

1.4. The Statement of Comprehensive Net Expenditure (SOCNE) (Figure 1) and the Statement of Financial Position (SOFP) (Figure 2) are two of the primary statements within the Annual Accounts.

1.5. The Departmental boundary is similar to the concept of a group under IFRS but is based on control criteria used by the Office for National Statistics (ONS) to determine the sector classification of the relevant Departmental sponsored bodies.

1.6. The Department's consolidated Annual Accounts aggregate the financial information of all entities within the Departmental boundary.

1.7. IMG transfers should generally only be used for the transfer of SOFP balances.

Figure 1

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

		£000
Administration Costs (para 1.63)		
Gross administration costs		**X**
Operating income (para 2.11)		(X)
Net administration costs before interest		**X**
Net interest payable	X	
Net administration costs		**X**
Programme Costs (para 1.63)		
Gross programme cost		**X**
Operating income (para 2.11)		(X)
Net programme cost before interest		**X**
Net interest payable		X
Net programme cost		**X**
Net operating cost		**X**
Other Comprehensive Net Expenditure		
Net gain/(loss) on revaluation of Property Plant and Equipment (para 5.93)	X	
Net gain/(loss) on revaluation of Intangibles (para 4.30)	X	
Net gain/(loss) on revaluation of Available for Sale Financial Assets (para 10.47)	X	
Total Net Comprehensive Expenditure for the year ended 31 March XX		**X**

Figure 2

Statement of Financial Position
As at 31 March XX

	£000	£000
Non-current assets		
Intangible assets (para 4.1)	X	
Property, plant and equipment (para 5.1)	X	
Financial assets (para 10.1)	X	
Receivables due after more than one year (para 10.44)	X	
Total non-current assets		**X**
Current assets		
Financial assets held for sale (para 10.1)	X	
Non-current assets classified as held for sale (para 5.177)	X	
Inventories (para 7.1)	X	
Trade and other receivables (para 10.1)	X	
Financial assets (para 10.1)	X	
Cash and cash equivalents (para 6.1)	X	
Total current assets		**X**
Total assets		**X**
Current liabilities		
Trade and other payables (para 8.14)	(X)	
Financial liabilities (para 10.1)	(X)	
Total current liabilities		(X)
Non-current assets plus net current assets/liabilities		**X**
Non-current liabilities		
Provisions for liabilities and charges (para 8.26)	(X)	
Other payables (para 8.14)	(X)	
Total non-current liabilities		**(X)**
Assets less liabilities		**X**
Taxpayers' equity		
General fund (para 1.16)	X	
Revaluation reserve (para 5.94)	X	
Total taxpayers' equity		**X**

Policy Detail

1.8. Policy detail is set out under the following headings; specific responsibilities; Annual Accounts accounting convention; application of accounting policies and principles; the composition of the Annual Accounts; consolidation; Inter Management Group transfers and retention of accounting records.

Specific Responsibilities

1.9. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

Head of Financial Management Policy and Accounting (Hd FMPA)

1.10 Hd FMPA is responsible for the Annual Accounts and for Departmental accounting policy.

MOD Accounting Policy Team

1.11. The MOD Accounting Policy Team is responsible for:

a. developing new and/or amending accounting policies;

b. developing new and/or amending significant estimation techniques.

The Corporate Financial Accounting Team (CFAT)

1.12. CFAT is responsible for:

a. maintaining and disseminating the Annual Accounts instructions and for controlling the format and timetables of the consolidation process;

b. mapping resource account codes (through the Chart of Accounts) to the consolidation codes.

TLBs

1.13. TLBs are responsible for:

a. ensuring that they, their Agencies and the organisations they sponsor (such as Non Departmental Public Bodies) record and report the information required to produce the Annual Accounts in accordance with the Annual Accounts Instructions;

b. ensuring the integrity of the data they submit and for strictly adhering to the consolidation timetable required by CFAT;

c. maintaining the integrity and content of data following receipt. Feeder files should be processed on receipt, with disputed items followed up subsequently;

d. ensuring that both submitting and receiving TLBs agree period-end balances, in writing, in accordance with the General Ledger timetable.

Inter-Management Grouping (IMG) Transfers

1.14. For IMG transfers:

a. the initiating Management Group (MG) is responsible for the transfer procedure, for providing appropriate data to the receiving MG and for obtaining the appropriate authority;

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

c. both TLBs are responsible for using the official group mail boxes for GL010 transfers;

d. the FMPA AMI Team is responsible for ensuring that the transfer is authorised and for uploading both sides of the transfer into the Defence Business Services (DBS) set of books for subsequent transfer into the relevant TLB set of books;

e. the FMPA Business Analysis Team is responsible for the monthly running of the IMG variance report by source. Given that the security rules applied to the GMG range of RA codes will prevent manual journals from causing any IMG imbalance, the relevant system operator will be informed of imbalances and the Business Analysis team will monitor their resolution, raising issues to the Chief Accountants' meeting, if appropriate;

f. CFAT is responsible, at the year end, for authorising the clear down to zero of the IMG current account balances to the General Fund. This will be actioned by the MGs;

g. Defence Resources acts as the arbiter on proposals, endorsed at TLB Chief Accountant level, to use the IMG transfer process to transfer costs that do not comply with the policy in this chapter;

h. the Non-Current Asset Processing Centre 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.

Annual Accounts Accounting Convention

1.15. The Annual Accounts are prepared on an accruals basis, under the historical cost convention, modified to include the revaluation of NCAs and inventories.

1.16. The General Fund represents net funding from HM Treasury within the Department and reflects the total net assets to the extent that they are not represented by other reserves.

1.17. The Annual Accounts are prepared in accordance with applicable International Financial Reporting Standards (IFRSs) to the extent that they are relevant to the public sector context.

1.18. It is likely that the requirements of IFRS and Parliamentary accountability together with public expenditure control will coincide. However, if there is a conflict the requirements of IFRS will be adapted and interpreted accordingly.

1.19. In addition to the Annual Accounts, the accounting policies contained within this manual apply to the preparation of other Departmental resource accounting information - for example, in-year reporting and planning.

Applying Accounting Policies and Principles

1.20. The Annual Accounts should be prepared using accounting policies which reflect the principles set out in IAS 8, as well as those set out in the International Accounting Standards

Board's (IASB) Framework for the Preparation and Presentation of Financial Statements (known as the Framework).

1.21. The objective of providing information about the Department's financial position and performance is to give a wide range of stakeholders useful information. Although the Framework does not deal directly with the true and fair view concept, by applying the principles set out in the Framework and selecting the accounting policies prescribed by IAS 8, the financial statements should convey a true and fair view of the accounts.

1.22. In the absence of an IFRS that specifically applies to a transaction or event, IAS 8 prescribes the following hierarchy of guidance to be used to identify the appropriate accounting policies:

a. requirements of Standards and Interpretations dealing with similar matters;

b. the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework;

c. the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework, provided that they do not conflict with IFRSs and the Framework.

True and Fair View

1.23. The Annual Accounts are required to give a true and fair view of the financial affairs of reporting entities within the Departmental Boundary.

1.24. Where, in exceptional circumstances, complying with the requirements of this manual would be so misleading as to conflict with the objective of financial statements set out in the Framework referred to in paragraph 1.32, MOD should restrict any departure to the minimum and disclose the following:

a. that management has concluded that the Annual Accounts presents the MOD's financial position, financial performance and cash flows fairly;

b. that the MOD has complied with the FReM, except that it has departed from a particular requirement to achieve a fair presentation;

c. the title of the IFRS (and, if appropriate, adapted or interpreted by the FReM) from which the MOD has departed, the nature of the departure, including the treatment that the FReM would require, the reason why that treatment would be so misleading as to conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and

d. for each period presented, the financial effect of the departure on each item in the Annual Accounts that would have been reported in complying with the requirement.

1.25. Where the MOD has departed from a requirement of this manual in a prior period and that departure affects amounts recognised in the Annual Accounts for the current period, the MOD shall make the disclosures set out in paragraph 1.24c and 1.24d.

1.26. Any proposed material departure can only be made with the agreement of the MOD Accounting Policy Team who will consult HM Treasury.

Materiality

1.27. The concept of materiality derives from the premise that although the Annual Accounts need not be spuriously accurate, this does not override the requirement for the accounts to present a true and fair view.

1.28. An item is regarded as being material if its omission, non-disclosure or misstatement could be expected to distort the view given by the Annual Accounts to a user. There is no formula for determining what is material.

1.29. TLBs must ensure that their policy on materiality is clearly documented to allow subsequent audit review. Principal factors to be taken into account are:

a. the item's size is judged in the context of the financial statements as a whole and also the other information available to users that would affect their evaluation of the financial statements. This includes, for example, considering how the item affects the evaluation of trends;

b. the item's nature in relation to:

   i. the transaction or other events giving rise to it;

   ii. the legality, sensitivity, normality and potential consequences of the event or transaction;

   iii. the identity of the parties involved; and

   iv. the particular headings and disclosures that are affected.

1.30. The process of preparing accounts gives rise to two types of materiality judgements:

a. whether an item needs to be disclosed;

b. the margin of error, if any, that is acceptable in the amount attributed to an item.

1.31. Overall Departmental materiality judgements will depend on the nature and relative importance of the amounts involved. The following factors will be relevant:

a. the inherent approximation. Some figures used for the accounts will be estimated. Their lack of precision may be a factor when considering materiality;

b. whether there is excessive precision. Detailed disclosure of immaterial items can serve to obscure the more important messages in the accounts and should be avoided unless the item is specifically required;

c. the amount offset and aggregation. This is the effect of offsetting two or more items which would be material if considered separately.

Key Concepts

1.32. 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>

1.33. The Annual Accounts 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.

1.34. 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

1.35. 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

1.36. 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 paragraphs 1.38 to 1.44;

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

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

Objectives

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

Relevance

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

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

Reliability

1.41. 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.

1.42. 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

1.43. 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

1.44. Information provided in the Annual Accounts 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

1.45. 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 Annual Accounts accounting policy note should describe the key areas of estimation uncertainty and the assumptions underpinning those estimates.

1.46. 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.

Prior Period Adjustments

1.47. Prior period adjustments are material adjustments applicable to prior periods which arise from changes in accounting policies or from the correction of material errors. Before any prior period adjustments are made, the MOD Accounting Policy team must be consulted as HM Treasury agreement will be required.

1.48. Material errors are those which could individually or collectively influence the economic decisions of users.

1.49. Prior period adjustments exclude normal recurring adjustments and corrections of accounting estimates made in prior periods. Examples of these include:

a. adjustments to provisions for bad debts or against inventories;

b. minor omissions of accruals and prepayments;

c. cost recoveries which relate to a prior period but were not recognised at that time because it was uncertain they would materialise;

d. recovery of a bad debt which was written-off in a previous period;

e. adjustments arising from a revision to the estimated useful economic life of an NCA;

f. changes to estimated recoveries over the life of a long-term contract.

1.50. Prior period adjustments should be accounted for by restating the comparative figures for the preceding period in the primary financial statements (excluding the Statement of Parliamentary Supply); the notes; likewise adjusting the opening balance of reserves for the cumulative effect. In addition, the cumulative effect of the adjustments should be shown in the Statement of Changes in Taxpayers' Equity.

1.51. In the Statement of Parliamentary Supply, prior period adjustments are treated as current year income or expenditure for the purpose of Parliamentary control. This entails including the adjustment as an item in the reconciliation between 'net operating cost' and 'net resource outturn' via the note in the Annual Accounts (when the adjustment affects the SOCNE and the SOFP).

1.52. The adjustment should also be disclosed in the Statement of Parliamentary Supply by including an explanation in the variation box. The explanation should briefly cover the reason for the prior period adjustment, referring as necessary to other notes for details of adjustments and any further explanation. Other notes will, as necessary, include additional line items captioned 'Prior Period Adjustment'. The notes should refer to any impact on the Statement of Parliamentary Supply and to the other primary statements.

1.53. Where practicable, the effect of prior period adjustments on the results of the preceding period should be disclosed.

Annual Accounts

1.54. The published Annual Accounts are available on the Department's intranet. While the Annual Accounts should be laid before the Parliamentary Summer Recess, the exact dates for the laying of the accounts are distributed each year following consultation with the NAO and the Treasury.

1.55. The Annual Accounts include:

a. an Annual Report which encompasses;

    i. disclosures in the Director's report (as set out in Schedule 7 to the Companies Act 1985), interpreted for the public sector context in Chapter 5 of the FReM;

    ii. disclosures for the Remuneration Report (including salary and pension disclosures), set out in Chapter 5 of the FReM. This includes the median remuneration of the MOD's staff and the ratio between this and the mid-point of the banded remuneration of the highest paid director. The calculation is based on the full-time equivalent staff of the MOD at the year end date on an annualised basis. The calculation should exclude Arm's Length Bodies within the consolidation boundary. Information should be disclosed explaining the calculation including the causes of significant variances where applicable. For further advice, please contact CFAT;

b. a statement of the Accounting Officer's responsibilities in which;

    i. the Accounting Officer should explain his/her responsibility for preparing the accounts next to a statement by the NAO about its reporting responsibilities;

c. a Governance Statement for which;

    i. detailed information on the requirement is contained in Managing Public Money;

d. the primary statements and notes to the accounts;

e. a Sustainability Report within the Management Commentary reporting performance against sustainability targets for greenhouse gas emissions, waste minimisation and management and the use of finite resources and their related expenditure.

f. the audit opinions and report.

1.56. The Annual Accounts consist of the following primary statements:

a. the Statement of Parliamentary Supply which shows:

i. a comparison of outturn against the Supply Estimate voted by Parliament in respect for each budgetary control limit. The summary should show net resource expenditure and net capital expenditure for both Departmental Expenditure Limit (DEL) and Departmental Annually Managed Expenditure (AME) budget classifications. It should in addition report the Estimate and outturn for non-voted expenditure;

ii. the net cash requirement (calculated on the same basis as the Supply Estimate), with a comparison of outturn against the Supply Estimate; and

iii. a reconciliation of resource outturn to the net operating cost disclosed in the SOCNE.

b. the SOCNE which shows:

i. resources consumed during the year in support of the Department's operating expenditure net of Departmental income and other comprehensive expenditure;

c. the SOFP which shows;

i. assets and liabilities at the year-end balanced by Taxpayers' Equity;

d. the Statement of Cash Flows which shows;

i. an analysis of the net cash flow on operating activities and capital expenditure together with how the net cash flow has been financed;

e. the Statement of Changes in Taxpayers' Equity;

1.57. Disclosures should be sufficient for users of the Annual Accounts to understand the effects of transactions. They cover two main areas:

a. the statement of accounting policies against which the accounts have been prepared;

b. the supporting detail needed to enhance the information presented in the primary statements.

Segmental Reporting

1.58. The NAO has agreed that as the Department's business output is not organised on any specific geographic, economic, regulatory, product or service basis, it is deemed appropriate to treat it as a single operating segment.

1.59. This is supported by the fact that the Defence Board reviews performance and allocates resources at an aggregated level, varying their mix to meet prioritised changes in activities which, in combination, deliver defence capability. Although the Department is organised into separate budgetary areas for financial management purposes, it is only by combining the activities undertaken by each of these budgetary areas that the Department is able to deliver its principal output of meeting UK defence commitments.

Core Department and Consolidated/Departmental Group

1.60. The Department is required to analyse both its SOCNE and SOFP by the 'core' department and consolidated/Departmental group.

1.61. HM Treasury has agreed that the Department should include all its executive agencies (which are Supply Financed Agencies) within the 'core' department. This is on the basis that the agencies are within the Department's general command structure and do not have the separate accountability arrangements assumed in the normal executive agency model. The consolidated group consists of Arm's Length Bodies (ALBs), which include Non-Departmental Public Bodies (NDPBs) and other bodies and are treated as non-core. Where material, disclosures are made to separately identify the activities and balances of the ALBs.

Disclosure of Non-Agency Parts of the Department

1.62. The Department need not produce separate financial statements for its Agency and non-Agency elements, as this would not accurately reflect the TLB organisational structure.

Disclosure of Administration and Programme Costs

1.63. The Department should split its SOCNE into Administration and Programme Costs (although at the time of publishing this manual, the attribution of Administration and Programme costs was still being discussed with HM Treasury - see Chapter 3.10). Disclosure should be made in the annual accounts on the basis of the split and the treatment of ALBs.

Supply-Financed Agencies

1.64. This chapter should be followed for supply financed Agencies except that:

a. in preparing their published Agency Accounts, Agencies should follow the format specified in their individual accounts direction, which may differ from that of the SOCNE. The degree of disclosure should be no less than that required by the FReM;

b. Agencies need not produce a Statement of Parliamentary Supply;

c. Agencies should continue to account for communicated costs in accordance with their Accounts Direction.

Intra-Government Balances

1.65. Intra-government balances are defined as balances between the reporting entity and other bodies within the boundary set for the Whole of Government Accounts (WGA).

1.66. The Annual Accounts should (where material) disclose the level of year end receivables and payables balances with other government bodies. This disclosure should be analysed between:

a. balances with other central government bodies (including pension and other central government funds);

b. balances with local authorities;

c. balances with NHS Trusts;

d. balances with public corporations and Trading Funds;

e. balances with bodies external to the Government. (These are included under the Intra-Government Balances Note.)

Subsidiaries, Associated Undertakings and Joint Ventures – The Departmental Boundary

1.67. The Department's consolidated Annual Accounts cover all entities within the Departmental boundary. The Departmental boundary is similar to the concept of a group under IFRS but is based on control criteria used by the Office for National Statistics (ONS) to determine the sector classification of the relevant Departmental sponsored bodies. Except where legislation requires otherwise, executive non-departmental and similar public bodies that satisfy the IAS 27, IAS 28 and IAS 31 criteria for consolidation as subsidiary undertakings, associate undertakings or joint ventures will be consolidated and accounted for in accordance with IAS 27, IAS 28 and IAS 31 only if they are designated for consolidation by order of HMT under statutory instrument, which will be reflect the ONS's classification of an entity to the central government sector.

1.68. The following entities are outside the Departmental boundary:

a. any body classified as a public corporation by the ONS (which includes most Trading Funds);

b. any body classified to the local government sector by the ONS;

c. non-public funds (such as service messes, sports associations);

d. any body classified to the private sector or to the rest of the world sectors by the ONS.

1.69. The Departmental resource accounting boundary will, therefore, include the following entities:

a. Supply-financed agencies;

b. non-agency parts of the department accounted for through the Supply process and other bodies whose expenditure is accounted for in separate financial statements, including non-executive NDPBs such as Advisory NDPBs and Tribunal NDPBs;

c. executive NDPBs or other public bodies that produce their own financial statements and which are classified by the ONS to the central government sector

1.70. Where the Department has a formal investment in another public sector entity that does not meet the criteria for consolidation in paragraph 1.67, the investment should be reported at historic cost less any impairment. Investments in other entities should be accounted for by following the requirements of financial instruments (see Chapter 10).

1.71. The accounting for interests in associated undertakings and joint ventures are governed by IAS 28 and IAS 31 respectively.

1.72. Accounting policy relating to other financial assets held by the Department is governed by IAS 32, IAS 39 and IFRS 7 (the financial instruments standards). These are covered in Chapter 10 of this manual.

Jointly Controlled Assets

1.73. Participants in joint ventures who jointly control assets are to account for their share of:

a. the assets and the liabilities that they incur and also their share of jointly incurred liabilities;

b. the expenses that they incur (and share of joint expenses) and the income that they earn from the sale of goods and services.

1.74. The MOD Accounting Policy Team should be consulted if TLBs have an arrangement which they believe is a joint venture involving jointly controlled assets.

Mergers

1.75. The merger of two or more departments into one new department, or the transfer of functions from the responsibility of one part of the public sector to another, is accounted for by using merger accounting. This requirement is an adaptation to IFRS 3 (Business Combinations) which excludes businesses under common control from its scope (and therefore does not prescribe the accounting for group re-organisations).

1.76. The Department could be the entity receiving the transfer or the entity transferring the function, depending on the circumstances.

1.77. The merger or transfer of functions (denoted simply as 'merger' below) should be accounted for as follows:

a. the carrying amount of assets and liabilities should not be adjusted to fair value on consolidation, although appropriate adjustments should be made in the accounts of the entity receiving the transfer to achieve uniformity of accounting policies. The net effect of any adjustments should be shown as a movement on reserves and no goodwill should be recognised in the acquiring party's accounts;

b. the results and cash flows of all combining entities should be brought into account from the start of the financial year in which the combination occurs. Restatement of prior-year comparative figures is also required;

c. the entity receiving the transfer should disclose that a merger has taken place, the date of transfer, and which department(s) were responsible for the activity prior to transfer, and (if material) should disclose in a note to the accounts the effect on its main financial statements;

d. the entity transferring the assets and liabilities will account in a similar way. This means disclosing that a transfer has taken place, writing off assets and liabilities from the start of the financial year in which the combination occurs, making corresponding adjustments to reserves rather than the SOCNE, restating prior-year comparators, and (if material) disclosing the effect of the transfer on its main financial statements.

1.78. Any adjustments needed to achieve uniformity of accounting policies in the accounts of the entity receiving the transfer should be treated as prior-period adjustments.

1.79. The effect of this accounting treatment is that central government bodies do not show profits or losses when transferring functions to other public sector bodies.

1.80. Accounting for mergers and a transfer of functions may, in some cases, cause differences between the totals in the Statement of Parliamentary Supply and the SOCNE. Such differences should be reconciled in a relevant note to the accounts. In addition, extra entries may be required in the Statement of Cash Flows. Guidance on the treatment of in year transfers of functions between departments is provided in the FReM.

Consolidation

1.81. Consolidation involves aggregating data submitted by TLBs, including Agencies within the Departmental boundary, to produce the Annual Accounts, enabling the Department to present its financial information as a single economic entity. For the purposes of applying the principles of consolidation, the Department will be the parent entity in departmental consolidations.

Consolidation Methodology

1.82. 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 FMPA-Dhd-A&TM ;

e. exporting data to higher level organisations.

1.83. The Department does not consolidate the results of its Trading Fund Agencies which are outside the Departmental boundary. The Armed Forces Pension & Compensation Schemes are also treated as falling outside the Departmental boundary. However, any expenditure which the Department incurs arising from, or in support of, these activities is reflected in the Annual Accounts.

1.84. 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.

1.85. TLBs are responsible for maintaining the integrity and content of data they receive. Feeder files should be processed on receipt, with disputed items followed up subsequently.

1.86. Both submitting and receiving TLBs are responsible for agreeing period-end balances in writing, in accordance with the General Ledger timetable. If balance differences cannot be agreed, the receiving TLB is responsible for adjusting its accounts to bring the balances into agreement (but see IMG transfer policy at paragraphs 1.100 to 1.102).

1.87. 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, Chief Accountant and Agency Chief Executive. These reports should also be made available for the year-end audit.

1.88. Period-end balances with Trading Fund Agencies and Departmental Entities, which responsibility fall outside the Departmental boundary, should also be agreed as part of the consolidation process.

1.89. Financial instructions are issued by FMPA each year detailing the tables and schedules required to be completed and other Annual Accounts related issues such as the Letter of Representation, commentaries and audit files.

1.90. Documentation to support the Governance Statement is co-ordinated by Defence Resources.

1.91. 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 submit their accounts to CFAT through the Annual Accounts Excel workbook with a supporting Management Validation File (and other supplementary information).

1.92. The trial balance data files are drawn from individual General Ledgers and passed to the consolidation 'bridge' which validates and summarises COA level data into consolidated accounting data. This, together with data drawn from other sources and from subsidiary ledgers, is entered in the Annual Accounts tables and loaded into the consolidation database.

1.93. The consolidation process is reviewed each year to ensure that it is compatible with any new system releases. Any changes during the year are explained in Financial Instructions.

1.94. All resource accounting transactions between Departmental entities such as transfers of NCAs and inventories should take place at cost or carrying amount, as appropriate, so that no surpluses or deficits arise. Accordingly, no consolidation adjustments will be required to eliminate intra-Departmental surpluses or deficits. All transactions between Departmental entities should be shown in the appropriate Annual Accounts tables.

1.95. The Annual Accounts Instructions provide guidance on consolidation adjustments.

1.96. 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.

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

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

Statements Requiring Signature by the Accounting Officer

1.99. The Accounting Officer is required to sign and date the following statements:

a. the Annual Report (including the Remuneration Report);

b. the SOFP;

c. the Governance Statement.

Inter-Management Grouping Transfers

1.100. IMG transfers should only be used for the transfer of SOFP balances. The IMG process cannot be used to transfer operating costs between MGs. Operating costs 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.

1.101. 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 MT);

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

d. International Collaboration Projects (RA code QDB001);

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

f. transfer entries that miss the mid-March cut off (through the EBT process, see paragraph 1.102(f)).

1.102. The key steps of the IMG transfer process are:

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

b. when the cost is incurred, the initiating entity 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 Asset Data Management Team;

c. the receiving entity 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 the FMPA AMI team who will process the journal into the SSC General Ledger, to be then transferred to the respective TLB General Ledgers;

e. all transfers of assets will be processed and accounted for through a DBS spreadsheet template which is available on the Financial Operations page of the Defence Intranet. The spreadsheet template validates the data in line with the current SDS mapping and enforces the GL010 policy by restricting access to certain RA Codes;

f. 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;

g. detailed desk instructions on this process are available on the Finance Operations page of the Defence Intranet.

Retention of Accounting Records

1.103. Accounting records relating to the preparation of the Annual Accounts, including Agency accounts, must be retained by the appropriate TLB for a minimum of six years and are subject to audit during this time. The requirement applies to all forms of accounting information, regardless of how it is recorded or stored.

1.104. Retention is required, for example, to satisfy the following:

a. Public Records and other statutes;

b. EC regulations;

c. Limitations Acts;

d. external and internal audits;

e. administrative purposes.

CHAPTER 2: INCOME

Introduction

2.1. This chapter sets out the accounting requirements for income.

Key Points

2.2. Income represents a gross inflow of economic benefits during the period (for example, cash and donated assets) which result in an increase in Taxpayers' Equity.

2.3. Income should be discounted where material.

2.4. The funding element of donated assets should be recognised as income in the SOCNE.

2.5. The funding element of grant funded assets should be recognised as income in the SOCNE.

2.6. Contingent assets represent a possible inflow of future economic benefits, where the inflow is dependent on an uncertain future event taking place. If the inflow is virtually certain, it should be accrued. If it is only probable, it should be disclosed in a note to the accounts. If it is not probable, no disclosure is required.

Policy Detail

2.7. Policy detail is set out under the following headings; specific responsibilities; the recognition of income; the measurement of income; and specific accounting requirements.

Specific Responsibilities

2.8. There are no specific responsibilities in respect of income. General responsibilities are listed in the Preface.

Recognition

2.9. Income represents a gross inflow of economic benefits during the period which result in an increase in Taxpayers' Equity. It is recognised only when it is probable that the economic benefits associated with the transaction will flow to the Department. Amounts collected on behalf of third parties such as value added tax do not increase Taxpayers' Equity and should be excluded from revenue. Similarly, where the Department acts an as agent, the amounts collected of behalf of another party are not treated as income.

2.10. Parliamentary Supply should not be accounted for as income but as financing through the General Fund. The Parliamentary process and accounting arrangements determine how income is presented and is set out in paragraphs 2.11 to 2.14.

2.11. Operating income is any income generated by the Department in pursuit of its activities (generally fees and charges) or as part of managing its affairs (for example, rents, interest and dividends receivable).

2.12. Proceeds from the sale of investments and Non-Current Assets (NCAs) should be accounted for as non-operating income. However, surpluses on the disposal of assets should be netted off expenditure in the Statement of Comprehensive Net Expenditure (SOCNE) where they are no more than adjustments to depreciation (or amortisation) or impairment previously charged. This is usually the appropriate treatment for depreciable tangible NCAs which are revalued and for other assets originally procured for the Department's own use which have become surplus and therefore written down to net realisable value. Other profits on disposal of assets are treated as income in the SOCNE.

2.13. Other non-retainable income includes any income or recovery of expenditure that is non-budget (Consolidated Fund Extra Receipts (CFERs)). It should be recorded in the SOCNE. The proceeds of realisations of confiscated, seized and forfeited property go to the Consolidated Fund and are not for the benefit of the Department. Hence, these assets should not be recognised in the financial statements. Any proceeds derived from realising them should be disclosed in a note to the Annual Accounts.

2.14. Items of income that the Department is authorised to net off gross expenditure in the Statement of Parliamentary Supply for the purpose of Parliamentary control, which relate to any recovery of expenditure recorded in the SOCNE or to returns on investments, should appear in the SOCNE.

2.15. Income is recognised only when it is probable that the economic benefits associated with the transaction will flow to the Department. In some cases, this may not be probable until the cash is received or until an uncertainty is removed. However, when any uncertainty arises over the recoverability of an amount already included within income or it becomes unlikely that it will be recovered, the amount in question is recognised as an expense, rather than as an adjustment to the amount of income originally recognised. See provision for bad debts (chapter 10.56).

2.16. In accordance with IAS 18, the recognition of income is usually applied separately to each transaction. However, it may be necessary to apply recognition criteria to the separately identifiable components of a single transaction in order to reflect its substance. For example, when the selling price of equipment includes an identifiable amount for subsequent maintenance, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, two or more transactions should be dealt with together as one transaction when they are linked. For example, the sale of equipment and, at the same time, a separate contractual agreement to repurchase the equipment at a later date. The substance of this arrangement may be that no sale has taken place.

Sale of Goods/Equipment

2.17. 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.

2.18. 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

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

2.20. Income is recognised in accordance with paragraph 2.15.

2.21. 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.

2.22. 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.

2.23. 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.

2.24. 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.

2.25. 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.

Measurement

2.26. Income should be measured at the fair value of the consideration received or receivable, including the deduction of any discounts and volume rebates.

2.27. 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 the MOD Accounting Policy team must be consulted. The 'interest' element is recognised as interest income.

2.28. 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.

Specific Accounting Requirements

Donated Assets

2.29. Donated assets are those which have been donated to the Department. Assets can be donated by a third party either by gifting the assets or gifting funds with which to purchase the assets.

2.30. To qualify as a donated asset, there should be no consideration given in return. However, donated assets do not include:

a. assets financed by grant-in-aid;

b. the subsequent expenditure on a donated asset which is capitalised (see paragraph 2.38);

c. assets constructed or contributed to by a developer to benefit the developer's business (i.e. the situation where the developer builds or enhances an asset (for example, when involved in the provision of a service to the public sector) but the public sector gains no direct economic benefit, as the primary purpose of the building/enhancement is to enable the developer to better perform the function;

d. assets accepted in lieu of tax.

2.31. Assets that do not pass this test should be accounted for in the same way as any other NCA. See Chapter 5.

2.32. Where a donor imposes restrictions or conditions on the use of a donated asset, details of the restrictions or conditions should be disclosed in a note to the accounts.

2.33. The Department may give or receive assets to/from another public sector body (including public sector bodies outside the Departmental boundary) for no consideration. Assets acquired in this way are not donated assets. The transfer of NCAs to another government department under a transfer of function, or a merger of departments, should be treated as a normal commercial transaction i.e. as a sale at fair value. If assets are to be transferred for no consideration, the MOD Accounting Policy team should be consulted before entering into such an arrangement as the proposal will need to be discussed with HM Treasury.

2.34. Donated assets are capitalised at their fair value on receipt. Where the value of the services provided by an asset will be less than the asset's fair value because it is over specified for its intended use, the lower value should be used. The funding element should be recognised as income in the SOCNE. This income should be deferred only if a condition imposed by the funder represents a requirement for the future economic benefits embodied in the donation to be consumed as specified by the donor (or if not, to be returned) - for example, the donation is conditional on the construction of an asset.

2.35. A contribution or donated asset may be received subject to a condition that it be returned to the donor if a specified future event does or does not occur (for example, a donation may need to be returned if the Department ceases to use the asset purchased with the donation for the purpose specified by the donor). In such cases, a return obligation does not arise until such time as it is expected that the condition will be breached, at which point the liability is first recognised. Such conditions do not prevent the contribution or the donated asset from being recognised as income in the SOCNE.

2.36. Donated assets should be recorded under an appropriate category within the SOFP of the NCAM and within the NCAR.

2.37. Donated assets are revalued, depreciated and impaired on the same basis as other NCAs. See Chapter 5.

2.38. Subsequent expenditure on donated assets must be captured separately if the expenditure is capital in nature. Capital expenditure in this category must not be treated as donated but should be accounted for in the same way as enhancements to other Departmental assets (see Chapter 5.111). The enhancement will be separately recorded in the NCAR.

2.39. Donated assets which are classified as held for sale should be removed from the NCAR and re-valued to the lower of their carrying amount and their fair value less costs to sell. Any decline in value down to depreciated historic cost should be taken through the Revaluation Reserve. Any decline in value below depreciated historic cost should be charged to the net operating cost section of the SOCNE. The subsequent disposal is accounted for in the same manner as other NCAs (see Chapter 5.177).

Assets Funded by Grants

2.40. Grants received can come from government and inter-governmental agencies and similar bodies, whether local, national or international, including the European Union (EU).

2.41. The NCAs purchased with the granted funds (which may finance the asset purchase in whole or in part) should be capitalised at full cost and reported within the SOFP under an appropriate NCA category. They should also be recorded on the NCAR. The funding element should be recognised as income in the SOCNE. This income should be deferred only if a condition imposed by the funder represents a requirement that the future economic benefits embodied in the grant are consumed as specified by the grantor or must be returned to them - for example, the grant is conditional on the construction of an asset.

2.42. A grant may be received subject to a condition that it be returned to the donor if a specified future event does or does not occur (for example, a grant may need to be returned if the Department ceases to use the asset purchased with the grant for a purpose specified by the grantor). In these cases, a return obligation does not arise until such time as it is expected that the condition will be breached and a liability is not recognised until that time. Such conditions do not prevent the grant from being recognised as income in the SOCNE.

2.43. Assets financed in whole or in part by a grant should be revalued, depreciated and impaired in the same way as other NCAs. See Chapter 5.

2.44. Subsequent expenditure on grant funded assets that is not financed by grant should be treated in the same way as subsequent expenditure incurred on donated assets. In addition, disposals of grant funded assets should be treated in the same manner as donated assets. See paragraphs 2.38 and 2.39.

2.45. The notes to the accounts should distinguish between UK grants and EU grants.

Contingent Assets

2.46. Contingent assets represent a possible inflow of future economic benefits, where the inflow is dependent on an uncertain future event taking place. If the inflow is virtually certain, the income/asset should be accrued. If it is only probable, it should be disclosed in a note to the accounts. If it is not probable, no disclosure is required.

2.47. Where a contingent asset is disclosed it should be by way of a note which includes a brief description of the nature of the contingent asset at the reporting period date, It should be measured in the same way as a provision for liabilities and charges. See Chapter 8.

CHAPTER 3: EXPENDITURE

Introduction

3.1. This chapter sets out the accounting requirements for expenditure. Details on accounting for the Department's foreign currency forward contracts are contained in Annex 6.

Key Points

3.2. The Statement of Comprehensive Net Expenditure (SOCNE) should be split between administration and programme costs.

3.3. A foreign currency transaction should be translated into sterling using the appropriate months' General Accounting Rate (GAR) for that particular currency.

3.4. GARs for US $ and Euros are based on a 5 day average published mid-market daily rate; or for other currencies, it is based on a single day's mid-market rate. GARs are published monthly.

3.5. At the year end and at each reporting period end which is subject to NAO audit (i.e. a 'hard close'), foreign currency monetary items (for example, cash, payables and receivables) are translated into sterling using mid-market closing rate. The GAR is used for all other reporting period ends.

3.6. All exchange differences, whether arising on settled or unsettled transactions, should be charged/credited to the SOCNE. See Figure 1.

Policy Detail

3.7. Policy detail is set out under the following headings; specific responsibilities; administrative and programme expenditure; construction contracts; reporting foreign currency transactions; accounting for exchange differences; accounting at the end of the reporting period; and disclosures.

Specific Responsibilities

3.8. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

The FMPA Ahd A&TM Banking Services Treasury Accountant

3.9. The FMPA Ahd A&TM Banking Services Treasury Accountant (BS TA) is responsible for:

a. the 'Offset Banking Group Scheme accounts overseas' (currently available for Germany, Italy, USA, Cyprus, Canada and Gibraltar);

b. the forward purchase contracts (currently US $ and Euros);

c. the funding of all non-offset banking arrangements;

d. the monthly calculation and promulgation of GARs for foreign currency translation;

8e. promulgating a Forces Fixed Rate (FFR) for foreign currency exchange payments made to UK based personnel on permanent posting overseas (the FFR is calculated by SP Pol);

f. promulgating the period end mid-market closing rates for use in the Annual Accounts.

Disclosure of Administration and Programme Costs

3.10. The Department should split its SOCNE into Administration and Programme Costs. However, at the time of writing this JSP, this process is temporarily suspended.

3.11. As a result of SDSR, it has been agreed with HM Treasury that the Department will revisit what is within the scope of Administration and what is Programme/Front Line Services. Once this process has been completed, the management information required for both Administration and Programme costs will be issued by Defence Resources.

Construction Contracts

3.12. Construction contract balances relate to commercial work undertaken on behalf of external customers and cover costs incurred on all production/repair and associated tasks.

3.13. The costs are recognised in the SOFP until the associated work is invoiced, at which point the invoiced amounts will be included in operating income. An appropriate amount is then released from the construction contract balance to the SOCNE and matched against the related income.

3.14. The period end construction contract balance should be reported as a receivable and should reflect the contract cost balance less any provision for contract losses.

3.15. As construction contracts balances are reported as receivables, they are not re-valued.

3.16. Amounts recoverable (i.e. receivable but not invoiced) on other long-term contracts not falling within the definition of construction contracts (for example, provision of training to external customers) are accounted for as income in accordance with Chapter 2.

3.17. Incomplete work relating to other tasks and services provided (for example, training for repayment customers) does not fall within the scope of IAS 11, ‘Construction contracts’. It is accounted for in accordance with Chapter 2.

3.18. Any costs incurred which will be capitalised on completion in the Department’s SOFP, i.e. in relation to NCAs (including capital spares and GWMB) for the Department’s own use rather than for an external customer, are accounted for as AUC.

Reporting Foreign Currency Transactions

3.19. Although the Annual Accounts are published in sterling, the Department undertakes many foreign currency transactions. It also holds some financial assets and liabilities that are denominated in currencies other than sterling.

3.20. Under IAS 21, foreign operations are required to measure results in their functional currency, i.e. the currency of the primary economic environment in which they operate. As the Department’s functional currency is sterling, the Annual Accounts are presented in sterling.

3.21. IAS 21 also states that if the activities of the foreign operation are carried out as an extension of the reporting entity, the functional currency of the foreign operation will be the same as that of the reporting entity. As the activities of the foreign operations are carried out as an extension of the Department's activities, the functional currency of those operations will always be the same as the Department's normal currency (i.e. £ sterling).

3.22. Occasionally the exchange rate changes between the date of the transaction and the date of payment, giving rise to:

a. settled transactions: where transactions are settled at an exchange rate that differs from the rate used when the transactions were recorded – typically when a payment is made in the month after the purchase is recorded;

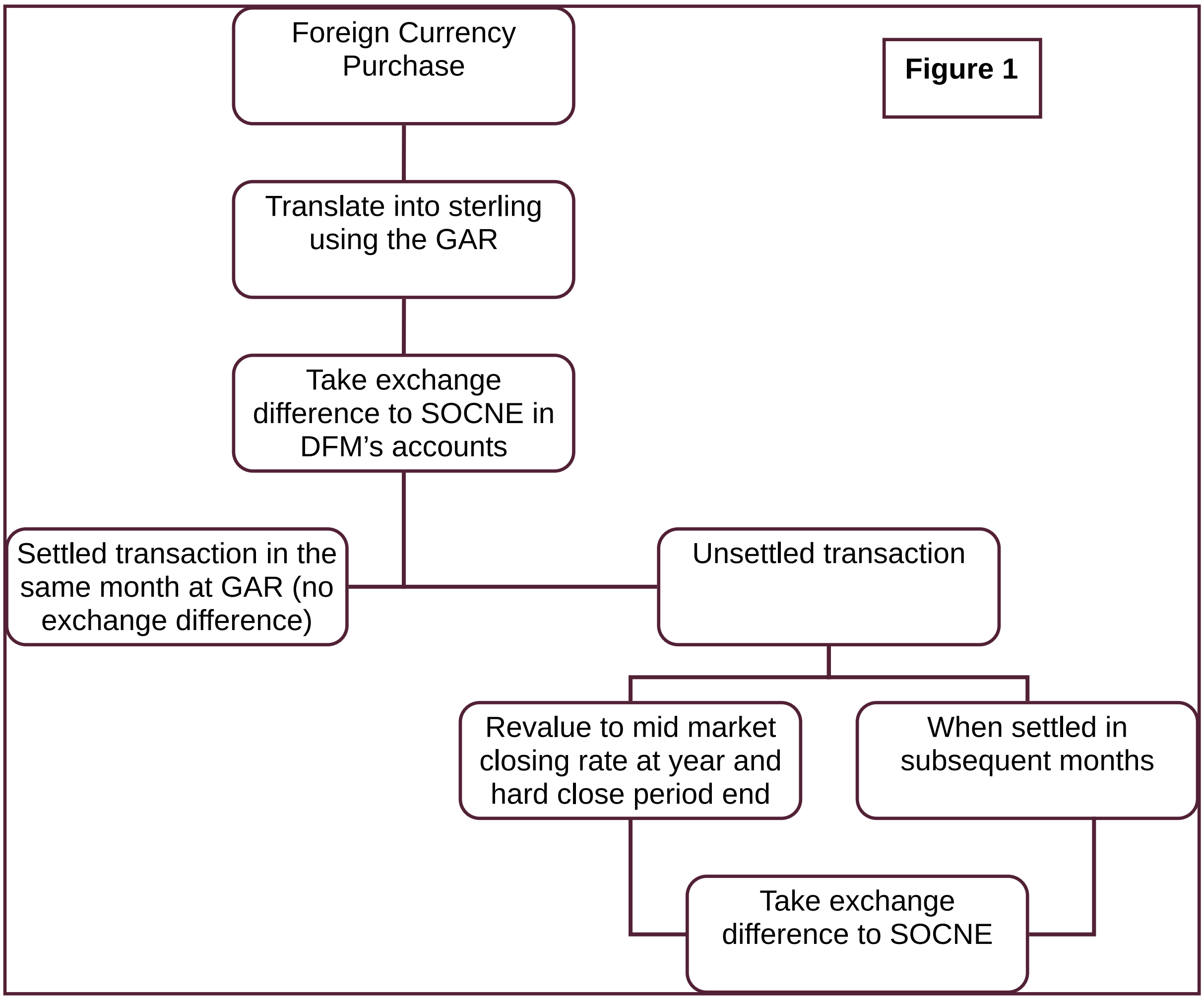
b. unsettled transactions: where the exchange rate at the reporting period date differs from the rates at which transactions were recorded in the accounts – typically at the year end and 'hard close' period ends (AP06/09/12) when currencies are translated from the GAR to the mid-market rate.

3.23. The Department enters into foreign currency forward contracts to buy US $ and Euros. Forward contract commitments are based on TLBs' planned future expenditure requirements which are identified in their planning round submissions.

3.24. In accordance with financial instrument accounting requirements, the fair value of the Department's forward contracts should be recognised as a financial asset or a financial liability in its Statement Of Financial Position (SOFP).

3.25. Forward contracts should be valued quarterly and again immediately prior to settlement. Any differences between the actual cost of the forward contract and the spot rate on the day of delivery will have been charged/credited to the SOCNE on valuation. See Annex 6 for further details.

3.26. All exchange differences, whether arising on settled or unsettled transactions, should be charged/credited to the SOCNE. See Figure 1 below.



Initial Recognition

3.27. Assets, liabilities, expenditure or income arising from transactions which are denominated in a foreign currency should be translated into sterling at the exchange rate prevailing at the transaction date.

3.28. For this purpose, the 'transaction date' is defined as the date on which the transaction is recognised in the accounting records under the accounting rules described in this manual.

3.29. The exchange rate prevailing at the transaction date (i.e. the spot rate) should be used on initial recognition. However, for practical reasons, IAS 21 permits an average monthly conversion rate to be used where exchange rates do not fluctuate significantly during the month. As a result, the Department can use a single representative rate as the GAR for translating its foreign currency transactions into sterling.

3.30. The GAR should be issued at the beginning of each month to represent the forecast monthly average spot rate for a particular currency. The NAO has approved the use of a monthly spot rate on materiality grounds.

3.31. The spot rates should be based on the published market rates.

3.32. The monthly GARs for the major currencies used (i.e. US $ and Euros) should be based on the FT published spot rates in the week immediately preceding the new month. For all other currencies the rate published on the last Friday before the month end should be used.

3.33. The FFR is the exchange rate used to convert sterling denominated pay and allowances of Service Personnel and UK Based Civilians serving overseas into local currency values. Its purpose is to ensure that personnel serving overseas are not penalised as a result of excessive exchange rate fluctuations. The difference between the sterling values of the pay/allowance and the subsequent sterling value charged back at the FFR or GAR is posted to the exchange gain/loss range of RACs.

3.34. The GAR and FFR rates should be published on a monthly basis by A&BS. The year-end closing mid-market rates are published by A&BS on the first working day after 1 April. Rates are promulgated to TLBs and they are also posted on the Defence Intranet.

3.35. The exchange rates applied in translating a foreign currency denominated transaction are summarised in Figure 2 below:

Figure 2

Spot & Forward Rates	The actual rates obtained by A&BS for purchase of currency.
Closing Mid-Market Rate	This is the rate at which monetary assets and liabilities at the financial year end and 'hard close' period ends denominated in foreign currency are revalued in sterling for the Annual Accounts. The year end rates are the FT published mid market closing rates for 31 March or the nearest working day before.
GAR	The rate at which all receipts/expenditure in foreign currencies are translated. Rates are based on the forecast average spot rate for the month and are notified monthly. Other than at the year end and 'hard close' period ends, monetary assets and liabilities are translated at the GAR.
FFR	The rate of exchange at which sterling denominated pay and allowances of UK Based Civilians and Service Personnel serving overseas are translated and paid in local currency.

Accounting for Exchange Differences

3.36. Exchange differences arise in the following circumstances:

a. where a currency transaction is settled at an exchange rate (see above) which differs from the rate used when the transaction was initially recorded;

b. where the rate of exchange used for unsettled transactions at the reporting period date differs from that used previously;

c. when an asset denominated in foreign currency is converted to sterling at the latest GAR/year-end rates;

d. when there is a foreign currency requirement for a currency not covered by the Offset Banking Group Scheme and A&BS makes a spot purchase. The cost of the currency at the GAR and any difference between the Spot Rate and the GAR is charged to the TLB requesting the currency using the appropriate gains/losses RACs.

3.37. All exchange differences, whether arising on settled or unsettled transactions, should be charged/credited to the Department's SOCNE (see Figure 1).

3.38. Exchange differences should be recorded by the TLB that holds the related foreign currency assets and liabilities or enters into a transaction denominated in a foreign currency.

Accounting at the Year End and 'Hard Close' Reporting Periods Ends

3.39. At each reporting period and at year-end, foreign currency monetary assets and liabilities (for example, cash and cash equivalent balances, payables and receivables) should be translated into sterling using the published 'hard close' period end or the year end mid-market closing rate.

3.40. The revaluation of a Non-Current Asset (NCA) or any other non-monetary asset or liability, expressed in a foreign currency should be translated back into sterling at the date of the revised revaluation. Where an annual review of an NCA does not result in a change to its foreign currency value, the value of the asset will still need to be re-translated into sterling at the exchange rate prevailing at the date of the review. Where non-monetary assets and liabilities are not revalued, their values should not be retranslated.

Disclosure

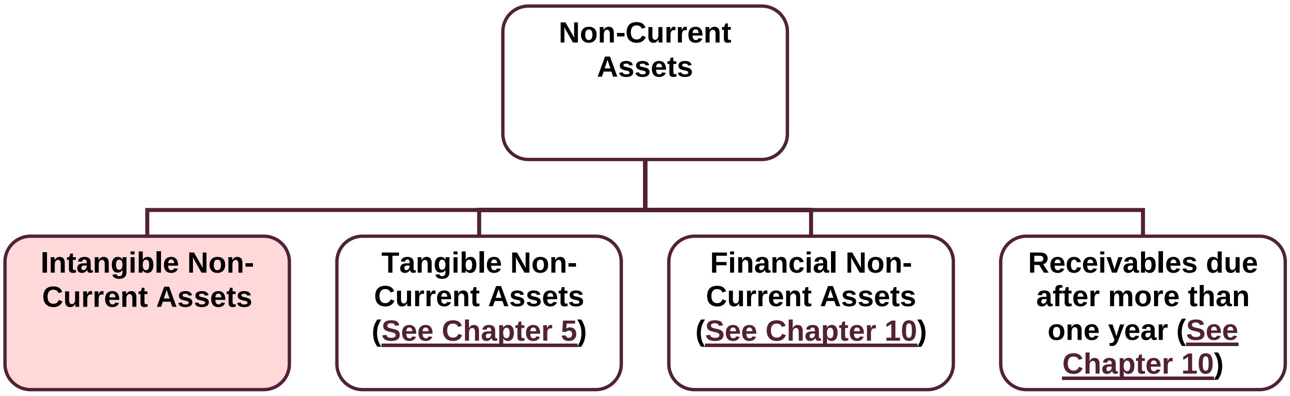
3.41. The following disclosures are made in the financial statements:

a. the translation method used (i.e. based on the functional currency);

b. the amount of exchange differences (net) charged or credited to the SOCNE;

c. the value of foreign exchange forward contracts.

CHAPTER 4: INTANGIBLE NON-CURRENT ASSETS



Introduction

4.1. This chapter sets out the accounting requirements for intangible Non-Current Assets (NCAs).

Key Points

Recognition of Intangible Non-Current Assets

4.2. Intangible NCAs are identifiable assets without physical substance.

4.3. All costs meeting the definition of intangible NCAs are capitalised on the Statement of Financial Position (SOFP).

4.4. All costs directly attributable to the creation of an intangible NCA should be capitalised.

Categorisation

4.5. All intangible NCAs should be categorised into development expenditure (separately identifying Single Use Military Equipment (SUME) development expenditure) and other intangible NCAs.

Measurement after Recognition

4.6. Intangible NCAs are initially measured at cost and then revalued.

Amortisation

4.7. Intangible NCAs are amortised, on a straight line basis, over their estimated useful economic life.

Policy Detail

4.8 Policy detail is set out under the following headings; specific responsibilities; recognition of intangible NCAs; categorisation; amortisation; transactions between Government departments; disclosure; and specific accounting requirements.

Specific Responsibilities

4.9. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

Non-Current Asset Managers

4.10 All the Department's intangible NCAs are owned, in financial management terms, by the Non-Current Asset Managers (NCAMs) on whose SOFP the assets are recorded.

4.11. The two NCAMs and their respective financial management responsibilities are described below.

Property Non-Current Asset Manager (PNCAM) within the Defence Infrastructure Organisation

4.12. The PNCAM has financial management responsibilities for any intangible assets which relate to:

a. land and buildings;

b. building related assets within the plant and machinery category;

c. property Assets Under Construction (AUC).

Equipment Non-Current Asset Manager (ENCAM) within DE&S

4.13. The ENCAM has financial management responsibilities for intangible assets which relate to:

a. SUME;

b. plant and machinery;

c. transport;

d. Information Technology (IT) and Communication equipment (comms).

4.14. NCAMs are responsible for ensuring that all intangible assets:

a. are recorded on a Non-Current Asset Register (NCAR) or equivalent accounting record;

b. are consistently accounted for in accordance with the policy set out in this chapter.

The Non-Current Asset Processing Centre

4.15. The Non-Current Asset Processing Centre is responsible for maintaining, updating and processing NCARs.

Recognition

4.16. An intangible NCA is an identifiable asset without physical substance. Examples most likely to arise within the Department are development costs, Intellectual Property Rights (IPR), software and software licences. Although greenhouse gas emission allowances are generally accounted for as an intangible NCAs for materiality reasons, the Department does not account for them as an intangible NCA – see paragraph 4.98.

4.17. An intangible NCA is recognised when:

a. it is held for use in the delivery of Departmental objectives or for administrative purposes; and

b. it has been acquired or is being developed with the intention of being used on a continuing basis for a period in excess of one year; and

c. the cost of the asset can be measured reliably (for example, it will generally be separately identifiable throughout its life); and

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

e. it is above the Department's capitalisation threshold of £25,000.

Costs to be Capitalised on Recognition

4.18. Intangible NCAs are recognised on an accruals basis at their cost of acquisition or creation. All costs directly attributable to creating and producing an intangible NCA for its intended purpose should be capitalised.

4.19. 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.

4.20. 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).

4.21. VAT paid on development expenditure may be recoverable. Guidance on whether VAT is recoverable for a particular category of development cost should be sought from the MOD VAT Team. Recoverable VAT should not be included in the capitalised value of development costs.

4.22. Where the Department's own staff are involved in the acquisition, creation or development of an intangible NCA, the relevant proportion of the internal costs which relate to those staff should, if material, be included in the cost of the asset, provided that the other criteria for capitalisation are met.

4.23. Please refer to Chapter 3 for information on intangible NCAs purchased in foreign currencies.

Categorisation

4.24. The principal intangible NCA categories are: development expenditure - on SUME items; development expenditure - for example, on software and other intangible assets – such as software licences.

Research and Development

4.25. Development is defined as the application of research findings or other scientific or technical knowledge to produce new or substantially improved materials, devices, products or services before commencement of production or use.

4.26. Research expenditure is not treated as an intangible asset, as there is no evidence that it will result in an intangible asset that will give rise to probable future service potential. As such, it is written off as incurred.

Other Intangible Assets

4.27. IPR includes, for example, concessions, patents, licences, copyrights, trademarks, databases and similar rights and assets.

4.28. Software licences confer the right to others to use software developed by third parties. Software (other than the operating system) which is owned by the Department and used in connection with providing a product or service to a body outside the Departmental boundary should be capitalised as an intangible asset if it meets criteria identified in paragraph 4.93.

4.29. Goodwill is classified as an intangible asset but is not normally expected to arise within the Department.

Measurement after Recognition

Valuation

4.30. After initial recognition, intangible NCAs should be revalued on the following basis:

a. where an active (homogeneous) market exists, intangible assets should be carried at fair (i.e. market) value;

b. where no market exists, indices should be used to revalue the intangible asset to the lower of Depreciated Replacement Cost (DRC) or value in use if the asset is income generating;

c. where there is no value in use, the intangible asset should be valued at DRC.

4.31. The above bases are a proxy for fair value. Further details on the specific accounting requirements can be found in paragraphs 4.43 to 4.107.

Amortisation

4.32. Intangible NCAs are amortised over their estimated useful economic life.

4.33. Straight line amortisation is applied as shown in Figure 1 below.

4.34. Any proposed variations to lives outside the ranges shown in Figure 1 should be agreed with the MOD Accounting Policy Team.

4.35. Where a range of lives is given, the NCAM is responsible for determining which is the most appropriate.

4.36. A full month's amortisation is charged in the month of transfer in, purchase or commissioning. No amortisation is charged in the month of transfer out or disposal.

4.37. If estimated useful economic lives or residual values are amended, the unamortised cost is written off prospectively over the remaining asset life.

Figure 1

Intangible NCA Category	Years
Development costs (including SUME development)	Useful economic life of the tangible NCA to which it relates
Intellectual property rights (IPR)	Useful economic life (determined by D/IPR)
Software licences	Over shorter of expected life or licence period

Transactions Between Government Departments

4.38. The transfer of intangible NCAs to another government department, except under a transfer of function or a merger of departments, should be treated as a normal commercial transaction, i.e. a sale. Assets transferred in this way should be transferred at fair value.

4.39. For intangible assets, fair value should usually be based on DRC.

4.40. If assets transfer for no consideration the MOD Accounting Policy Team must be consulted, as HM Treasury approval is required.

Disclosure

4.41. Intangible NCAs are disclosed in the Annual Accounts under the following headings:

a. SUME;

b. software;

c. other intangible assets.

4.42. The disclosure note for intangible assets must explain the basis on which each category of intangible NCA has been valued.

Specific Accounting Requirements

4.43. Specific intangible NCA accounting treatments are set out in the following paragraphs.

Research and Development Costs

4.44. 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.

4.45. All expenditure on research should be expensed to the Statement of Comprehensive Net Expenditure (SOCNE) in the year in which it is incurred.

4.46. The Department must capitalise development cost expenditure which meets all of the following criteria:

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 be completed and 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.

4.47. Development costs which do not meet the above criteria should be expensed to the SOCNE. In addition, the TLB managing the procurement should treat all costs associated with, for example, failed designs and technological advances which arise between original project inception and final commissioning as abortive costs, expensing them to the SOCNE on recognition or, exceptionally, on project completion.

4.48. The dividing line between research and development expenditure is often indistinct and some expenditure may have the characteristics of more than one category. The Main Gate approval stage within the CADMID project life cycle is often cited as a dividing line between research expenditure and development expenditure. However, although this approval hurdle may act as a useful guide for deciding whether to record the expenditure as research or development expenditure, the correlation between certain stages in the CADMID cycle and certain types of expenditure should not be viewed as a hard and fast decision rule.

4.49 Any proposal to capitalise development costs prior to Main Gate must be approved by the MOD Accounting Policy Team.

4.50. All costs directly attributable to the development project should be capitalised, provided that they meet the definition of development costs and the general criteria for capitalisation as an intangible asset.

4.51. Development expenditure meeting the criteria in paragraph 4.46 may be incurred in relation to NCA development projects or to development projects which will be subsequently treated as RMC within the Department's supply systems.

4.52. Development costs should be recorded at their current value. As such they are subject to indexation. The price indices applied to development expenditure should be the same as those applied to the underlying NCAs to which the development expenditure relates.

4.53. Development costs are subject to the same review processes (for example, impairment and remaining life) that are applied to NCAs in general and should be amortised over their useful economic life. The useful economic life of a development cost intangible NCA should never extend beyond the economic life of the underlying tangible NCA or the RMC item to which it relates.

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

4.54. 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.

Determining the Amount of Development Costs to Transfer

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

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

4.57. 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 ENCAM.

4.58. 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 ENCAM. A material omission is defined as £5M or 5% (if lower) of the total development costs already transferred.

4.59. Where a material omission does come to light, the additional tranche of development costs should be transferred to the ENCAM.

4.60. 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 ENCAM as an intangible asset when the asset is accepted back into service.

4.61. The amount to be included in the ENCAM's 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 Planning Round (PR) process**.** The relevant Project Manager should advise the ENCAM of the planned asset life so that the development costs can be amortised over the same period.

Accounting for Development Costs after the Transfer

4.62. The ENCAM must account for 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 ENCAM will need to ensure that the development costs for each 'asset class' can be traced back to the associated underlying asset.

4.63. The ENCAM 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, the ENCAM may start to amortise development costs ahead of the period in which the associated NCA comes into service. The ENCAM must not directly relate the amortisation of development costs to individual assets received into service.

4.64. The Non-Current Asset Processing Centre is responsible for maintaining the capitalised development costs on an NCAR and for performing the accounting functions.

4.65. Agencies may be required to reflect development costs within their own Agency accounts, in which case the ENCAM will be required to communicate development costs (off-line) to the respective Agency.

4.66. If a whole class 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 is written off. For example, where a whole class 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.

4.67. 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.

4.68. 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 prospectively by accelerating the amortisation of the asset's remaining (i.e. shorter) useful economic life.

4.69. An extension to the underlying NCA's life will also affect the life of any associated development cost. This should be accounted for prospectively 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

4.70. 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).

Capital Spares

4.71. 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 development costs relating to the associated NCA. The same accounting treatment is applied as is used for NCAs. See paragraphs 4.54 to 4.69.

4.72. Expenditure on developing enhancements should be collected by the PT managing the enhancement project and transferred to the ENCAM for capitalisation. Costs which fail the capitalisation criteria set out in paragraph 4.46, plus any associated in service support costs, should be expensed by the PT, as incurred.

Guided Weapons, Missiles and Bombs

4.73. 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 paragraphs 4.54 to 4.69.

Development Costs Incurred in Relation to Raw Materials and Consumables

Raw Materials and Consumables

4.74. 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.

4.75. 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 paragraph 4.46, they should be recorded on an NCAR as an intangible NCA and reported on DE&S's SOFP.

4.76. Capitalised development costs should initially be accounted for in the same way as those relating to an NCA. See paragraphs 4.54 to 4.61.

4.77. On first delivery of the RMC item, the ENCAM 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.

4.78. 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 ENCAM accordingly.

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

4.80. The ENCAM, with the assistance of the Non-Current Asset Processing Centre, 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 ENCAM should ensure that it is possible to map development costs to the RMC items to which they relate.

4.81. The points raised at paragraph 4.65 in respect of Agency accounts also apply to development costs associated with RMC items.

4.82. When development costs for RMC items are transferred to the ENCAM, 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.

4.83. 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.

Intellectual Property Rights

4.84. On initial recognition, IPR purchased separately from a business should be capitalised at cost.

4.85. IPR which are developed in-house by the Department are only capitalised if they already have (or subsequently acquire) a readily ascertainable market value. This means the asset must belong to a homogeneous population of assets and also that an active market, evidenced by frequent transactions, exists for them.

4.86. IPRs are to be amortised over their assessed useful economic life, which is to be determined in conjunction with D/IPR.

4.87. IPR are regarded as impaired if their recoverable amount (i.e. the higher of net realisable amount and value in use) falls below their carrying amount. Annual impairment reviews are performed to ensure that IPR are not carried at a value which exceeds their recoverable amount. The first review should be carried out at the end of the first full financial year following initial recognition of the intangible asset on the SOFP.

4.88. IPR with readily ascertainable market values are revalued by reference to these market values.

4.89. Reversal of a past impairment can only be recognised if it is clearly attributable to an unforeseen reversal of the external event that led to the impairment. Past impairments cannot be reversed if the restoration in value is internally generated.

4.90. The majority of IPR are held by the Department's commercial contractors and the Department normally secures 'freedom of use' during the time that the asset is in service. Consequently, any IPR element will invariably be included in the overall project development cost and will be indistinguishable from the direct cost of the asset. Therefore, as IPR are only of value while the Department is using the asset and cannot be sold separately to a third party, it is not appropriate in such circumstances to attempt to identify an IPR element.

4.91. Where IPR arises from Departmental in-house research and development work, costs which meet the capitalisation threshold of £25,000 must be capitalised as part of the project development costs. The only exception to this is where the IPR is separately identifiable, has a readily ascertainable market value and is material in nature (for example, where the Department has a right to a Commercial Exploitation Levy as the result of a contractor exploiting Departmental funded work).

Software

4.92. Software which is purchased from a third party for internal business use should be capitalised as an intangible asset. Software which the Department develops internally for its own use should only be capitalised as an intangible asset if it meets the criteria in paragraph 4.46. Any software that is integral to the operation of the hardware should generally be capitalised as part of the hardware, although this will depend on whether the tangible or intangible element is the more significant. Further details are given in Annex 1.

4.93. Software costs incurred by the Department in connection with a product or service which is to be supplied to a body outside the Department should be capitalised as an intangible asset if the Department can demonstrate the following:

a. the technical feasibility of completing the project so that the software is available for sale;

b. its intention is to complete the software and sell it;

c. adequate technical, financial and other resources exist to complete the project and sell the software;

d. its ability to reliably measure and separately identify the expenditure incurred on developing the software, and that it is separately identifiable.

4.94. Any such software intangible assets should be amortised on a systematic basis over the period in which the related product or service will be sold or provided for use.

4.95. 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 contributes to the provision of services or other Departmental outputs for a period in excess of one year, the cost of the licence must be capitalised as an intangible asset and amortised over the shorter of its economic life or the licence period.

Website Costs

4.96. If TLBs have developed websites for internal or external access, the development costs are capitalised as part of the cost of the internally generated intangible asset provided that the requirements of paragraph 4.46 are met.

4.97. If a website is capitalised as an intangible NCA, a conservative view should be taken of its useful life.

EU Greenhouse Gas Emission Allowances

4.98. 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.

4.99. 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.

4.100. 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.

4.101. 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.

4.102. 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.

4.103. A cap and trade scheme, such as the EU ETS, gives rise to an asset in relation to the allowances held; to a government grant that is subject to a condition for the fair value of allowances issued free to the Department; and to a liability for the obligation to deliver allowances equal to the emissions that have been made. Allowances intended to be held for use on a continuing basis are to be classified as intangible assets, otherwise they should be classified as current assets.

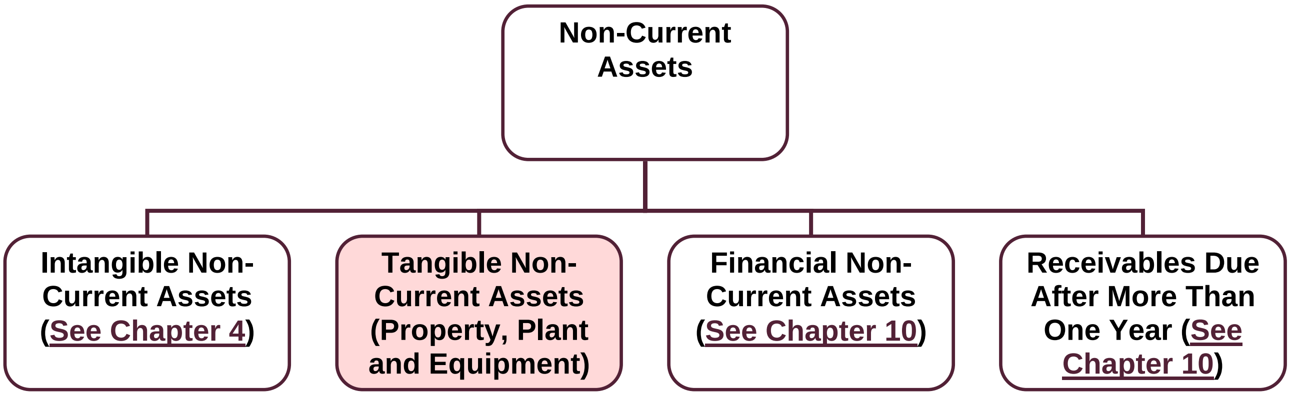
4.104. The intangible or current asset should be valued at fair (i.e. market) value on recognition and periodically revalued in the same way as all NCAs. The fair value of the allowances issued free to the Department should be accounted for as a government grant subject to a condition. Therefore, the income should be deferred and released to the SOCNE as the liability to emit greenhouse gases is recognised through the SOCNE.

4.105. A liability is recognised for the obligation to deliver allowances equal to emissions that have been made. This liability is a provision and should be measured as the best estimate of the expenditure required to settle the present obligation at the reporting period date. This should be the current market price of the number of allowances required to cover emissions discharged up to the reporting period date.

4.106. For materiality reasons, the Department does not fully comply with the cap and trade scheme accounting requirements. Instead of registering an asset and a liability to represent allowances held and its obligation to deliver allowances to offset emissions made, 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.

4.107. 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.

CHAPTER 5: TANGIBLE NON-CURRENT ASSETS



Introduction

5.1. This chapter sets out the accounting requirements for tangible Non-Current Assets (NCAs), including capital spares and Guided Weapons, Missiles and Bombs (GWMB) which are recorded on a supply system rather than on a Non-Current Asset Register (NCAR).

Key Points

Recognition of Tangible Non-Current Assets

5.2. All costs which meet the definition of tangible NCAs are capitalised and included on the Statement of Financial Position (SOFP).

5.3. A tangible NCA is defined as, and recognised when, an item displays all of the following characteristics:

a. it is held for use in delivering Departmental objectives or for administrative purposes;

b. it has been acquired or is being constructed with the intention of being used on a continuing basis for a period in excess of one year;

c. the cost of the item can be measured reliably. For example, it will generally remain separately identifiable throughout its life;

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

e. it is above the Department’s capitalisation threshold of £25,000. (No capitalisation threshold is applied to non-current assets, capital spares or GWMB held on the supply system or by industry partners).

5.4. All costs directly attributable to bringing the tangible NCA into its working condition for its intended use should be capitalised.

Categorisation

5.5. All tangible NCAs should be assigned to one of the following categories: land; buildings and dwellings; Single Use Military Equipment (SUME); transport equipment; plant and machinery; IT and communications equipment; Assets Under Construction (AUC); capital spares; GWMB.

Measurement after Recognition

5.6. Tangible NCAs are initially measured at cost and then revalued to their fair value.

5.7. Fair value will usually be determined by market-based evidence or value by appraisal. If there is no market value, Depreciated Replacement Cost (DRC) is used as a proxy for fair value. See Figure 1.

Depreciation

5.8. Depreciation is charged on all tangible NCAs except for land (unless held under a finance lease); AUC; operational heritage assets with an infinite life; and assets held for sale or disposal.

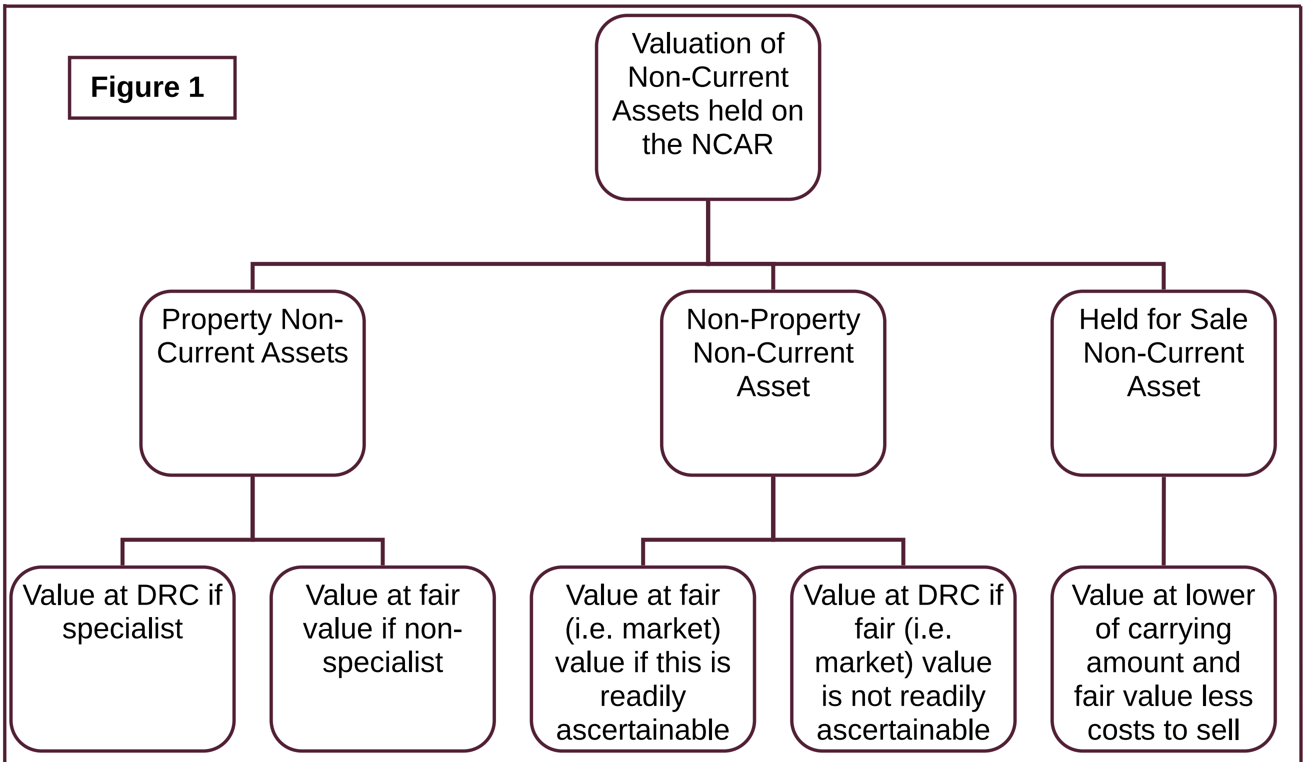
5.9. Depreciation is charged to allocate the gross carrying amount of tangible NCAs, less their estimated residual value, evenly over their estimated useful economic life.

Disposals

5.10. An asset is deemed to be held for sale if its carrying amount will be recovered principally through a sales transaction and the sale will be complete within twelve months.

5.11. Tangible NCAs which are deemed to be held for sale should be valued at the lower of their carrying amount and their fair value less costs to sell.

Figure 1



Policy Detail

5.12. Policy detail is set out under the following headings; specific responsibilities; categorisation; recognition of tangible NCAs; measurement after recognition; componentisation and subsequent expenditure; depreciation; physical verification of NCAs; write-ons; NCAs reclassified to raw materials and consumables; transfers; disposals; gifting of NCAs; disclosure; and specific accounting requirements.

Specific Responsibilities

5.13. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

The MOD Accounting Policy Team

5.14. The MOD Accounting Policy Team is responsible for:

a. agreeing, in consultation with Hd FMPA, capitalisation thresholds with HM Treasury;

b. defining the NCA principal and minor categories (i.e. SUME is a principal category and SUME Land Systems is a minor category).

Non-Current Asset Managers

5.15. The Non-Current Asset Managers (NCAMs) are the Departmental financial recording and reporting entities on whose SOFP the NCAs listed in paragraphs 5.16 and 5.17 below appear.

Property Non-Current Asset Manager (PNCAM) within Defence Estates

5.16. The PNCAM has financial management responsibility for:

a. land and buildings;

b. building related assets within the plant and machinery category;

c. property AUC.

Equipment Non-Current Asset Manager (ENCAM) within DE&S

5.17. The ENCAM has financial management responsibility for:

a. SUME;

b. plant and machinery;

c. transport;

d. Information Technology (IT) and Communications (Comms) equipment.

5.18. NCAMs are responsible for:

a. ensuring that NCAs are included on their SOFP and recorded on the NCAR;

b. ensuring that NCA accounts are true and fair, including reviewing valuations;

c. ensuring that NCAs are physically verified;

d. defining sub-classification of NCAs below the principal and minor categories;

e. allocating each of their NCAs to the appropriate NCA category;

f. ensuring that all items identified as ancillary, composite or grouped assets are correctly recorded in an NCAR;

g. ensuring that all valued heritage assets, with the assistance of the Non-Current Asset Processing Centre (NAPC), are entered onto the NCAR;

h. maintaining, with TLB assistance, a separate register of unvalued non-operational heritage assets which meets the disclosure requirements;

i. ensuring that all NCAs in use are depreciated at an appropriate rate and that their life and residual value are periodically reassessed.

DE&S

5.19. DE&S is responsible for reporting the following NCAs on its SOFP:

a. equipment AUC;

b. GWMB;

c. capital spares;

d. Government Furnished Equipment (GFE) held in project accounts.

The Non-Current Asset Processing Centre

5.20. The NAPC is responsible for:

a. processing Asset Change Notifications and maintaining and updating NCARs;

b. managing the NCA verification process.

Inventory Accounting Team

5.21. The Inventory Accounting Enabling Team (IAET) is responsible for ensuring that financial accounting policy is consistently applied to capital spares and GWMB.

TLBs

5.22. TLBs are responsible for:

a. ensuring that NCA accounting policy is correctly applied;

b. ensuring the safe custody and physical control of the NCAs they use;

c. physically verifying NCAs on behalf of the NCAMs;

d. transferring locally acquired NCAs, using NCA clearing accounts, to the appropriate NCAM for inclusion in the NCAR and also the SOFP.

Asset Disposals

5.23. Defence Estates (DE) is responsible for:

a. applying property disposals accounting policy;

b. reviewing property utilisation;

c. identifying assets deemed surplus to requirements as early as practicable;

d. recognising surplus assets in its Planning Round (PR) submissions.

5.24. DE&S is responsible for

a. applying equipment disposals accounting policy;

b. identifying plant and equipment NCAs for disposal (with the assistance of the user TLBs).

Government Furnished Equipment

5.25. DE&S is responsible for reporting Contract Work Item (CWI) and Contract Support Item (CSI) NCAs, including capital spares and GWMB, on its SOFP.

5.26. The CWI and CSI NCAs are recorded on an NCAR or on inventory records as appropriate. The NAPC is responsible, on behalf of DE&S, for accounting for the assets recorded on the NCAR, whilst the appropriate inventory holder is responsible for accounting for the CWIs and CSIs, including capital spares and GWMB held on inventory records.

5.27. The Project Team (PT) operating the project account to which Jigs Tools and Test Equipment (JTTE) and Contract Embodiment Items (CEIs) have been charged is responsible for maintaining proper records and accounting for the items.

5.28. The PT managing the project is responsible for maintaining appropriate records for CWIs and CSIs loaned to contractors.

5.29. The PT managing the project must ensure that:

a. contractors provide annual audit certificates for all items provided to them under the contract;

b. all necessary investigations are undertaken and appropriate accounting adjustments made;

c. the Asset Accounting Centre (AAC) is notified of all certificates received by the PT.

Categorisation

5.30. Tangible NCAs, including those held under a finance lease, are analysed into major categories which comply with HM Treasury's Whole of Government Accounts (WGA) and the European System of Accounts 95 (ESA95) disclosure requirements. The major categories are set out in paragraphs 5.32 to 5.52.

5.31. Construction contract balances (including work classified as long term contracts) relate to work which the Department undertakes for external repayment customers (including OGDs).

Balances are accounted for within receivables but are not re-valued to current values. See Chapter 3.12.

Land, Buildings and Dwellings

5.32. 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;

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 and the Civil 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 paragraph 5.109.

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

5.33. 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.

Transport Equipment

5.34. Transport equipment is defined as equipment for moving people and/or objects - for example, lorries, trains, ambulances and aircraft. All non-SUME vehicles (i.e. vehicles that do not have an equivalent civilian role) are included in this category.

Plant and Machinery

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

5.36. 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

5.37. 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.

5.38. 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 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 paragraph 5.306.

Assets Under Construction

5.39. 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).

5.40. Subsequent expenditure on NCAs (for example, enhancement and MRO projects) should be treated as AUC if costs are accumulated during the project and the enhancement/MRO meets the capitalisation criteria. See paragraphs 5.111.

Capital Spares

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

5.42. 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 Chapter 7, Figures 2 to 10.

5.43. 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.

5.44. 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.

5.45. 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.

5.46. 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

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

5.48. 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).

5.49. In this context ‘maintained’ specifically excludes routine refurbishment of ammunition and other conventional explosive devices.

5.50. GWMB are issued as complete munitions, even if they are held in parts for safety reasons and are categorised as shown in Chapter 7, Figures 2 to 10. Parts which are held as spares are not categorised as GWMB.

5.51. 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.

5.52. 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.

Recognition

5.53. A tangible NCA is defined as, and recognised when, an item displays all of the following characteristics:

a. it is held for use in delivering Departmental objectives or for administrative purposes;

b. it has been acquired or is being constructed with the intention of being used on a continuing basis for a period in excess of one year;

c. the cost of the item can be measured reliably. For example, it will generally remain separately identifiable throughout its life;

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

e. it is above the Department's £25,000 capitalisation threshold (No capitalisation threshold is applied to non-current assets, capital spares or GWMB held on the supply systems or by Industry partners. For accounting purposes, theses assets are treated as pooled and included within the SUME category of tangible NCAs.

5.54. When an NCA that is not held on a supply system meets the capitalisation threshold and is recorded on an NCAR, it is treated as an NCA regardless of any subsequent impairment which might cause its value to fall below the capitalisation threshold. Similarly, when an asset is classed as below the threshold and expensed to the Statement of Comprehensive Net Expenditure (SOCNE), it should not be reclassified as an NCA if, as a result of revaluation, it then meets the capitalisation threshold.

5.55. NCAs that do not meet the capitalisation threshold (either on an individual or grouped basis) and low value articles in use should be expensed to the SOCNE as incurred or on issue from the supplying inventory management system. Items written off must continue to be properly recorded and controlled via, for example, permanent loan records and articles in use registers under existing Departmental Materiel Accounting Regulations.

5.56. Although held as inventory items on the supply system, for financial reporting purposes both GWMB (NCA Resource Account Codes (RACs)) and CS (inventory RACs) are disclosed as NCAs in the Annual Accounts. It should however be noted that the capitalisation threshold is not applied to these items.

Non-Current Assets on Loan

5.57. NCAs on loan to third parties are recorded on an NCAR and reported within the SOFP of the appropriate NCAM with a record of the current location. For example, GFE and Government Owned-Contractor Operated (GOCO) establishments.

5.58. Where NCAs are loaned to the Department on a short-term basis - i.e. for less than one year - they should not be included in an NCAR or the accounts. They should, however, be properly recorded and controlled under Departmental Materiel Accounting Regulations.

5.59. Assets that are loaned to the Department for more than 12 months as part of a sponsorship arrangement (i.e. there is no cost to the Department) and meet the capitalisation threshold should be treated as donated assets (see paragraph 2.29). If the assets do not meet the capitalisation threshold, they should be recorded and controlled under Departmental Materiel Accounting Regulations.

Collaborative Projects

5.60. In most cases legal ownership of NCAs used within collaborative projects which are run by a Joint Project Office (JPO) rests with the JPO prior to completion.

5.61. NCAs created under collaborative projects and intended for Departmental use are recorded in project accounts. On completion, the NCAs are recorded on the NCAR.

5.62. Where NATO funds assets which are used by the Department, the asset should be capitalised at fair value and the NATO funded proportion accounted for in accordance with paragraph 2.29.

Items of Personal Equipment

5.63. Items of personal equipment below the Departmental capitalisation threshold, which are repairable and preserved for future use (for example, the Future Integrated Soldier Technology) should be accounted for as grouped NCAs or as Capital Spares where held on a MoD supply system or by industry partners under a management contract.

Articles in Use

5.64. Articles in use are items which are issued from forward stores but not deemed to be consumed by the end user – for example, torpedoes on a ship or items recorded within the Managed Joint Deployed Inventory (MJDI) System where accountability remains with the inventory holder even though the items have been issued forward. Articles in use are generally capital spares although there may be low value exceptions – for examples, bullets issued for guarding purposes.

5.65. Articles in use are deemed to have passed the point of consumption unless capitalised as an NCA, either individually or on a group basis or managed as a Capital Spare. Articles in use are subsequently surrendered and accounted for as returned items if previously treated as consumed (written off).

Agencies

5.66. NCAMs may record NCAs whose historic cost is below the Departmental capitalisation threshold on an NCAR but only where the cost of these assets needs to be communicated for Agency accounting purposes. Agencies may have agreed lower materiality thresholds with their auditors.

5.67. An Agency should only recognise NCAs on its SOFP where the risks and rewards of ownership lie with the Agency, as opposed to the Department. Assets such as these will be bespoke to the Agency's business (i.e. not subject to any form of Departmental whole fleet management regime), will be material to its business and will have restrictions on their use, for example, donated assets, operational heritage assets, assets under PFI deals and assets held for charitable use. Responsibility for maintaining them is expected to fall directly to the Agency.

Cost Recognition

5.68. Tangible NCAs are recognised on an accruals basis at their cost of acquisition or creation. See paragraphs 5.236 to 5.240 for further details on capitalising the cost of capital spares and GWMB. All costs directly attributable to bringing the tangible NCA into its working condition for its intended use should be capitalised. These costs comprise:

a. the asset's purchase price, including import duties and non-recoverable VAT, less any trade discounts and rebates;

b. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the Department;

c. the initial estimated cost of dismantling and removing the item and restoring the site on which it is located, to the extent that it can be recognised and measured in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'. This obligation will fall to the Department either when the item is acquired or as a consequence of the Department having used it during a particular period for purposes other than producing inventory. Note that if an item is used for producing inventory, IAS 2, 'Inventories' applies and the cost is included in the item's carrying amount.

5.69. Examples of directly attributable costs are:

a. the cost of site preparation;

b. initial delivery and handling costs;

c. installation and assembly costs;

d. the cost of testing whether the asset is functioning properly, after having deducted the net proceeds from selling any items produced in bringing the asset to its present location and condition (for example, samples produced when testing equipment);

e. professional fees.

5.70. Where the Department's own staff are involved in the acquisition or construction of a NCA, the relevant proportion of the internal costs relating to those staff should, if material, be included in the cost of the asset, provided that the other capitalisation criteria are met.

5.71. Where internal costs are capitalised they will include the Department's employees' salaries and expenses which arise directly from the construction or acquisition of the specific NCA.

5.72. Administration and other general overhead costs should be excluded from the cost. Employee costs which do not relate to the specific asset are not directly attributable costs and should therefore not be capitalised.

5.73. Borrowing costs are the interest and other costs incurred in borrowing funds to finance the acquisition, construction or production of a qualifying asset (i.e. one that takes a substantial period of time to prepare for its intended use or for sale). Borrowing costs incurred on the construction of assets should be expensed.

Retention Payments

5.74. Retention payments are amounts which the Department withholds from the contractor until it is content that the contractor's work has been completed satisfactorily.

5.75. Where there is a binding contract a retention payment should be accounted for as follows:

a. if it is judged fairly certain that the Department will pay the retained amount, it should be accrued for and reflected in the value of the non-current asset;

b. if it is judged probable that the Department will pay the retained amount, a provision should be created and the amount reflected in the value of the non-current asset;

c. if it is judged only possible that the Department will pay the retained amount, it should (if sufficiently material) be disclosed as a contingent liability (but not reflected in the value of the non-current asset).

5.76. Donated NCAs, assets obtained under a finance lease, and assets funded by grants should be reported on the SOFP and separately identified on an NCAR in the same way as purchased NCAs.

Measurement after Recognition

5.77. NCAs are initially measured at cost and then revalued to fair value, which is based on market-based evidence or value by appraisal. If fair value cannot be determined, DRC is used as a proxy.

Valuation of Property Assets

5.78. Valuers use the Royal Institute of Chartered Surveyors' (RICS) "Red Book" (RICS Appraisal and Valuation Standards) to determine the most appropriate methodology for obtaining a fair value for property assets.

5.79. For non-specialist properties, fair value is usually determined from market based evidence. For 'in-use' non-specialised property assets, fair value should be interpreted as market value for existing use. In the RICS Red Book, this is defined as 'market value on the assumption that property is sold as part of the continuing enterprise in occupation'.

5.80. For specialist properties or properties not normally traded on the open market, DRC can be used as a proxy for fair value. In line with the Red Book, the DRC approach is based on the cost of replacing an existing NCA with a modern equivalent asset less any deductions for the cost of physical deterioration and all relevant forms of obsolescence.

5.81. Property assets which are to be disposed of and are within the scope of IFRS 5, 'NCAs held for sale and discontinued operations' should be valued at the lower of their carrying amount and their fair value less costs to sell.

5.82. A DRC valuation consists of two principal components: firstly, the depreciated replacement cost assessment of the buildings and infrastructure assets; and secondly the market value of the underlying land which is valued as part of the buildings. The property's valuation should be based on its existing site unless it is government policy for the service provided by the property to be located at a different site (for example, schools and hospitals might need to be on expensive inner-city sites or in towns and city centres rather than on the outskirts).

5.83. Certain infrastructure NCAs and items of plant and machinery are included within a property valuation due to their integrated nature – for example, utility supply cables and piping, heating systems, roads, boundary fences and mains drainage. Where an NCA is primarily installed to provide services to the buildings, it is valued as part of the buildings.

5.84. New IT and Communications cable installations should not be treated as infrastructure assets. See paragraph 5.316 for more details.

5.85. Please refer to the RICS Red Book for details of items of plant and machinery normally included in land and buildings valuations. This information is available from DE.

5.86. All property NCA fair values should be periodically reviewed and updated. This is achieved through a mixture of professional valuation (i.e the quinquennial review (QQR)) which is a professional revaluation at intervals of not more than five years)) and the application of appropriate price indices with no interim professional revaluation. However, the assets' existing values should be updated if, in the opinion of the PNCAM in discussion with the appropriate TLBs, there is likely to have been a material change in value during the intervening years and it has not been reflected through the application of indices. Property assets are also subject to an annual impairment review.

5.87. As part of the QQR, a valuer's report and certificate are required together with a documented process of the review and validation of data.

5.88. Care should be taken to ensure that NCAs whose values are expressed in a foreign currency are re-valued to reflect both the movement in asset value expressed in the foreign currency and the movement in the sterling exchange rate.

Valuation of Non-Property Assets

5.89. The valuation accounting treatment below only applies to assets held on the NCAR. See paragraphs 5.241 to 5.243 for the treatment of assets held on a supply system.

5.90. Non-property assets are valued on the basis of fair value, unless there is no readily ascertainable market value in which case DRC can be used as a proxy for fair value.

5.91. The DRC cost approach is based on the cost of replacing an existing NCA with a modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence.

5.92. All non-property NCA fair values should be periodically reviewed and updated, which is achieved by applying appropriate price indices. Plant and equipment NCAs are subject to an annual impairment review.

Revaluation Accounting Treatment

5.93. The revaluation accounting treatment described below only applies to assets held on the NCAR. See paragraphs 5.244 to 5.253 for the treatment of assets held on a supply system.

5.94. An upward revaluation of an asset should be reflected as an increase to its carrying amount and credited to the Revaluation Reserve. However, if it reverses a revaluation loss previously recognised in the net operating cost section of the SOCNE, the amount of the credit which can be matched to the previous charge should be taken to the net operating cost section of the SOCNE and the remainder to the Revaluation Reserve.

5.95. Downward revaluations which are due solely to fluctuations in market value are to be written off against the Revaluation Reserve until the carrying amount reaches the level of depreciated historical cost. For this purpose 'historical cost' means the value at which an asset was first recorded on the NCAR if no historical cost information is otherwise available. The effect of this is that the write-off should only be made against that proportion of the credit balance on the reserve which relates to the asset concerned. Any further downward revaluation results in an impairment and should be recognised in the net operating cost section of the SOCNE.

Revaluation Reserve

5.96. The Revaluation Reserve reflects the cumulative balance of indexation and revaluation adjustments to NCAs, current asset investments in marketable securities and inventory. It comprises two elements:

a. the in-year revaluation;

b. the backlog amortisation/depreciation

5.97. Each year the realised element of the Revaluation Reserve, i.e. an amount equal to the excess of the actual depreciation over depreciation based on historical cost, is transferred from the reserve to the General Fund.

5.98. Backlog amortisation/depreciation represents the additional amount that would have been charged in prior years if the asset had been valued at today's price from initial purchase. This 'under amortisation/depreciation' resulting from earlier years is debited to the Revaluation Reserve.

Impairment

5.99. Assets should be carried at no more than their recoverable amount, i.e. the amount recoverable through use or sale. For the Department, value in use is assumed to equal the cost of replacing the service potential provided by the asset, unless this has declined significantly.

5.100. An impairment occurs when there is a permanent diminution in the value of an asset as a result of a clear consumption of economic benefits or a reduction in service potential. If this is the case, the asset is impaired and the impairment loss recognised. Assets that are damaged but repairable, and have a repair loop available, are not required to be impaired as long as the repair work carried out does not enhance either the life or capability of the asset beyond the original specification. Where no impairment is made the repair costs should be expensed. Downward revaluations arising from changes in market value - for example, as a result of the QQR and/or indexation, do not necessarily result in an impairment. See paragraph 5.95.

5.101. Examples of impairments arising from a loss of economic value or service potential are:

a. disposal of equipment where the sale is likely to complete within 12 months. These assets should be valued at the lower of their carrying amount and their fair value less costs to sell. Any write-down of the asset should be recognised as an impairment in accordance with paragraph 5.177;

b. assets which remain in service but at a reduced capability. The asset should be impaired to reflect its revised service potential.

5.102. Impairments such as these must be reflected immediately, regardless of whether a Board of Inquiry is to be held or a decision has yet to be taken on whether the asset is to be written off or repaired.

5.103. All impairments (except for those arising from a loss of economic value or service potential) should be written off against the Revaluation Reserve until the carrying amount of the asset reaches the level of depreciated historical cost. For this purpose 'historical' refers to the value at which the asset was taken on to the NCAR if no historical cost information was available. The write-off should only be made against that proportion of the credit balance on the Revaluation Reserve that relates to the asset concerned. Downward revaluations below this should be recognised in the SOCNE (net operating cost section).

5.104. All impairment losses arising from a clear consumption of economic value or service potential should be taken to the net operating cost section of the SOCNE. Any balance within the Revaluation Reserve (up to the level of the impairment) should be transferred to the General Fund.

5.105. In circumstances where an asset is scrapped, destroyed, sold for scrap or lost, the reduction in value is charged to the NCA write-off account (MKB range) and not to an impairment heading. The sale of an asset for scrap is deemed equivalent to a write-off, as any income is incidental.

5.106. At the end of each financial year TLBs, as custodians/users of the assets, should carry out an overall review of assets for impairment, applying local knowledge and experience, as appropriate. Any impairments should be communicated to the NAPC (via the appropriate NCAM) to enable the NCAR to be updated. The assumptions made in estimating the amount of the impairment (if any) should be documented. The assumptions should be reviewed at the end of each financial year to reassess their validity and, if necessary, to recalculate the impairment estimate.

Impairment Reversals

5.107. Where an impairment (up to depreciated historical cost) has been charged to the net operating cost section of the SOCNE and the impairment is subsequently reversed, the reversal is also accounted for in the net operating cost section of the SOCNE. Any further increase in an asset's value above its depreciated historical cost should be taken through the Revaluation Reserve.

Budgetary Treatment

5.108. In budgetary terms, certain impairments will score as DEL and others as AME. The budgetary treatment does not influence the accounting treatment. However, the Department may need to disclose information in the Annual Accounts about the type and cause of impairment if the amounts are significant.

5.109. A reduction in the service potential (consumption of economic benefits) of an asset can arise for various reasons. The reason for the impairment determines whether it scores against AME or non-cash RDEL in budgets. The types of impairments, together with their budgetary treatment, are detailed below:

a. loss or damage, which results from normal business operations, other than those caused by a catastrophe. This category covers all loss and damage to assets which is caused by management and staff action (or inaction) or by the actions of third parties. It also includes theft. This class of impairment scores in non-cash RDEL;

b. loss resulting from a catastrophe. This category includes: major earthquakes; volcanic eruptions; tidal waves; exceptionally severe hurricanes, droughts and other natural disasters; acts of war, riots and other political events; and technological accidents such as major toxic spills or release of radioactive particles into the air. This class of impairment scores in AME;

c. abandonment of assets under construction. This category covers the impairment of assets under construction caused by a management decision to abandon the construction process and also includes the abandonment of software assets under construction. This class of impairment scores in non-cash RDEL;

d. unforeseen obsolescence. All assets are subject to obsolescence. However, the rate of obsolescence tends to be category specific – for example, IT assets become obsolescent more quickly than buildings. Any foreseeable obsolescence is reflected in asset lives. Unforeseen obsolescence generally only occurs when a completely new technology is introduced or new legislation renders the asset illegal. As such events are rare, HM Treasury should be contacted before this category is used. This class of impairment scores in AME;

e. over specification of assets (gold plating). Gold plating relates to the over-specification of assets. This category should be used where the value of the asset is impaired to bring it into line with its utility to the business or alternatively where the cost of the gold plating is not recoverable. Care should be taken to distinguish between gold plated assets and those that are, by necessity, of a higher specification. For example, an embassy is likely to be of a high specification to meet security requirements and also to reflect its national representational status. Therefore, the value of the building should not be impaired to that of standard office accommodation. The rule is that any higher specification must be justifiable. Where this is not the case, the NCA should be impaired. This class of impairment scores in non-cash RDEL;

f. other impairments. This category includes impairments which do not fall into any of the categories described above. It includes impairments associated with disposals, changes in use and write-downs of development land or specialised buildings. It also includes write-downs to the value of enhancements which occur after the first professional valuation. This class of impairment scores in AME.

Componentisation and Subsequent Expenditure

Componentisation

5.110. Where components of a tangible NCA (excluding capital spares and GWMB) have a cost that is significant in relation to the asset's overall cost, each should be separately depreciated.

Subsequent Expenditure

5.111. Subsequent expenditure on an NCA is capitalised when the following two criteria are met:

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

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

5.112. Where subsequent expenditure is capitalised, the carrying amount of the part which is being replaced must be derecognised, even if it has been separately depreciated. However, see following paragraphs.

5.113. Expenditure on labour and consumables, including the cost of small parts (i.e. day to day servicing or repairs and maintenance) is expensed to the SOCNE, as it does not meet the recognition criteria in paragraph 5.111.

5.114. Parts of some tangible NCAs may need to be replaced at regular intervals over the life of the asset (for example, aircraft interiors such as seats) or they may only need to be replaced on an infrequent or non-recurring basis. The cost of the replacement part is recognised in the carrying amount of the tangible NCA under the recognition criteria in paragraph 5.111.

5.115. If it is not practicable to determine the carrying amount of the replaced part, the cost of the replacement can be used as an indication of the original acquisition/construction cost. The accounting treatment for different categories of NCAs is covered below.

Property Assets

<u>Componentisation</u>

5.116. Non-specialist new build property assets need not be componentised at the point of initial capitalisation, as the cost of any potential component is unlikely to be significant against the overall cost of the asset. However, this will need to be assessed on a case by case basis.

5.117. Specialist property assets such as runways should be componentised.

<u>Subsequent Expenditure</u>

5.118. Where subsequent expenditure covers the refurbishment of the majority of an existing asset, the cost should be capitalised and the total carrying amount of the replaced asset derecognised. Where only part of the asset is refurbished, the replaced element should be derecognised if the asset's carrying amount exceeds £500,000. The QQR will correct any short term over/understatement of valuations. This materiality threshold should be reviewed on an annual basis.

Non-Property Assets – Sea Environment

5.119. Expenditure on repairs, other than during Major Refits and Overhauls (MRO), is charged to the SOCNE as incurred.

5.120. The decision on whether or not to capitalise subsequent expenditure will normally be determined by reference to the Equipment Plan (EP). However, the final decision will be agreed at the Main Gate approval stage of a project. DE&S should review the EP in the light of this guidance to determine the capital and revenue split. Once the decision to capitalise expenditure has been made within DE&S it should not normally be expensed subsequently.

5.121. Subsequent expenditure on a platform, whether related to an enhancement or a modification, should normally be expensed unless it meets the criteria in paragraph 5.111. In practice, this should result in the asset's capability or its life being significantly enhanced.

5.122. It is likely that expenditure to enhance or modify a ship or submarine will cover an upgrade to the whole (or significant proportion) of an asset class. Enhanced or modified assets are often identifiable by a change in their mark or role.

5.123. As part of the planning process, PTs managing enhancement packages of work should consult their TLB on the materiality of any expenditure on enhancements which occur between MROs. If appropriate, the PT should consider grouping a series of related enhancements to achieve a true and fair reflection of asset values and associated operating costs.

Accounting for Major Refits and Overhauls

5.124. The principle aim of an MRO is to restore the operational capability that has already been consumed and reflected through depreciation. However, the opportunity to enhance the asset may also be taken, in which case care should be taken to separately identify enhancement costs and restoration costs.

5.125. Under MRO accounting only costs arising at the time of an MRO will be considered for capitalisation. The term MRO is intended to cover any instance of substantial base depot maintenance, during which significant expenditure is incurred, whether on refit, maintenance or upgrade work. Significant expenditure is defined as costs which are £1M or 10% of an asset's gross carrying amount, whichever is the higher. As with enhancements, PTs managing the package of work should, as part of the planning process, consider grouping a series of related refits if this will result in a true and fair reflection of asset values and associated operating costs.

5.126. Subject to materiality considerations, expenditure on enhancements carried out between MROs should be capitalised when the criteria in paragraph 5.111 are met. The cost should then be depreciated on an appropriate basis.

5.127. All expenditure on enhancements carried out during an MRO will be capitalised as part of the MRO regardless of financial criteria, even though this approach may result in minor accounting treatment inconsistencies for similar items.

5.128. Enhancements which share the same life as that of the core asset should be depreciated across the same period. Where an asset enhancement is capitalised, the associated development expenditure should also be capitalised.

5.129. In cases where asset enhancements are capitalised, the ENCAM will need to ensure that when adjusting the carrying amount of the principal asset, the value of the replaced element is also removed.

5.130. Where expenditure is expensed this is to be carried out by the PT responsible for managing or effecting the work package.

5.131. Subsequent expenditure on a major rebuild takes place when an existing type or mark of an asset is withdrawn completely from operational service to become the basic building block for its replacement, which will be fundamentally different in characteristics, role and performance. In such cases the withdrawn assets (i.e. those put into the programme for major rebuild) will have been written down to their expected recoverable amount and will be re-released into operational service based on their newly determined gross carrying amount. Where applicable, any new builds will be indistinguishable from rebuilt assets (i.e. they form a homogenous group). However, few assets will meet this strict definition.

5.132. Where material, the following costs should be capitalised:

a. external contractor costs;

b. Departmentally supplied materiel (including embodied capital spares);

c. RMC consumed;

d. direct internal labour and other costs which are incremental to the project.

5.133. Some capital spares will be removed and replaced at each MRO. Costs incurred on repairing them should continue to be expensed in line with current policy on capital spares.

5.134. Other expenditure - for example, station, line and afloat repairs, which maintain the asset at its previously assessed standard of performance - should be charged to the SOCNE as incurred.

<u>Accounting for the Major Refit and Overhaul Element of New Assets</u>

5.135. The decision on whether or not to apply MRO accounting to new assets will be made at the Main Gate submission stage

5.136. The PT will notify the ENCAM of the AUC cost to enable it to be split between:

a. the core asset cost, depreciated over the life of the core asset; and

b. the restoration cost, depreciated over the period to the first MRO.

5.137. The restoration cost element relates to the future cost of restoring the operational capability of the asset that will have been consumed by the time the first MRO occurs. This cost will usually be derived as the present value of the forecast cost of the first MRO, depreciated to the forecast date of that MRO. The sum of the core asset cost and restoration cost must equal the total AUC value transferred to the ENCAM. The ENCAM will hold the core and MRO assets on its SOFP and record them on the NCAR.

<u>Accounting for the Major Refit and Overhaul Element of Existing Assets</u>

5.138. Where it is necessary to apply MRO accounting to an existing asset to avoid materially misstating the accounts, the asset's value should be split between the core asset and the MRO element. The MRO value can be determined in one of two ways:

a. prior estimate - whereby the estimated costs and date of the last MRO are determined and the unamortised element calculated by using the projected date of the next MRO and interim indexation; or

b. future estimate - whereby the estimated costs and date of the next MRO are determined, adjusted for any difference between the projected level of cost inputs compared to the last MRO (where material), and also adjusted to reflect indexation and depreciation over the period between MROs.

5.139. In both cases, the calculated gross MRO cost is deducted from the carrying amount of the asset to determine the value of the core asset. There is no change to the total gross carrying amounts in the year of the most recent formal revaluation of the asset.

5.140. The core asset value should be depreciated over the useful economic life of the core asset. The MRO asset value should be depreciated over the period to the next MRO.

5.141. Where an asset will not be undergoing any further major refits, it can be excluded from MRO accounting.

5.142. Approval and advice should be sought from the CFAT team on whether it is appropriate to create a prior period adjustment when first applying MRO accounting to existing assets.

Non-Property Assets – Land Environment

5.143. Equipment assets within the Land Forces environment need not be componentised. Instead, subsequent expenditure should be expensed in the year in which it is incurred rather than capitalised and should be depreciated over the period to the next major refurbishment. This is because the rolling nature of the refurbishment programme results in an annual maintenance charge that is similar to the depreciation that would have been charged had the expenditure been capitalised.

5.144. To satisfy the NAO that the refurbishment costs recognised in the SOCNE are consistent with the economic benefits consumed over the same period, Land Forces is required to provide NAO with the following information:

a. the current year value of the refurbishment costs recognised for assets;

b. the refurbishment costs incurred in each of the last three years;

c. the latest projected spend for refurbishment costs for the next five years.

5.145. If the NAO judges that the value or pattern of refurbishment costs could lead to a material misstatement, further evidence will be required to show that the condition of the asset base as a whole has not deteriorated over time and that the economic benefits of the assets are not being consumed more quickly than the refurbishment costs are being recognised in the accounts. This could be achieved, for example, by carrying out an annual condition survey. Further evidence will also be available from impairment reviews.

Non-Property Assets – Air Environment

5.146. Assets within the Air Environment need not be componentised. Therefore, subsequent expenditure should be expensed in the year in which it is incurred rather than being capitalised and depreciated over the period to the next major refurbishment. This is permissible on the grounds of materiality and practicality.

Depreciation

5.147. Depreciation is charged on all NCAs (including those in a supply system) except for:

a. land (unless held under a finance lease):

b. AUC;

c. operational heritage assets with an indefinite life;

d. assets held for sale or disposal.

5.148. Depreciation is charged on a straight line basis and allocates the gross carrying amount of tangible NCAs, less their estimated residual value (if this can be ascertained with reasonable certainty), evenly over their estimated useful life.

5.149. An NCA's useful life should be reviewed annually and, where appropriate, revised to reflect changing circumstances – e.g. arising from decisions taken in the latest finalised Planning Round. All assumptions made in determining the estimated useful life should be documented and included in this annual review. Particular attention should be paid to assets which are nearing the end of their useful life or are subject to an extension to or/curtailment of their useful operational life. A regular review of asset lives will ensure that all assets used to deliver economic benefit are depreciated over the appropriate period.

5.150. Where material, the residual values of NCAs should be reviewed annually and adjusted if appropriate. All assumptions should be documented.

5.151. A change to either the useful life or the residual value of an NCA should be accounted for prospectively over the asset's remaining useful life.

5.152. Any material variations to asset lives outside the ranges shown in Figure 2 must be cleared through the MOD Accounting Policy Team.

5.153. Donated NCAs, assets funded by grants, leased assets, and PFI assets are all subject to depreciation in the same way as other assets.

5.154. Temporarily unused facilities are depreciated on the same basis as when they are in use.

5.155. Where a range of lives is given, the NCAM is responsible for determining the appropriate estimated useful life which should be applied to the NCA.

5.156. A full month's depreciation is charged in the month of transfer in, purchase or commissioning. No depreciation is charged in the month of transfer out or disposal.

5.157. If an estimated useful life or a residual value is amended, the carrying amount is written off prospectively over the asset's remaining life, with a consequential effect on amount of depreciation charged.

Figure 2	Category	Years
Tangible Non-current Assets:		
Land and Buildings	Land Buildings (dwellings and non-dwellings): - permanent - temporary Leasehold	Indefinite and not depreciated unless held under a finance lease. 40 – 50 5 – 20 Shorter of expected life and lease period.
Single Use Military Equipment (including GWMB)	Air Systems - Fixed Wing Air Systems – Rotary Wing Sea Systems – Surface Ships Sea Systems – Submarines Land Systems – Armoured Vehicles Land Systems – Small Arms	13 – 35 25 – 30 24 – 30 28 – 32 25 – 30 10 – 15
Plant and Machinery	Equipment Plant and Machinery	10 – 25 5 – 25
Transport	Air Systems – Fixed Wing Air Systems – Rotary Wing Sea Systems – Surface Ships Land Systems – Specialised Vehicles Land Systems – Other Standard Vehicles	25 – 35 15 – 32 20 – 30 15 – 30 3 – 5
IT and Communications Equipment	Office Machinery Communications Equipment	3 – 10 3 – 30
Capital Spares	Items of repairable material retained for the purpose of replacing parts of an asset undergoing repair, refurbishment, maintenance, servicing, modification, enhancement or conversion.	Use the same life as that of the prime equipment supported.
Operational Heritage Assets*		As for other tangible non-current assets.

*Operational Heritage Assets are separately disclosed within the principal asset category to which they relate.

Physical Verification

5.158. The existence of NCAs, other than those held on the supply system, is checked annually through a mixture of physical verification and other procedures. See Departmental Material Accounting Regulations.

5.159. Periodic physical verification of NCAs held on an NCAR is required for management control, for audit purposes and to substantiate the entries on the NCAR. This verification process is managed by NAPC on behalf of the NCAMs.

5.160. Physical verification is facilitated through the use of a unique NCA identifier which is physically attached to each NCA. The unique NCA identifications are derived from existing serial numbers and identifiers. Annex 8 lists the non-financial data standards that are used to identify NCAs.

5.161. In addition, AUC balances are periodically reviewed to validate balances carried forward.

5.162. In rare cases, confirmation that an asset exists and is in use can replace physical verification - for example, verifying the existence of large IT platforms such as DII(F).

5.163. Verification includes a physical check of the asset against the asset register listing provided by the NAPC. However, for non-property assets, only those assets valued at over £100,000 require verification. User TLBs are also required to assess assets for any impairment caused through damage, obsolescence or shortening of their life and to confirm that assets have a continuing business use. The return is checked for completeness and any differences between the NCAR and the verification are identified and processed by the NAPC.

5.164. Where GFE is held on an NCAR, assets held at the contractor's premises must be physically verified. The Asset Accounting Centre audits defence contractors' systems and procedures to confirm that they are robust enough to safeguard GFE provided by the Department.

5.165. Wherever practicable, there must be a segregation of duties between the personnel undertaking physical verification and the NCA custodians.

5.166. Where a NCA is on temporary loan to another user, either in another part of the Department or to a third party, and it is impractical for the user TLB to physically inspect the NCA, arrangements must be made for the user TLB to confirm the NCA's existence. Third party user arrangements take the form of an annual certification.

Write-Ons

5.167. A write-on occurs when it is necessary to correct a previous failure to account for an NCA. Approval to treat the write-on as a prior period adjustment (coded to KAX000 – NCAs found in year) must be obtained from the DFM Corporate Financial Accounting Team. Whilst approval is awaited, the value of the asset should be credited to MKC000 in the year in which the omission is discovered and must be retained within this account if approval is withheld.

Non-Current Assets Reclassified to Raw Materials and Consumables

5.168. When a change in function makes an NCA more akin to RMC, it is reclassified to RMC at its carrying amount. No profit or loss should arise on reclassification.

5.169. Errors in coding (i.e. RMC items wrongly coded to NCAs) that are rectified in the same financial year as the error was made should be treated as reclassification rather than a code correction.

5.170. If items of inventories were wrongly classified as NCAs in a previous year and have therefore been wrongly depreciated, the correcting entries will firstly be to write back the depreciation to the net operating cost section of the SOCNE and then to transfer the gross carrying amount from NCAs to RMC.

Transfers

Transfers Within the Department

5.171. Transfers of AUC (including capitalised development expenditure) typically take place within the DE&S TLB. AUC balances on TLB managed projects are transferred to the appropriate NCAM on delivery into service. TLBs which acquire NCAs locally (i.e. one-off purchases) are to bring them onto the SOFP using the appropriate in-year capital additions codes. Each balance is to be transferred immediately, using the appropriate NCA clearing accounts, to the appropriate NCAM for input on to an NCAR or to the owning PT in the case of Capital Spares

5.172. The NAPC is responsible for reconciling inter-management grouping accounts on a monthly basis and for highlighting and resolving imbalances. This identifies any NCAs not recorded in the accounts of the receiving NCAM and allows them to be investigated and subsequently cleared.

5.173. NCAs in use should not generally be transferred within the Department.

Transactions Between Government Departments

5.174. The transfer of NCAs to another government department, except under a transfer of function or a merger of departments, should be treated as a normal commercial transaction - i.e. as a sale at fair value.

5.175. For NCAs, fair value should be based on market value (i.e. based on values of similar assets bought and sold in an open market) or at DRC.

5.176. If assets are to be transferred for no consideration, the MOD Accounting Policy Team must be informed as HM Treasury will need to be consulted.

Disposals

5.177. In accordance with IFRS 5, NCAs which are held for sale should be valued at the lower of their carrying amount and their fair value less costs to sell. Any write-down of the asset should be recognised as an impairment in accordance with paragraph 5.104.

5.178. An asset is deemed to be held for sale if its carrying amount will be recovered principally through a sales transaction rather than through continuing use. For this to be the case, the sale must be highly probable and the asset (or group of assets) available for immediate sale in its/their present condition (subject only to terms that are usual for the sale of such assets).

5.179. For the sale to be highly probable the appropriate level of management (which will depend on the asset's value) must be committed to a plan for selling the asset/group of assets and an active programme to locate a buyer to complete the sale must be in place. The sale should be expected to complete within one year from the date on which the asset is classified as held for sale. If it becomes necessary to extend the sales completion timeframe beyond one year, the asset can still be classified as held for sale, provided that the delay is caused by events or circumstances beyond the Department's control and the Department can demonstrate its on-going commitment to sell the asset.

5.180. An NCA that is to be abandoned shall not be classified as held for sale. This is because the carrying amount will not be recovered principally through a sales transaction – examples include an asset under construction that is cancelled, NCAs that are closed rather than sold and an asset in service that is scrapped and the scrap proceeds are incidental. An NCA that has been temporarily taken out of use shall not be accounted for as if it has been abandoned. As an abandoned NCA is not classified as held for sale, the NCA should continue to be depreciated until the end of its useful life. It should be reviewed for impairment and any write-down of the asset should be recognised as an impairment in accordance with paragraph 5.104.

5.181. In accordance with IFRS 5, assets which are held for sale should be presented and disclosed separately within current assets in the SOFP. No further depreciation is charged on those assets.

5.182. The point of disposal is the point at which legal ownership or legal title to the NCA passes to a third party or when the asset is physically scrapped because it is surplus to requirements or beyond economic repair.

5.183. All losses on disposal of NCAs are charged to the SOCNE.

5.184. Profits on disposal are only netted off against expenditure in the SOCNE where they are no more than adjustments to depreciation (or amortisation) or to an impairment previously charged to the SOCNE. This is usually the appropriate treatment for depreciable NCAs which are revalued and for other assets originally acquired for the Department's own use which have been written down to fair value less costs to sell. Other profits on disposal of assets will be treated as income in the SOCNE.

5.185. Where a strategic decision is made to dispose of assets - i.e. one falling outside current disposal policy, any material effect this has on the SOCNE is reported as an exceptional item (with associated explanatory notes).

Disposals of Property Non-Current Assets

5.186. 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. DE values the asset in accordance with paragraph 5.177. 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.

5.187. DE 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 paragraph 5.177.

5.188. DE 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.

5.189. Once the property has been disposed of, DE 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 Revaluation Reserve balances which relate to the particular property item should be released to the General Fund.

5.190. If a decision is taken to demolish a building, DE 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 Services Authority (DSA)

5.191. Except for local sales (see paragraphs 5.199 to 5.200), 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.

5.192. 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.

5.193. 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.

5.194. 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.

5.195. 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.

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

5.197. 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.

5.198. 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 NCAM when it is identified for disposal.

Local Disposals

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

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

Gifting

5.201. The Department sometimes makes gifts of public property to outside bodies. This effectively represents a waiver of the receipts due to the Defence budget and thus constitutes Defence expenditure.

5.202. Items for gifting need to be valued on the basis of open market value (OMV) or, in the rare instances where items have to be replaced, at DRC.

5.203. If the OMV (or DRC) is greater than the asset's carrying amount, the asset should be revalued following the accounting treatment set out in paragraph 5.94. However, if the OMV (or DRC) is less than the asset's carrying amount, it should be revalued by applying the accounting treatment for impairments described in paragraphs 5.103 and 5.104.

5.204. On gifting the asset, it should be removed from the NCAR/supply system with its carrying amount taken through the disposals account. This treatment will result in a loss on disposal being recognised in the SOCNE. Any Revaluation Reserve balances relating to the gifted asset should be released to the General Fund.

5.205. The NAPC should be informed of any proposed gifting to ensure that any disclosure requirements in the Departmental Resource Accounts are met.

5.206. Please refer to JSP 462 for further details on gifting policy and approval procedures.

Decommissioning

5.207. Decommissioning is the process through which an NCA is taken out of commission and brought to a state where it is available for unrestricted alternative use, with waste materials permanently and safely disposed of.

5.208. PTs must identify the cost of decommissioning NCAs and create a provision within their SOFP. In most cases decommissioning will not be required - for example, when disposing of motor vehicles.

5.209. Decommissioning work that the Department is obliged to undertake is provided for in full at the time that the environmental damage first takes place or the contamination occurs.

5.210. The provision is capitalised as an asset if the Department will derive economic benefit from it – e.g. the decommissioning provision which is recognised during the operational life of a submarine.

5.211. Detailed guidance on how to account for provisions for liabilities and charges is provided in Chapter 8.

Disclosure

5.212. NCAs are disclosed in the accounts under the following sub-headings:

a. Land;

b. Buildings;

c. Dwellings;

d. Information technology;

e. Single use military equipment;

f. Plant and machinery;

g. Transport;

h. Assets under construction – SUME;

i. Assets under construction – Others.

5.213. Capital spares and GWMB are included within the appropriate category of tangible NCAs.

5.214. NCAs obtained under hire purchase, leasing and PFI arrangements have other disclosure requirements. For assets held under finance leases, the net amount should be disclosed by each sub-heading - for example, plant and equipment.

5.215. Separate disclosure is required for assets held for use in operating leases - i.e. where the Department is the lessor. The gross carrying amount of assets held for use in operating leases and the accumulated depreciation charges, which are included in the overall asset totals, should be disclosed by each asset sub-heading. Extensive disclosures are required for heritage assets. See paragraphs 5.393 to 5.398.

5.216. The fair value of assets funded by a donation (including donated assets) or by a government grant should be separately disclosed in the NCA note in the year in which the asset is acquired. Where the funder provides cash, rather than the physical assets, any difference between the cash provided and the fair value of the assets acquired should also be disclosed.

5.217. The following SOCNE disclosure notes are required:

a. the depreciation charge for the period analysed between non-current tangible and intangible assets;

b. in-year depreciation on assets held under finance leases;

c. the aggregate finance charges in respect of finance leases;

d. the total of operating lease rentals, analysed between amounts payable for the hire of plant and machinery and amounts payable for other operating leases;

e. the aggregate amount of rentals receivable in respect of operating and finance leases.

5.218. For capital spares and GWMB:

a. capital spares depreciation and GWMB depreciation (net of releases of depreciation and backlog depreciation adjustments to the Revaluation Reserve) are to be included within depreciation and amortisation of tangible and intangible NCAs;

b. surpluses or deficits arising on disposal of capital spares and GWMB are to be included within the surplus/deficit arising on disposal of tangible NCAs.

c. write-off or write-on of capital spares and GWMB are to be included within NCAs written-off/written-on (net).

Specific Accounting Requirements

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

Assets Under Construction

5.220. 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 and are subject to revaluation.

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

5.222. 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.

5.223. 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 paragraph 5.53.

5.224. 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.

5.225. 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.

5.226. On completion of the project or on delivery of an NCA with phased deliveries the costs should be transferred to the NCAM and entered on the NCAR. The receiving NCAM must be given all the information needed to record the asset.

5.227. 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

5.228. Paragraphs 5.229 to 5.267 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 paragraphs 5.268 and 5.282 respectively. Chapter 7.93 contains the accounting treatment for Contracting for Availability contracts (sometimes referred to as Contractor Logistic Support contracts).

5.229. Capital spares pools and asset pools for GWMB are accounted for by a single owner throughout their life (normally a PT in DE&S). 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.

Receipts

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

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.

5.231. 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.

5.232. 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.

5.233. 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.

5.234. 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.

5.235. 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

5.236. 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

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

5.238. Where more than one contract exists for the supply of items based on different order quantities, and different prices apply, BMP is calculated based on a price which will minimise the incidence of purchase price variances, i.e. a standard price. Purchase price variances arising on such purchases are expensed to the SOCNE.

Cost of Conversion

5.239. 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.

5.240. 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

5.241. 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.

5.242. 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.

5.243. 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

5.244. 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.

5.245. 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.

5.246. 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.

5.247. 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.

5.248. 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.

5.249. 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.

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

5.251. 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

5.252. The Inventories Revaluation Reserve is used for the revaluation of all capital spares, GWMB and RMC (see 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 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.

5.253. 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:

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

* 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

5.254. Issues are accounted for on the appropriate supply system by the owner at the point of issue:

a. to a different owner within the same TLB (in which case it continues to be reported in that owner's SOFP);

b. to an owner in another TBB (for inclusion in that new owner's SOFP);

c. for use by the end user;

d. for loan (in which case it continues to be reported in the owner's SOFP);

e. for sale (in which case it is reported in the owner's SOCNE);

f. write-off or disposal (in which case it is reported in the owner's SOCNE).

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

5.256. Sales (including repayment and prepayment issues) are priced at BMP with an addition to reflect recovery of applicable overheads (as set out in JSP 368 (MOD Guide to Repayment). The difference is reported in the SOCNE as a surplus on disposal.

5.257. The TLB supplying the item in transit is responsible for accounting for it until it is received by the end user or receiving owner, at which point the PT must make the relevant system adjustment or, if this is not possible, raise a manual journal. Issuing IPTs and receiving owners should liaise closely to ensure the corresponding journals are posted in the same accounting period.

Transfers

5.258. The gross carrying amount, accumulated depreciation and an element of reserves are individually transferred.

Physical Verification

5.259. IPTs are responsible for physically verifying assets. They should satisfy themselves that the custodians (for example, the Joint Support Chain Services and Front Line Commands) are carrying out appropriate physical verification procedures. JSP 886 explains stocktaking policy and procedures.

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

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

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

Disposals

5.263. Capital spares and GWMB are disposed of once they have been declared surplus to requirements or become unsuitable (i.e. obsolete), defective or damaged.

5.264. 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. This will usually mean that they are valued at their estimated disposal proceeds less costs to sell - for example, agent's fees.

5.265. 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.

5.266. 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.

5.267. Items declared for disposal, in accordance with JSP 886, Volume 2, Part 6, whose sales receipts (either collected by the Disposal Services 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

5.268. Paragraphs 5.229 to 5.267 cover accounting policies which apply to both capital spares and GWMB. Those which relate solely to capital spares are set out below.

5.269. 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.

5.270. 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).

5.271. 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 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;

5.272. 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.

5.273. 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.

5.274. 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.

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

5.276. 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. Where, by exception, items are transferred, the accumulated depreciation is also transferred unless there are overriding reasons for it to be released and a new accumulated depreciation balance created in the receiving TLB's accounts. For example, where individual items are transferred between pools.

Capital Spares in the Repair Loop

5.277. 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.)

5.278. 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.

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

5.280. 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).

5.281. 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

5.282. Paragraphs 5.229 to 5.267 cover accounting policies which apply to both capital spares and GWMB. Those which relate solely to GWMB are set out below.

5.283. 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.

5.284. 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.

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

5.286. 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.

5.287. 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.

Transfers

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

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

5.290. Initial provision of spares may be undertaken by a TLB who will not be the owner of the items in which case the cost will be transferred to the owning TLB by an inter-management grouping transfer regardless of whether or not they are physically transferred.

5.291. Where there is a difference in the recorded value of an item being transferred and the value recorded in the receiving inventory account, the difference, adjusted upwards, is reported in the appropriate Revaluation Reserve account in the receiving TLB's Accounts.

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

a. depreciation should be charged to 'GWMB Provisions' (MLA 002);

b. usage of GWMB - i.e. the firing of GWMB to destruction - should be charged to 'GWMB Additional Depreciation for Firings Used to Destruction' (MLA 003);

c. write-offs should be charged to 'NCA Write-Offs' (MKB001);

d. impairment due to a loss of service potential below depreciated historical cost should be charged to MBJ002;

e. where a single item of GWMB is available for immediate sale in its present condition and the sale is highly probable it should be valued at the lower of its carrying amount and fair value less costs to sell, with the balance mapped to DMA004;

f. where it will not be possible to match the receipts from the sale of GWMB to individual items, balances are mapped to DMA003 'Non-Current Assets Declared for Disposal with Non-Specific Receipts'.

Construction Contracts

5.293. Construction contract balances relate to commercial work undertaken on behalf of external customers and cover costs incurred on all production/repair and associated tasks. See Chapter 3.12.

Government Furnished Assets

5.294. Government Furnished Assets (GFA) is a term used to describe Departmentally funded and owned assets which are supplied to industry to support Departmental contracts. GFA is synonymous with the term Assets in Industry (AiI) and consists of four categories:

a. Government Furnished Equipment (GFE);

b. Government Furnished Facilities (GFF);

c. Government Furnished Information (GFI);

d. Government Furnished Resources (GFR).

Government Furnished Equipment

5.295. Government Furnished Equipment (GFE) is loaned or provided to a contractor to assist with developing, constructing or maintaining equipment other than a repair contract where items will be in a repair loop.

5.296. GFE covers Departmentally owned materiel classified as an NCA (including capital spares and GWMB) or RMC and is categorised as follows

a. 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;

b. Contract Work Item (CWI) is an item of materiel temporarily issued to a contractor without charge to be worked on and returned in a specified condition;

c. Contract Support Item (CSI) is an item of materiel provided to a contractor to support work on a CWI, which is then returned to the Department (also referred to as Issued Property);

d. Contract Embodiment Item (CEI) is an item of materiel provided to a contractor for incorporation into a CWI (also referred to as Issued Property);

e. Contract Work Arising (CWA) is an item of materiel removed from a CWI for incorporation into another item of materiel or which is retained as an item of materiel in its own right.

5.297. JTTE and CEIs provided to contractors to support current projects should be charged to project costs in the related project account. If they meet the capitalisation criteria, they should be capitalised as either development costs or AUC.

5.298. CWIs and CSIs issued to contractors in support of current projects are reported on the SOFP. The appropriate inventory holder records CWI and CSI inventory items within its SOFP.

5.299. Where equipment charged to one project is incorporated into a different project, the cost of the items is recorded in the latter’s equipment project account.

5.300. Where equipment is removed from an existing NCA for incorporation into another NCA - for example, where the existing NCA is being disposed of or cannibalised - the value of the existing NCA is adjusted to reflect the cost of the equipment which has been removed. Similarly, the value of the NCA into which the equipment has been incorporated is increased by the cost of that equipment to the extent that capitalisation is appropriate.

5.301. More detailed definitions of GFA and their accounting treatment is covered in Annex 3.

Ancillary, Composite and Grouped assets

5.302. 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.

5.303. 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.

5.304. Grouped items are generically similar items whose individual values do not warrant capitalisation but, due to their total value, are grouped and capitalised.

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

5.306. 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.

5.307. 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.

5.308. Grouped items are registered as a single group NCA, where the omission of the NCAs would cause a material understatement of the NCAM’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.

5.309. 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.

5.310. 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

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

5.312. 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 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.

5.313. 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.

5.314. 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 Chapter 7.102) 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).

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

5.316. 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.

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

STC containers

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

5.319. 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.

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

Ammunition Boxes

5.321. 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.

Packed Fuel Containers

5.322. Empty containers are recorded as individual RMC items. See Chapter 7.103.

Leased Assets

5.323. A lease is an agreement whereby the lessor conveys to the Department the right to use an asset for an agreed period of time in return for an agreed level of payments.

5.324. IAS 17 lease accounting requirements are not confined 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 a series of payments) may be deemed to contain a lease if the following criteria are met:

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

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

    i. the Department has the ability or right to operate the asset or direct others to operate it 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 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.

5.325. If an arrangement contains a lease, the Department should apply IAS 17, ‘Leases’ to the lease element of the arrangement. At present, the Department is not applying IFRIC 4 to its contracts (other than to PPP arrangements – see paragraph 5.357) because the costs of applying the IFRIC outweigh the benefits of compliance. This is due to the volume and complexity of the contractual arrangements, the difficulties in obtaining the required information, the cost of obtaining the information and of keeping it up to date. It has therefore been concluded that complying with IFRIC 4 does not represent best value for money for the Department.

5.326. It has been agreed with the NAO that IFRIC 4 does not apply between the Department and its Trading Funds, as the Trading Funds’ assets are already in the Public Sector and are therefore fully visible. However, IFRIC 4 would apply to Trading Fund accounts if they had an IFRIC 4 type arrangement with the private sector. Items leased to the Department may be held under either finance or operating leases.

5.327. A finance lease is one which transfers substantially all the risks and rewards of ownership of an asset to the lessee. Examples of situations which individually or in combination 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. the arrangement contains a bargain purchase option making it 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.

5.328. 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 and any losses suffered by the lessor as a result of the cancellation are borne by the lessee;

b. gains or losses generated by fluctuations in the fair value of the residual value fall to the lessee. For example, a rebate equal to most of the sales proceeds at the end of the lease);

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

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

5.330. 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 paragraphs 5.333 and 5.334. In applying these situations and indicators to the land element, an important consideration is that land normally has an indefinite economic life.

5.331. 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.

5.332. The Department may obtain use of NCAs under leasing arrangements. Items leased to the Department may be held under either a finance or an operating lease.

Where the Department is the Lessee

5.333. Where TLBs enter into a lease, they must consult the MOD Accounting Policy Team for advice on its classification and accounting treatment. All leases with an annual charge of greater than £10,000 must be reviewed to determine their categorisation under IAS 17.

5.334. NCAs which the Department, as lessee, holds under a finance lease are capitalised as NCAs in accordance with the Departmental capitalisation threshold and recorded in the NCAR. They are subject to the same revaluation policies and accounted for in the same way as NCAs owned by the Department.

5.335. NCAs held under a finance lease are depreciated over the shorter of the lease period and the useful economic life of the asset. 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.

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

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

5.339. The Department may have an option to purchase the asset at a price that is expected to be below fair value at the date that the option becomes exercisable. If, at the inception of the lease, it is reasonably certain that the Department will exercise this option, the minimum lease payments should comprise the minimum payments payable over the lease term to the date on which it is anticipated that the purchase option will be exercised and the payment made.

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

5.341. 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 will equate to the related NCA entry).

5.342. 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. This is calculated in proportion to the relative fair values of the leasehold interests in the separate land and buildings elements 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.

5.343. Payments made under finance leases are apportioned (in accordance with the leasing agreement) between reductions in the ‘obligation under finance lease’ liability and the finance charges which are expensed to the SOCNE.

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

<u>Where the Department is the Lessor</u>

5.345. NCAs which are owned by the Department but leased under a finance lease to a body outside the Departmental boundary should not be shown as NCAs within the Department’s SOFP, as the risks and rewards of ownership of the assets have been transferred to the external body. The present value of the minimum lease payments due, which are calculated by discounting them at the interest rate implicit in the lease, should be accounted for as a receivable.

5.346. Payments received under finance leases are apportioned (in accordance with the leasing agreement) between reductions in the receivable balance in the SOFP and the finance charges which are credited to the SOCNE.

5.347. NCAs that are owned by the Department but which are leased to a body outside the Departmental boundary under an operating lease should be shown on the Department’s SOFP as NCAs. These assets should be recorded in an NCAR.

5.348. Payments received under operating leases, excluding any service charges (for example, maintenance charges) should be credited to the SOCNE.

Historic Leaseholds

5.349. From 1 April 2001, historic leaseholds have been accounted for as operating or finance leases as appropriate.

Dilapidations

5.350. Many property leases include tenant repairing clauses. Such clauses typically require the tenant to return the property to the landlord at the end of the tenancy in a specified condition. The tenant will therefore have a legal obligation, arising from the terms of the lease agreement, to pay the costs of any dilapidations. Please refer to Chapter 8 for the accounting treatment.

Leasehold Improvements

5.351. Leasehold improvements relate to Departmental expenditure on making leased buildings suitable for occupation. The value of leasehold improvements can be capitalised if they meet the capitalisation criteria in paragraph 5.109. They should be depreciated over the shorter of the lease period and the useful economic life of the asset.

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

5.352. This section deals with the accounting treatment of PPP arrangements, including PFI contracts, that meet the definition of service concession arrangements contained in IFRIC 12, ‘Service Concession Arrangements’.

5.353. The MOD Accounting Policy team must be consulted and agree the accounting treatment of all PPP/PFI/Service Concession Arrangements.

5.354. To be within the scope of IFRIC 12, the service concession arrangement must contractually oblige the private sector operator to provide the services relating to the infrastructure to the public on behalf of the Department.

5.355. 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.

5.356. Generic examples of infrastructure for public services are roads; bridges; tunnels; prisons; hospitals; airports; water distribution facilities; telecommunication networks; permanent installations for military etc. operations; and NCAs used for administrative purposes to deliver services to the public.

5.357. Each PPP 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 covers the Department’s strategic assets (or groups of assets) and the means by which the Department carries out its business. In this sense all the Department’s service concession agreements are, in principle, capable of being infrastructure. For example, assets such as vehicle fleets could validly be seen as infrastructure given their size and role in delivering Departmental outputs.

5.358. 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 in accordance with paragraph 5.327. If it does contain a lease, IAS 17 should be applied to determine whether the lease is a finance or an operating lease and it should be accounted for accordingly (see paragraphs 5.330 to 5.346). Where the arrangement does not contain a lease, the expenditure will be recognised as it falls due.

5.359. There may be rare cases where some assets of a PPP contract meet the definition of infrastructure and some do not. A split SOFP treatment (i.e. some assets on the Department's SOFP and some off the Department's SOFP) may be required in these circumstances.

5.360. 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.

5.361. Where there is infrastructure, whether previously owned by the contractor 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 PFI contract is a service concession within the meaning of IFRIC 12.

5.362. The residual interest in the infrastructure is the estimated value of the infrastructure as if it were already of the age and in the condition expected at the end of the arrangement. Where the Department has the option to purchase the asset, at whatever price, it will mean that the Department has control over the residual interest. In addition, the overall value of the residual value should be borne in mind when reviewing the substance of the agreement.

5.363. Where the infrastructure asset is used for its entire life, and there is little or no residual interest, the arrangement falls within 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.

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

5.365. 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 should be recognised where:

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 measure reliably.

5.366. In practice, this means that the Department will usually only recognise the asset when it comes into use.

5.367. Additional guidance can be found in Annex 2 which covers accounting for assets transferred to the Private Sector Operator and also accounting for residual interests.

5.368. Chapter 7.93 contains the accounting treatment for Contracting for Availability contracts (sometimes referred to as Contractor Logistic Support contracts).

Heritage Assets

Definition

5.369. A heritage asset is a tangible asset with historical, artistic, scientific, technological, geophysical or environmental qualities that is held and maintained principally for its contribution to knowledge and culture.

5.370. Heritage assets are those which are preserved in trust for future generations because of their cultural, environmental or historical associations. They are held by the Department to meet the overall objective of maintaining the heritage.

5.371. Heritage assets include: historical buildings: archaeological sites; military and scientific equipment of historical importance: museum and gallery collections; and works of art.

5.372. Heritage assets display the following attributes:

a. their value to the Government and to the public in cultural, environmental, educational and historical terms is unlikely to be fully reflected in a financial value derived from a market price;

b. established custom and, in many cases primary statute and trustee obligations, impose prohibitions or severe restrictions on disposal by sale;

c. they are often irreplaceable and their value may increase over time, even if their physical condition deteriorates;

d. they may require significant maintenance expenditure to enable them to be enjoyed by future generations;

e. their life may be measured in hundreds of years.

5.373. Heritage assets are categorised as either operational or non-operational:

a. non-operational heritage assets are those which are held primarily for the purpose described in paragraph 5.375. For example, archaeological sites.

b. operational heritage assets are those which, in addition to being held for their characteristics as part of the nation’s heritage, are also used by the Department for other activities or to provide other services. For example, historical buildings used as office accommodation.

5.374. Antiques and other works of art which are held by the Department (and lie outside the main collections) will only meet the definition of an heritage asset if they fulfil the criteria in paragraph 5.378. Those which fail the heritage asset definition should be capitalised using the same methodologies as for non-heritage assets.

5.375. The Department should attest annually to the on-going heritage credentials of its heritage assets.

Recognition and Measurement

5.376. Operational heritage assets should be valued using the same valuation methodologies as for other assets of that general type (for example, buildings).

5.377. Non-operational heritage assets should be valued subject to the requirements set out in paragraphs 5.385 to 5.392.

5.378. All NCAs (whether non-heritage or heritage) should be valued at fair value. However, where, in exceptional cases, it is not practicable to obtain a fair value, the heritage assets may be reported at historical cost.

5.379. Where information is available on the cost or value of heritage assets (both operational and non-operational):

a. they should be presented in the SOFP separately from other tangible assets;

b. the SOFP or the notes to the accounts should separately identify classes of heritage assets being reported at cost and those at valuation; and

c. changes in the valuation should be recognised in the Other Comprehensive Net Expenditure section of the SOCNE, apart from impairment losses that should be recognised in the same way as for non-heritage assets in accordance with paragraphs 5.99 to 5.109.

5.380. Where assets have previously been capitalised or recently purchased, information on their cost or value will be available. However, where this information is not available and cannot be obtained at a cost commensurate with the benefits to users of the Annual Accounts, the assets will not be recognised in the SOFP and the disclosures required in paragraphs 5.393 to 5.398 should be made.

5.381. Valuations may be made by any method that is appropriate and relevant.

5.382. There is no requirement for valuations to be carried out or verified by external valuers nor is there any prescribed minimum period between valuations. However, where heritage assets are reported at valuation, the carrying amount should be reviewed sufficiently often to ensure that the valuations remain current.

5.383. Where the Department transfers non-operational heritage assets to an NDPB under Managing Public Money gifting rules, a best estimate of their market value should be applied - for example, by using any available insurance or auction sales values. Obtaining a professional valuation may not be viewed as value for money in which case alternative sources should be sought.

Depreciation and Impairment

5.384. Heritage assets which have an indefinite life are not depreciated.

5.385. The carrying amount of an heritage asset should be reviewed where there is evidence of impairment - for example, where it has suffered physical deterioration or breakage or new doubts arise as to its authenticity.

5.386. Any impairment recognised should follow the policy for non-heritage assets. (See paragraphs 5.99 to 5.109)

Donations

5.387. The value of donated heritage assets should be credited to income unless a condition is imposed by the funder in which case the income is deferred (see Chapter 2.34 and 2.35). Where, in exceptional cases, it is not possible to obtain a valuation for a donated heritage asset, the disclosures required in paragraph 5.397 must be applied.

Disclosures

5.388. The disclosures required for all heritage assets are:

a. the Department's Annual Accounts should contain an indication of the nature and scale of the heritage assets it holds;

b. the Annual Accounts should set out the Department's policy for the acquisition, preservation, management and disposal of heritage assets. This should include a description of the records maintained by the Department for its collection of heritage assets and also information on the extent to which access to the assets is permitted. This information can alternatively be provided in a document that is cross-referenced to the Annual Accounts;

c. the accounting policies adopted for the Department's holding of heritage assets should be stated, including details of the measurement bases used;

d. for heritage assets that are not reported in the SOFP, the explanation for not doing so should be provided and the notes to the Annual Accounts should explain the significance and nature of the assets not reported in the SOFP;

e. the disclosures relating to assets that are not reported in the SOFP should aim to ensure that, when read in the context of information about capitalised assets, the Annual Accounts provides useful and relevant information about the Department's overall holding of heritage assets.

5.389. Where heritage assets are reported in the SOFP, the following should be disclosed:

a. the carrying amount of heritage assets at the beginning of the financial period and at the SOFP reporting date, including an analysis between those classes or groups of heritage assets that are reported at cost and those that are reported at valuation; and

b. where assets are reported at valuation, sufficient information to assist in an understanding of the valuations being reported and their significance. This should include:

   i. the date of the valuation;

   ii. the methods used to produce the valuation;

   iii. whether the valuation was carried out by external valuers and, where this is the case, the valuer's name and professional qualification, if any; and

   iv. any significant limitations on the valuation - for example, where an asset has a particular provenance, the effect of which is not fully captured by valuation.

5.390. Information that is available to the Department and is helpful in assessing the value of those heritage assets that are not reported in the Department's SOFP should be disclosed.

5.391. The Annual Accounts should contain a summary of transactions relating to heritage assets. This should provide separate disclosure (i.e. for assets that are reported in the SOFP and those that are not) of the following information for the accounting period and for each of the previous 4 accounting periods:

a. the cost of acquisitions of heritage assets;

b. the value of heritage assets acquired by donation;

c. the carrying amount of heritage assets disposed of in the period and the proceeds received; and

d. any impairment recognised in the period.

5.392. Where, exceptionally, it is not practicable to obtain a valuation of heritage assets acquired by donation, the reason should be given. Disclosures should also be provided on the nature and extent of significant donations of heritage assets.

5.393. The disclosures required in paragraphs 5.393 to 5.397 may be presented in aggregate for groups or classes of heritage assets, provided that this aggregation does not obscure significant information. Separate disclosures should be provided for assets reported at cost and those reported at valuation.

Donated Assets

5.394. Donated assets are those which have been donated to the Department. Assets can be donated by a third party either by gifting the assets or gifting funds with which to purchase the assets.

5.395. To qualify as a donated asset, no consideration can be given in return.

5.396. Assets that do not pass this test should be accounted for in the same way as any other NCA.

5.397. The Department may give or receive assets to/from another public sector body (including public sector bodies outside of the Departmental boundary) for no consideration. Assets acquired in this way are not donated assets. The MOD Accounting Policy team should be consulted before entering into such a transaction, as the proposed transaction will need to be discussed with HM Treasury.

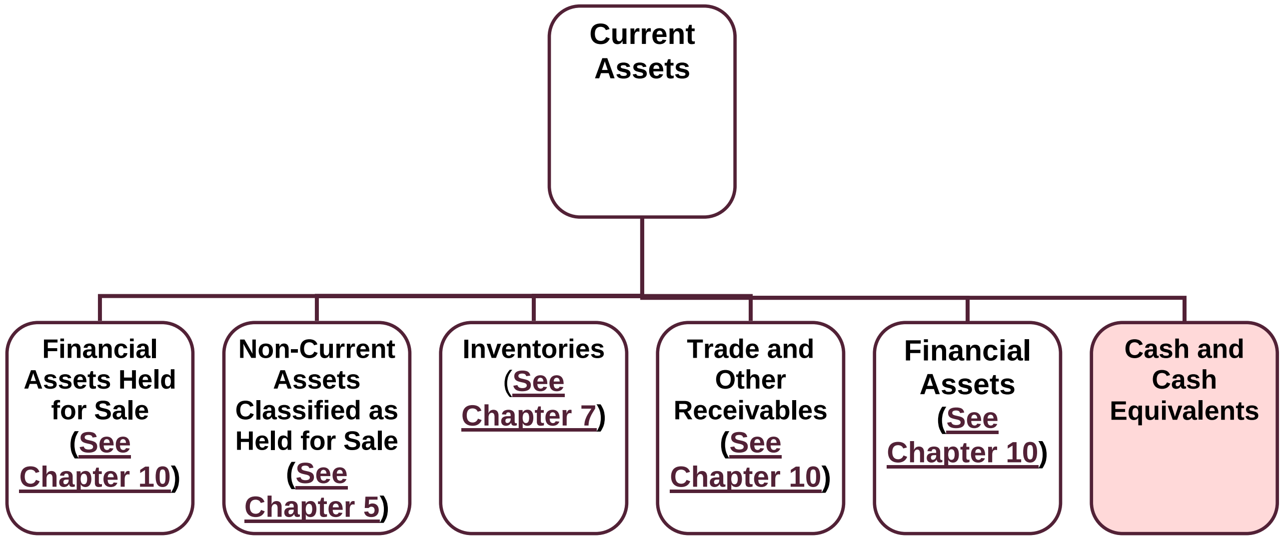
5.398. The accounting treatment for donated assets is contained in Chapter 2.29.

Assets Funded by Grants

5.399. Grants received can come from government and inter-governmental agencies and similar bodies, whether local, national or international, including the European Union (EU).

5.400. The accounting treatment for grant funded assets is contained in Chapter 2.40.

CHAPTER 6: CASH AND CASH EQUIVALENTS



Introduction

6.1. This chapter sets out the policy for cash and cash equivalents and explains how the Department manages and controls its bank accounts. It also outlines how the Department draws down its funding within the limits of the Net Cash Requirement.

Key Points

6.2. Cash comprises cash in hand, gold coins and deposits (repayable on demand) with any commercial bank or other financial institution.

6.3. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash.

6.4. For the purposes of this chapter, bank accounts are deemed to fall within the definitions of cash and cash equivalents.

6.5. Whereas the FMPA Ahd A&TM Banking Services Treasury Accountant (BS TA) is responsible for managing and funding the Departmental central bank accounts, local bank accounts, both stand alone and within central schemes, are the responsibility of the relevant TLBs.

6.6. Bank charges on all bank accounts are retained within the owning TLB.

Policy Detail

6.7. Policy detail is set out under the following headings; specific responsibilities; definitions; bank account management; accounting; and disclosure.

Specific Responsibilities

6.8. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

The FMPA Ahd A&TM Banking Services Treasury Accountant (BS TA)

6.9. The BS TA is responsible for:

a. setting overall control policies and procedures and monitoring compliance with those controls, at all levels, including TLBs;

b. setting and periodically reviewing target levels of bank balances;

c. reviewing funding requirements for commercial bank accounts;

d. monitoring actual balances against target levels;

e. reporting on TLB cashflow forecasting performance.

TLBs

6.10. TLBs are responsible for accounting for:

a. all cash and cash equivalents transactions associated with bank account balances reported on their Statement of Financial Position (SOFP);

b. preparing and monitoring monthly cash flow projections for BS TA to allow the monthly draw down of Supply from the Consolidated Fund to be calculated. TLBs are also responsible for explaining variations from forecasts.

Definitions

6.11. Cash and cash equivalents are defined as follows:

a. cash comprises cash on hand and demand deposits (repayable on demand) with any commercial bank or other financial institution. It includes cash in hand; gold coins and deposits denominated in foreign currencies after allowing for unpresented payments and uncleared deposits. Cash in hand (petty cash) includes postal orders and stamps;

b. cash equivalents comprise short-term, highly liquid investments that are readily convertible to known amounts of cash with no significant risk of the value changing.

Bank Account Management

6.12. To ensure that funds are available to TLBs at the correct time:

a. the Department’s cash flows are forecast and managed to minimise unutilised cash and cash equivalents balances and to control foreign currency risks;

b. bank charges and interest costs are minimised;

c. effective control policies and procedures are exercised to ensure that the movement of funds can be accounted for.

Central Bank Account Management

6.13. Group account balances with commercial banks (designated in both Sterling and foreign currencies) are funded from the main Departmental Supply bank account in the Government Banking Service (GBS). In practice, most UK-based bank accounts will be held with the GBS.

6.14. The principle payment organisations within the Department are DBS, SPVA, WPB and AFPS. These have authority to issue Payable Orders and Bankers' Automated Clearance Services (BACS)/Clearing House Automated Payment System (CHAPs) payments which are encashed against their individual GBS accounts.

6.15. Supply is drawn down monthly from the Consolidated Fund in accordance with TLB forecasts into the main Departmental Supply bank account by the BS TA who also funds the GBS bank accounts of the principle payment organisations on a monthly basis. In addition:

a. BS TA and the principle payment organisations record the transactions and reconcile all their own bank accounts;

b. BS TA manages funds and maintains optimum balances on all central bank accounts.

6.16. Bank charges on all bank accounts are retained in the owning TLB.

Local Cash and Cash Equivalents Account Management

6.17. TLBs must ensure that:

a. their set procedures align with the policies and procedures detailed in JSP 891;

b. bank reconciliations are carried out regularly in compliance with JSP 891;

c. all bank-related control accounts are reconciled at least once a month;

d. internet access to bank accounts complies with security guidelines and the policies set out in JSP891;

e. accounting records correctly reflect all bank accounts within their control and that complete audit trails are maintained and available;

f. ensure that bank accounts are used solely for the purpose for which they were originally authorised and opened;

g. all bank account postings, which give rise to Statement Of Comprehensive Net Expenditure (SOCNE) charges or credits and therefore affect the Departmental outturn are made in the relevant financial year;

h. bank accounts specifically opened for exercises/deployments are properly controlled and cleared immediately on completion of the associated activity.

6.18. Where interest is earned on a bank account holding non-Exchequer funds - i.e. third party funds - and it has been agreed that the interest can be retained by the Department, the sums have to be surrendered to the Consolidated Fund. TLBs should transfer the interest to the CFER control account in the BS TA accounts.

Accounting and Disclosure

6.19. Cash and cash equivalents balances are included in the Annual Accounts as current assets.

6.20. Payments made from bank accounts are to be accounted for when the relevant payable instruments (cheques, POs, BACS/CHAPS) are issued, not when they are presented. This is known as the cashbook position and means that, for accounting purposes, the balances are made up of:

a. the balances shown on the bank statements; less

b. the value of any payable instruments issued but not yet presented for payment; plus

c. deposits banked but not yet reflected on the bank statement.

6.21. HM Treasury policy is for bank overdrafts to be accounted for in the SOFP as a payable and not as a negative cash balance. Balances on Offset Group Bank Accounts should be recorded as negative cash balances, as the net overall position is always a positive balance on all such accounts.

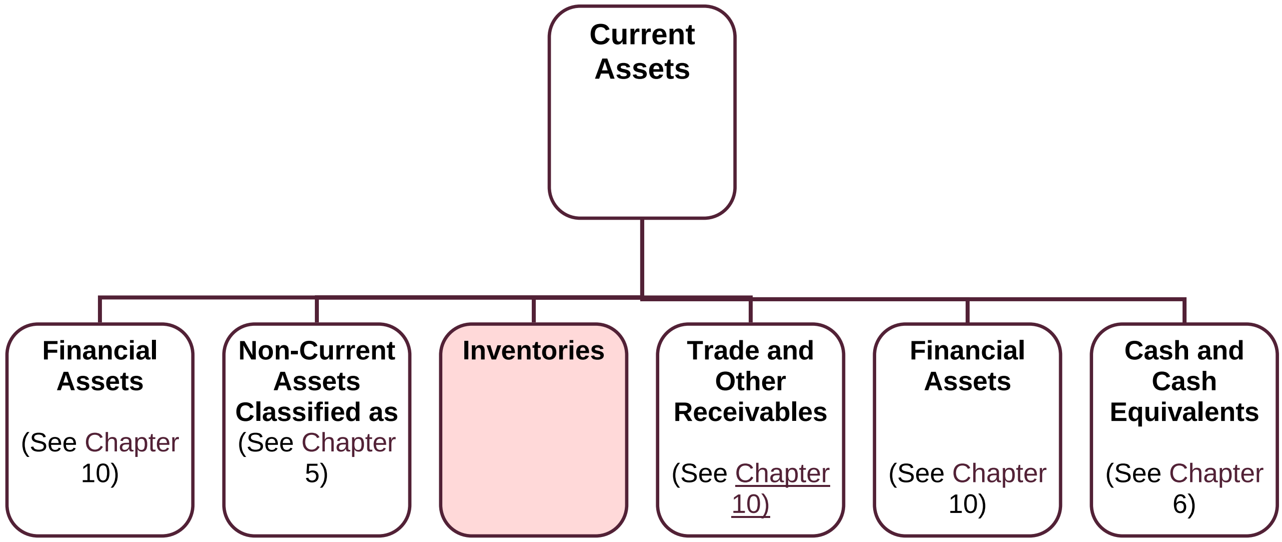
6.22. Balances in the main GBS bank accounts are maintained in a net positive position at year end after allowing for large values of unrepresented payable instruments, if necessary.

6.23. The notes to the accounts show balances with accounts within the GBS and Commercial banks. Further analysis shows Exchequer Funds and other balances held on behalf of third parties.

6.24. Amounts drawn from the Consolidated Fund at year-end in excess of the Net Cash Requirement should be disclosed as a year-end liability after adjusting for any Excess Appropriations in Aid. This liability will be offset in the subsequent year when the previous year’s surplus drawing will deemed to have been repaid and replaced by a matching issue from the current year’s provision. There may, by exception, be circumstances where after adjusting for any Excess Appropriations in Aid, insufficient Supply has been drawn down. Presuming Supply is still available, a receivable will be set up and recovered in the following year.

6.25. The amount due to the Consolidated Fund for cash drawn but not spent at year end should be disclosed in a note to the accounts. This should be separate from other payables and also separate from any amount which, when received, is due to be surrendered to the Consolidated Fund.

CHAPTER 7: INVENTORIES (RMC)



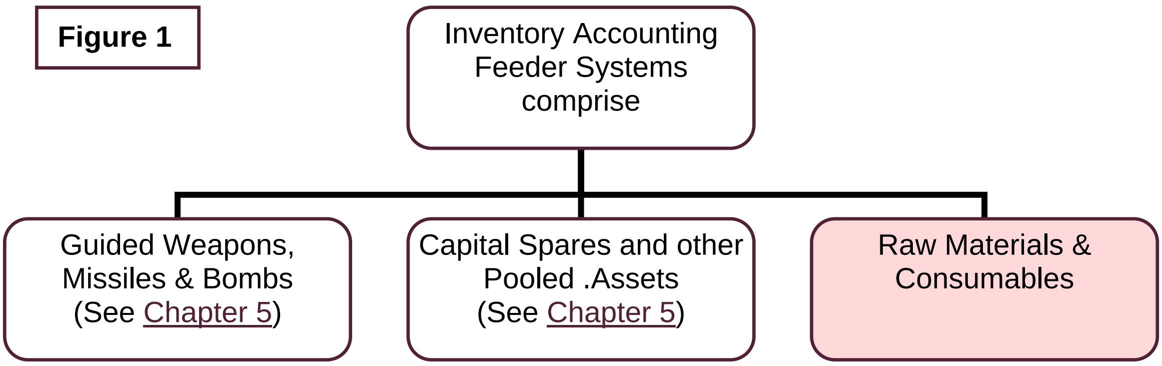
Introduction

7.1. This chapter sets out the accounting requirements for inventories which, for financial accounting purposes, comprise Raw Materials and Consumables (RMC). See Figure 1.

7.2. In the financial accounting context, Capital Spares and Guided Weapons, Missiles and Bombs (GWMB) are defined as Non-Current Assets (NCAs). Their accounting treatment is covered in Chapter 5.

7.3. The term 'inventory' covers materiel (i.e. Capital Spares, GWMB and RMC) accounted for in the MoD Statement of Financial Position (SoFP) and held on a MoD supply system or by inventory partners under a contractual arrangement. Materiel accounting rules are covered in the Defence Logistics Supply Chain Manual, JSP 886.

Figure 1



Key Points

7.4. Raw materials are purchased for conversion and incorporation into NCAs and are considered consumed when issued from the supply system to the user.

7.5 RMC are valued on an inflation adjusted basis - i.e. at current cost. There is no upper or lower value threshold for RMC.

7.6. Financial provisions to reduce the gross carrying amount to net realisable value should only be made when there is sufficient certainty that the items will be disposed of.

7.7. RMC items are disposed of when damaged, defective, obsolescent, surplus or no longer suitable for known requirements.

7.8. Consumables are not repairable and consist of items such as ammunition, fuel and support items (for example - hand tools).

Policy Detail

7.9. Policy detail is set out under the following headings; specific responsibilities; ownership and inter-departmental boundaries; valuation; revaluation; consumption; issues and items in transit; transfers; receipts; physical verification; disposals; disclosures; and specific accounting treatments.

Specific Responsibilities

7.10. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

Inventory Accounting Team

7.11. The Inventory Accounting Enabling Team (IAET) is responsible for ensuring that financial accounting policy is applied consistently.

Categorisation

7.12. The term ‘inventory’ covers materiel (which can be capital spares, inventory or RMC) which is held on a supply system. Figure 2 shows how capital spares and RMC are categorised. The accounting treatment for Capital Spares and GWMB is covered in Chapter 5.

7.13. 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 2 below.

Figure 2

	Capital Spares	**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	✓	✓

7.14. Coverage of each inventory group, under the generic inventory system item descriptions, is shown in Figures 3 to 10 below.

Figure 3

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
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 4

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

Figure 5

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
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 6

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
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 7

Guided Weapons, Missiles and Bombs	
Guided Weapons	Guided Missiles
Guided Bombs	

Figure 8

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 9

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

Figure 10

Strategic Weapon System	
Trident	

Ownership and Inter- Departmental Boundaries

7.15. Departmental ownership of items is recognised at the point of acquisition - i.e. when they are delivered to a storage depot, front line unit or a contractor. Boundaries must be established to ensure that TLBs capture and record balances but avoid any double-counting.

Materiality

7.16. Ready-use items outside DE&S tend to be local purchases by Front Line Commands. Although their value may not be material, in marginal cases it should be disclosed within the RMC balance.

7.17. Guidance on materiality in relation to ownership and how to treat various categories of RMC is summarised in Figure 11 below.

Figure 11

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.
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.

Valuation

7.18. Items are valued at the lower of current cost (or, if not materially different, historic cost) and Net Realisable Value (NRV).

7.19. Consistent valuation across the Department is maintained through the operation of a single pricing record which is maintained in the Integrated Stock Ownership and Pricing System (ISOPS). Only one price is recorded for an individual item on a price record at any one time.

7.20 Items are recorded at their Basic Material Price (BMP) which is determined by:

a. the most up to date contract price;

b. the latest value obtained from a running contract price list;

c. the best technical valuation for a materiel conditioned “A1” item available from contractors, MOD engineers or professional commercial valuers;

7.21. Prices entered on to ISOPs that are more than 12 months old are adjusted for inflation. Prices over 5 years old must be revalued by one of the methods in the preceding paragraph.

7.22. The relevant project, commodity or equipment support manager (normally a PT) will identify the circumstances in which NRV should be applied – one example being where items have been damaged or are not expected to be used or sold in the ordinary course of business.

7.23. Contract embodiment items, when they come off the shelf and for whatever purpose are considered as being consumed.

Definitions

7.24. An obsolete item is an item for which there is no further service use, either because it no longer meets the purpose for which it was acquired or because requirements have changed.

7.25. A defective item is an item which cannot be repaired because it is faulty, has been damaged or has deteriorated.

7.26. A surplus item is an item which exceeds estimated requirements or authorised holdings.

Cost of Purchase

7.27. The cost of purchase is defined as the purchase price and/or cost of conversion net of trade discounts or other rebates and subsidies. It includes the addition of packaging, carriage, customs duties and other expenses which are incidental to acquisition and can be identified to individual items or are specified in individual purchase contracts. Where applicable, costs will be VAT inclusive.

7.28. Guidance on accounting for development costs - for example, contractors’ design, licensing, tooling and testing of RMC, can be found in Chapter 4.74 to 4.83.

7.29. Where more than one contract exists and items are supplied at different prices and in different order quantities the BMP should be that applicable to the most common order quantity. Thus using the BMP minimises any purchase price variance. Where a purchase price variance arises, it should be expensed to the Statement of Comprehensive Net Expenditure (SOCNE).

Cost of Conversion

7.30. Cost of conversion comprises direct materials, labour and expenses and other attributable overheads (including irrecoverable VAT). Where work is carried out by an external contractor, cost of conversion is represented by the invoiced cost net of any avoidable abnormal conversion costs.

7.31. Cost of conversion results in a revised valuation for items which have undergone material modification, enhancement or conversion.

Current Cost

7.32. Current cost is defined as 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 latest cost of acquisition or indexation and applies to items expected to be used or sold in the ordinary course of business

7.33. Where supply system 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, as this will be sufficiently close to their value to the business. There is also unlikely to be any material difference between the two valuations.

Net Realisable Value

7.34. NRV is defined as the estimated disposal sales value of an item of materiel not expected to be used or sold in the ordinary course of business – for example, to reflect a change in demand or a movement in market conditions. Where appropriate, an NRV valuation also applies to RMC held for the manufacture of or incorporation into goods.

7.35. The estimated disposal value may be nil or scrap value. Any costs which are incidental to the sale (such as agent’s fees) and can be identified to individual items or sales contracts are deducted from the sales proceeds on a net receipt basis. Disposal costs which are charged separately are reflected in the calculation of the surplus or deficit on disposal and reported in the SOCNE.

7.36. NRV takes into account the usage and condition of items. This typically covers: age: physical deterioration; serviceability; transaction history; and future frequency of issue or sales demand. Items valued at NRV should be identified for disposal.

<u>Provisions</u>

7.37. Financial provisions for RMC are created by assessing the quantity of a particular item which is not expected to be used or sold in the ordinary course of business. All assumptions made in determining the estimated provisions should be documented and reviewed at the end of each financial year.

7.38. Provisions are also created for munitions and shelf-lifed items to reduce their value over their estimated useful economic life - for example, to adjust valuations to reflect NRV. Where the usage of life of type (lifetime) buys is expected to be limited, provisioning may commence at the start of the estimated useful economic life or at any time from acquisition to disposal. In certain circumstances this also applies to war maintenance reserves.

7.39. Provisions should only be created where there is sufficient certainty that the condition requiring the provision will materialise. General provisions are not permitted (for example, for physical losses and stocktaking adjustments).

7.40. An RMC valuation provision reduces an item's value to NRV. The provision is offset against the gross carrying amount. The value on individual price records and price status identification remains at current cost. The provision is applied to surplus, unserviceable, defective and obsolete items as follows:

a. excess items. An RMC valuation provision for surplus items is created for the quantity of items which are not expected to be used or sold in the ordinary course of business.;

b. defective and obsolete items. An RMC valuation provision is made to write down the valuation for the total quantity of defective and obsolete items;

c. obsolescent items, i.e. items which are still in use but no longer commercially available continue to be valued at current cost unless classed as surplus or defective. No provision is made against an obsolescent item expected to be used or sold in the ordinary course of business. This is unless its use is expected to be limited from the outset, in which case a lifetime provision can be made. An item is valued at current cost, even if it is becoming obsolete, if there is a reasonable expectation that it will be used.

7.41. Irrespective of whether a provision has been made, issues (other than to disposal) will be made at the full current cost . The provision is released to the SOCNE on disposal.

7.42. NRV is assessed separately for each item. Individual valuation provisions and status identification changes are made as they arise. Where this is impracticable, the provision can be made by applying a certain percentage reduction - for example, on a stores range basis. Exceptionally, where a professional assessment of the aggregated estimated sales proceeds from a range of items declared for disposal is appropriate, an aggregate provision can be made by applying an adjustment factor derived from the composite NRV valuation. The basis of the assessment is documented.

7.43. RMC valuation provisions are reported in the appropriate RMC valuation provision account and offset against the gross carrying amount. These accounts are maintained separately from the RMC write-off accounts for physical RMC losses and stocktaking adjustments.

Price Records

7.44. The BMP for individual items is recorded on ISOPS. Where practicable, direct interfaces from principal RMC systems to the CPRs are established to ensure that pricing is consistent across the Department. Local price databases, which are maintained independently, have no effect on the financial accounts and must therefore be regularly updated against the Central Pricing Record currently maintained on ISOPS. Further details can be found in JSP 886 Volume 2, Part 6.

Valuation Summary

7.45. A summary of how valuation policy is applied is set out in Figure 12 .

Figure 12

Status of items	Basis of valuation	Price Status (supply system)	Provision
Expected to be used/sold (non-life of type buy).	CC	CC	• None.
Expected to be used/sold (life of type buy).	CC	CC	• Surplus provision (calculated on CC less estimated net realisable value). • Offset against the SOFP valuation.
RMC - excess (i.e. surplus and defective).	NRV	NRV	• Provision for relevant quantity of excess. • Offset against the SOFP valuation.
Obsolete.	NRV	NRV	• Provision for total quantity of obsolete items. • The SOFP valuation is written-down to net realisable value.

Revaluation

7.46. Revaluation updates the value of an individual item through price supersession, indexation or other assessment. Revaluation to current cost is undertaken on an individual item basis and at least annually. Appropriate revaluation reserves are maintained. Consistency of valuation across the Department is maintained through reference to ISOPS and local price databases.

Periodicity

7.47. Where appropriate, periodic revaluation is undertaken more frequently than annually - for example, where prices for certain items are subject to short-term material fluctuations. Price supersession (i.e. price update) takes place at the time the item is purchased or acquired. Periodic revaluation is carried out on fixed dates or effective dates. for example, contract revisions.

Price Supersession

7.48. 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) supersedes the existing price record. However, this should not be done if would distort the total value of the items - for example, in the case of one-off purchases to meet critical supply shortages.

7.49. Where there has been no price supersession, annual revaluation is made through indexation, reference to price lists, revised contracts, or through a professional valuation assessment. Items subject to recurring indexation are revalidated against current price lists or, in the absence of price lists, by professional valuation assessment every 5 years.

7.50. Price changes reflected in a contract revision are taken into account during periodic revaluation, provided that the contract is in force at that time. Periodic revaluation may 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 line with the revised contract.

7.51. 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 in the purchase price variance account. 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 for which variances will be carried forward. Material purchase price variances are reported as exceptional items.

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

7.53. When items are declared obsolete, revaluation is suspended.

7.54. Where the cost of an item includes irrecoverable VAT, a change in the rate of VAT is taken into account during revaluation.

RMC Revaluation Reserve

7.55. Revaluation adjustments are reported in the appropriate Revaluation Reserve account. The balance on the Revaluation Reserve account reflects the unrealised elements of the cumulative revaluation adjustments. When items are issued for use, consumption, sale, write-off, disposal or permanent diminution in value (for example, to NRV) the associated balance in the Revaluation Reserve account is realised and released to the General Fund. See Chapter 5.252 and 5.253.

Consumption

7.56. The physical holder of the items is the custodian of the RMC. However, it is the owner who makes the decisions about acquisition, retention and disposal. The end user is the consumer who is also responsible for accounting for small value articles in use (for example, hand tools) which are regarded as consumed on issue. When items of RMC are consumed, the amount is charged to the SOCNE of the consuming TLB.

7.57. DE&S purchases RMC on behalf of Front Line Commands (FLCs). Items are considered to be consumed on issue to the FLC unless a material amount (for example, imprest or buffer RMC) remains, in which case the FLC credits the SOCNE and debits the SOFP. Where this is the case the FLC must reverse those entries as the material holding reduces on consumption. Regarding the Land environment, although inventory which is managed and accounted for across the Land environment is expensed on issue by the accounting systems, an ‘add back’ is made at year end to reflect the value of inventory issued but not consumed. HQ Land Forces, in conjunction with CFAT, is currently leading on examining the impact of this add back.

Issues and Items in Transit

7.58. Issues are accounted for by the relevant owner on the appropriate inventory system at the point of:

a. issue to a different owner within the same TLB;

b. issue by one TLB and receipt by another;

c. issue for use or consumption by the end user;

d. transfer on a feeder system;

e. loan (which is rare);

f. sale;

g. write-off or disposal.

7.59. Internal Departmental issues are made at the current recorded price on the relevant price record.

7.60. In accordance with the policy set out in JSP 368 (Guide to Repayment), issues which are external to the Department (for example, to commercial customers, Other Government Departments and Trading Fund Agencies) include a charge to recover appropriate overheads (normally by percentage addition).

Treatment

7.61. Once an owner has issued items of RMC, the accounting treatment is as follows:

a. the items are reported in the end user's SOCNE as consumed;

b. the items are transferred to a different owner within the same TLB. The items continue to be reported in the new owner's SOFP;

c. the items are transferred to an owner in another TLB through GMG accounts. The items are reported on the new owner's SOFP;

d. the items are loaned. The items continue to be reported in the owner's SOFP.

7.62. Issues are made at basic material price (BMP), including VAT, if appropriate. Sales (including repayment issues) are priced at BMP with an addition to recover applicable overheads (as defined in Departmental repayment pricing procedures). The difference is reported in the appropriate SOCNE as a surplus on disposal of RMC.

7.63. RMC that are either consumed or are in the process of being used up, or which are otherwise regarded as consumed on issue, are reported as consumption in the SOCNE.

7.64. Items in transit are reported in the balances of the supplying owner up to the point of receipt by the end user or receiving owner. They must remain on the owner's account. PTs are responsible for making the relevant systems adjustment or, if this is not possible, for raising a manual journal. Issuing PTs and receiving owners should liaise closely to ensure that corresponding journals are posted in the same accounting period.

Transfers

7.65. Items may be transferred within or between TLBs.

Treatment

7.66. When items are issued from one BLB to another BLB within the same TLB, they continue to be reported in the issuing BLB's SOFP.

7.67. When items are transferred between TLBs, the new owning TLB reports them on its SOFP. The carrying amount, accumulated provision and associated element of reserves are individually transferred but should be reviewed to see that they are still appropriate.

7.68. When items are procured by a purchaser who is not the owner, they should be physically transferred to the owner. In such cases, an inter-management grouping transfer is made to reflect the payment made by the purchaser for items delivered directly to the owner or the transfer from the purchaser to the owner if a physical transfer is involved. The only exception is where they are directly procured by the FLC for immediate consumption.

7.69. All transfers between TLBs are reconciled at the period end. Where there is a difference in the recorded value of an item being transferred and the value recorded in the receiving inventory account, the difference, if adjusted upwards, is reported in the appropriate Revaluation Reserve account in the receiving TLB's Accounts.

Receipts

7.70. Receipts are accounted for by the relevant owner on the appropriate RMC system. This may be: at the point of acquisition; when legal title transfers from a third party; when internally manufactured items are brought on charge; when items are returned; when items transfer between TLBs; and when spares are cannibalised or salvaged from other assets.

7.71. The point of receipt occurs on delivery, i.e. when items are brought on charge to the relevant RMC system, which may be in advance of formal acceptance. When items are received into non-Departmental locations, the Department accounts for them from the point at which it receives notification from the custodian.

7.72. 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 enable the items to be recorded on the new owner's SOFP.

Returns (Other than Returns to the Manufacturer)

7.73. Items returned from a consuming TLB to a custodian/owning TLB are accounted for in the same way as receipts. Returns may occur as a result of items having become obsolete, defective, damaged, or having deteriorated, in which case a corresponding write-off will be required.

7.74. Returns also occur as a result of items having been incorrectly issued or because they are no longer required. Where the items have previously been reported as consumed, a credit to consumption is made at the same time as the items are brought on charge to the appropriate account - for example, return of expendable consumables and low value articles in use.

Revaluation

7.75. Where there is a difference between the recorded value of items being returned and the value recorded in the receiving account, the difference is reported in the RMC Revaluation Reserve account or the RMC financial provision account (as appropriate) in the receiving Management Group's accounts. The relative validity, accuracy and appropriateness of the individual prices on the relevant databases are assessed to determine which price to use.

Physical Verification

7.76. PTs are responsible for physical verification and should be satisfied that the custodians (for example, JSCS and FLCs) are following appropriate physical verification procedures. See JSP 886 for stocktaking policy and procedures.

7.77. All RMC are subject to physical verification.

7.78. Stocktaking is undertaken to reconcile actual RMC holdings with recorded RMC holdings to verify the validity, accuracy and completeness of accounting records.

7.79. During stocktaking the location and condition of items, the level of RMC holdings (highlighting potential excess items) and the storekeeping arrangements should also be examined.

7.80. Departmental Materiel Accounting Regulations for continuous stocktaking remain extant but with an increased emphasis on high value items and stocktaking discrepancy rates. Stocktaking performance and results provide evidence of how adequate the arrangements are. See JSP 886.

7.81. Wherever practicable, continuous stocktaking is undertaken through a 70% by value quadrennial rolling programme, in accordance with JSP 886, which must cover 100% of all items over the 4 year period.

7.82. Where discrepancies are found, stocktaking adjustments are made in the accounting records after appropriate investigations have been concluded.

7.83. Stocktaking records and reports of performance and results should be completed.

Disposals

7.84. Items declared for disposal include those that are obsolete, defective, damaged or surplus to, or no longer fit for, known requirements.

7.85. RMC declared for disposal is valued at NRV.

7.86. Where the estimated disposal sales value or scrap value is very low or nil, items can be fully written-down by way of an RMC valuation provision when issued for disposal. In most cases this should be nil as any sale proceeds will be retained by the Disposal Services Authority.

7.87. Items declared for disposal for which receipts (either collected by the Disposal Services Authority or generated from local sales) are anticipated to be separately identifiable are transferred to the RMC Declared for Disposal account and evidence of their transfer retained. Receipts are matched with the NRV (Value of RMC Disposed) and any associated surplus or deficit on disposal, after deducting direct costs incurred in the sale, is reported at TLB level.

7.88. Items declared for disposal for which receipts (either collected by the Disposal Services Authority or generated from local sales) are not anticipated to be separately identifiable on sale are transferred to the RMC Declared for Disposal (RMC) account. The receipts are offset against the balance on this account (Value of RMC 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 based on the average lead time between declaration for disposal and sales receipts. Any associated surplus or deficit on disposal (after deducting direct costs incurred in the sale) is reported at TLB level.

Disclosure

7.89. There is no requirement for war maintenance reserves to be disclosed separately in either the SOFP or the notes to the accounts.

7.90. The balance on the Inventories Revaluation Reserve is included within the Revaluation Reserve on the face of the SOFP. Elements of the Revaluation Reserve which are realised and transferred to the General Fund are disclosed separately in the notes to the accounts.

7.91. The following operating cost charges are disclosed separately in the SOCNE under programme costs:

a. RMC consumption;

b. surplus or deficit arising on disposal of RMC items (reported as exceptional items, where material);

c. provisions to reduce RMC to NRV (net of any amounts released);

d. write-offs for physical losses and stocktaking adjustments (net of write-ons);

e. reversals of RMC write-downs.

7.92. Details of write downs and any reversal of write-downs (including the circumstances leading to the reversal) are shown in the inventories note to the accounts where material.

Specific Accounting Treatments

Contracting for Availability Contracts

7.93. Contracting for Availability (CFA) contracts are sometimes referred to as Contractor Logistic Support (CLS) contracts or Integrated Operational Supply (IOS) contracts. Although their titles may vary, it is the nature of the arrangement rather than its title which determines the appropriate accounting treatment.

7.94. These types of contracts constitute arrangements under which the Department typically pays for the platform to be made available. The cost will include items of capital spares, GWMB or RMC used to achieve this.

7.95. As IFRIC 4 is not currently being applied by the Department (see Chapter 5.331) CFA arrangements should continue to be accounted for as they were under UK GAAP (i.e. by applying FRS 5).

7.96. If the situation changes and a decision is taken to apply IFRIC 4, Chief Accountants will be advised accordingly and CFA arrangements should then be accounted for in accordance with paragraphs 7.97 to 7.100 below. It is emphasised that the treatment in paragraphs 7.97 to 7.100 should not be followed at the present time and is for information only.

7.97. Contracts which fall within the remit of CFA contracts or display characteristics akin to CFA contracts should be assessed under IFRIC 4 (see Chapter 5.330) to determine whether the contract is, or contains, a lease. If it is a lease or if it contains one, IAS 17 should be applied to determine whether the lease is a finance or an operating lease (see Chapter 5.333).

7.98. The contract should be assessed as a whole rather than just assessing the individual capital spares, GWMB or RMC items. If it is not or does not contain a lease, the contract costs should be expensed.

7.99. If the lease is an operating lease, the contract costs relating to the operating lease should be expensed and the operating lease disclosures followed (see Chapter 5.217(d)). The remaining contract costs should be expensed.

7.100. If the lease is a finance lease, the contract cost should be disaggregated. Any capital spares should be capitalised as tangible NCAs (see Chapter 5) and any RMC as current assets. A finance lease payable should also be established.

Construction Contracts

7.101. Work performed on Construction Contracts relates to work which the Department undertakes for external repayment customers. Accounting for construction contracts is governed by IAS 11, Construction Contracts. See Chapter 3.12.

Containers

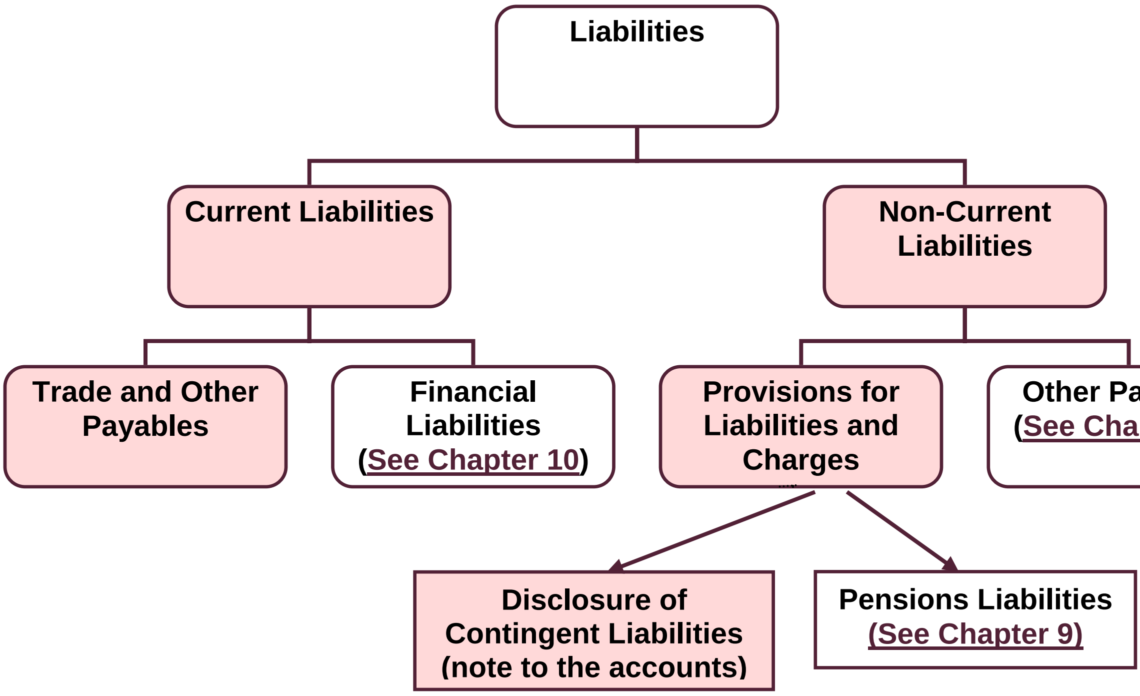
7.102. A container is a receptacle which is specifically designed for the transportation or storage of an item of materiel. Containers are accounted for as RMC items or as grouped NCAs depending on the nature, quantity and value of the items concerned. See Chapter 5.317.

7.103. Empty packed fuel containers are recorded as individual RMC items and all issues and receipts are accounted for. Issues are expensed and returns are credited to RMC consumption.

Items of Personal Equipment

7.104. The accounting treatment is covered in Chapter 5.63.

CHAPTER 8: LIABILITIES



Introduction

8.1. This chapter covers the financial accounting treatment and disclosure of current liabilities (i.e. those falling due within one year); provisions for liabilities and charges; and contingent liability disclosure requirements as set out in the Government Financial Reporting Manual (FReM).

8.2. It should be read in conjunction with Chapter 13, which explains the Managing Public Money (MPM) requirement for the Department to seek authority from HM Treasury and, in some cases, notify Parliament before it assumes certain actual and contingent liabilities.

8.3. Non-current other payables (i.e. those falling due after more than one year, excluding provisions) are covered in Chapter 10. Accounting for pension schemes, including pension scheme liabilities, is covered in Chapter 9.

Key Points

8.4. A liability is a legal or constructive obligation (see Figure 1) which is settled through a future transfer of economic benefits.

8.5. An **accrual** is created to reflect the estimated value of goods and/or services received but not paid for or invoiced. This includes amounts owed to employees for untaken holiday.

8.6. Where goods and/or services have been received and invoiced but not paid for the liability is reflected as a **trade payable** (see Figure 2).

8.7. Where a liability exists but it is uncertain when it will be settled or at what cost, a **provision** is created if a reasonable estimate of the cost can be made. It is this uncertainty over the amount or timing of settlement that distinguishes a provision from other liabilities.

8.8. A **contingent liability** will only crystallise into an actual liability if a specific set of circumstances materialises at some point in the future. See Figure 3.

Policy Detail

8.9. Policy detail is set out under the following headings; specific responsibilities; liabilities; current liabilities; non-current liabilities; disclosure; accounting for specific provisions and contingent liabilities.

Specific Responsibilities

8.10. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

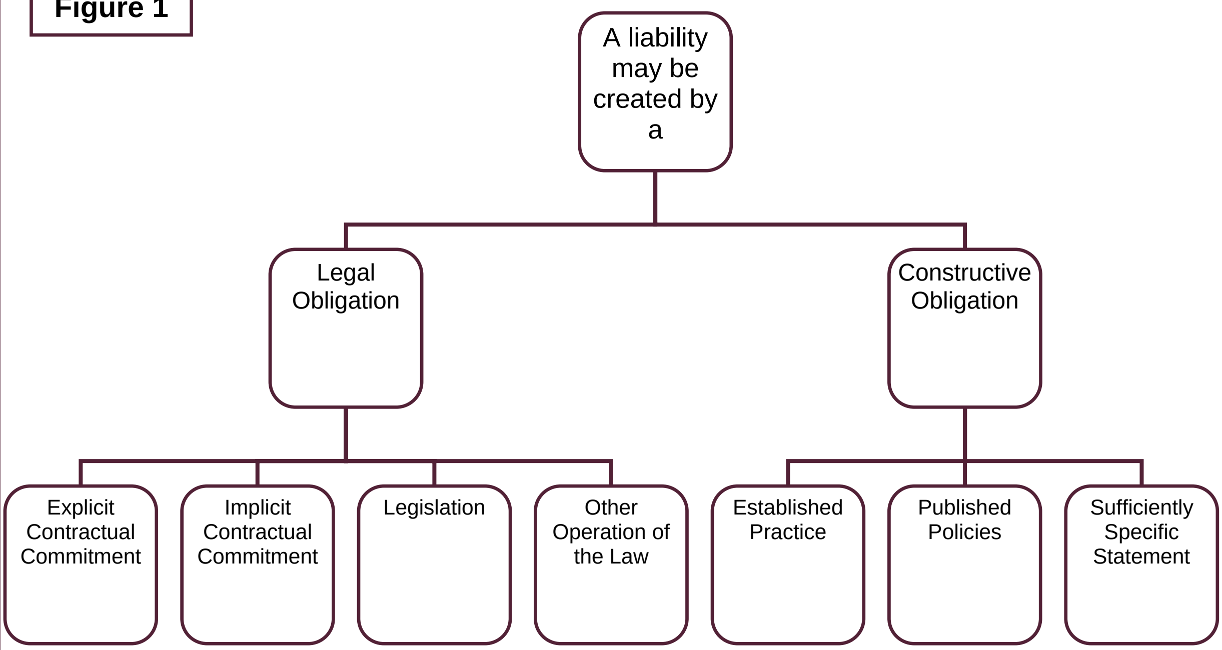
The FMPA A&TM Corporate Financial Accounting Team (CFAT)

8.11. CFAT is responsible for approving the creation (or amendment) of a new (or existing) nuclear or non-nuclear provision, regardless of its value.

Liabilities

8.12. Liabilities are defined in Figure 1 below. A liability can arise from either a legal or a constructive obligation.

Figure 1



Current Liabilities

8.13. The policy for ‘Trade and Other Payables’ is contained in paragraphs 8.14 to 8.24 below. The policy on ‘Financial Liabilities’ is contained in Chapter 10.

Trade and Other Payables

8.14. The categories of trade and other payables are shown in Figure 2 below.

8.15. When recognising the cost of goods and services in the accounts, a distinction should be drawn between a ‘trade payable’ and an ‘accrual’. A trade payable represents a liability to pay for goods or services which have been received or supplied and have been invoiced.

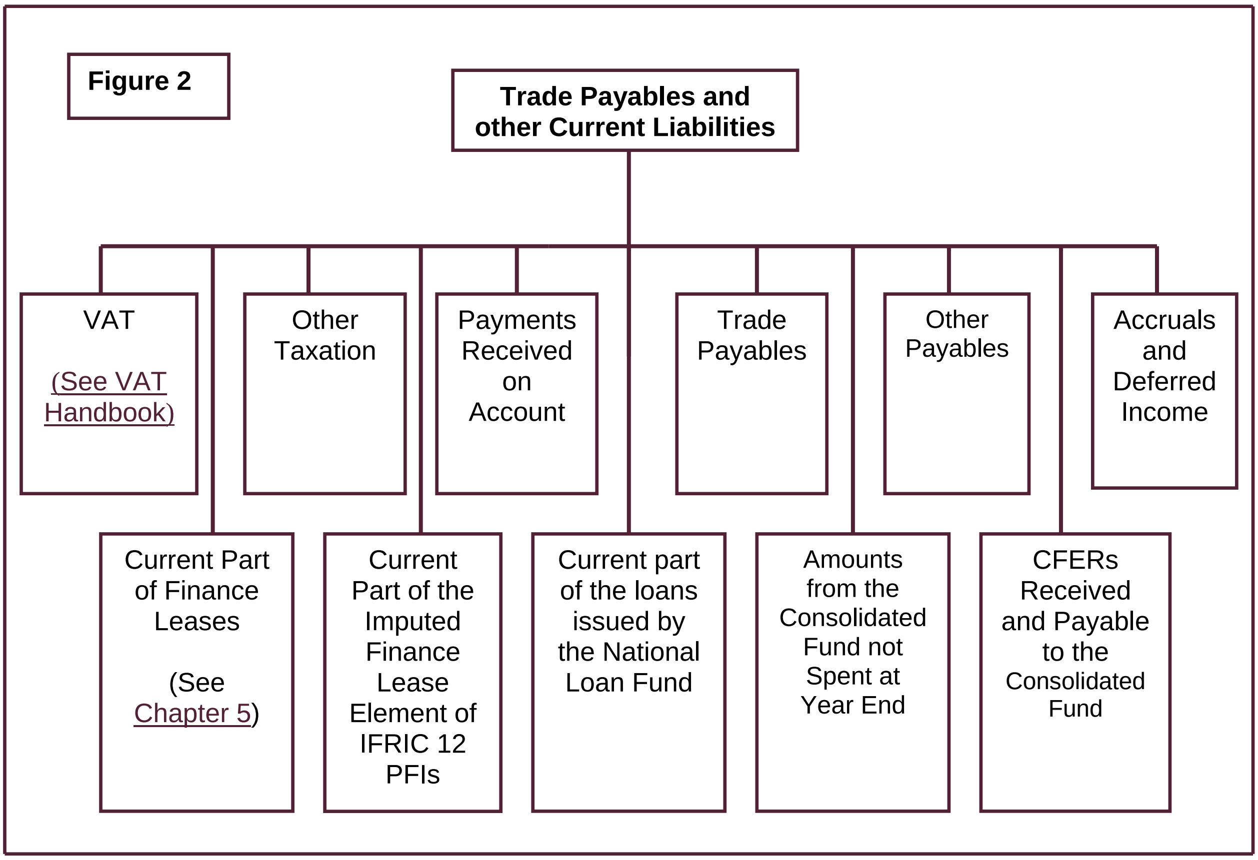


Figure 2

Accruals and Deferred Income

8.16. Accruals represent a liability to pay for goods and services that have been received but not invoiced. This includes amounts owed to employees. Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Examples of transactions included under the heading of accruals and deferred income are:

a. goods or services received but not invoiced;

b. deferred income (i.e. income received for goods and/or services not yet supplied);

c. unused annual leave;

d. rents payable;

e. services received;

8.17. Accruals are not usually made for the following (on materiality grounds):

a. pay and allowances (excluding Reserve Forces Bounty Payments);

b. national insurance;

c. travel and subsistence;

d. superannuation contributions adjusted for past experience (SCAPE).

8.18. Under Departmental contracting arrangements, receipt of the red copy of MOD Form 640 acts as a proxy for a Goods Received Note (GRN) where goods are supplied on a 'one-off' basis. Where services are provided, an authorised MOD Form AG173 serves as a proxy for an invoice.

8.19. Where a contractor undertakes work at risk and the Department is not liable at the reporting period date for meeting the cost, an accrual should not be included in the accounts.

8.20. Charges that attract irrecoverable VAT (input tax) are accrued gross. Where VAT is fully recoverable, accrued balances are reported net of VAT.

8.21. In calculating the accrued value of completed work, all contractual stage or progress payments should be included.

8.22. The value of work completed on all major contracts is fully accrued where there is a contractual obligation to pay for it. The accrual is calculated by taking into account all stage or progress payments. Further details and examples of accruals are provided in Annex 4.

Short-Term Employee Benefits

8.23. Short-term employee benefits are defined as wages, salaries, social security contributions, paid annual leave, flexi leave and post-operational tour leave. All short-term employee benefits should be accrued, with the exception of wages and salaries, which are considered by the Department to be immaterial. Bonuses should be accrued where they are carried over from the previous financial year but due to be used or paid within twelve months after the service was rendered. Short-term employee benefits do not include early retirement or departure benefits.

8.24. Short-term employee benefits are not discounted due to their immateriality.

Non-Current Liabilities

8.25. The policy for 'provisions' (excluding pension scheme provisions which is covered in Chapter 9) is contained in paragraphs 8.26 to 8.42 below. The policy on 'Other Payables' is contained in Chapter 10.

Provisions for Liabilities and Charges

8.26. Creating a provision ensures that a liability, which has arisen from a past or present obligating event but will not be settled until a future date, is charged in the accounts when it is first recognised.

8.27. A provision is a liability for which the amount or timing of the expenditure that will be undertaken is uncertain. Provisions can be distinguished from other liabilities such as trade payables and accruals because there is a higher level of uncertainty over the timing or amount of the future expenditure. Further details and examples are given in Annex 5.

8.28. Approval must be sought from CFAT before creating a new nuclear or non-nuclear provision, regardless of its value. Similar approval must be sought before amending the value of an existing provision. The assumptions underpinning the estimates in calculating the provision should be documented. These assumptions should be reviewed each financial year to ensure their continuing validity or to recalculate the estimate if the assumptions have changed. Detailed guidance is provided in the In Year Management Instructions.

Recognition

8.29. A provision is only recognised in the accounts when:

a. the Department has a present obligation, legal or constructive, to transfer economic benefits as a result of past events; and:

b. it is probable that a transfer of economic benefits will be required to settle the obligation; and

c. a monetary estimate of the amount of the obligation can be assessed with sufficient reliability.

8.30. A provision cannot be created to recognise:

a. a liability which arises from an executory contract, unless the contract becomes onerous (see paragraph 8.31);

b. expenditure which management could avoid by its own actions;

c. adjustments to the carrying value of assets, for example, to reflect depreciation or a provision for bad debts;

d. future expenditure to overcome a shortfall in funding.

8.31. An executory contract is one in which neither party has performed any of its obligations or alternatively both parties have performed their obligations in equal measure. An onerous contract is one in 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 the other party would have to be compensated if the terms of the contract were not fulfilled. Provision should be made for onerous contracts.

8.32. When a provision for liabilities and charges is created, the double entry is effected through:

a. a charge to the Statement of Net Comprehensive Expenditure (SOCNE) if the Department will not derive any associated economic benefit - for example, from decommissioning an *out of service* nuclear submarine; or

b. the creation of a capitalised asset provision if the Department will derive economic benefit from the associated asset, for example, a nuclear test facility used to support in-service assets. The capitalised asset is given a unique identification number, recorded separately in the NCAR, and held in the same category as the associated asset. By depreciating it over the same timescale as the associated asset, the cost and economic benefit are matched.

8.33. Provisions for the restitution and decommissioning of Non-Current Assets (NCAs) are recognised in the accounts of the TLB which has the financial management responsibility for the related asset.

Measurement

8.34. Provisions are calculated at current year price levels. Where it is only possible to estimate a range of possible costs, the best estimate should be used. The minimum or maximum amount should only be used if it will provide the best estimate. If material, the minimum and maximum amounts should be disclosed separately.

8.35. Where material, provisions are discounted back to the reporting period date. The 'real' discount rate set by HM Treasury (as promulgated by PES papers available on the Treasury website) must be applied to future cash flows unless they relate to voluntary early retirement under pension scheme rules in which case the appropriate pension discount rate should be used (see PES (2010) 17).

8.36. The formula $1/(1+r)^n$ is used to discount future cash flows, where 'r' is the real discount rate, for example, 2.2% or, if appropriate, the pension scheme's discount rate, and 'n' is the number of years over which the discounting applies (back to the date of the current reporting period). An example of how to discount a provision is provided in Annex 5.

8.37. Each year, the provision is adjusted to take into account inflation during the past year and one year's discount is removed as the future expenditures move a year closer. The unwinding of the discount is taken as an interest charge to the SOCNE.

8.38. As the inflation rate changes annually, the new rate should be assessed each year to ensure that the correct settlement cash flows are created. If no better information is available, the inflation rate used in the most recent Planning Round can be applied. Capitalised asset provisions should not be subject to MHCA adjustment (i.e. NCA indexation) but should be revalued in accordance with latest prices for decommissioning provisions. The increase should be treated as an 'Addition' in the Annual Accounts.

8.39. Where the provision does not have a corresponding capitalised asset provision, cash flows which have been updated to reflect changes in assumptions and estimates should be stated at current prices and discounted to the Reporting Period date. These changes in value should be charged/credited to the SOCNE together with the annual charge for unwinding the discount factor and any changes arising from inflation/price changes. See Annex 5 for the accounting entries.

8.40. Where there is a capitalised asset provision that has not been fully depreciated, the carrying amount of the associated asset is adjusted to reflect any increase or decrease in the value of the provision. The balance is then depreciated over its remaining useful life. However, if the decrease in the provision exceeds the carrying amount of the asset, the excess should be recognised in the SOCNE. The inflation adjustment should be capitalised as should any changes arising from inflation/price changes and a change in the discount rate. See Annex 5 for the accounting entries.

8.41. Provisions for decommissioning costs and any capitalised provision assets are generally recognised by the PT that has financial management responsibility for the associated asset - for example, a submarine. Where the asset has never been, and will not be included in the accounts (for example, an asset may have a value below the NCA capitalisation threshold), the provision should normally be recognised in the accounts of the PT responsible for managing the NCA category to which the asset belongs.

8.42. The financial effects of a change in the discount rate for early retirement provisions should be recognised in the SOCNE.

Disclosure

8.43. For accruals, the notes to the accounts should disclose amounts payable on stage payments and show separately the amounts which fall due after five years.

8.44. For provisions the following information is required:

a. a brief description of the nature of the obligation;

b. the estimated timing and value of the provision. Where there is significant uncertainty over either of these, the determining factors should be identified;

c. the amount provided for and, if estimated, the basis on which the estimate has been made including any range of estimates, if applicable;

d. the discount rate (if applicable);

e. an analysis of the expected timing of discounted flows;

f. movements in the year on each material class of recognised provision, separately identifying:

   i. additional provisions made in the year;

   ii. amounts used, i.e. charged against the provision;

   iii. amounts released unused;

   iv. the discount rate (if applicable);

   v. amounts capitalised;

   vi. amounts transferred;

   vii. any foreign exchange differences.

Accounting for Specific Provisions

Provisions for Decommissioning and Restoration

8.45. A provision is created from the point at which contamination first occurs. For example:

a. nuclear submarines (hull, reactor plant and associated storage facilities). A provision for the full costs of decommissioning nuclear submarines should be created from the date on which the plant becomes operational. This recognises that no material obligation is created until the reactor is activated;

b. the national repository for eventual waste disposal. A provision should be created for the cost of operating the storage facility from the point at which the obligation to operate it and store the waste material first arose;

c. contaminated land. A provision should be created from the date on which the activities responsible for the contamination first take place.

8.46. The key assumptions underpinning the estimates used in calculating the provision should be documented by the PT and disclosed in the Annual Accounts. For decommissioning and restoration provisions, these are likely to be the time period over which the provisions are estimated, the costs for the future storage and decommissioning of waste, the VAT rate and the discount rate used. For example, if the best estimate of the probable date of decommissioning is likely to vary significantly, the notes to the accounts should show the potential effect on the value of the provision as a result of the present value of the cash flows changing.

8.47. Where expenditure covered by a decommissioning or abandonment provision will give rise to future Departmental outputs, the provision is capitalised and included in the value of the associated asset. The capitalised value is depreciated over the estimated useful life of the asset. Apart from the cost of unwinding the discount, which is expensed as an interest charge to the SOCNE, all subsequent changes to the value of the provision are capitalised unless a decrease in the provision exceeds the asset’s carrying amount (in which case, the excess is recognised in the SOCNE).

Provisions for Restructuring/Reorganisations

8.48. A provision for restructuring is recognised from the point at which the organisation is demonstrably committed to the reorganisation, cannot realistically withdraw from it and has a detailed plan for its implementation.

8.49. It can only include expenditure which arises directly from the restructuring or the reorganisation activities and therefore excludes any costs associated with new or on-going business activities such as the cost of retraining or relocating staff remaining with the business.

Provisions for Early Release or Redundancy

8.50. The Department retains responsibility for financing all early retirement costs up to Normal Retirement Age (NRA), which is usually set at age 60, after which the normal occupational pension scheme funding arrangements take effect. For example, if the civilian is a member of the PCSPS, funding responsibility would transfer to the Office of Public Service (OPS) after NRA. However, the additional element payable beyond NRA, which derives from the enhancement of reckonable service, continues to be met by the Department.

8.51. When a letter offering early release or early departure is issued to individuals, a provision is set up to represent the future liability to pay early pensions and lump sum payments. For a compulsory redundancy scheme, the provision is recognised when the announcement of the redundancies is formally made.

8.52. For an early release scheme, the provision is recognised as an accrual when the early release offer letters are accepted by the individuals and release dates agreed. For compulsory redundancy schemes, the provision is recognised as an accrual when the individuals are notified. Voluntary early retirements under pension scheme rules should be discounted at the pension’s discount rate and not the provisions discount rate. The financial effects of a change in the discount rate for early retirement provisions should be recognised in the SOCNE.

8.53. The employing TLB is responsible for calculating future civilian early retirement and departure provisions.

Provisions for Dilapidation

8.54. Many property leases include a tenant repairing clause which places a legal obligation on the tenant to return the property to the landlord in a specified condition at the end of the tenancy.

8.55. At the inception of a lease which contains a dilapidations clause, the future estimated costs of dilapidations should be disclosed as a contingent liability. However, if during the duration of the lease a sufficiently reliable monetary estimate of the dilapidation costs can be assessed and it is probable that a transfer of economic benefits will be required to discharge the obligation (for example, once a decision to terminate the lease has been made), a provision for dilapidations should be created and charged to the SOCNE.

8.56. Normal maintenance expenditure should be charged to the SOCNE as incurred.

Contingent Liabilities

8.57. A contingent liability reflects:

a. 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; or

b. a present obligation, legal or constructive, that arises from past events but is not recognised in the accounts because:

   i. it is not probable that a transfer of economic benefits will be required to settle the obligation; or

   ii. the amount of the obligation cannot be measured with sufficient accuracy.

8.58. A contingent liability is not included in accounting balances but may be disclosed in the notes to the accounts. All contingent liabilities should be regularly reviewed to determine whether an outflow of resources embodying economic benefits has become sufficiently probable to make it necessary to create a provision.

8.59. Each class of contingent liability disclosure should include a brief description of the nature of the contingent liability and, where practical:

a. an estimate of its financial effect (discounted where material);

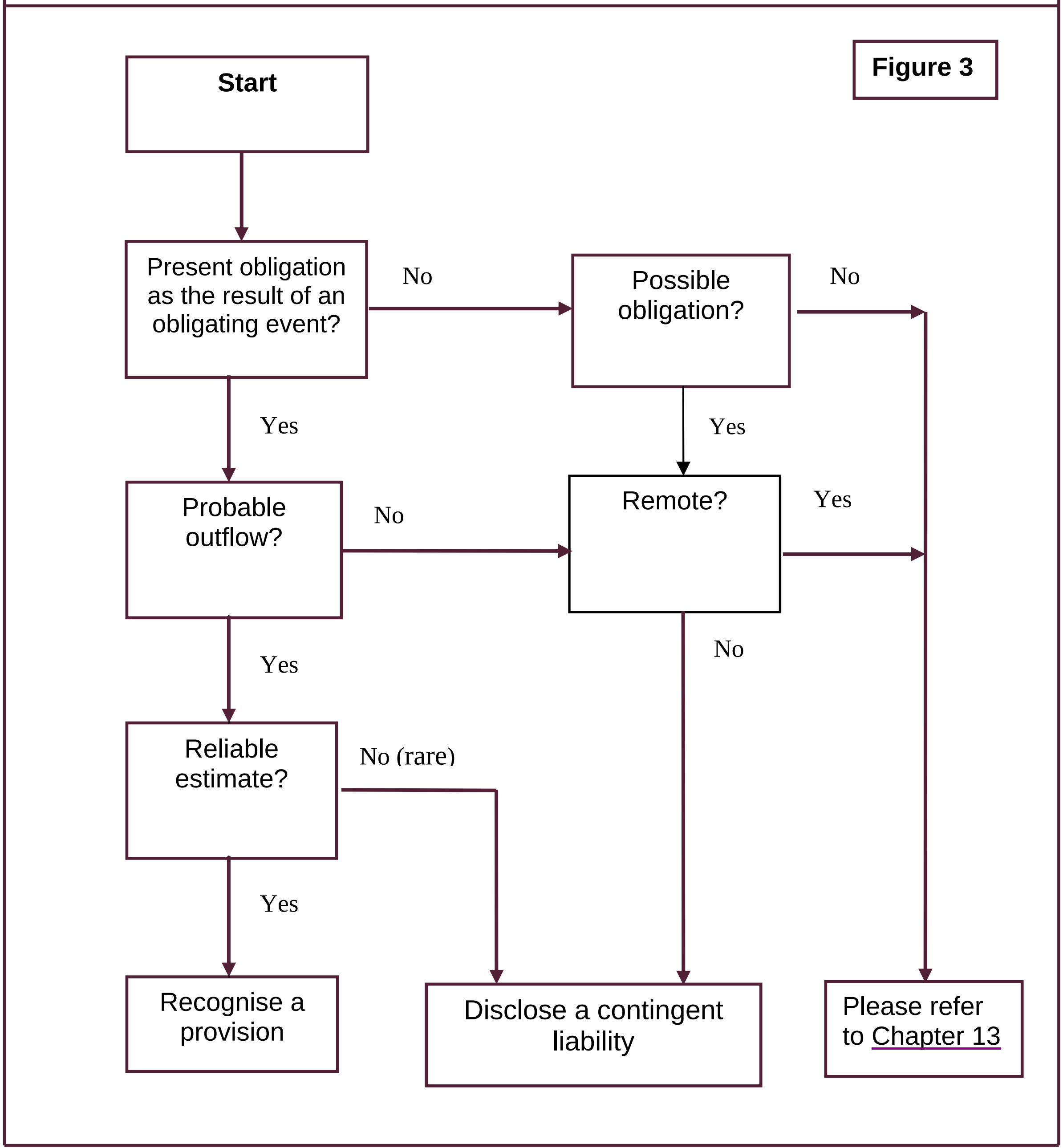
b. an indication of the uncertainties relating to the amount or timing of any outflow;

c. the possibility of any reimbursement.

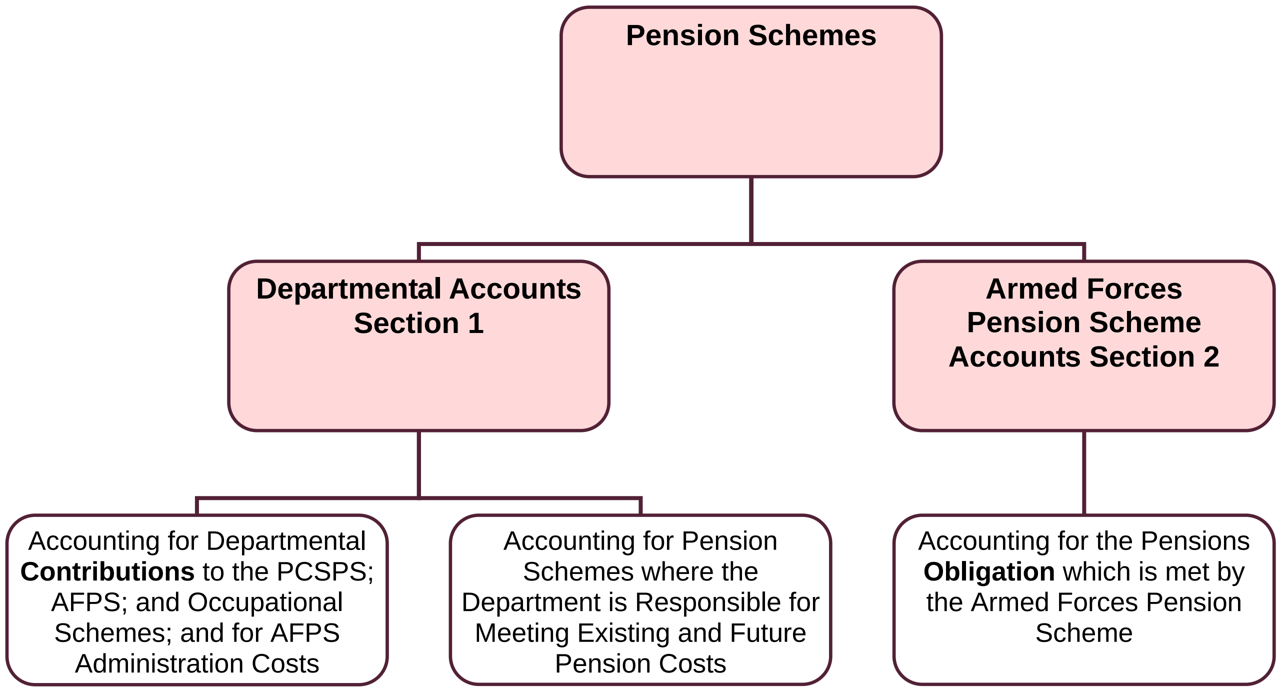
8.60. Separate disclosure of information about a particular contingency may not be made if the publication of such information could be expected to be seriously prejudicial. The relevant amount should be included in the aggregate figure for such contingencies. CFAT should be consulted prior to the application of this exemption.

8.61. See Figure 3 for the main recognition requirements for provisions and contingent liabilities. See Chapter 2.46 for the policy on contingent assets.

Summary of the Main Recognition Requirements for Provisions and Contingent Liabilities



CHAPTER 9: PENSION SCHEMES



Introduction

9.1. This chapter covers pension accounting. In doing so, it differentiates between the pensions accounting policy adopted by the Department, as an employer, and the pensions accounting policy adopted by the Service Personnel and Veterans Agency (SPVA), as administrator of the Armed Forces Pension Scheme (AFPS).

Key Points

9.2. The Department contributes to the Principal Civil Service Pension Scheme (PCSPS); the Armed Forces Pension Scheme (AFPS); and to other occupational pension schemes such as the NHS Superannuation Scheme and the Teachers' Pension Scheme by making Superannuation Contributions Adjusted for Past Experience (SCAPE).

9.3. SCAPE charges represent the estimated cost of the Department providing future pension protection for staff currently in employment. Contributions outstanding are reflected as a liability on the Department's Statement of Financial Position (SOFP).

9.4. Pension payments to former employees (excluding those for early retirement and redundancy) are met by HM Treasury.

9.5. Although the AFPS is reported separately in independent pension scheme accounts prepared by SPVA, the SCAPE charges and the cost of administering the scheme are included in the Department's Statement of Comprehensive Net Expenditure (SOCNE).

9.6. PUS is responsible for approving the AFPS accounts.

9.7. The Department also operates a number of unfunded defined benefit schemes paying pensions directly from its own resources and participates in a funded defined benefit scheme.

9.8. Voluntary early retirements under pension scheme rules are discounted at the pension's discount rate and not the provisions discount rate.

Policy Detail

9.9. Policy detail is set out under the following headings: specific responsibilities; SCAPE; civilian pension schemes; civilian pension schemes disclosure requirements; and AFPS.

Specific Responsibilities

9.10. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

Service Personnel and Veterans Agency

9.11. The Service Personnel and Veterans Agency (SPVA) administers the Armed Forces Pension Scheme (AFPS).

SCAPE

9.12. SCAPE contributions represent the estimated cost of providing future superannuation protection for civilian personnel currently in employment (other than those whose pension is paid directly from the Department's own resources) and also for serving military personnel.

9.13. The PCSPS and the AFPS are unfunded 'defined benefits' schemes. Therefore, although no fund is built up, each scheme is financed to meet specified levels of benefits payable under particular circumstances.

9.14. The amount of future benefit is linked to various factors, most notably to the amount of final salary and to the number of years served. As this information is not known in advance, the future cost of providing benefits is actuarially assessed.

9.15. For civilian personnel, staff are grouped according to salary band and the rate at which SCAPE is payable is calculated as a percentage of the salary band. For military personnel there are two rates (one for officers and one for other ranks). Contribution rates are reassessed every three years.

9.16. TLBs responsible for the related salary costs account for SCAPE on an accruals basis through their SOCNE.

9.17. The AFPS accounts for SCAPE as income and shows it on the scheme's Revenue account at the reporting period date.

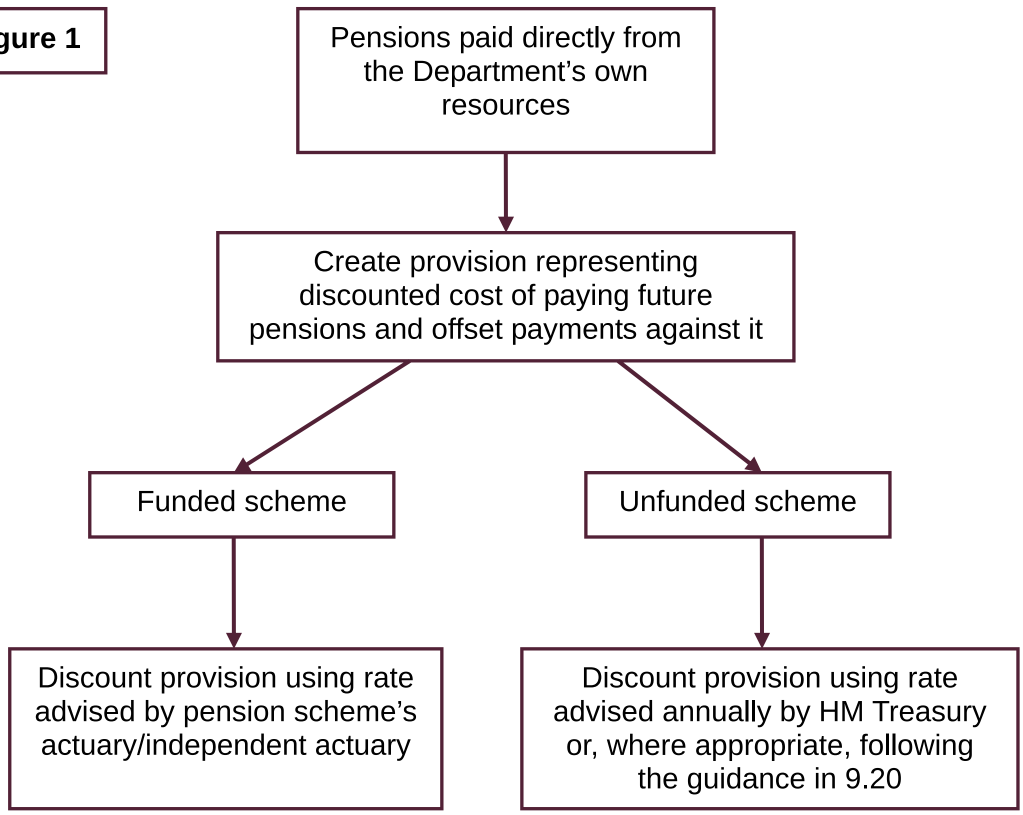
9.18. SCAPE is transferred to the Office of the Paymaster General's superannuation account and outstanding amounts are accounted for as a payables balance.

Section 1 – Civilian Pension Schemes

9.19. The PCSPS is a defined but unfunded benefit scheme, whose benefits are secured against future tax yield and paid by the Office of Public Service (OPS) as they fall due. The future cost, which is determined by factors such as final salary and the number of years served, is actuarially assessed.

9.20. The Department also operates a number unfunded defined benefit schemes where pensions are paid directly from the Department's own resources. In addition, it participates in a funded defined benefit scheme. Funded and unfunded schemes should normally be accounted for as described in Figure 1. However, HM Treasury has stated that the Department's defined benefit pension schemes for civilians employed in Gibraltar and Cyprus should use the discount rate (both nominal and real) advised by the schemes' actuaries. The rates will be specific to the particular scheme. If there are cost or practicality issues associated with this, the next best discount rate assumptions to use are the CPI derived assumptions as per the pensions' discount rate PES paper issued annually by HM Treasury, provided that the end result from doing so is not materially different.

Figure 1



9.21. The provision is calculated on an actuarial basis using the projected unit basis (i.e. allowing for future salary inflation) and discounted to reflect the time value of money (see Figure 1 above).

9.22. Full actuarial valuations must be obtained from a professionally qualified actuary at least every four years. Actuarial gains and losses, including those arising from a change in the discount rate, should be recognised in reserves. Current and past service costs and the unwinding of the discount rate should be charged to the SOCNE.

9.23. Approximate assessments, based on the latest available membership data, are acceptable during intervening years.

Disclosure Requirements

Multi-Employer Defined Benefit Schemes

9.24. 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.

9.25. 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).

9.26. 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.

9.27. 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.

9.28. For funded schemes, 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).

9.29. 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.

9.30. 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;

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.

9.31. 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.

9.32. 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

9.33. The AFPS is an unfunded, defined benefit, salary-related, contracted-out occupational pension scheme administered by the SPVA and open to the majority of the Armed Forces.

9.34. As the scheme lies outside the budgetary control total imposed by HMT, it is reported separately in independent pension scheme accounts, which incorporate the AFPS 75, AFPS 05, Reserve Forces Pension Scheme (RFPS) and the AFCS.

9.35. Although no fund is built up, the pension scheme rules specify the level of, and the circumstances under which, benefits are to be paid. The scheme is financed from the Consolidated Fund.

9.36. Whereas in the separate AFPS accounts the scheme is treated as a defined benefit scheme, in the Annual Accounts it is accounted for as if were defined contribution scheme, with SCAPE charges and the cost of administering the scheme recognised in the SOCNE.

Financial Statements

9.37. The statements recommended by the SORP and reflected in the Magenta statements are:

a. Report of the Scheme's Managers;

b. Report of the Scheme's Actuary;

c. Statement of the Accounting Officer's responsibilities;

d. Statement of Internal Control;

e. Report of the Auditor;

f. Statement of Parliamentary Supply;

g. [Revenue] Account;

h. [Combined] SOFP;

i. [Combined] Statement of Cash Flows;

j. supporting notes.

9.38. Comparative figures should be shown throughout.

Benefits Payable

9.39. 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.

9.40. 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 assets and liabilities should treat such payable orders as if they had been presented at the reporting period date.

9.41. The statement of assets and liabilities 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

9.42. If a member has no choice over the allocation of benefits between lump sum and annual payment 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.

9.43. 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

9.44. Income tax is accrued on a daily basis and all tax due as at month end is paid to HMRC by the nineteenth day of the following month.

Statement of Financial Position

Provision for Pension Scheme Liabilities

9.45. 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.

9.46. 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 Actuaries Department (GAD). The rate will be reviewed annually by the GAD and promulgated by HM Treasury. 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.

9.47. 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.

9.48. Gains and losses arising on the initial recognition of items in the primary statements should be dealt with as a prior period adjustment.

Revenue Account

Income

Employers' Normal Contributions

9.49. 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

9.50. 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

9.51. Employees' normal contributions exclude amounts for the purchase of added years and Additional Voluntary Contributions (or AVCs).

9.52. 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.

Transfers In

9.53. Transfers in should generally be accounted for on a cash basis, i.e. as cash is received by the scheme. 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.

9.54. 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.

Additional Voluntary Contributions

9.55. 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.

9.56. 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.

9.57. AVC transactions should be included in the financial statements of the pension schemes by way of a note showing:

a. the value of the AVC investments at the beginning of the year;

b. amounts paid to the AVC providers during the year;

c. the investments purchased by the AVC providers;

d. the value of the sales of investments to provide pension benefits;

e. the changes in the market value of investments;

f. the value of the AVC investments at the end of the year;

g. the existence (if any) of any guarantee given by the scheme.

9.58. Preparation of this AVC note will require pension scheme managers to obtain direct confirmation from their approved AVC providers of the sums paid over to them, together with details of how they have been invested and movements in the AVC fund during the period.

9.59. In practice, the approved AVC providers may be unable to provide the requisite information to meet the required timetable for the preparation of the scheme statements. Where such problems exist, the AVC note should be based on the latest available information and explain the treatment which has been adopted in its preparation.

9.60. If the AVC arrangements include life assurance cover, the note should also show the contributions received to provide life cover, and the benefits paid on death.

Other Income

9.61. Other income should be accounted for on an accruals basis.

9.62. 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

9.63. The current service cost is the increase in the present value of the scheme liabilities arising from employee service in the current period. The cost should be based on the discount rate used to discount the scheme liability.

Past Service Costs

9.64. 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.

9.65. Past service costs should be recognised in the revenue account 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

9.66. 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 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

9.67. 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

9.68. Other payments should be accounted for on an accruals basis.

Administration Costs

9.69. The costs of administering the scheme should fall on the principal operating department or agency and should not be included in the scheme statements.

Ex Gratia Costs

9.70. 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 a scheme or a department/agency, Treasury guidance should be sought.

Other Movements on the Pension Scheme Liability

Transfers Out

9.71. The same rules apply for transfers out as transfers in.

Pensions Payable

9.72. 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.

9.73. 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.

9.74. 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.

9.75. 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

9.76. 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.

9.77. 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.

Payments to Those Retiring

9.78. 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.

9.79. 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

<u>Actuarial Gains and Losses</u>

9.80. 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.

9.81. Actuarial gains and losses arising from any new valuation and from updating the latest actuarial valuation to reflect conditions at the reporting period date should be recognised in the statement of other net comprehensive expenditure.

Commutation

9.82. 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.

9.83. Two forms of commutation exist for Service personnel:

a. life commutation, (which is currently being phased out and 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.

9.84. 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.

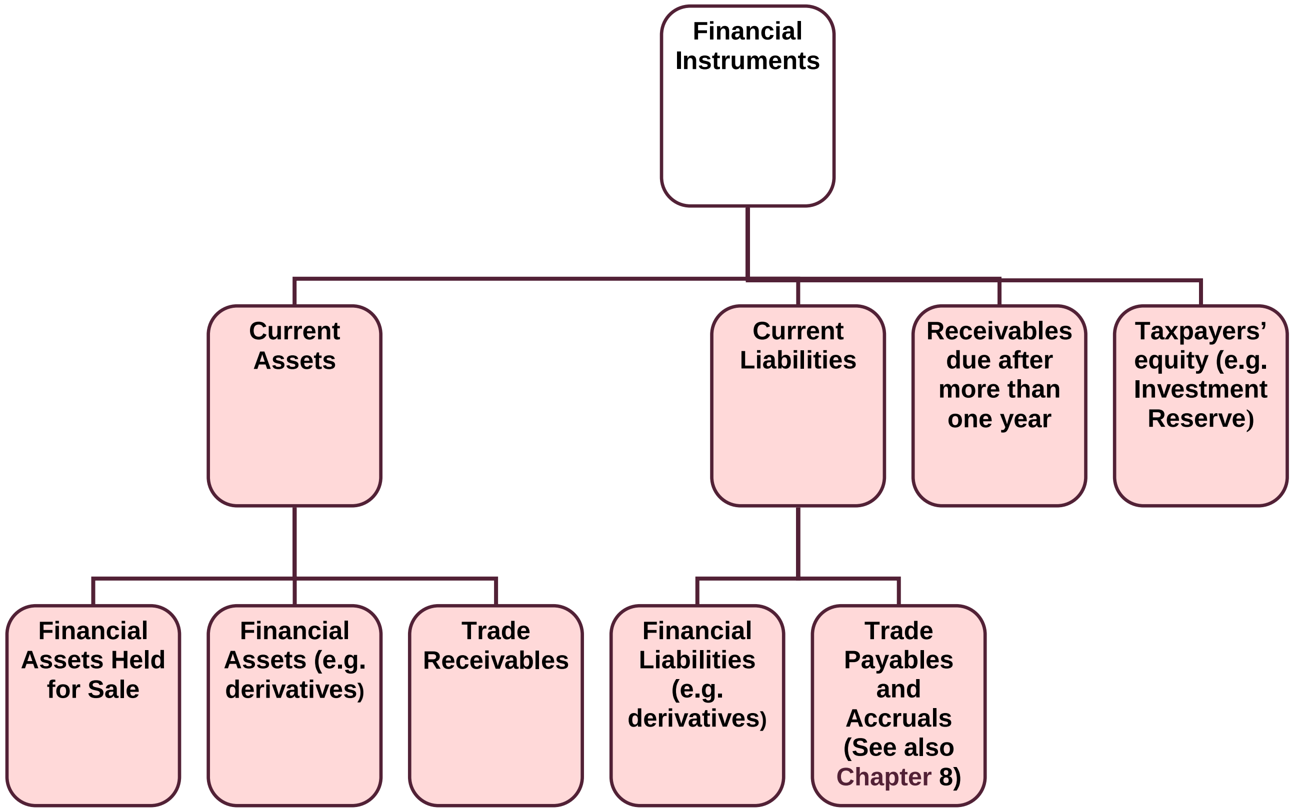
Transfer of Superannuation Rights

9.85. Under current pensions legislation personnel may opt to transfer their rights to future benefits to a personal pension plan or to another approved occupational pension scheme.

9.86. 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.

9.87. Transfers are to be accounted for on an accruals basis. However, due to the usual timeliness of the transfer of rights and the appropriate cash funding, transfers are generally accounted for on a cash basis.

CHAPTER 10: FINANCIAL INSTRUMENTS



Introduction

10.1. This chapter sets out the accounting requirements for assets, liabilities and transactions classified as financial instruments. Detailed information and examples are contained in Annex 6. Information on trade payables and accruals is contained in Chapter 8 and Annex 4 respectively.

Key Points

Definitions

10.2. Financial instruments include cash, receivables, payables, loans, derivatives and shares.

Ownership and Control

10.3. The terms of ownership are formally recorded in the associated documentation and, in the case of Trading Fund Agencies, the Framework Document.

Presentation

10.4. On initial recognition, the Department should present a financial instrument as a financial asset, a financial liability or an equity instrument.

Recognition and Measurement

10.5. All financial assets and liabilities are initially measured at fair value.

10.6. Subsequent measurement depends on the category of financial instrument. There are five main categories (see Figure 1).

10.7 Receivables and payables should be discounted where material.

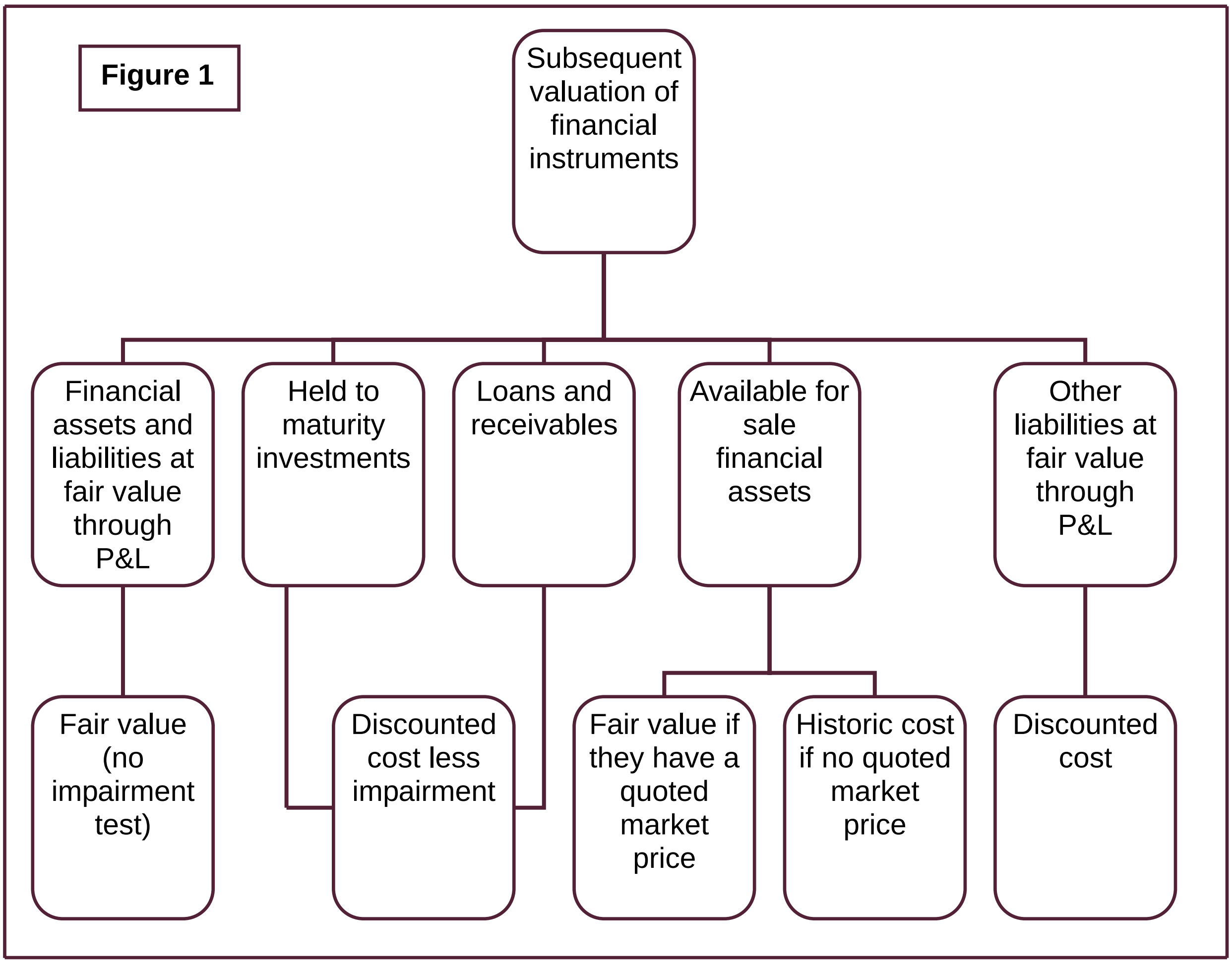
10.8. Provision for bad debts should only be made where there are specific indications that the debtor will be unable or unwilling to settle all or part of the debt.

10.9. Derivatives may be embedded (i.e. contained) within contracts. One example of this is a Variation of Price (VOP) clause.

10.10. If an embedded derivative is not closely related to its host contract, it is separated and valued in its own right.

10.11. All contracts should, where material, be reviewed for the existence of embedded derivatives.

Figure 1



Policy Detail

10.12. Policy detail is set out under the following headings: specific responsibilities; definitions; ownership and control; presentation; recognition and measurement; and disclosure.

Specific Responsibilities

10.13. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

The FMPA Ahd A&TM Banking Services Treasury Accountant

10.14. The FMPA Ahd A&TM Banking Services Treasury Accountant (BS TA) is responsible for implementing the accounting policy for:

a. the Department's foreign currency forward contracts;

b. the Department's fixed price fuel swaps.

Definitions

10.15. A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

10.16. A financial asset is 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. Loans, receivables and cash are examples of financial assets.

10.17. A financial liability is a liability that is mainly a contractual obligation to deliver cash to another entity or to exchange financial assets or liabilities under conditions that are potentially unfavourable.

10.18. An equity instrument is a contract that entitles an entity to receive an interest in the ownership of another entity. Ordinary share capital is the most basic form of equity instrument. It represents an ownership interest in a corporation, including an interest in earnings that translates into declared dividends and also an interest in assets distributed on dissolution.

10.19. A derivative is a financial instrument that must have all of the following characteristics:

a. its value changes in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of rates or prices, credit rating or other variable; and

b. it requires no or little initial investment; and

c. it is settled at a future date.

10.20. An embedded derivative is a feature within a contract that causes the associated cash flows to behave in a similar fashion to a stand-alone derivative.

10.21. Fair value is defined as the amount for which an asset could be exchanged or a liability settled between knowledgeable willing parties in an arm's length transaction. A hierarchy should be used to determine the fair value of the financial instruments within its scope:

a. quoted market prices in an active market are the best evidence of fair value and should be used, where they exist, to measure the investment;

b. if the market for a financial instrument is not active, an entity should establish fair value by using a valuation technique that will produce a value that most closely replicates the market price;

c. if there is no active market for an equity instrument and the range of reasonable fair values is significant but cannot be estimated reliably, the equity instrument should be measured at cost less impairment.

Ownership and Control

10.22. The terms of ownership are formally recorded in the documentation relating to the financial instrument and, in the case of Trading Fund Agencies, the Framework Document. In most cases ownership rests with the Secretary of State for Defence. Where a TLB has issued a loan to a Trading Fund, the TLB is responsible, on behalf of the Secretary of State for Defence, for making the appropriate accounting entries.

10.23. Where financial instruments are not held to further the outputs of the Department but are held on behalf of Government more generally, they are accounted for in separate Trust Fund Statements, the format of which is dependent upon the item in question. TLBs should liaise with the MOD Accounting Policy Team if they are considering holding financial instruments of this type.

10.24. Copies of documents of title or formation (such as a Framework Document) must be safeguarded and made available for periodic review by internal and external auditors.

Presentation

10.25. On initial recognition, the Department should classify a financial instrument as a financial asset, financial liability or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial asset, financial liability and an equity instrument.

10.26. Under IAS 32, a financial instrument is an equity instrument only if there is no contractual obligation or economic compulsion to deliver cash or another financial asset to the holder of the instrument. Preference shares that have been classified by the Companies Act as shares and presented in non-equity shareholders' funds should be presented as financial liabilities (i.e. a loan) and related dividends as interest payments.

10.27. Dividends from equity instruments are to be debited directly to equity. In the unlikely event that the MOD issues equity instruments (except for PDC) to a creditor to extinguish all or part of a liability and the equity instruments are recognised initially, they should be measured at fair value. If fair value cannot be reliably measured, then the equity instruments should be measured to reflect the fair value of the financial liability extinguished.

10.28. Trading Funds' Public Dividend Capital (PDC) should not be disclosed as a financial instrument in the Annual Accounts.

10.29. In the Trading Funds' financial statements, unpaid dividends from PDC are presented in their income and expenditure account and are accounted for as liabilities within their Statement of Financial Position (SOFP). In the Annual Accounts they are accounted for as a receivable.

10.30. Golden shares (i.e. shares retained in businesses that have been privatised but in which the Department wishes to retain a regulatory interest or to reserve power) should not be recognised on the Department's SOFP. However, disclosures are required (see paragraph 10.86).

10.31. A financial asset and a financial liability are offset and the net amount presented in the SOFP when the Department:

a. has an existing legally enforceable right to set off the recognised amounts; and

b. intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

10.32. Interests in associated undertakings and joint ventures falling within the Departmental boundary should be recognised in accordance with IAS 28 and IAS 31. Chapter 1.67 to 1.72 provides further details.

Recognition and Measurement

10.33. The Department should not recognise a financial asset or a financial liability on its SOFP until it becomes party to the contractual provisions of the instrument.

10.34. Initial recognition of a financial instrument should be at fair value and, in the case of financial assets or financial liabilities not categorised at fair value through profit or loss, should include all transaction costs that are directly attributable to their acquisition or issue.

10.35. Where future cash flows are discounted to measure fair value, the discount rate used should be the higher of the rate intrinsic to the financial instrument and the discount rate set by HM Treasury (the non-pension's liability discount rate).

10.36. Subsequent measurement depends on how the financial instrument is categorised. If it is considered that financial assets and liabilities should be categorised as financial assets and liabilities at fair value through profit and loss and, in the case of non derivative financial assets, as available for sale, the MOD Accounting Policy Team must be consulted as HM Treasury approval will be required. In addition, the MOD Accounting Policy Team must be consulted before any financial assets or liabilities are reclassified as HM Treasury approval is similarly required.

10.37. Financial instrument categories and their subsequent measurement are described in the following paragraphs and Figure 1.

Financial Assets and Liabilities at Fair Value through Profit and Loss

10.38. These include financial assets and liabilities that are deemed to be held for trading or financial instruments that an entity elects, at initial recognition, to classify within this category (for example, to eliminate or reduce a measurement or recognition inconsistency).

10.39. A financial asset or liability is deemed to be held for trading if it is acquired or incurred principally for the purpose of selling it or repurchasing it in the near future or if it is a derivative.

10.40. A derivative must always be treated as a financial asset or liability held for trading, irrespective of the Department's motive for holding it.

10.41. Following initial recognition all financial assets and liabilities held for trading should be measured at their fair value. The best evidence of fair value would be the quoted prices in an active market. The movements in fair value should be taken to the Statement of Comprehensive Net Expenditure (SOCNE). Financial instruments within this classification are not tested for impairment.

Held to Maturity Investments

10.42. These are non-derivative financial assets with fixed or determinable payments which an entity has the ability and the positive intention to hold to maturity (but which cannot be equities). However, a number of very strict criteria need to be met.

10.43. After initial recognition all financial assets and liabilities classified as held to maturity investments should be measured at their discounted cost (i.e. the net present value of estimated future cash-flows) less any impairment.

Loans and Receivables

10.44. These are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and which the entity has no intention of selling in the immediate or near term.

10.45. They are subsequently measured at discounted cost less any impairment. The discount rate should be the higher of the rate intrinsic to the financial instrument and the non-pension's liability discount rate set by HM Treasury. Where the time value of money is not material, they can be held at cost.

Available for Sale Financial Assets

10.46. This classification covers non-derivative financial assets that are not classified as financial assets at fair value through profit or loss, held to maturity financial assets or loans and receivables.

10.47. Available for Sale Financial Assets are subsequently measured at fair value, which is generally their quoted market price without any deductions for selling costs. Movements in their fair value are recognised through the Revaluation Reserve unless they are equity instruments with no quoted market price and whose fair value cannot be reliably measured, in which case they are subsequently measured at historical cost.

<u>Available for Sale Financial Assets Subsequently Measured at Fair Value</u>

10.48. These should be reviewed annually for impairment. However, an impairment should only be recognised if there is objective evidence to support it - for example, the issuer is having significant financial difficulties.

10.49. When a decline in the fair value of an available for sale financial asset has been recognised directly in the Revaluation Reserve and there is objective evidence that the asset is impaired, the cumulative loss recognised in the Revaluation Reserve should be removed and charged to the net operating cost section of the SOCNE even though the financial asset has not been derecognised.

10.50. Impairments to an investment in an equity instrument which is classified as available for sale (for example, shares held in a publicly quoted company) and recognised in the SOCNE should not be reversed through the SOCNE. The MOD Accounting Policy team should be consulted for further direction.

10.51. If in a subsequent period, the fair value of a debt instrument (classified as available for sale) increases and the increase can be objectively linked to an event which has occurred after the impairment was recognised in the SOCNE, the impairment can be reversed and the value of the reversal recognised in the SOCNE.

10.52. On disposal of an available for sale financial asset, any associated Revaluation Reserve balance should be recognised in the SOCNE as a gain or loss.

<u>Available For Sale Financial Assets Subsequently Measured at Historic Cost</u>

10.53. These should also be tested for impairment and any impairment charged to the SOCNE. Such impairment losses should not be reversed and the MOD Accounting Policy Team should be consulted for direction.

10.54. Non-Trading Fund dividend income generated by available for sale financial assets should be recognised in the period in which the dividends are declared by the entity at its general meeting. Trading Fund dividend payments not made by the year-end should be accrued.

10.55. Any interest receivable on available for sale financial assets is recognised in the SOCNE.

Provision for Bad Debts

10.56. A provision for bad debts should be made where there is significant doubt that the sums due will be received in full. This is after taking into account the risks attached to slow payment and the overall credit risk. It should be noted that a financial asset is impaired (and hence provision is made) if, and only if, there is objective evidence of impairment due to one or more events occurring after the asset was first recognised. As a result, the use of general provisions covering a range of bad and doubtful debts is precluded.

10.57. Each receivable should be reviewed for specific indications that the debtor will be unable or unwilling to settle all or part of the debt. Examples of indicators include significant financial difficulty of the debtor or a breach of contract. When the debtor is in financial difficulty and there is little historical data relating to similar receivables, experienced judgement will be needed to estimate an appropriate provision. All assumptions should be documented.

10.58. Where a debt is known to be irrecoverable, it should be written off.

10.59. Provisions for bad debts include irrecoverable VAT. However, VAT previously paid to HMRC is recoverable if the bad debt is subsequently written-off.

10.60. Receivables are shown in the accounts net of any provision for bad debts. All provisions and debt write-offs are charged to the SOCNE of the TLB to whom the income was due.

Provision for Credit Notes

10.61. Specific provision should be made for any credit notes to be issued which have not been processed to the sales ledger. Under Order to Cash credit memos are raised on receipt of the DAB1.

10.62. Credit note provisions are calculated exclusive of VAT, except where the tax point for the invoice falls within the period and the VAT has been treated as recoverable in the VAT return.

10.63. Receivables are shown in the accounts after any provision for credit notes.

Other Liabilities

10.64. Other Liabilities cover financial liabilities that are not included within ‘financial assets and liabilities at fair value through profit and loss’ and include trade payables, accruals, deferred income and liabilities arising from financial risk (i.e. financial instruments such as financial guarantee contracts that transfer credit risk to the entity, see paragraph 10.68).

10.65. Liabilities, including contingent liabilities, which arise from non-financial risks such as damage to property, claims made under product warranties and the outcome of legal actions, are governed by the requirements of IAS 37 – Provisions, Contingent Liabilities and Contingent Assets (see Chapter 8).

10.66. The financial liabilities that fall within the classification of Other Liabilities are subsequently measured at discounted cost, using the higher of the rate intrinsic to the financial instrument and the discount rate set by HM Treasury (i.e. the non-pension’s liability rate).

10.67. Liabilities need not be discounted if the time value of money is deemed not to be material.

Financial Guarantee Contracts

10.68. Liabilities which arise under financial guarantee contracts fall within the scope of IAS 39 (financial instruments) rather than IAS 37 (Provisions, Contingent Liabilities and Contingent Assets). All other provisions, including those arising from statutory, constructive and other contractual obligations (not giving rise to credit risk) are covered by IAS 37.

10.69. A financial guarantee contract requires the issuer to make specified payments to reimburse the holder for a loss it incurs as a result of a specified debtor failing to make due payment. Financial guarantee contracts can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract - for example, Navy Command indemnifies companies hired to tow foreign warships in UK ports against the possibility of non-payment of any claims or debts.

10.70. Financial guarantee contracts not accounted for as insurance contracts are initially recognised at fair value. In the context of the public sector, the fair value of a financial guarantee contract is usually estimated using a discounted cash flow analysis which incorporates an assessment of the probability of an event occurring that would give rise to a claim under the contract.

10.71. Subsequent changes in the probability assessment should not be reflected in the carrying amount of the financial guarantee contract, unless the result is such that IAS 37 would require the liability to be recognised because it is more probable than not that a transfer of resources will occur. Financial guarantee contracts are revalued (if appropriate) at AP09 and AP12 and movements in the valuation are taken to the SoCNE.

Embedded Derivatives

10.72. Some contracts which are not themselves financial instruments may contain an embedded financial instrument.

10.73. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, commodity price, foreign exchange rate, index of prices or rates or other variable (provided that in the case of a non-financial variable, any impact will affect all parties to the contract).

10.74. A derivative that is attached to a financial instrument but is contractually transferable independent of that instrument is a separate financial instrument rather than an embedded derivative.

10.75. An embedded derivative must be accounted for in the same way as a stand alone derivative, i.e. at fair value on the SOFP with changes recognised in the SOCNE.

10.76. The requirement to separate an embedded derivative from a host contract and account for it as a derivative should be undertaken when the Department first becomes party to the contract. TLBs should ensure that all contracts let since 1 April 2010 are reviewed for embedded derivatives. Subsequent re-assessment is prohibited unless a change in the contract terms will significantly modify the expected cash flows.

10.77. 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 SOCNE.

10.78. If an embedded derivative is separated, the host contract is accounted for under the appropriate standard - for example, IAS 39 if the host contract is a financial instrument or IAS 16 for the purchase of an NCA.

10.79. The Department has various types of contract pricing arrangements for purchasing goods and services. These include embedded derivatives, such that the cash flows of the combined contract vary in a way similar 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 of all potential embedded derivatives. However, a number of examples are provided in Annex 6.10.

10.80. When a contract contains a derivative and the whole contract is not already at fair value, an assessment must be made of 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 standalone derivative, being valued at its fair value.

10.81. Determining whether an embedded derivative is closely related should be done on a case by case basis. IAS 39 does not define closely related. Appendix A to Annex 6 lists examples of embedded derivatives that are likely to be closely related to their host contracts.

10.82. If TLBs consider that they have embedded derivatives but are unsure of the accounting treatment, they should seek advice from the MOD Accounting Policy Team.

Disclosure

Quantitative Disclosures

10.83. The following is disclosed for each of the financial assets and financial liabilities categories:

a. the amounts at the beginning of the financial year and as at the reporting period date;

b. all movements in year, e.g. fair value movements, acquisitions, disposals and transfers;

c. the cumulative impairments in value as at the beginning and the end of the financial year on the appropriate basis of amortised cost or fair value, the impairments for the period and adjustments in respect of disposals or for other reasons.

10.84. Where the investment in a listed financial asset is significant - for example, ownership of 10% or more of the shares, the following are disclosed:

a. the name of the investee;

b. its country of incorporation (or base country);

c. a description and the proportion of investment held;

d. the amount of income (in the SOCNE).

10.85. For each investment which represents an interest in a subsidiary undertaking, an associate or joint venture which falls outside the boundary or a public body to which PDC has been issued, the Department should disclose its share of any of the following:

a. net assets;

b. turnover;

c. profit or loss.

Special or ‘Golden’ Shares

10.86. The following information on special or ‘golden’ shares should be disclosed:

a. the full name of the body in which the share is held;

b. the nominal value;

c. a brief description of the terms of the shareholding;

d. an indication of where further detailed information can be obtained (i.e. the annual report and accounts).

Qualitative Disclosures

10.87. The objective of IFRS 7 is to give users of financial statements an enhanced understanding of the significance of financial instruments to an entity’s financial position, performance and cash flows.

10.88. To meet this objective, the qualitative disclosures required by IFRS 7 include:

a. information on the significance of financial instruments for an entity’s financial position and performance;

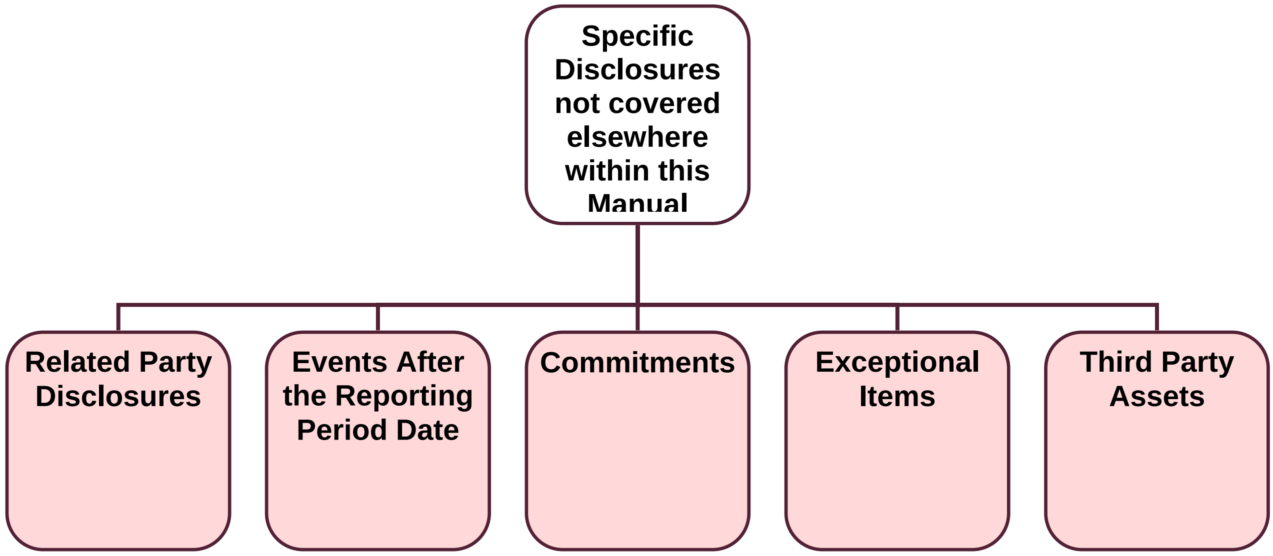
b. information on any exposure to risks arising from financial instruments. This includes certain minimum qualitative disclosures about credit, liquidity and market risks together with descriptions of management’s objectives, policies and processes for managing those risks. Quantitative disclosures are also required on the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management.

10.89. Due to the largely non-trading activities of the Department and the way in which it is financed, it is not exposed to the degree of financial risk commonly faced by business entities. In fact, financial instruments play a much more limited role in creating or changing risk than would be typical of listed companies to which the IFRSs mainly apply. Within the Department, financial assets and liabilities tend to be generated by day-to-day operational activities rather than used as a tool to manage financial risk.

10.90. As such, disclosures are only necessary where the Department holds financial instruments that are complex or play a significant medium to long term role in its financial risk profile. Where the Department does not face significant medium to long term financial risks, then it is sufficient to make a statement to that effect.

10.91. The financing of entities covered by the FReM is ultimately tax-based and therefore the Department does not need to follow the IFRS 7 requirement to disclose information on how capital is managed.

CHAPTER 11: SPECIFIC DISCLOSURES



Introduction

11.1. This chapter sets out specific disclosure requirements not covered elsewhere in this manual.

Key Points

11.2. The Annual Accounts should disclose information alerting users to the possibility that the reported financial position and results may have been affected by the existence of related parties and transactions with them.

11.3. The Annual Accounts should be amended for an adjusting post reporting period event which is judged to be material.

11.4. Non-adjusting events are disclosed in the Annual Accounts if sufficiently material to affect users' understanding of the Department's financial position.

11.5. The Annual Accounts should include details of material capital commitments not accrued or provided for.

11.6. The Annual Accounts should include details of material financial commitments that are relevant to assessing the Department's financial position.

11.7. The Annual Accounts should separately disclose exceptional items.

11.8. Exceptional items are material items which derive from events or transactions that fall within the ordinary activities of the Department but which need to be disclosed due to the nature of their size or incidence.

11.9. Closing balances of third party monies and listed securities should be disclosed at the year end. Third party physical assets and unlisted securities should be noted in the accounts by providing information on the asset categories.

Policy Detail

11.10. Policy detail is set out under the following headings: specific responsibilities; related party disclosures; events after the reporting period; third party assets; and contingent assets.

Specific Responsibilities

11.11. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

TLBs

11.12. TLBs are responsible for:

a. identifying events which occur after the reporting period date that need to be disclosed;

b. ensuring all their material capital and financial commitments are reported to the Corporate Financial Accounting Team (CFAT) in the format specified in the Annual Accounts Instructions.

Related Party Disclosures

11.13. The Annual Accounts should disclose any information which is necessary for drawing attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by internal transactions with them.

Definition of a Related Party

11.14. 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.

11.15. 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.

11.16. 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.

Disclosure

11.17. Only material transactions need be considered. Materiality should be judged 'in the surrounding circumstances' and thus be judged from the viewpoint of both the entity and the related party. Material is defined in Chapter 1.27 to 1.31.

11. 18. To prevent the related parties note becoming unduly long, it has been agreed that central government bodies should provide:

a. the name of the parent department (if any);

b. a note of the main entities within government with which the Department has had dealings. No information about those transactions need be given;

c. details of material transactions between the Department and individuals who are regarded as related parties.

Events After the Reporting Period Date

11.19. Events after the reporting period date are those which occur between the reporting period date and the date on which the Annual Accounts are approved.

11.20. The two types are:

a. an adjusting event, for which the Annual Accounts are adjusted;

b. a non-adjusting event that may require disclosure but does not require the Annual Accounts to be adjusted.

The Dating (Approval) of the Annual Accounts

11.21. The date (approval) on which the Accounting Officer authorises the financial statements to be issued is normally the same as that of the Certificate and Report of the Comptroller and Auditor General.

11.22. The date of authorisation for issue must be included in the Annual Accounts but not on the title page. The statement should read, 'The Accounting Officer authorised these financial statements for issue on [insert date of issue]'.

Adjusting Post Reporting Period Events

11.23. 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.

11.24. 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;

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

11.25. 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.

11.26. 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.

Commitments

11.27. Commitments are disclosed as either capital or financial commitments.

Capital Commitments

11.28. Capital commitments relate to proposed capital expenditure.

11.29. Details of material capital commitments should be included in the notes to the Annual Accounts if not already included elsewhere.

11.30. Details are disclosed of the actual or estimated aggregate amount of capital expenditure contracted for, but not accrued or provided for, at the reporting period date.

Financial Commitments

11.31. Where material to assessing the Department's financial position, details of financial commitments not disclosed elsewhere in the Annual Accounts should be included in the notes to the accounts.

11.32. For Annual Accounts disclosure purposes, financial commitments do not include outstanding purchase commitments.

11.33. Financial commitments are likely to be relevant to assessing the Department's financial position when they represent future obligations or unusual risks to the Department, either because of their nature, size or duration.

11.34. Examples of commitments that need to be disclosed include:

a. commitments as a lessee under operating leasing agreements (see paragraph 11.35);

b. finance lease commitments existing at the reporting period date where inception occurs after that date;

c. purchase commitments in excess of normal requirements;

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 paragraph 11.36).

11.35. 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.

11.36. 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.

11.37. 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.

11.38. Chapter 9 explains pension disclosure requirements.

Exceptional Items

11.39. Exceptional items are material items which arise from events or transactions that fall within the ordinary activities of the Department but need to be disclosed because of the nature of their size or incidence.

11.40. Exceptional items are charged or credited to the Statement of Comprehensive Net Expenditure (SOCNE) under the relevant headings. The amount of each item is disclosed separately by way of a note or, if the nature of the item warrants prominence, on the face of the SOCNE.

11.41. The test should be whether non-disclosure could affect the users' understanding of the relative application of resources to different objectives. Such items may include (but should not be limited to):

a. losses or gains on the disposal of NCAs;

b. major 'insurance' losses where the risk is self insured;

c. costs relating to objectives which are no longer current, such as early departure costs and retrospective awards;

d. other exceptional events.

Third Party Assets

11.42. Third party assets are assets for which the Department acts as custodian or trustee but in which neither the Department nor the government overall has a direct beneficial interest. Third party assets are not public assets and should not be recorded in the SOFP. Third party monies should not be held in public bank accounts.

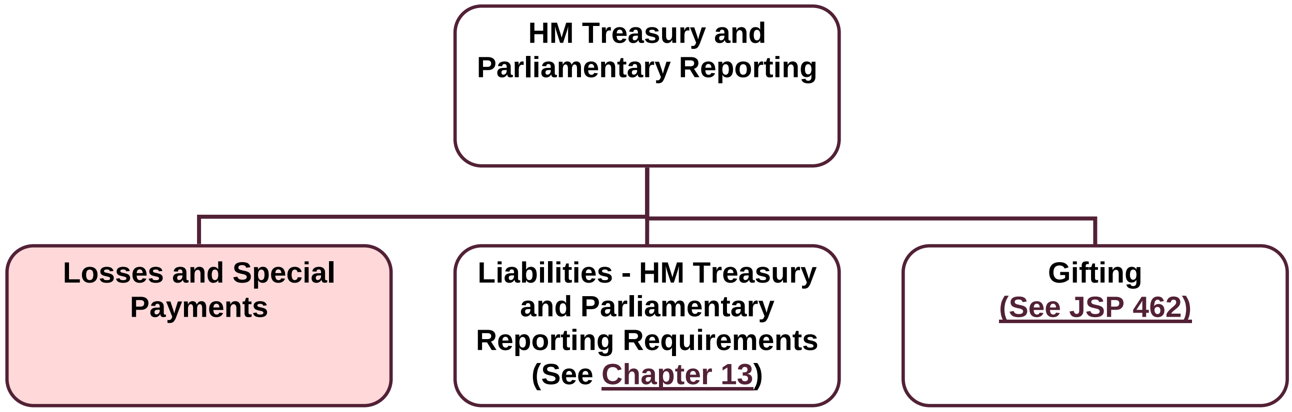
11.43. Third party assets should be reported by way of a note. Where significant, the note should differentiate between:

a. third party monies and listed securities. The minimum level of numerical disclosure required is a statement of closing balances at the year end. For listed securities, this will be the total market value;

b. third party physical assets and unlisted securities. The disclosure may be by way of narrative note. For physical assets, the note should provide information on the asset categories involved. Such disclosure should be sufficient to give users of the Annual Accounts an understanding of the extent to which third party physical assets and unlisted securities are held by the entity; and

c. in the event that third party monies are found to have been in a public bank account at the end of the reporting year, this should be disclosed in the note on cash at bank and in hand. It should also be disclosed as part of the requirements identified in 11.43a and 11.43b above.

CHAPTER 12: LOSSES AND SPECIAL PAYMENTS



Introduction

12.1. This chapter sets out the requirements for classifying, managing, writing-off and reporting losses and special payments.

Key Points

Classification of Losses and Special Payments

12.2. Writing off losses and making special payments are outside Departmental core business.

12.3. As their funding has not been approved by Parliament, they are subject to greater control than other payments and are brought to Parliament's attention in the annual losses statement in the Annual Accounts.

12.4. Certain losses are only reportable if culpability is involved:

a. losses which arise from, or occur during, the provision of direct support to operations;

b. losses which result from tests or practice firings;

c. losses which are caused by damage due to fair wear and tear or are associated with repairable damage.

12.5. Special payments should only be authorised if they are in the public interest and capable of withstanding Parliamentary challenge.

12.6. Losses are grouped into one of the following categories:

a. category A covers cash losses; bookkeeping losses; exchange rate fluctuation losses; losses of pay, allowances and superannuation benefits; losses arising from overpayments of benefits due to miscalculation, misinterpretation or missing information; and losses arising from failure to make adequate charges for the use of public property or services;

b. category B covers losses of accountable stores;

c. category C covers fruitless payments and constructive losses;

d. category D covers claims waived or abandoned.

12.7. A fruitless payment occurs when the Department incurs expenditure which it ought to have been able to avoid - for example, failing to take appropriate action to cancel a hotel booking in time to avoid having to pay for it.

12.8. A constructive loss arises when, for example, the value of correctly ordered goods and services is affected by a change in strategic or political policy, so that they become surplus to requirements or less useful than envisaged at the time of procurement.

12.9 A claim waived or abandoned occurs when, for example, a decision is taken to write off a claim which could legitimately have been pursued.

12.10. A special payment falls into one of the following categories:

a. extra-contractual payments - i.e. those which the Department is not legally bound to honour but which it makes because the claim in question is likely to be upheld by the Courts;

b. extra-statutory and extra-regulatory payments - i.e. those which, although broadly within the intention of the statute or regulation, breach the strict interpretation of its terms;

c. compensation payments - i.e. those which provide redress for personal injuries (other than for payments under the Civil Service Injury Scheme) - for example, as the result of a traffic accident;

d. special severance payments - i.e. those which go beyond normal statutory or contractual requirements and are made to employees, contractors or others who leave the Department following resignation, dismissal or agreed termination of contract;

e. ex-gratia payments - i.e. those which go beyond statutory cover; legal liability or administrative rules; and are made to counteract hardship arising from, for example, Departmental failure or delay.

Management and Control of Losses and Special Payments

12.11. Before writing off expenditure, there must be clear evidence that all reasonable action has been taken to recover the loss and that no feasible alternative exists. If completion of a loss or special payment exceeding £250,000 is likely to be protracted, a best estimate of the value should be included in the Annual Accounts via an advance notification.

12.12. In writing off a loss or making a special payment, the Department must always review the adequacy of its control systems. Where any shortcomings are identified, appropriate action must be taken to address and eliminate them.

12.13. HM Treasury has given the Department delegated authority to write off certain categories and values of losses and special payments. However, where the Department does not have delegated authority to write off expenditure or to make a special payment, it must first seek approval from HM Treasury via FMPA-A&TM-Ahd-ACCTAXPOL.

12.14. Approval must also be sought from HM Treasury before writing off a loss or making a special payment which is novel or contentious; involves a failure in control; would create a precedent for other departments; involves important questions of principle; or has arisen as a result of ambiguous instructions issued by HM Treasury.

Valuing and Reporting Losses and Special Payments

12.15. Any loss or special payment whose value exceeds £250,000 must be identified separately in the Annual Accounts and an accompanying description provided.

Policy Detail

12.16. Policy detail is set out under the following headings: specific responsibilities; classification of losses and special payments; management and control of losses and special payments; and the valuing and reporting of losses and special payments.

Specific Responsibilities

12.17. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

Accounting Officer

12.18. The Permanent Under Secretary (PUS), as Accounting Officer, must ensure the regularity and propriety of expenditure. This includes seeking HM Treasury's approval for any expenditure outside normal delegations.

12.19. In practice, HM Treasury delegates authority to write off certain categories of losses and to make certain special payments to the Accounting Officer. The Accounting Officer sub-delegates this authority to appropriate staff in the Department. HM Treasury retains the authority to approve the write-off of particular categories of losses and the making of certain special payments.

12.20. Accountability for all losses and special payments rests with the Accounting Officer and, below her, with the staff who are able to prevent similar losses recurring. Where a loss involves more than one area, it is for the one with the greatest involvement to provide write-off approval or to authorise the payment after consulting the other parties.

MOD Accounting Policy Team

12.21. The MOD Accounting Policy Team sets Departmental policy for losses and special payments. The team is responsible for publishing policy; providing guidance on its application and for providing advice on specific issues. The team should be consulted in cases where there is any doubt.

The Corporate Financial Accounting Team

12.22. The Corporate Financial Accounting Team (CFAT) is responsible for consolidating and publishing details of losses and special payments in the Annual Accounts.

TLBs

12.23. TLBs are responsible for reporting all losses and special payments to CFAT in accordance with the requirements of this chapter and with those set out in the IYM and Annual Accounts instructions. It should be noted that, for bad debt write-offs, TLBs are responsible for obtaining the necessary approvals but the DBS Revenue and Administration Team is responsible for reporting the bad debt write-offs to CFAT.

12.24. Where a Non-Current Asset (NCA) write-off is required and the NCA is on the non-current asset manager's (NCAM) Statement of Financial Position (SOFP), the operational users (for example, the Front Line Commands) are responsible for:

a. notifying the NCAMs each quarter of all closed cases of NCA losses below £250,000;

b. raising an advance notification for an NCA loss of £250,000 or above and for forwarding details to the NCAM;

c. raising the subsequent casework and, if an advance notification crystallises into a loss, for obtaining write-off approval from their Senior Finance Officer (SFO) or the appropriate level within the TLB and, if no loss transpires, for cancelling the advance notification and informing the NCAM. Although an advance notification may straddle two financial years, it cannot be allowed to remain open indefinitely and should be closed as soon as possible;

d. sending an Asset Change Notification (ACN) to the NCAM, once the write-off has been approved.

12.25. Where the NCA loss is greater than £250,000 and affects more than one TLB, only one loss case is to be raised and this is done by the lead TLB. When an NCA is in operational use, the user TLB is responsible for reporting the loss through to closure. For example, during a non-operational period when a major refit and overhaul is undertaken, DE&S is responsible for reporting the loss and will be the lead TLB. Other TLBs involved in the case are responsible for providing the lead TLB with all costs and details required to support the loss case.

Non-Current Asset Managers

12.26. For the transaction at paragraph 12.24, NCAMs are responsible for:

a. entering all NCA losses write-downs below £250,000 into the Annual Accounts and their aggregated value into the DE&S/DIO losses and special payments quarterly return to CFAT;

b. reporting the advance notification and any subsequent cancellation or closure of the NCA loss in DE&S/DIO losses & special payments quarterly return to CFAT;

c. forwarding the ACN from the TLB operational users to the Non-Current Asset Processing Centre (NAPC) to enable the Non-Current Asset Register (NCAR) to be updated.

TLB Audit Committees

12.27. TLB Audit Committees should carry out regular reviews in accordance with Appendix C to Annex 7.

Classification of Losses and Special Payments

Losses

12.28. All losses arising from culpable causes must be included in the losses statement, with separate disclosure of those of £250,000 and above. However, 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 does not constitute 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. TLBs must review unsupported asset balances and, where appropriate, take the required write-off action.

12.29 The losses and special payments classifications, together with their delegation group (see paragraphs 12.80 to 12.85), are shown in Figures 1 and 2. Although the Department has delegated authority to write off all losses and incur special payments which fall into Group 1, HM Treasury retains control over those in Group 2.

Figure 1 - Losses

Type	Sub-Type	Description	Delegation Group
A	A(i)	**Cash losses.** Physical losses of cash and cash equivalents (e.g. bank notes, credit cards, electronic transfers, payable orders).	1
	A(ii)	**Bookkeeping losses.** Losses arise from un-vouched or incompletely vouched payments, including missing items, or because of charges to RfRs to clear inexplicable or erroneous debit balances.	1
	A(iii)	**Exchange rate fluctuations.** Losses arise from fluctuations in exchange rates or revaluations of currencies.	1
	A(iv)	**Losses of pay, allowances and superannuation benefits** paid to civil servants, members of the armed forces and non-departmental public bodies employees:	
		• overpayments due to miscalculation, misinterpretation or missing information;	1
		• unauthorised issues, e.g. inadmissible payments;	1
		• losses arising from other causes, e.g. non-disclosure of full facts by the beneficiary, short of proven fraud.	2
	A(v)	**Losses arising from overpayments** of social security benefits, grants, subsidies, etc, arising from miscalculation, misinterpretation or missing information.	2
	A(vi)	**Losses arising from failure to make adequate charges** for the use of public property or services.	2
B	B(i)	**Losses of accountable stores.** Losses are the result of proven or suspected fraud, theft, arson or sabotage, or any other deliberate act (including repairable damage caused maliciously to buildings, stores, etc. even where a legal claim is not possible).	1
	B(ii)	**Losses of accountable stores**. Losses arise from other causes.	1
C	C(i)	**Fruitless payments**	1
	C(ii)	**Constructive losses**	1
D		**Claims waived or abandoned:**	
		Up to £250,000	1
		£250,000 and above	2

Figure 2 – Special Payments

Description	**Delegation Group**
Special payments: extra-contractual and *ex gratia* payments to contractors.	**2 (and see Note 1)**
Special payments: other *ex gratia* payments:	
Up to £250,000	**1**
£250,000 and above	**2**
Special payments: special severance payments	**2**
Special payments: compensation payments:	
Compensation payments made on legal or other professional advice:	
Up to £250,000.	**1**
Other compensation payments	**2**
Special payments: extra-statutory and extra-regulatory payments:	
Up to £250,000	**1**
£250,000 and above	**2**

Note 1: Extra-contractual payments to contractors, not exceeding £1,000,000, involving Departmental default and made other than on legal or other appropriate professional advice fall into Delegation Group 1.

12.30. If a case does not readily fall into a specific category, it should be assigned to the one which it most closely fits. However, Treasury authority must be obtained if the loss is not within the Department's delegated limits. Where particular difficulties exist, the MOD Accounting Policy Team should be consulted.

Type A Losses

12.31. Circumstances which lead to Type A losses are defined in Figure 1.

12.32. Where a cash loss is wholly or partly recovered by reducing the amounts of pay or pension which would otherwise be due or it is recovered under statutory or other specific powers, only the resulting outstanding balance needs to be written off as a loss.

12.33. Where bookkeeping losses include balances which are written off because they cannot be supported due, for example, to assets no longer being in existence or simply not traceable, these losses should be disclosed in the losses note. However, if an error has resulted in two entries being made for the same asset, the resultant write-off should not be included in the Annual Accounts losses note, although a full audit trail should be maintained to enable NAO to audit the final position.

12.34. Exchange rate fluctuations arise when units and/or individuals returning from exercise or deployment convert unused foreign currency back into sterling at a different exchange rate from the one used for the original transaction (i.e. to convert the sterling into the respective foreign currency). This information is collated and reported centrally by FMPA Ahd A&TM Banking Services Treasury Accountant (BS TA) and, unless approached with a specific query by BS TA, TLBs are not required to take any action.

12.35. Where a loss is wholly or partly met by voluntary payments by the person responsible or by a payment from an insurance company or other non-public source, only the net loss is written off. However, if there are no powers to apply the sum withheld, for example, by deducting it from pay, the gross amount of the loss is written off.

12.36. A note is not generally necessary if the net loss is nil by the time the Annual Accounts are finalised. However, there may be exceptions (for example, losses arising from culpable causes) where the circumstances of the loss are such that it is appropriate to bring them to the notice of Parliament by including them in the losses statement.

Type B Losses – Losses of Accountable Stores

12.37. Detailed Materiel Accounting instructions covering the loss of stores are contained in JSP 886. Losses of accountable stores are, in effect, money spent without the authority of Parliament, and must be included in the losses statement. They cover all loss and damage to Departmentally owned equipment, materiel, buildings and livestock. Examples of stores losses arising from other causes (type B(ii)) include:

a. losses by fire (other than arson);

b. losses by weather damage or by accidents beyond the control of any responsible person;

c. negligence;

d. errors of judgement on the part of Departmental military and civilian personnel in the performance of their duty.

e. failure to rotate inventories correctly;

f. losses arising from deterioration in stores caused by some defect in administration or Departmental error, such as over provisioning.

12.38. Unless due to a culpable cause, the following are not treated as losses. However, with reference to 'a.' below, the appropriate materiel account should be adjusted in accordance with the relevant instructions contained in JSP 886.

a. losses arising from or in direct support of enemy operations. An operation is defined as: a military action or a strategic, tactical, training or administrative military mission; or undertaking combat action, including movement, supply, attack, defence and the manoeuvres necessary to achieve the objectives of any battle or campaign. Losses cover equipment lost on exercises or in-theatre but not where the loss occurs through accident or theft. Hence, a loss arising in-theatre but through theft or culpable accident would be included as a loss;

b. losses arising from authorised tests, experiments or practice firings in which destruction, loss or damage may be expected;

c. shortage due to evaporation, shrinkage, breaking down from bulk etc within authorised limits;

d. damage through fair wear and tear;

e. deficiencies resulting from book-keeping errors in depot inventories or in unit main stores unless due to proven or suspected fraud or theft;

f. repairable damage.

12.39. 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.

12.40. 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.

12.41. Any loss recoverable from a third party, which is waived under a knock for knock agreement, should be noted as a stores loss.

12.42. Valuing the loss for reporting purposes is determined by the net value of the loss less any sums recovered. See paragraphs 12.123 to 12.129.

12.43. Where there is an identifiable claim against an individual, the loss need not be noted immediately. However, if the Department subsequently decides to waive the claim, or finds that it cannot be presented or enforced, the loss should be treated as a claim abandoned.

Type C Losses – Fruitless Payments and Constructive Losses

12.44. 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.

Fruitless Payments

12.45. A fruitless payment is a payment for which liability ought not to have been incurred. For example:

a. forfeitures under contracts which have arisen as a result of some error or negligence by the Department;

b. erroneous bookings for travel tickets or hotel accommodation;

c. failure to cancel unwanted goods or services early enough to avoid having to pay for them;

d. the cost of rectifying design faults which were caused by a lack of diligence or defective professional practices;

e. costs arising from a failure to allow for foreseeable changes in circumstances i.e. poor planning.

12.46. 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 simply whether the Department was at fault in incurring, or not avoiding, liability to make the payment. As the Department has not received any associated benefit, the payment is treated as a loss and brought to Parliament's attention. The recipient's legal entitlement to the money prevents the expenditure from being classified as a special payment.

Constructive Losses

12.47. 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 or due to some other non-culpable cause.

12.48. 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 has agreed that the expenditure should not be treated as a constructive loss. Hence nugatory 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, exceptionally, there is evidence of a lack of diligence, defective professional practice or culpability. In such cases, the expenditure is to be treated as a fruitless payment or a constructive loss.

12.49. A similar principle applies to cancelled Urgent Operational Requirement (UOR) projects within the following parameters. If a Project Team has been allowed to incur costs and has followed established Departmental/TLB financial procedures in advance of an approved business case, any subsequent write-off of costs caused by project cancellation is not to be treated as a loss if no culpability was involved. Examples include a subsequent operational decision not to proceed with the project or an operational decision which makes the project unnecessary. However, if the UOR has gone through the Main Gate approvals process, any subsequent loss would be treated in the same way as that of a loss in the core programme.

12.50. If a project is cancelled or significantly changed after Main Gate approval, all nugatory expenditure (including any incurred pre-Main Gate) should normally be treated as a constructive loss. Where assets are sold (for example, an asset under construction), the value of the loss is calculated, as the difference between the value of the asset and the sales receipt.

12.51. 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. For example, equipment and sites impacted by a Strategic Defence and Security Review (SDSR). All additional costs such as the asset write-off or accelerated depreciation charge and/or the asset impairment charge should be treated as a constructive loss. The losses should be reported in the financial year in which the associated SDSR option is approved.

Type D Losses – Claims Waived or Abandoned

12.52. Waiver 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.

12.53. Examples of claims waived or abandoned include:

a. a reduction in the rate of interest on a loan;

b. bad debts written off;

c. those which are actually made but then reduced in negotiations or for policy reasons;

d. those which MOD intended to make but which could not be enforced or were never presented;

e. 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;

f. 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;

g. those which are reduced by compositions in insolvency cases or in out-of-court settlements, other than reductions arising from corrections of facts;

h. those which are dropped on legal advice, or because the amounts of liabilities could not be determined.

12.54. The following should not be treated as claims waived or abandoned:

a. any claims wrongly identified or presented, whether in error or otherwise. However, a claim should not be regarded as withdrawn where it is possible that it could succeed if pursued in a court of law, or if the debtor's liability cannot be accurately assessed;

b. waivers or remission of tax. HMRC has special rules about remissions of tax. The Department should consult HM Treasury about the appropriate treatment when a case arises; or

c. a claim for a refund of an overpayment which fails or is waived. This should be regarded as a cash loss.

12.55. Losses arising from a failure to make adequate charges for the use of public property or services are classified as a cash loss.

12.56. A claim not presented should normally be noted in the Annual Accounts at its original figure.

12.57. The policy on losses associated with International Courtesy Rules is contained in JSP 368 – The MOD Guide to Repayment.

12.58. If a claim is waived or abandoned but, as part of a negotiated settlement, the MOD receives offsetting benefits in lieu of cash, the loss should be reported in the Annual Accounts at the gross amount. If the gross loss exceeds £250k, the value of any benefits received in lieu of cash should be separately noted and included in the description of the loss.

12.59. Where more than one department is involved, each department should record the extent of its interest in its own records but without any attempt to achieve spurious accuracy. Where claims between departments are waived or abandoned, it is not necessary to record them in the Annual Accounts, as they are viewed as domestic matters.

Special Payments

12.60. Where the Department is considering making a special payment, it should only do so after having fully considered the facts and when it is satisfied that the proposed course of action is defensible. HM Treasury approval must be obtained where the Department has no delegated authority – see paragraph 12.29.

12.61. The special payments detailed in paragraphs 12.62 to 12.76 are those that must be brought to the notice of Parliament in the notes to the Annual Accounts. The list is not exhaustive and in cases where there is any doubt, advice should be sought from the MOD Accounting Policy Team.

Special Payments to Contractors

Extra-Contractual Payments

12.62. An extra-contractual payment is one which, although not legally due under the original contract or its subsequent amendments, is likely to be upheld by the courts, even though the Department is not legally obliged to settle it. A payment may be extra-contractual even where there is some doubt about the Department's liability to pay - for example, where the contract provides for arbitration but 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. The commercial branch is responsible for settling extra-contractual claims.

12.63. If legal advice has been taken and the opinion is that the Department is legally liable for the payment, it is viewed as 'legally due under the contract'. As such, it is not an extra-contractual special payment but a normal contractual payment. If legal advice has been taken and the opinion is that the Department is not legally liable for the payment but, nevertheless, the Department (for whatever reason) wishes to make the payment, the Department has no delegated authority to make such a special payment and the Treasury must approve it. If legal advice has not been taken (which could be for a variety of reasons) and the Department wishes to make the payment, then the Department has a £1m delegation.

Ex-Gratia Payments

12.64. An ex-gratia payment goes beyond statutory cover, legal liability or administrative rules and is usually made outside a contract - for example, to meet hardship which the contractor has suffered as a result of the Department's failure or delay;

12.65. Whether or not to make an ex-gratia payment is largely a financial or political decision. Therefore, the commercial branch should consult the relevant finance branch before starting to administer the claim. The Commercial Toolkit, which can be accessed through the Acquisition Operating Framework (AOF), provides general guidance on handling claims made by contractors for ex-gratia payments. Ex-gratia payments should not normally exceed the amount of the total loss on the contract.

Ex-Gratia Payments other than to Contractors

12.66. 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, for example:

a) payments made to meet hardship caused to people 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.

12.67. Any ex-gratia payments to individuals for stress and inconvenience are novel and contentious and require HM Treasury approval.

Special Severance Payments

12.68. 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 HM Treasury 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.

12.69. To obtain HM Treasury approval, the pro-forma ‘HM Treasury approval for special severance payments’ (available from the MOD Accounting Policy Team) must be completed in full and include the approval of the Senior Finance Officer, a list of which can be found at paragraph 12.141. The pro-forma should be submitted to the MOD Accounting Policy Team who will review it on behalf PUS as Accounting Officer. If satisfied that the template has been correctly completed and the proposed payment is defensible and represents value for money, the MOD Accounting Policy team will forward it to HM Treasury for approval. (Please note that this template can only be used for special severance payments).

12.70. As a TLB cannot make an offer of a special severance payment until the requisite approval from HM Treasury is in place, sufficient time must be built into the process to allow the MOD Accounting Policy Team and HM Treasury **a minimum of 15 working days** to progress the issue. Under no circumstances may a special severance payment be offered, either in words or in writing, until HM Treasury approval is in place.

12.71. TLBs should note that HM Treasury 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 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.

12.72. 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.

12.73. 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.

Retention Payments to Delay Staff Departures

12.74. 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 HM Treasury approval. HM Treasury 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.

Compensation Payments

12.75. Compensation payments are made 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. They include payments to public servants and are outside statutory schemes or contracts. Any compensation payments to individuals for stress and inconvenience are novel and contentious and require HM Treasury approval.

Extra-Statutory Payments and Extra-Regulatory Payments

12.76. 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.

Management and Control of Losses and Special Payments

12.77. TLBs should review published write-off cases, as shown in the latest copy of the Annual Accounts, to establish whether similar risks exist within their own TLB and, if so, to take effective steps to offset that risk. TLBs should also complete post-implementation reviews of any processes and procedures which have been introduced in response to previous write-off cases, as this will enable them to evaluate the effectiveness of the remedial action taken.

12.78. TLB Audit Committees should carry out regular reviews in accordance with Appendix C to Annex 7.

12.79. The MOD Director General Finance (DG Fin) undertakes a review of losses and special payments at accounting periods 6, 9 and 12. (Details are included in the In Year Management Instructions, issued by DG Strategy, Defence Resources). TLBs must ensure that losses and special payments are reviewed on a regular and timely basis by their audit committees and keep a record of any decisions made not to classify a potentially significant loss as a loss.

Losses and Special Payments Delegations

12.80. All losses and special payments are to be categorised in accordance with Figures 1 and 2. Although the Department has delegated authority to write off all losses and incur special payments up to £100m which fall into Group 1, HM Treasury retains control over those in Group 2, except where it has made specific delegations to the Department (which are shown in Figures 1 and 2). For further guidance on delegations, refer to JSP 462.

12.81. In order to meet HMT requirements, all proposed submissions to HMT for approval to write off losses and special payments must first be sent to the MOD Accounting Policy Team for review before being sent to HMT. When the submission is made to HMT, the MOD Accounting Policy team should be a copy addressee.

12.82. If a loss relates to an Urgent Operational Requirement (UOR), the loss submission must first be sent to SecEC-Ops for review prior to being sent to the MOD Accounting Policy Team and HM Treasury. SecEC-Ops agrees the funding for all UOR projects with HM Treasury.

12.83. Irrespective of any delegated authority or the value of a loss or special payment, HM Treasury must be consulted before any write-off action is taken or a special payment made, when either of them:

a. involves important questions of principle;

b. raises doubts as to the effectiveness of existing systems;

c. contains lessons which might be of wider interest;

d. is novel or contentious;

e. might create a precedent for other departments in similar circumstances;

f. is the result of obscure or ambiguous instructions issued by HM Treasury.

12.84. Where a single set of circumstances, a defect or an irregularity gives rise to multiple losses, their total value should be exposed by grouping them together and reporting them as a single loss. The individual losses must still be reported separately in the losses register, regardless of their value. If, however, the total value of payments made under a single contract exceeds the Department's delegated authority, HM Treasury must be consulted, even if the individual amounts are within the Department's delegated limit. Where losses and recoveries appear in the same control account, TLBs are allowed to net off their values, for example, write-ons and write-offs.

12.85. Where a TLB proposes to revise an unexpired contract in order to regularise future losses that would be incurred if the terms of the contract remained unchanged, the proposal must first be cleared with HM Treasury.

Irregularity, including Fraud, Theft and Corruption, Arson, Sabotage and Malicious Damage

12.86. Cases which involve unexplained or physical loss, sabotage or malicious damage or arise from suspected or proven irregularity, including fraud, theft and corruption must be dealt with promptly to avoid any action that might prejudice the possibility of legal proceedings. Procedures for reporting suspected irregularity, including fraud, theft and corruption are contained in JSP 462 and should be read, with particular reference to the responsibilities of the Defence Irregularity Reporting Cell (DIR Cell).

12.87. All suspicions, apart from those relating to Service Personnel and civilians who are subject to military jurisdiction, should be reported to the DIR Cell in the first instance, after which any further suspicions will be recorded on a database and given a reference number. The DIR Cell then decides whether investigative action should be taken by the Defence Police authorities, the Defence Fraud Analysis Unit (DFAU) or line management. The DIR Cell is required to monitor the progress and outcome of investigations and will require regular reports from those conducting the investigations.

12.88. The DIR Cell also provides reports on a quarterly basis to TLB Fraud Focal Points to advise them of any suspicions which are being addressed within their business areas. Depending on the stage of the investigation and the sensitivities involved this information may not be comprehensive but will highlight the potential requirement for write-off action to be taken.

12.89. Where line management has investigated a suspicion raised by the DIR Cell it should report the outcome to the losses focal point. The same applies to cases investigated by the DFAU where reports are usually sent directly to line management if internal disciplinary action is appropriate. Details of outcomes should be available to losses focal points.

12.90. When recording reported suspicions, the DIR Cell will log the estimated or actual value of the potential loss to the Department, although this may change as the case proceeds. In some cases, particularly where theft is suspected, the person reporting the loss should be able to supply a reasonably accurate figure. In others cases, a best estimate will have to be used. However, once a case has been closed following investigative and disciplinary action (if appropriate), write-off action for the full value of any loss should be instigated.

12.91. Where write-off action has been taken for a loss associated with suspected or proven irregularity, including fraud, theft or corruption, the value and date of the write-off should be reported to the DIR Cell.

12.92. Where a request for write-off action is made without an accompanying DIR Cell reference number, one must be obtained before the write-off can be effected. This process ensures that the DIR Cell is able to record instances of proven or suspected irregularity, including fraud, theft and corruption on its central database.

12.93. Reporting losses which involve irregularity, including fraud, theft and corruption and identifying previously unreported suspicions contributes significantly to the Department's understanding of the associated risks.

Write Off and Authorisation of Special Payments

12.94. Losses should only be written off after the facts have been properly considered (including whether all reasonable action has been taken to effect recovery and that there is no feasible alternative). In dealing with individual cases, the Department must always consider the soundness of its control systems and the effectiveness with which they have been operated. Where there is any evidence of failure, appropriate steps must be taken to prevent it from recurring.

12.95. 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 who believe they have a such a case, must seek approval from NAO before submitting it to CFAT. TLBs should note, however, that the case may need to be reopened if the estimated write-off value proves to be materially incorrect.

12.96. In circumstances where a case needs to be investigated further the Department should make use of additional resources (either internal or, exceptionally, external) to investigate, report and learn lessons. The additional resources should primarily be drawn from an area which is not involved in the loss - for example, from a different TLB or from the Directorate of Internal Audit (DIA).

12.97. When preparing a case for write-off, it is important to:

a. ensure, before a write-off is finalised, that the payment details can be reconciled with payments made against the RACs;

b. ensure that project management and finance staff have an up-to-date copy of the contracts document, with relevant copies of amendments;

c. ensure that there is a comprehensive list of the relevant RACs, and that all payments made against them reflect payments made by the DBS I&R. It is recommended that the Financial Management Shared Service Centre is consulted before the figure is agreed;

d. obtain written confirmation from the relevant SFO or person who has the delegated authority to write off the loss that he/she is satisfied that the value of the write-off is correct.

12.98. 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 in a registered file and also in a local register. Full details of special payments should also be recorded in a registered file. Before approving any write-off (or, in cases beyond the Department's authority for approval, before any submission is made to HM Treasury) the authorising officer must be clear:

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.

12.99. Pending recovery or write-off of a cash loss, the amount should be accounted for as a receivable.

12.100. RAC EYA001 can be used for the write-off or write-on of erroneous or inexplicable debit/credit control account balances but only after all efforts have been made to identify the correct or more appropriate RAC. Using this RAC will move the balance from the control account, and create a receivable on the SOFP, which will need to be cleared via the Statement of Comprehensive Net Expenditure (SOCNE).

Recording Losses and Special Payments

12.101. All Service units and formations, establishments and other management areas, which exercise delegated write-off authority, must maintain registered files and local registers of all losses which are reported in the Annual Accounts (consulting the NCAMs, if appropriate), including those that do not require separate notation. In addition, they must retain records of any special payments made, including the date on which they were paid.

12.102. Local registers should separately record cases which exceed the management area's delegated authority and must be available for examination by the NAO. Agencies should maintain registers which contain enough detail to meet the Annual Accounts reporting requirements set out in the Annual Accounts Instructions. The losses reporting chain (for both cash and stores) sits within the TLB who took the write-off action and is the reverse of the delegation chain. TLBs should send CFAT a consolidated list off all recorded losses.

12.103. To avoid errors of omission or commission, TLBs should cross-check their losses register against the losses noted in the TLB Annual Accounts submission.

12.104. 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.

12.105. The supporting evidence is regarded as a financial record which covers not only accounting records such as vouchers, approvals, schedules and computer records, but also financial management records and policy papers which support financial transactions.

12.106. While the financial records are normally required to be kept for six years and main ledgers for seven years, the actual timetable for destroying main ledgers and supporting records should be agreed with the NAO who will wish to see original documents when conducting audits.

Supporting Write-Off and Special Payments Case

12.107. When BLBs/PTs submit registered files on losses or special payments to TLBs, the supporting casework should include a copy of the proforma reproduced in Appendix A of Annex 7. If appropriate, a copy of HM Treasury's letter of authority should be attached. The following information should be supplied:

a. the category of loss or special payment. This should be a full definition, for example, 'cash loss due to over-issue of pay, allowances and superannuation benefits';

b. the nature and cause of each loss (if not evident from the category description);

c. the date on which, or the period during which, the loss occurred (or, if this is not known, when it was discovered), or the date on which a special payment was or is to be made, and the paying office;

d. the gross value of the loss, the amount of any recovery made or expected to be made, and the net loss. If full recovery is not made, the reasons must be recorded;

e. confirmation that the following checks have been made:

    i. all relevant contracts have been identified;

    ii. all expenditure has been identified;

    iii. all benefits to the Department from the expenditure have been identified and the write-off has updated to reflect the cash benefit.;

    iv. any monies have been charged to suspense pending the write-off and, their value declared and that they have been cleared to the appropriate Estimate;

f. the RAC (where applicable), TLB and UIN to which the cash loss or special payment has been charged or to which sums written off as claims abandoned have been credited;

g. whether prosecution or disciplinary action was appropriate and practicable and, if so, what action has been taken. If prosecution was practicable but not undertaken, the reasons and authority for not having done so should be provided;

h. a copy of the approving officer's letter of delegation has been attached;

i. confirmation that the case has already been reported to CFAT as a loss of major significance;

j. for items requiring individual notation, that a draft note suitable for inclusion in the Annual Accounts has been provided;

k. that sufficient documentary evidence to prove the calculated value of the loss or special payment, including any necessary reconciliation and summation of figures cross-referenced to supporting papers has been provided;

l. that a schedule recording key dates in progressing the case, e.g. the date on which the loss was first identified, dates when cross-referred to other branches for comment etc has been provided;

m. that a press brief has been provided for use when the Annual Accounts are published;

12.108. For all losses arising from theft, arson, sabotage, malicious damage or gross carelessness, a certificate should be included to show that any appropriate court martial or other disciplinary action has been taken.

Treasury Approval to Write Off Losses

12.109. Where losses exceed the Department's delegated authority, the Department will need to obtain HM Treasury authority to write them off. In order to approve a write-off case, HM Treasury requires the following facts:

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.

12.110. If HM Treasury is not satisfied that a case has been appropriately managed (for example, appropriate financial penalties or disciplinary measures have not been imposed), it will withhold approval and will also notify the Comptroller and Auditor General (C&AG). The C&AG will then notify the PAC, who may require the Accounting Officer to justify and defend the Department's actions.

Treasury Approval to Make Special Payments

12.111. Where the Department does not have the required delegation (see Figures 1 and 2), the Department must always seek advance approval from HM Treasury. For special severance payments there is a proforma which is available from the MOD Accounting Policy team. The submission to HM Treasury 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.

12.112. 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.

Consultation

12.113. An officer handling a loss case must consult all management areas concerned and should contact the MOD Accounting Policy team if any particular guidance or assistance is required. Paragraph 12.136 sets out the action to be taken for losses and special payments of major significance. In each of the circumstances described below the appropriate area(s) to consult before taking write-off are:

a. The authorities responsible for formulating the regulations or directives must be consulted and their agreement obtained before the write-off is authorised, where a loss arises out of misinterpretation of regulations or procedural directives, or where such considerations are a contributory factor;

b. Cases must be referred to the appropriate pay administration authority, whose agreement must be obtained before write-off is approved, where there are personnel management implications or over-issues of pay and allowances, in which the Department's recovery proposals are disputed;

c. The management area with the appropriate responsibility must be consulted where the circumstances of the loss point to a possible defect in the system of control, and the officer handling the loss is not directly responsible for that system, .

Avoidance of Delay

12.114. Cases of apparent loss should be investigated promptly and, if a loss is confirmed, recovery and/or write-off action should begin immediately. Losses may be mitigated through a prompt and thorough response and by reporting them early to the appropriate higher authority.

12.115. TLBs should ensure that losses cases are completed as quickly as possible, using formal project management techniques to do so.

Gross Carelessness

12.116. Where the need to write off a loss or make a special payment is the result of gross carelessness by either Service or civilian personnel and disciplinary action is to be taken against the individual concerned, the person authorising the write-off must be notified of what the disciplinary action will be.

Personal Involvement and Level of Write-Off

12.117. An officer, other than in his/her line management role, must never write off a loss to which he/she has contributed in any way, for example, through collusion or negligence. 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.

12.118. TLBs should implement appropriate controls (if they have not already done so) to ensure that the gross amount of losses is visible to heads of establishments and senior staff to enable amounts to be monitored and action taken, as appropriate. For example, there may be numerous relatively small losses but as full recovery is made, they will not be reported as an actual loss. However, the fact that such a large number of losses is occurring may indicate a lack of control and the need for corrective action.

<u>Loss Connected with Interdepartmental Transactions</u>

12.119. Where one government department supplies goods or services to another, any associated loss or special payment will be borne by the customer department and reported in the customer department's resource accounts.

12.120. 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.

12.121. 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 HM Treasury approval, the submission should not be made until after it has consulted the customer department.

12.122. 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 HM Treasury 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.

Valuing and Reporting of Losses and Special Payments

Valuation of Losses and Special Payments for Write-Off and Reporting Purposes

12.123. For write-off and reporting purposes, the value of losses and special payments is decided as follows:

a. the value usually reflects a precise sum which will include (where applicable) VAT, 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. the waiving and abandonment of claims which relate 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;

c. for claims abandoned that are directly related to stores losses, the value will be assessed as for stores losses (see d. below);

d. 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 d.iii below) – 75% of current replacement cost;

iii. clothing and textiles part-worn and all repairable equipment – 50% of current replacement cost (except Defence Accommodation Stores which are to be assessed in accordance with JSP 384 Chapter 13);

iv. stores classified as surplus or scrap before discovery of the loss – disposal value either known or estimated;

v. items produced for sale – current selling price;

vi. 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;

vii. where estimates have to be used, time and effort should not be wasted in trying to achieve unnecessary precision.

Recoveries

12.124. When the main facts of a case are known and have been thoroughly investigated, the write-off should not be delayed on the grounds of any potential recoveries. For example, income tax refunds associated with overpayment of salary; penal deductions; stoppages of pay; and voluntary payments (but not fines). 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.

12.125. Action to write off the balance should be taken immediately, although the fact that a loss is written off does not necessarily mean that recovery attempts must cease. Therefore, any decision to write off a sum of money or an item of equipment does not mean that attempts to recover the sum involved have been abandoned. The loss may also be reduced by the value of benefits which have been, or will be, transferred to other projects, in which case their value should be identified (but not netted off the loss).

12.126. No adjusting action is necessary if the sum written off equals or exceeds the net loss. When an expected recovery is not achieved in full, the balance of the loss should be written off. Where it is agreed that the recovery can be effected 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.

12.127. Where the full amount of lost cash or the full value of lost or damaged stores is recovered, there is no loss to the public and consequently no need for write-off action. However, such cases may reveal a need to rectify defects in administration. A report should be made to CFAT and also be brought to the attention of the TLB/Agency audit committee if the cause shows a serious defect in administration, likewise if recovery will not be completed within six months of the date of discovery. CFAT will need to be satisfied that all necessary remedial measures have been taken.

12.128. Action on recovery of overpayments should be pursued in accordance with JSP 462. Details of set-off are in Annex 7. If full recovery is not made, the reasons must be recorded within the write-off file.

12.129. 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 should seek approval to write off the debt by submitting a case to the officer holding the appropriate write-off delegation.

Reporting Losses and Special Payments

12.130. Losses and special payments are reported in the Annual Accounts 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 more £250,000 or above are separately noted;

b. advance notification. The Department must bring cases exceeding £250,000 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. Where an individual loss or special payment is £250,000 or above, it is individually disclosed in the Annual Accounts. The amounts stated under advance notification are the best estimates. The advance notification section also includes cases brought forward from the previous year which remain outstanding. Where these cases have been formally signed off during the year, they are shown under the closed cases section of the Annual Accounts losses and special payments note.

12.131 Losses should be reported on an accruals basis. Special payments should be accrued in the Annual Accounts, even if they may be reduced by subsequent recoveries. Any special severance payments for senior staff should be individually itemised in the Annual Accounts.

12.132. The MOD Accounting Policy Team 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 Annual Accounts. In cases where a contractor has caused a loss and may be liable under the terms of a contract, advice should be sought from the appropriate commercial officer.

12.133. The report should be limited to a brief note giving details of the loss or special payment; when it is likely to be finalised; and whether it needs to be disclosed to HM Treasury. (Where there is conflict between timing and thoroughness, the bias should always be to disclose the loss to Treasury and to Parliament (through the Annual Accounts)).

12.134. Advance notification should be given if investigations are likely to last beyond the end of the relevant financial year. Unless there is a compelling case to withhold the information from Parliament (which should be discussed with the MOD Accounting Policy Team), the Department should declare the loss or special payment by means of an advance notification.

12.135. When reporting losses and special payments to CFAT, TLBs must ensure they have included the losses and special payments of agencies within their boundaries.

12.136. Where a loss or special payment is deemed to be of major significance (i.e. it is £250,000 or above; or it exceeds the Department's delegated authority; or because of its nature it needs to be reported to Parliament; or it fulfils any of the criteria in paragraph 12.83) a preliminary notification should immediately be forwarded to CFAT and also to the officer who will be responsible for write-off action. A copy of the notification should also be sent to the TLB budget holder/TLB Chief Accountant/business unit manager. Reports should not be delayed pending completion of administrative or disciplinary action. If necessary, such details can be submitted later.

Reports to CFAT

12.137. CFAT requires information on losses and special payments to be submitted as follows:

a. for losses of major significance, reports must be made at an early stage - i.e. well before formal write-off. Case files should not be sent to CFAT;

b. at APs 6, 9 and 12, in accordance with the Annual Accounts instructions.

12.138. Amounts disclosed in the year-end return should be consistent with the amounts charged to the TLB SOCNE and reflected in the TLB SOFP. Case files are not required as part of the Annual Accounts submission. Guidance produced by the Defence Audit Committee on the drafting of losses statements for the Annual Accounts is at Appendix B to Annex 7.

12.139. Further instructions and details of reporting arrangements are given in Service regulations and instructions. JSP 886 contains the Materiel Accounting Instructions for Stores Losses.

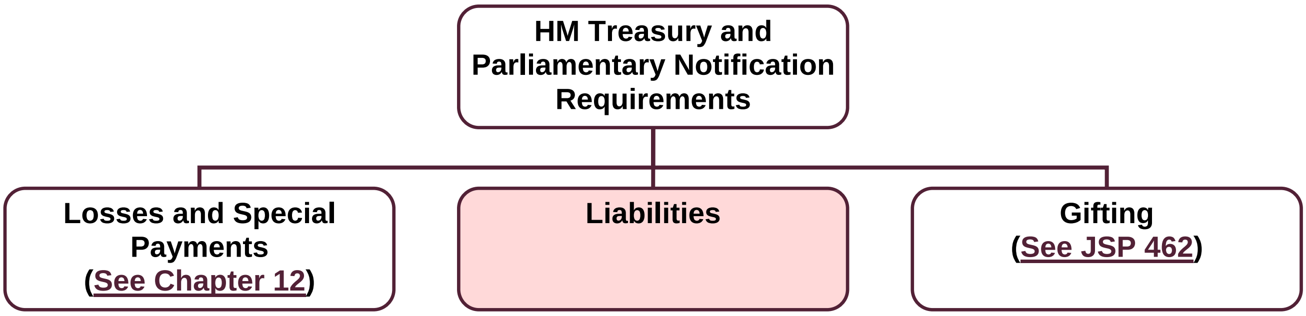
Additional Information

12.140. HM Treasury has given a financial delegation to PUS as Accounting Officer, however this delegation does not include the making of a Special Severance payment. Therefore HM Treasury approval must be sought before an offer of a Special Severance payment can be made.

12.141. As The Senior Finance Officer (SFO) is responsible for managing the budget on behalf of the Top Level Budget Holder (TLB), the SFO must seek permission from HM Treasury, on behalf of the TLB, to make a Special Severance payment. A list of SFOs is provided in the following table:

TLB	Senior Finance Officer	Appointment
Centre	Mrs Carole Tolley	CTLB D
Navy Command	Miss Liz Cassidy	FLEET-COMMAND SEC
Air Command	Mr Guy Lester	AIR-D Res
Land Forces	Mr David Stephens	LF-Res-Director
DE&S	Mr David Noble	DES Finance-Dir
PJHQ	Mr Paul Lincoln	PJHQ-COMDSEC
DIO	Mr Mike Martindale	DIO Fin-CFO

CHAPTER 13: LIABILITIES - HM TREASURY AND PARLIAMENTARY NOTIFICATION REQUIREMENTS



Introduction

13.1. This chapter explains the circumstances under which HM Treasury approval must be obtained, and if over £250k, approval to notify Parliament before the Department can enter into the liability. The liabilities in question are those which are within the ambit of the vote but which have not been included in Estimates. The chapter also sets out the notification process which must be followed.

13.2. Throughout this chapter, liabilities which require HM Treasury approval and notification to Parliament are referred to as 'notifiable liabilities'.

13.3. To ensure that the differences between Parliamentary notification requirements set out in HM Treasury's Managing Public Money and the financial accounting requirements set out in the Government Financial Reporting Manual are fully understood, it is recommended that Chapter 8 of this manual be read in conjunction with this chapter.

Key Points

13.4. Actual liabilities are notifiable if they are novel or contentious or involve significant costs downstream - e.g. nuclear decommissioning costs.

13.5. Contingent liabilities are notifiable **unless** the Department can demonstrate that the contingent liability will be incurred in the 'normal course of business'. The circumstances that are considered to be in the normal course of business are **covered**:

a. within the Indemnity Against Risk Chapter of the Commercial Toolkit;

b. by statute; or

c. by standard commercial leasing arrangements; or

d. by generic indemnities; or

e. by one of the redundancy indemnities contained in HM Treasury's PFI Standardisation of Contracts; or

f. by the Government's standard indemnity to Board members (which also includes civil servants involved in legal proceedings).

13.6. Any actual or contingent liabilities associated with proposals to accept charitable funding are notifiable.

13.7. Contingent liabilities for £250k and below can be approved by the Senior Finance Officer, however, if the liability is considered to be novel and/or contentious, HM Treasury approval should be sought. For notifiable liabilities that exceed £250k, HM Treasury approval must be sought to incur the liability and to notify Parliament, before a contract is signed.

13.8. Parliament is notified by laying a Departmental Minute. However, if the liability is considered to be sensitive, approval must be sought from HM Treasury to send a letter 'in confidence' to the Chair of the Public Accounts Committee (PAC). Please refer to Figure 1 for the full distribution list.

13.9. The required format and content of the Departmental Minute are shown in Figure 2. For the letter to the Chair of the PAC, the wording in the opening and closing paragraphs of Figure 2 should be customised and information requirements a. to e. met. The letter should also explain why it is necessary to notify the liability "in confidence".

13.10. The Departmental Minute must justify why the Department is entering into a notifiable liability. Please note that even the strongest value for money argument does not negate the requirement to seek HM Treasury approval and to notify Parliament before entering into any commitment. The Department will usually be expected to meet the cost of the liability (if it comes to fruition) from within existing budgetary provision.

13.11 With effect from AP9, HM Treasury should be provided with a quarterly report of all new contingent liabilities incurred by the Department, including those that do not require HM Treasury approval.

Policy Detail

13.12. Policy detail is set out under the following headings: specific responsibilities; scope of liabilities; identifying a notifiable liability; approval and Parliamentary notification process; notifying liabilities outside Parliamentary sessions; Annual Accounts Disclosures; and Supply Estimates.

Specific Responsibilities

13.13. Specific responsibilities are listed below. General responsibilities are listed in the Preface.

Commercial Officers' and Finance Officers' Responsibilities

13.14. The commercial officer must inform the finance officer if the contract terms involve significant costs downstream - e.g. nuclear decommissioning costs as these are classified as actual notifiable liabilities. The commercial officer must also inform the finance officer if any contractual terms appear to be novel and/or contentious which could give rise to a contingent liability.

13.15 The Department does not routinely buy commercial insurance to indemnify contractors as it is generally cheaper for the government to pool and spread its own risks.

13.16. However, there are occasions when a contractor may request an indemnity, guarantee or letter of acceptance or comfort. As these represent a form of insurance, the commercial officer should:

a. notify the Team Leader (TL) and the finance officer well in advance of contract placement if the Department is considering including an indemnity, guarantee or letter of acceptance or comfort in the terms of a contract;

b. state whether the liability is covered by those listed in paragraphs 13.32 to13.33;

c. explain the benefits to the Department of limiting the contractor's liability

13.17. The finance officer is responsible for:

a. making the final decision on whether the liability (either contingent or actual) is notifiable;

b ensuring that the TL is content to proceed on the basis that the liability is notifiable;

c. informing the SFO in accordance with TLB internal processes;

d. seeking assurance from the SFO that if the liability came to fruition, the funding would be manageable from within Estimates.

13.18. Even if a liability is not notifiable, the finance officer must still seek the necessary TLB financial approval to incur the liability in accordance with internal TLB instructions. However, as HM Treasury requires visibility of all new liabilities, including those that do not require Parliamentary notification, any new details will taken from the AP 6, 9 and 12 submissions to CFAT.

Senior Finance Officer Responsibilities

13.19. SFOs have a delegation to incur contingent liabilities up to and including those for £250k, unless they are novel and/or contentious. However, SFOs must ensure that they seek approval from HM Treasury, through FMPA-A&TM-Ahd-ACCTAXPOL, to incur liabilities above £250k and to notify Parliament by the laying of a Departmental Minute. This gives visibility to all Members should they wish to raise an objection.

13.20. However, a Departmental Minute cannot be used if the liability is considered to be sensitive and not for public viewing. Instead, HM Treasury approval must be sought to notify the Chair of the PAC by letter 'in-confidence', copy to HCDC.

13.21. As well as preparing the draft Departmental Minute or letter to the Chair of the PAC, SFOs are responsible for:

a. preparing the associated Ministerial advice;

b. answering any Parliamentary objections;

c. informing HM Treasury of any objections and their outcome.

13.22. When preparing the draft Departmental Minute/letter to the Chair of the PAC, as appropriate, SFOs must provide a robust justification for the proposal to incur the liability. In addition, information must be provided on its scope, value and duration; confirmation must be given that funds will be managed from within Estimates; and also that the liability will be noted in the Accounts.

13.23. SFOs must scrutinise all proposed international agreements for the possibility of a notifiable liability. Should a liability be identified, the SFO should ensure that the Parliamentary notification process is correctly followed, even if the agreement is covered by legislation, noting also that 21

Parliamentary sitting days are required for approval. All financial responsibilities of the signatories are usually set out in a Memorandum of Understanding.

13.24. As government departments cannot indemnify each other, SFOs should jointly agree which department will bear any financial consequences.

13.25. SFOs must ensure that the Department does not assume any liabilities through the non-public activities of its staff. Individuals involved in non-public activities should seek an indemnity for any personal liability from the non-public organisation.

13.26. If there is any doubt as to whether or not HM Treasury approval is required, SFOs should always seek advice from the MOD Accounting Policy Team. Please note that even the strongest value for money argument does not negate the need to seek HM Treasury approval and to notify Parliament before entering into any commitment.

Scope of Liabilities

13.27. Liabilities fall into two categories:

a. actual - an obligation to pay another party an amount in the future – e.g. an accrual, a provision or a contractual commitment to make payments in future years under long term contracts, such as the procurement of major equipment;

b. contingent - a financial obligation to pay another party in the future if certain circumstances materialise – e.g. where the Department issues an indemnity, guarantee, letter of acceptance or comfort.

Identifying a Notifiable Liability

13.28. Liabilities are notifiable unless the Department can demonstrate that the liability has been incurred in the 'normal course of business'. Actual liabilities incurred in the normal course of business are set out in paragraph 13.29. The indemnities that give rise to contingent liabilities incurred in the course of normal business are set out in paragraphs 13.32 and 13.33. Other situations involving contractor's liability are set out in paragraphs 13.35 to 13.40.

Actual - Notifiable

13.29. Actual liabilities that are notifiable are those that:

a. are considered to be novel or contentious;

b. involve significant costs downstream - e.g. nuclear decommissioning costs.

Actual - In the normal course of business

13.30. The following liabilities occur in the normal course of business and are therefore not notifiable:

a. liabilities arising in the course of the purchase or supply of goods and services in delivering Departmental outputs – for example, short term accruals and invoices;

b. contractual commitments to make payments in future years arising under long-term contracts – for example, the procurement of major equipment;

c. commitments to pay grants in future years under a statutory grant scheme.

Contingent - Notifiable

13.31. **Unless** contingent liabilities have been incurred under the circumstances described in the Indemnity Against Risks Chapter of the Commercial Toolkit see paragraph 13.32), or under those listed at paragraph 13.33, they are notifiable. Other situations giving rise to contingent liabilities are found under paragraph 13.35 to 13.41.

Contingent - Normal Course of Business

13.32. The Department has agreed that if an activity is an unavoidable part of Departmental business and the required insurance cannot be purchased on the open market, contractors may be relieved of their liability if any of the contract specifications can be attributed to the circumstances described in any of the following indemnities:

a. Aviation Products;

b. Aircraft Flight and Taxiing Trials;

c. Refit and Repair of Naval Vessels;

d. Shipbuilding Contracts;

e. Nuclear Submarine Builders;

f. Nuclear Risks;

g. Research and Development Contracts – Guided Weapons;

h. War Risks - contractors on deployed operations (CONDO) – DEFCON 661;

i. Diversion of Orders to the Department from Other Customers.

13.33. If an indemnity is covered by statute, the liability should be notified to Parliament in line with any statutory requirement. However, there are circumstances in which indemnities can be issued without HM Treasury approval and Parliamentary notification – i.e:

a. those covered by statute (both UK and international), including;

   i. the Nuclear Installations Act;

   ii. the Merchant Shipping Act;

   iii. the Anti Deficiency Act (US statute which is relevant in the context of Foreign Military Sales);

   iv. the Ordnance Factories and Military Services Act 1984;

b. leasing contracts which contain standard commercial leasing conditions. For example:

   i. BARECON 2001 for shipping charters;

c. generic indemnities such as:

   i. DEFCON 632, Third Party Intellectual Property – Rights and Restrictions;

   ii. DEFCON 656, Break;

d. the indemnities contained in the Report by the Review Board for Government Contracts;

e. where TUPE clauses contained in the draft contract comply with the TUPE Commercial Policy Statements contained in the Commercial Toolkit. HM Treasury has agreed that the redundancy indemnities contained in HM Treasury PFI Standardisation of Contracts and incorporated into the TUPE guidance in the Commercial Policy Statement can also be applied to other types of PPP contracts such as outsourcing;

f. the standard indemnity provided by the Government to Board members of central government departments and NDPBs and also to civil servants involved in legal proceedings or formal enquiries arising as a consequence of their employment.

13.34 Please note that if any of the terms of the 'normal business' indemnities are changed in such a way that alters their intent, the resultant liability will be notifiable.

Other Situations Involving Contractor's Liability

13.35 As detailed in the Commercial Toolkit under 'Limiting/ Excluding Liability for Risks', the Department does not provide contractors with a limitation on their liabilities under contract or general law, without good defence or value for money reasons for doing so.

<u>DEFCON 76 (Contractor's Personnel at Government Establishments)</u>

13.36 Under the terms of DEFCON 76, the value of the contractor's liability for loss or damage is undetermined. As highlighted in the Commercial Toolkit 'Limiting/ Excluding Liability for Risks', the onus is on the contractor to seek a limit of liability under DEFCON 76 and it must not be agreed unless it meets the criteria set out in the Commercial Toolkit.

13.37 If the Department agrees to a limit on a contractor's liability because there are good defence or value for money reasons for doing so, it will result in a notifiable contingent liability unless the following circumstances are met:

a. the clause uses the standard DEFCON wording and commercial staff follow the process laid down in the Commercial Toolkit; and

b. a full and robust risk assessment has been undertaken to identify risks and mitigating action. Project teams will need to defend this risk assessment if necessary. TLBs should satisfy themselves that the risk assessment is robust; and

c. the level of limit of liability is per incident; and

d. the level of rectification costs is below the level of the limit of liability.

13.38 If any of the above conditions are not met, the subsequent liability is notifiable.

<u>DEFCON 611 (Issued Property), DEFCON 612 (Loss of or Damage to The Articles) and DEFCON 614 (Default)</u>

13.39 These DEFCONs specify the contractor's responsibilities for any MOD Issued Property, loss or damage to any Articles until delivery and provides a remedy for the failure of the contractor to deliver or perform on time.

13.40. As the policy guidance on DEFCONs 611, 612 and 614 is currently under review, please contact the MOD Accounting Policy Team for further information.

Acceptance of Charitable Donations

13.41. All proposals to accept charitable donations by the Department are deemed novel and contentious and HM Treasury approval must be sought. Actual or contingent liabilities that arise from HM Treasury approved charitable funding are within the scope of the novel and contentious category and are notifiable.

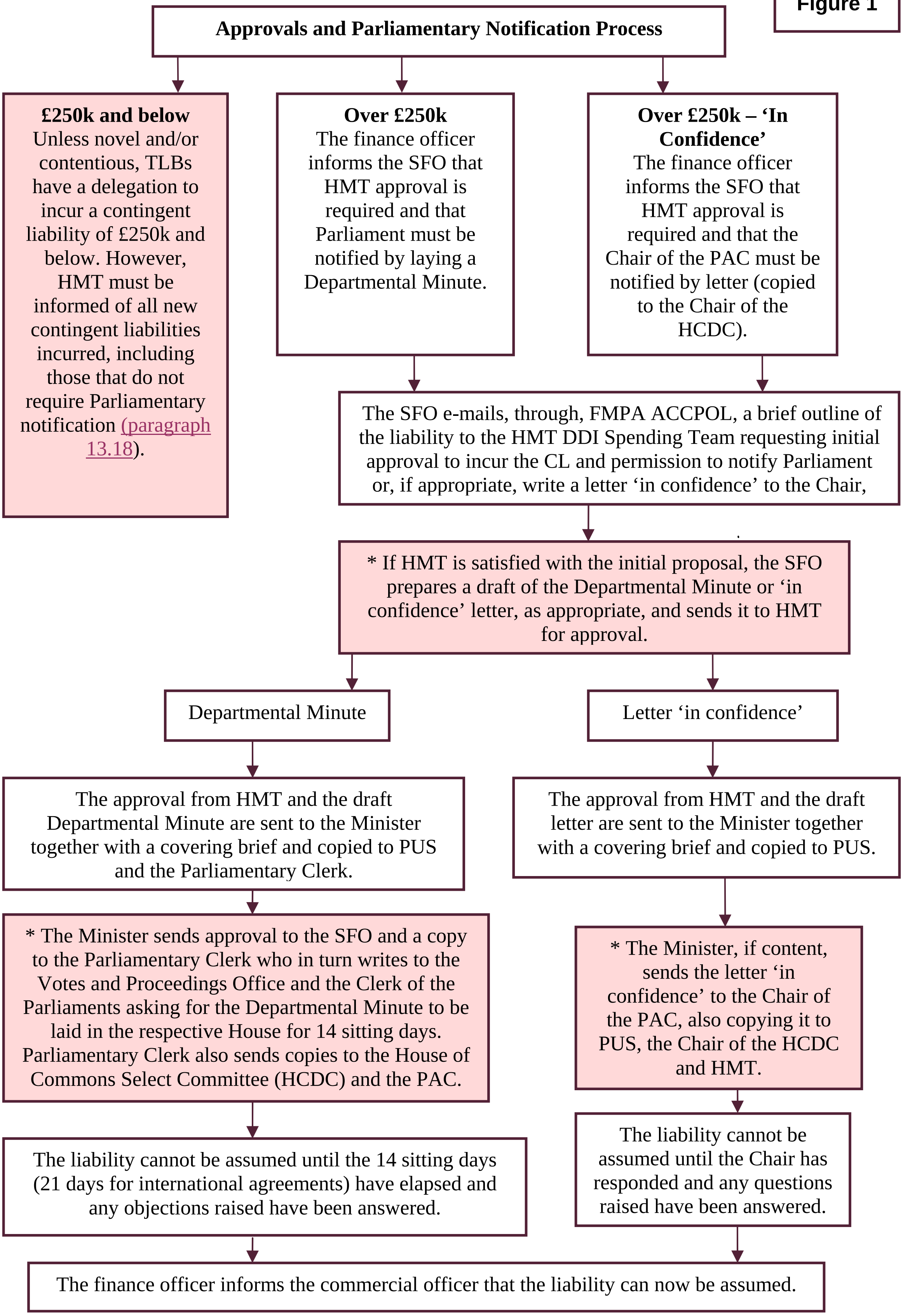
13.42. Paragraphs 13.32 and 13.33 may not be exhaustive. If any others sources come to light they must be brought to the attention of FMPA-A&TM-Ahd-ACCTAXPOL who will review the evidence.

Approval and Parliamentary Notification Process

13.43. As explained in paragraphs 13.19 to 13.26 under Senior Finance Officer Responsibilities, notifiable liabilities of £250k and below do not require HM Treasury approval. However, unless novel and/or contentious, all those above £250k require both HM Treasury approval and Parliamentary notification.

13.44. An overview of the approvals and Parliamentary notification process is set out in Figure 1.

Figure 1



*** Pink shaded boxes indicate where correspondence must be copied to FMPA-A&TM-Ahd-ACCTAXPOL.**

13.45. The process for laying a Departmental Minute is:

a. the finance officer sends a brief outline of the liability, through FMPA-A&TM-Ahd-ACCTAXPOL, to HM Treasury seeking authority to incur it. HM Treasury does not wish to see the draft Departmental Minute at this stage;

b. on approval, the finance officer sends a draft Departmental Minute to the SFO, incorporating the standard wording, shown at Figure 2 and sends it to FMPA-A&TM-Ahd-ACCTAXPOL for review;

c. FMPA-A&TM-Ahd-ACCTAXPOL advises the SFO of any necessary changes to meet HM Treasury requirements;

d. the SFO incorporates any necessary changes and sends the draft Departmental Minute to HM Treasury, copy to FMPA-A&TM-Ahd-ACCTAXPOL;

e. when the Departmental Minute has been approved by HM Treasury, the SFO forwards the Ministerial Submission together with a covering brief to the Minister, copying them to PUS, FMPA-A&TM-Ahd-ACCTAXPOL and the Parliamentary Clerk;

f. the Minister's Office keeps the Parliamentary Clerk informed of progress. Once the Departmental Minute has been approved by the Minister, the Parliamentary Clerk sends it to the Votes and Proceedings Office (House of Commons) and to the Clerk of the Parliaments, Printed Paper Offices (House of Lords) to request that it be laid before the respective House. A copy is also sent to the Chair of the PAC and the HCDC;

g. Parliament must be given 14 sitting days notice in order for Members to raise any objections, although for international defence collaborative agreements 21 sitting days are required;

h. if a Member of Parliament raises an objection by letter to the Minister, a Parliamentary Question or by otherwise raising the matter in Parliament during the normal 14 sitting days notice period, the liability should not be assumed until the objection raised has been answered. In some cases, the advice to the Minister might be that the objection is sufficient for the liability to be delayed or indeed withdrawn pending further consideration by the Government.

13.46. The notification process for a letter "in confidence" to the Chair of the PAC is:

a. the SFO sends a brief outline of the liability, through FMPA-A&TM-Ahd-ACCTAXPOL, to HM Treasury explaining the nature of the liability and the reason for it to be treated as 'in confidence', seeking authority to accept it and permission to write a letter to the Chair of the PAC 'in confidence'. HM Treasury does not wish to see the draft letter at this stage;

b. on approval, the SFO drafts a letter, which incorporates a suitable adaptation of the framework shown in Figure 2 including all the essential elements listed in a. to e., forwarding it to FMPA-A&TM-Ahd-ACCTAXPOL for review;

c. the SFO incorporates any necessary changes and submits the draft letter (copied to PUS) for the relevant Minister's approval;

d. The Minister, when content, sends the letter to the Chair of the PAC and copies it to PUS, the Chair of the HCDC, HM Treasury and FMPA-A&TM-Ahd-ACCTAXPOL. The liability cannot be assumed until the Chair has responded and any questions raised have been answered.

13.47. The National Audit Office (NAO) will be informed by DFM-FMPA-DHd-A&TM of a notifiable ‘sensitive’ liability as the NAO will wish to investigate the background before providing advice to the Chair of the PAC.

13.48. Any changes to existing liabilities should be notified in the same format as they were originally notified to Parliament. However, any liability, originally notified by letter, but no longer considered to be sensitive, should be notified using a Departmental Minute instead.

13.49. In emergency situations, consideration may be given to a reduction in the number of days notice to Parliament. The reasons for the emergency must be included in the Departmental Minute. However Parliament, and in particular the PAC, will take a dim view of liabilities reported under emergency conditions if this was due to poor planning and preparation.

Framework for a Departmental Minute/Letter ‘In Confidence’ to the Chair of the PAC

Figure 2

The opening paragraph should say:

It is normal practice, when a government Department proposes to undertake an actual or contingent liability in excess of £250,000 for which there is no specific statutory authority, for the department concerned to present to Parliament a Minute/ to the Chair of the PAC a letter, giving particulars of the liability created and explaining the circumstances; and to refrain from incurring the liability until fourteen parliamentary sitting days after the issue of the Minute/letter, except in cases of special urgency.*

** actual or contingent as appropriate.*

The body of Minute/letter should:

a. set out the reasons for issuing an indemnity that will incur a notifiable liability;

b. describe the scope, value and duration of the liability; for a contingent liability, also comment on the likelihood of the liability being called and include an estimate of the maximum exposure;

c. explain which bodies are expected to benefit and why;

d ensure that if the liability is called, provision for any payment will be sought through the normal Supply procedure;

e. confirm that the Department will be noting the liability in its Accounts.

The letter must explain why the liability needs to be notified in confidence.

.

The Minute/[letter] should have the following closing paragraph:

The Treasury has approved the proposal in principle. If during the period of fourteen parliamentary sitting days beginning on the date on which this Minute was laid before Parliament/[received by the Chair of the PAC], a Member signifies an objection by giving notice of a Parliamentary Question or by otherwise raising the matter in Parliament/[you have any objections on Parliament’s behalf], final approval to proceed with incurring the liability will be withheld pending an examination of the objection.

Notifying Liabilities Outside Parliamentary Sessions

13.50. The Department should avoid notifying Parliament of a liability during a Parliamentary recess. In cases of special urgency it can, with HM Treasury consent, notify the Chair of the PAC (also copying the letter to the Chair of the HCDC). This is done by attaching a covering letter to the draft Departmental Minute which would have been tabled had Parliament been sitting.

13.51. If the required 14 days' notice cannot be given for reasons of particular urgency, this should be explained in the letter.

13.52. As soon as the House of Commons reassembles, the Department should lay the Departmental Minute, having updated it to show the current status of the liability and whether or not it has now been incurred.

Annual Accounts Disclosures

13.53. Although IAS 37 (see Chapter 8) states that contingent liabilities are only disclosed in the accounts if they are remote, Parliamentary reporting requires that all actual and contingent liabilities are to be disclosed, regardless of the likelihood of them coming to fruition.

13.54. However, when disclosing liabilities which are intended to be or have been notified in confidence, care must be taken with the description to ensure that the sensitive aspects of the liability have not been compromised.

13.55. The indemnities provided in paragraphs 13.32 to 13.33 d, also known as schemes, have given rise to contingent liabilities, and will continue to do so. Although each scheme might have incurred several contingent liabilities, HMT is content that only the name of each scheme needs to be disclosed and this will be undertaken by CFAT.

Supply Estimates

13.56. The Estimate includes details of all contingent liabilities in force which, if came to fruition, would by exception, involve the voting of additional expenditure though the Estimate. However, this does not replace the requirement to obtain HM Treasury and Parliamentary approval before incurring a notifiable liability above £250k.

ANNEX 1: SOFTWARE COSTS

Purpose

A1.1. This annex expands on the guidance in Chapter 4 by providing further detail on how to account for the cost of software which is either purchased by the Department or developed in house.

Recording Software Costs as a Separate Non-Current Asset

A1.2. 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.

A1.3. Guidance on whether VAT is recoverable for a particular software cost should be sought from the MOD VAT Policy Team.

Software Procured for Internal Departmental Use

A1.4. 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;

e. it is procured under PPP/PFI arrangements.

A1.5. Costs relating to procurement methods a. to c. should be capitalised as intangible Assets Under Construction (AUC) if the requirements set out in paragraph A1.8 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.

A1.6. 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.

A1.7. 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

A1.8. 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.

A1.9. 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).

A1.10. 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.

A1.11. 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

A1.12. 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 paragraph A1.8 and the Department intends to sell either of them.

Asset Lives, Depreciation and Amortisation

A1.13. 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.

A1.14. 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.

A1.15. 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.

A1.16. 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

A1.17. After an asset is brought into use, further expenditure may be incurred.

A1.18. 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.

A1.19. 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.

Revaluation

A1.20. 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.

A1.21. 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.

ANNEX 2: ACCOUNTING FOR PUBLIC PRIVATE PARTNERSHIP (PPP) ARRANGEMENTS INCLUDING PRIVATE FINANCE INITIATIVE (PFI) CONTRACTS

Purpose

A2.1. This annex expands on the guidance provided in Chapter 5 by explaining:

a. the main features of a PPP/PFI contract;

b. how to report and account for PPP/PFI transactions (including those in which the Department has a residual interest in the asset(s) at the end of the contract);

c. how to account for contracting for availability contracts;

d. how to account for gains arising on the refinancing of contracts.

Scope

A2.2. PPP/PFI contracts generally involve the private sector designing, building, financing and operating a property in order to provide a contracted service.

A2.3. 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.

A2.4. 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.

A2.5. 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.

A2.6. 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.

A2.7. VAT paid to the PPP/PFI contractor may be recoverable and guidance on this can be sought from the MOD Accounting and Tax Policy VAT team.

Main Features of a PPP/PFI Contract

A2.8. 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

A2.9. All NCAs are reported on the SOFP of the Non-Current Asset Manager (NCAM) responsible for that particular category of asset. Although the PPP/PFI contract may be managed in a different TLB, this will not prevent the NCA value being allocated to the NCAM and managed as any other conventionally procured asset.

A2.10. 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 NCAM at the point at which it needs to be reported. The NCAM will then have the asset in its segment of the Non-Current Asset Register (NCAR), giving visibility of the totality of one asset class on a single SOFP.

A2.11. 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 to the NCAM.

A2.12. 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 NCAM for the asset class involved and the TLB that will receive the unitary charge from any PPP/PFI arrangement are fully consulted during the course of the IAB submission.

A2.13. Where an Agency satisfies the ownership criteria for the PPP/PFI asset, the NCAM 'communicates' the NCA values at year end so that the Agency can report it on its SOFP. The NCAM also communicates the depreciation cost charged to its Statement of Comprehensive Net Expenditure (SOCNE).

A2.14. '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.

A2.15. 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.

A2.16. 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

A2.17. The MOD Accounting Policy team must be consulted and agree the accounting treatment for all service concession arrangements. Figure 1 (at Appendix B) summarises the accounting decisions for PPP/PFI arrangements.

A2.18. 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

A2.19. 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.

A2.20. 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.

A2.21. 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. some assets 'on' the Department's SOFP and some 'off' the Department's SOFP) may be required.

A2.22. 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.

A2.23. 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.

A2.24. 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.

A2.25. 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.

A2.26. 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

A2.27. 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:

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.

A2.28. In practice, this means that the Department will usually only recognise the asset when it comes into use. Where the Department makes contributions to the PSO in advance of the asset coming into use, the Department should account for them as prepayments.

A2.29. 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 paragraph A2.30), the asset will initially be measured by following the guidance in IAS 17 (as stated in the paragraphs A2.35 to A2.52), 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 paragraphs A2.31 and A2.32.

A2.30. 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.

A2.31. 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 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).

A2.32. 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

A2.33. 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.

A2.34. 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.

A2.35. 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.

A2.36. 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.

A2.37. 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.

A2.38. 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.

A2.39. 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.

A2.40. 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 chapter 5.333 and 5.334. In applying these situations and indicators to the land element, an important consideration is that land normally has an indefinite economic life.

A2.41. 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.

A2.42. 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.

A2.43. 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.

A2.44. 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.

A2.45. 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.

A2.46. 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.

A2.47. 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).

A2.48. 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.

A2.49. 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.

A2.50. Expenditure under operating leases is charged directly to the SOCNE in the period in which it is incurred.

A2.51. 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.

A2.52. 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 the MOD Accounting Policy Team;

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

A2.53. 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.

A2.54. 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.

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

A2.55. 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

A2.56. 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

A2.57. 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.

A2.58. 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

<u>Cash Receipt from the Sale of Assets</u>

A2.59. 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.

A2.60. The accounting transactions are to debit cash and credit PFI payables.

<u>Reduction in Unitary Charge</u>

A2.61. 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

A2.62. 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. If a PPP/PFI contract contains a residual interest the MOD Accounting Policy Team must be consulted.

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

A2.63. 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.

A2.64. 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 <u>Appendix A</u> for the accounting entries.

A2.65. 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 <u>Appendix A</u> for the accounting entries.

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

A2.66. Where the Department has a contractual obligation to make a payment to obtain 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.

A2.67. 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.

A2.68. The above two paragraphs provide an indication of the likely accounting treatment. However, the treatment will depend on the particular circumstances of the contract. If an 'on' SOFP PPP/PFI contract includes a contracted amount that the Department must pay to purchase the asset at the end of the contract, the MOD Accounting Policy team must be consulted to determine the exact treatment.

Refinancing of Contracts

A2.69. 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).

APPENDIX A TO ANNEX 2

ACCOUNTING FOR RESIDUAL INTERESTS

A2.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.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.

A2.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

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

A2.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

A2.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?

A2.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.

A2.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

A2.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.

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?

A2.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.

A2.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

A2.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 (x 5) = £200,000
Cr SOCNE (PFI Contract RAC) £40,000 (x 5) = £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.

A2.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

A2.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?

A2.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.

A2.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

A2.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.

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?

A2.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.

A2.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

A2.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

A2.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.

Accounting Treatment

A2.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?

A2.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.

A2.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

A2.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
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?

A2.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.

A2.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

A2.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

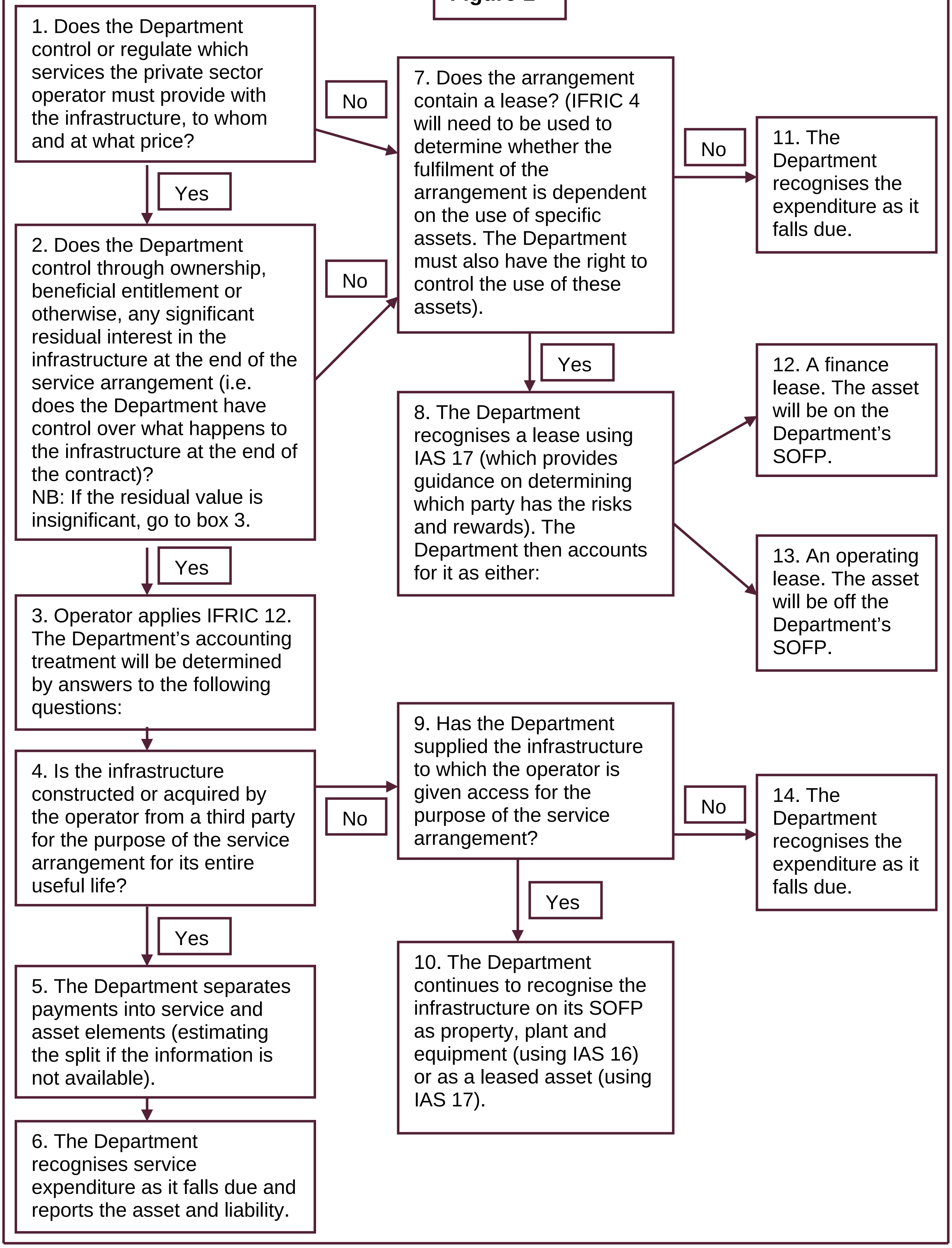
Dr Non-Current Assets £3,000,000
Cr Cash £3,000,000

APPENDIX B TO ANNEX 2

Accounting For PPP/PFI Arrangements

A2.B1. Figure 1 below summarises the accounting decisions required for PPP/PFI arrangements.

Figure 1



ANNEX 3: GOVERNMENT FURNISHED ASSETS

Purpose

A3.1. This annex builds on the guidance in Chapter 5 by covering:

a. the categorisation of Government Furnished Assets (GFA);

b. ownership;

c. how to account for Government Furnished Assets (GFA).

Scope

A3.2. 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.

A3.3. For the purpose of this chapter, the owner of Government Furnished Assets (GFA) within the Department is referred to as the Authority.

Categorisation

Government Furnished Assets (GFA)

A3.4. 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.

A3.5. 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).

A3.6. GFA can be provided to project teams 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.

A3.7. GFA can be issued to, or retained by Trading Funds and by contractors to support Public/Private Partnership (PPP), Private Finance Initiative (PFI) and collaborative projects. 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.

A3.8. The Asset Accounting Centre (AAC) is responsible for auditing the stewardship of GFE and is the custodian of the AII database.

Government Furnished Facilities (GFF)

A3.9. 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)

A3.10. GFI includes data, books, software, drawings and Intellectual Property Rights (IPR) supplied in accordance with, or generated as a result of, a Defence contract.

A3.11. IPR includes concessions, patents, licences, copyrights, trademarks, databases and similar rights and assets, and are included within intangible NCAs.

Government Furnished Resources (GFR)

A3.12. 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)

A3.13. GFE is an item of Authority owned materiel provided to a contractor in support of a Defence contract (other than a repair contract where the items will be in a repair loop) to assist with research or the development, manufacture, production, construction, repair, refurbishment, maintenance, servicing, modification, enhancement or conversion, of facilities, equipment or RMC.

A3.14. The contract conditions determine whether an item falls 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.

A3.15. The items, for which title is clearly vested in the Authority (but see paragraphs A3.19 and A3.27 regarding inclusion within project accounts prior to transfer of legal title), may be purchased or provided to the contractor from existing NCAs and RMC (as authorised issues) by the Authority, or may be purchased directly or manufactured by the contractor on the Authority's behalf.

A3.16. Items are normally 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 Asset Register (DC23) or a Public Store Account (DC 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.

A3.17. GFE can be supplied either as JTTE under DC23 arrangements or as issued property (which is synonymous with the term loan) under DC 611 arrangements. As each category has its own specific accounting treatments, this annex makes a clear distinction between JTTE and issued property.

A3.18. JTTE are typically purchased under DC23 to support projects engaged in development, manufacture, production, construction, modification, enhancement or conversion. Decisions on the future use of the items for the provision of in-service support are not made until project completion. Issued property can either be purchased specifically to support a contract or supplied from existing inventory holdings. It is recorded on an inventory record or on the Authority's non-current asset register (NCAR) and is expected to be embodied or physically returned when the period of use is complete - i.e:

- transferred to Issued Property (DC611);
- transferred to another development contract;
- returned to Authority custodianship;
- disposed of, as directed by Defence Sales Authority.

A3.19. 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 paragraph A3.38) up to that point in time.

A3.20. Although JTTE are recorded on commercial asset registers during the period of the project 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

A3.21. A simplified GFE category structure has now been adopted and the terms are explained in paragraphs A3.22 to A3.25. Where appropriate, former GFE category definitions are cross-referenced to the revised rationalised terms.

Contract Work Item (CWI)

A3.22. 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. It is typically issued for the purpose of enabling repair, refurbishment, maintenance, servicing, modification, enhancement or conversion, 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.

Contract Support Item (CSI)

A3.23. 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, 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

Contract Embodiment Item (CEI)

A3.24. CEI is an item of materiel embodied in a CWI in accordance with a contract issued by the Authority. It is an item of materiel provided to a contractor, without charge, for incorporation into an asset under manufacture, production, construction, repair, refurbishment, maintenance, servicing, modification, enhancement or conversion. 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

Contract Work Arising (CWA)

A3.25. An item of materiel removed from a CWI in accordance with a contract (issued by the Authority) from an existing item of materiel for incorporation into another item of materiel. 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

A3.26. 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 (but only if applied by the Department which is not currently the case) and/or IAS 17.

Authority Ownership

A3.27. 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 paragraph A3.19).

A3.28. Authority ownership includes items of Authority materiel transferred into the direct custodial responsibility of contractors, where the contract includes retention of title clause. NCA items (held on the Authority's NCAR or a supply system) are generally provided to contractors by DE&S and RMC items are provided by the inventories holder.

Joint Ownership

A3.29. 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 Equipment Non-Current Asset Manager (ENCAM)/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 should therefore be established on a contract by contract basis.

Jigs, Tooling and Test Equipment (DC23) AUC

A3.30. 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 (DC 611) NCA

A3.31. 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 DE&S who holds the assets on the ENCAM's SOFP. Financial management of inventories is vested in the responsible Inventories Holder. Custodial responsibilities for the issued property remain with the PT for which the items are being used.

Orphan Assets

A3.32. Any assets loaned to industry which cannot be identified to an appropriate owner should be allocated to a proxy owner by the relevant TLB.

Government Furnished Facilities

A3.33. 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 PNCAM 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

A3.34. 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

A3.35. As contractors' personnel are not treated as assets on the SOFP, ownership is not applicable.

Accounting

Government Furnished Equipment

A3.36. The accounting treatments for GFE make a clear distinction between special JTTE (paragraphs A3.38 to A3.47) and issued property (paragraphs A3.48 to A3.66) under the various schemes. The accounting treatment is generally governed by ownership considerations and the terms under which materiel is issued to contractors (DC 611).

A3.37. 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.

Jigs, Tools and Test Equipment

Items Provided for Current Project Delivery

A3.38. JTTE (DC23) provided to contractors to support current projects, (see paragraphs A3.61 to A3.63), should be charged to the appropriate project account operated 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.

A3.39. 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 can be done on an individual asset basis or, in cases where JTTE are accounted for as pooled assets, on a grouped NCA basis.

A3.40. 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 pooled assets. Subject to the application of standard NCA capitalisation criteria and valuation policies, the accounting actions described in the following paragraphs should be taken.

Items to be Retained for Future In-Service Support

A3.41. Items are 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 are normally 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.

Items to be Retained for Future Project Delivery

A3.42. Items are valued at fair value (DRC) and are charged to the appropriate project account operated by the DE&S PT responsible for future project delivery (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.

A3.43. 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.

Items Identified as no Longer Required and for Disposal

A3.44. 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.

Items to be Retained by the Contractor for Commercial Purposes

A3.45. Although items no longer required would ordinarily be disposed of, in exceptional cases they may be retained by the contractor, in accordance with the principles in JSP 462, 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

A3.46. Where there is a balance on the project account, adjustments resulting from the actions set out in paragraphs A3.41 to A3.47 are made to the amount capitalised as development costs or AUC. Otherwise the adjustment is made to the revaluation reserve.

Items Classified as RMC

A3.47. For items classified as RMC, the general principles set out in paragraphs A3.41-A3.46 apply. However, valuation is in accordance with standard inventories valuation policies for items retained for future use or Net Realisable Value (NRV) for those items identified for disposal. The items are to be included in the appropriate inventories records.

Contract Embodiment Items

A3.48. All CEIs provided to contractors for subsequent embodiment should be charged to the project account operated by the appropriate PT

A3.49. 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).

A3.50. 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 paragraphs A3.41-A3.45.

A3.51. 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.

A3.52. It is the responsibility of each TLB to ensure contractors are accountable for physical verification of CEI holdings and for recording and accounting for CEIs on non-Departmental systems, including all receipts, issues, transfers, disposals and losses.

A3.53. 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 which apply to each.

A3.54. Records of items issued to contractors or Trading Funds in the capital spares repair loop (CWIs) are 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.

A3.55. 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.

A3.56. Permanent issue, write-off or disposal action is taken in appropriate circumstances.

A3.57. Where materiel is not held on the Departmental Supply System, the PT is responsible for securing the relevant information to ensure financial accounts are complete and accurate via DEFCON 694 (Transactional Information) which can be accessed on the Acquisition Operating Framework (AOF) database.

A3.58. 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 manual.

Embodiment of Capital Spares

A3.59. 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 paragraph A3.48. 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.

A3.60. Capital spares 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). All other issues of capital spares are accounted for in accordance with the guidance given in paragraph A3.48.

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

A3.61. 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 (see paragraph A3.63). 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.

A3.62. 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. However, charges may be levied on the contractor under specific contract conditions.

Assets Issued Direct

A3.63. The majority of assets provided to contractors on CWI or CSI terms will be financially managed by DE&S and held on the Authority's NCAR or on DE&S supply systems, although they may not be under the physical custody of the Authority. In the case of items initially surrendered by TLBs other than DE&S against the issue of a replacement item, the inventory is processed in accordance with standard transfer policies. However, in circumstances where items are issued without replacement direct from TLBs other than DE&S, the items continue to be accounted for by the original owner in accordance with the rules set out in paragraph A3.61 and are not subject to transfer action.

Contract Work Arisings

A3.64. 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

A3.65. Records of CWI and CSI issues should be maintained and returns monitored during and at the end of specified issue periods. This is normally done through centralised management and data support cells in DE&S but for other TLBs local arrangements apply. 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 assets recorded individually in the contractor asset registers.

A3.66. Records include transfers to sub-contractors, write-offs and issues for disposal. However, items issued to the Disposal Services 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.

Asset Transfers

A3.67. 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

A3.68. 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.

A3.69. 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

A3.70. If an asset provided to a contractor is lost, damaged or subject to a repair fault and liability is disclaimed under specific or standard contract conditions, then the owning PT or MG is responsible for the costs associated with replacement or repair. The costs will not be transferred to project costs as described in paragraph A3.62.

A3.71. Where liability is upheld, then the AAC 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

A3.72. 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.

Government Furnished Facilities

A3.73. 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.

A3.74. 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.

A3.75. 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 paragraphs A3.41 to A3.46.

Government Furnished Information

A3.76. 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 paragraph A3.73.

A3.77. 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.

A3.78. 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

A3.79. 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.

ANNEX 4: ACCRUALS AND DEFERRED INCOME

Purpose

A4.1. This annex expands on the guidance in Chapter 8 by providing examples of:

a. the financial accounting entries needed to record transactions which involve accruals and/or deferred income;

b. areas where mistakes have been found in the past and their effect on the Annual Accounts;

c. the correct accounting treatment.

Acquisition of Goods

A4.2. 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

A4.3. 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 (GBA000)	2 2	Create accrual on receipt of laptop computer and red MOD 640.
AP02	Dr. Accruals A/C (GBA000) 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.

A4.4. 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

A4.5. 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) Cr. Capital Accruals A/C (GBA010)	30 30	Create accrual for work performed as at AP01 (i.e. 1/3 of £90m).

Acquisition of Services

A4.6. 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

A4.7. 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.

Figure 3

		£K	
AP07	Dr. SOCNE (NAB000) Cr. Accruals A/C (GBA000)	5 5	Create accrual.
AP08	Dr. SOCNE (NAB000) Cr. Accruals A/C (GBA000)	7 7	Create accrual.
AP09	Dr. SOCNE (NAB000) Cr. Accruals A/C (GBA000)	6 6	Create accrual.
AP10	Dr: Accruals A/C (GBA000) Cr. SOCNE (NAB000) Dr. SOCNE (NAB000) Cr. Payables A/C (GAA000)	18 18 20 20	Reverse cumulative AP7-9 accrual. Create payable.

Example 4

A4.8. 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 (GBA000)	15 15	Create accrual to reflect 30% of courses completed in AP01.
AP02	Dr. SOCNE (NGB000) Cr. Accruals A/C (GBA000)	20 20	Create accrual to reflect 40% of courses completed in AP02.
AP03	Dr. Accruals A/C (GBA000) Cr. SOCNE (NGB000) Dr. SOCNE (NGB002) Cr. Payables A/C (GAA000)	35 35 50 50	Reverse cumulative AP01 accrual. Create payable.

Accruing for Deferred Income and Interest Payable

A4.9. 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.

A4.10. 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

A4.11. 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.

A4.12. 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 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

A4.13. 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.

Accruals – Correct Accounting Treatment

A4.14. To reinforce understanding, the correct accruals accounting treatment is explained below:

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

A4.15. 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.

ANNEX 5: ACCOUNTING FOR PROVISIONS

Purpose

A5.1. This annex expands on the guidance in Chapter 8 by providing:

a. examples of the accounting entries used to create and record transactions associated with both nuclear and non-nuclear provisions;

b. an explanation of the relationship between the time value of money and discount factors, including when it is appropriate to use the nominal or the real discount factor;

c. worked examples of unwinding the discount factor and applying the inflation factor.

Accounting Entries for Nuclear and Non-Nuclear Provisions

A5.2. 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.

Creating Provisions and On-Going Entries

A5.3. The entries for creating a provision to recognise a nuclear provision which does not have a capitalised asset provision are:

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

A5.4. The entries to create a provision to recognise a nuclear provision which does have an associated capitalised asset provision are:

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

A5.5. The entries to depreciate the capitalised asset provision over the life of the associated asset are:

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

A5.6. The entries to unwind the discount are:

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

A5.7. The entries to apply inflation where there is no associated capitalised asset provision are:

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

A5.8. The entries to apply inflation where there is an associated capitalised asset provision are:

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

Changes in Assumptions/Estimates/Prices

A5.9. Inflation adjustments must be made before adjusting for changes in assumptions and/or estimates.

A5.10. Where there is no capitalised asset provision or it has been fully depreciated, the accounting entries are:

	DR	CR
For an increase		
Provision in the SOFP (J*A100)		X
SOCNE (NW****)	X	
For a decrease:		
Provision in the SOFP (J*A200)	X	
SOCNE (NW****)		X

A5.11. If there is a capitalised asset provision which has been fully depreciated, the accounting entries are:

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

A5.12. If the capitalised asset provision has not been fully depreciated, the accounting entries are:

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

Explanation of the Discount Factor and the Time Value of Money

A5.13. 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).

A5.14. In practice, both of the above options should arrive at the same Net Present Value (NPV). However, because the discount rate prescribed by HM Treasury is a real rate, the Department needs to express its cash flows at current prices.

A5.15. 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.

A5.16. 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.

Example

A5.17. 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).

A5.18. 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

A5.19. 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.

A5.20. 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.

A5.21. 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

A5.22. The total NPV and value of the provision at Yr 0 is therefore £2,872. (£978+£957+£937)

Calculating the NPV Using a 'Nominal' Rate

A5.23. 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%.

A5.24. 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

A5.25. 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

A5.26. This example continues from that at paragraphs A5.17 to A5.25. The objective of unwinding the discount factor and applying inflation is to adjust the provision to the value at which it will be settled.

A5.27. 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.

A5.28. 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.

A5.29. 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.

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

A5.30. 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

A5.31. 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).

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

A5.32. The total charged to the SOCNE over the period (£3,142) equates to the value settled.

A5.33. 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 Planning Round should be used.

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

A5.34. 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;

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

Revalorisation: Unwinding the Discount Factor and the Application of Inflation

A5.35. This is covered in paragraphs A5.26 to A5.33.

Change in Assumptions/Previous Estimates

A5.36. 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.

A5.37. Where the provision has not been capitalised, the change in the estimated cash outflow is taken as an adjustment through the SOCNE.

A5.38. The example is continued from that described in paragraphs A5.26 to A5.33.

A5.39. 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.

A5.40. 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

A5.41. 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

A5.42. 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.

A5.43. 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.

A5.44. 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

A5.45. 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 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

A5.46. 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

A5.47. 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.

A5.48. 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:

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.

A5.49. An example of a capitalised provision is provided below. The details are taken from paragraphs A5.36 to A5.46. 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.

A5.50. 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

A5.51. 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 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.

A5.52. The example is followed through from above.

A5.53. 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).

A5.54. 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

A5.55. The revised total provision value in Year 2 would now have been £2,545 compared to £1,018, an increase of £1,527.

A5.56. 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)
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

A5.57. Note that the total value charged to the SOCNE over the period of £4,765 equates to the total amount settled.

A5.58. The same principles apply where a decrease in the provision occurs although advice should be sought from the MOD Accounting Policy Team if this produces a negative value for the capitalised provision.

ANNEX 6: FINANCIAL INSTRUMENTS

Purpose

A6.1. This annex expands on the guidance in Chapter 10 by explaining 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.

A6.2. Appendix A , Appendix B and Appendix 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

A6.3. This annex 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

A6.4. IAS 32 and IAS 39 accounting requirements are detailed below.

Derivatives

A6.5. 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.

A6.6. 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 Appendix C.

A6.7. 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

A6.8. An embedded derivative is a feature within a contract whereby the associated cash flows behave in a similar fashion to a stand-alone derivative.

A6.9. 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.

A6.10. 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;

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.

A6.11. 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 Appendix A for examples of when an embedded derivative is likely to be closely related.

A6.12. 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.

A6.13. If a separable embedded derivative needs to be valued, advice should be sought from the MOD Accounting Policy team. A basic example is provided at Appendix B. 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:

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.

A6.14. 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		

A6.15. 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 the MOD Accounting Policy Team.

Other Investments

A6.16. 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.

A6.17. 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.

A6.18. 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. The MOD Accounting Policy team should be consulted for further direction.

A6.19. 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.

A6.20. In accordance with HM Treasury instructions, the Department's investment in special or 'Golden' shares should not be recognised on the SOFP.

A6.21. 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.

A6.22. 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

A6.23. 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.

A6.24. 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.

A6.25. 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 (i.e. the non-pensions liability discount rate which is a real discount rate and should be applied to cash flows which exclude inflation). However, the MOD Accounting Policy Team should be consulted before such action is taken.

A6.26. 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.

A6.27. 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 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.

A6.28. 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)

A6.29. 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.

A6.30. 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.

A6.31. 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.

A6.32. 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 – i.e. the non-pension liability discount rate.

Financial Guarantee Contracts

A6.33. 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.

A6.34. 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 Chapter 10.

Appendix A to Annex 6

Determining when Embedded Derivatives are Closely Related to the Host Contract

A6.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.

A6.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;

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.

A6.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).

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.

A6.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 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.

A6.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.

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.

Appendix B to Annex 6

Example of How to Value and Account for Embedded Derivatives

A6.B1. During 2011-12 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 2012 (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 2014 (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
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

<u>Statement of Comprehensive Net Expenditure</u>
Dr Fair value loss on embedded derivatives £900

<u>Statement of Financial Position</u>
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

Appendix C to Annex 6

Foreign Currency Forward Contracts

Scope

A6.C1. The policy contained in this appendix is to be implemented by Financial Management Shared Service Centre Accounting & Banking Services Treasury Accountant (A&BS TA).

Properties of the Department's Foreign Currency Forward Contracts

A6.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 €.

A6.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

A6.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.

A6.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.

A6.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.

A6.C7. The fair value of the Department's individual contracts is established by A&BS TA. For audit purposes, A&BS TA should maintain separate 'off-line' records of the individual contract valuations.

A6.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.

A6.C9. When settling the contract, A&BS 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

A6.C10. The following accounting entries should be made in the A&BS Cash and Banking Services MG set of books:

a. on initial recognition, A&BS 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).

A6.C.11. A&BS TA is to seek valuations at APs 6, 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.

A6.C.12. The adjustments made to the financial asset and liability accounts described in paragraph A6.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.

ANNEX 7: LOSSES AND SPECIAL PAYMENTS

Purpose

A7.1. This annex builds on the guidance in Chapter 12 by covering additional aspects of losses and special payments including:

a. the set-off of debts;

b. complaints and remedy;

c. writing a loss's statement for the Annual Accounts;

d. the role of TLB and Agency Audit Committees in reviewing losses and special payments;

e. the information/evidence required to support the closure of losses and special payments;

Set-off of Debts

A7.2. In appropriate circumstances, a common law right of set-off enables mutual debts to be settled between two parties. There are also statutory provisions which allow accounts to be balanced in the event of bankruptcies and liquidations in England, Wales and Northern Ireland. However, these may be overridden by particular statutes which require payment to be made in full.

A7.3. Although under common law the Crown is indivisible, it requires leave of the Court before it can set-off debts relating to another department.

A7.4. As a matter of policy, any common law set-off against superannuation benefits under the Principal Civil Service Pension Scheme (PCSPS) should be confined to:

a. debts which arise directly out of employment by the Crown; and

b. debts where the nature and amount of the debt is acknowledged by the debtor in writing at the time set-off is to be applied.

A7.5. Further guidance on this is available from Civil Service Pensions (CSP) in the Cabinet Office.

A7.6. Where there is excessive delay in settling a claim on another government, departments should consider setting off the claim, wholly or in part. If the department concerned has no counter claim it can make, it should inform the appropriate geographical department of the Foreign and Commonwealth Office, which will investigate the possibility of setting-off the claim against debts due by other departments to the debtor government.

Complaints and Remedy

A7.7. The Department should deal with complaints arising from the services it has provided promptly and consistently. Where groups of complaints raise common issues, remedies offered should be fair, consistent and proportionate.

A7.8. If the Department has caused injustice or hardship because of maladministration or service failure, it should consider:

a. providing remedies so that, as far as possible, it restores the wronged party to the position that he/she would have been in had things been done correctly; and

b. whether its policies and procedures need changing to prevent the failure recurring.

A7.9. The remedies available are:

a. an apology;

b. an explanation;

c. correction of the error or other remedial action;

d. an undertaking to improve procedures or systems; or

e. financial payments, for example, one off or as part of a structured settlement.

A7.10. 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.

A7.11. Before any individual remedy payments are made, the Department must consult HM Treasury about cases which:

a. fall outside its delegated authority; or

b. raise novel or contentious issues; or

c. could set a potentially expensive precedent or cause repercussions for other public sector organisations.

A7.12. The Department must consult HM Treasury 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.

A7.13. It should be noted that payment for non-financial loss should be exceptional and must be approved by the appropriate Senior Finance Officer, except for Service Board redress cases which must be approved by 2nd PUS.

A7.14. The normal approach to complaints where no financial payment is called for is to offer an apology and an explanation. Great care should be taken in designing financial compensation schemes since they may set expensive precedents.

A7.15. 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.

A7.16. Some factors worth considering in deciding financial compensation are:

a. whether a loss has been caused by failure to pay an entitlement;

b. whether someone has faced any additional costs as a result of the action or inaction of the Department - for example, because of delay;

c. whether the process of making the complaint has imposed costs on the person complaining - for example, lost earnings or costs of pursuing the complaint;

d. the circumstances of the person complaining - for example, whether the action or inaction of the Department has caused knock on effects or hardship;

e. whether the damage is likely to persist for some time;

f. whether any financial remedy would be taxable when paid to the complaint.

A7.17. 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.

A7.18. If the Department recognises that it needs a scheme for a set of similar or connected claims arising from maladministration or service failure, it should ensure that the arrangements chosen deal equitably with all potential applicants and take into account the Ombudsman's Principles of Good Administration.

A7.19. If those seeking compensation have suffered injustice or hardship in a way that is likely to persist, it may not be appropriate to pay compensation as a lump sum. Instead it may make sense to award a structured settlement with periodic (such as monthly or annual) payments. The Department should seek both legal and actuarial advice when drawing this up.

Appendix A to Annex 7

Write-off/special payment case checklist

Information required in support of cases of Write-off or Special Payment

A7.A1. A copy of this pro-forma should be completed in conjunction with Chapter 12 and included in the papers supporting the write-off case/special payment.

Information Required	Included? Yes/No	Enclosure
Category of loss or special payment		
Use the full definition.		
Date or period of loss?		
Date or period of Special Payment?		
Gross Value of Loss.		
Amount of Recovery.		
Value of benefits that have or will be transferred to other projects.		
Have any Monies been charged to a control account?		
Which control account?		
How much?		
Date cleared?		
Which RAC used?		
Which RAC has been charged with this loss or Special Payment?		
TLB and UIN		
Has any prosecution or disciplinary action taken place?		
Lessons learnt?		
New procedures or preventative action taken to avoid recurrence?		
Has the Accounting Officer been notified?		
Has the SFO been notified?		
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 Accounts been provided?		
Has written documentary evidence been provided to prove the calculated value of the loss, including agreement by the SFO?		
Special Payment: Has evidence that proves payment has been made been included?		
Has a schedule recording key dates in progressing the case been included?		
Has a Press Brief been provided?		

Appendix B to Annex 7

DEFENCE AUDIT COMMITTEE (DAC)

DAC(06)17 - A guide to writing losses statements for the Annual Accounts 2005-06

(A note by the Secretariat)

A7.B1. The note in the Annual Accounts setting out Losses and Special Payments is one of the first (and sometimes only) part of the accounts that journalists, MPs and their researchers look at, and is routinely scrutinised by the House of Commons Defence Committee. These are key opinion formers for public perception of the management of defence business. They are rarely familiar with accounting terminology and concepts or with the day-to-day business and language of defence. If we are to get over an accurate picture of the Department's performance and high standards the short statements explaining each entry must, as well as meeting the audit criteria of fairness and accuracy, set out the key points of the case for such readers clearly and succinctly, and in terms they can understand. You should therefore write in plain English with minimum use of accounting terminology or defence jargon. The PUS, Defence Board and DAC attach considerable importance to getting this right. The DAC and TLB Audit Committees will scrutinise departmental performance in this area closely.

A7.B2. There can be no single definitive template for a loss statement for the accounts. However, in producing one you should take into account that the more unusual or contentious the item being reported, the more likely it is to generate scrutiny and comment. It is difficult to predict what will be seen as contentious, but as a rule of thumb you should bear in mind that:

a. cash losses and special payments are more contentious than constructive losses, as they raise in the lay reader's mind the possibility that someone has walked away with public money or goods without paying for them;

b. any case where a Minister has been personally engaged is politically sensitive; and

c. anything that the public can easily identify with or has a human face is potentially interesting (examples in recent years include buying torches that rattle for the Special Forces – picked up by The Sun newspaper – and compensatory payments to individuals).

A7.B3. In this context, when drafting text on a loss for publication in the accounts, the sort of points you should aim to explain are:

a. what caused the loss or potential loss;

b. whether or not it arose for reasons beyond the Department's control;

c. whether or not it arose as a result of deliberate management action (such as when a project is cancelled, incurring a constructive loss, because the Department has decided that it is no longer a high enough priority to be funded in the defence programme; it is not going to deliver what is needed; or our requirement has changed);

d. in the case of gifts and special payments, what exactly was provided; who it has been given to; and why (making clear when payments have been made because the Department had a legal obligation to do so).

A7.B4. Not all of these will be relevant to every case. Try not to be excessively discreet or secretive. This never gives a good impression and can easily come over as trying (and failing) to hide incompetence. Moreover, under the Freedom of Information Act we are under an obligation to be as open as possible about what we do. A good rule of thumb is that if it's in the material you produce for the press office (which will always be required for every loss or special payment reported in the Annual Accounts), or if the Department has already said it in public, you can say it in the loss statement. It goes without saying that you should also keep the entry as short as possible!

Appendix C to Annex 7

GUIDANCE FOR TLB AND AGENCY AUDIT COMMITTEES ON THEIR ROLE IN REVIEWING LOSSES AND SPECIAL PAYMENTS

CONTENTS

GUIDANCE FOR TLB AND AGENCY AUDIT COMMITTEES ON THEIR ROLE IN REVIEWING LOSSES AND SPECIAL PAYMENTS

INTRODUCTION

A7.C1. Losses and special payments are one of the indicators of a possible failure of internal controls. As such, TLB and Agency Audit Committees have a role to play in providing the leadership which makes it absolutely clear that all losses and special payments are to be pursued and closed in a timely fashion. One of their key responsibilities is to seek assurance about the accuracy and completeness of the losses statement.

A7.C2. The aim of this guidance, which has been endorsed by the Defence Audit Committee (DAC) and covers TLB, Agency and other subordinate audit committees but not NDPBs and Trading Funds, is to define more clearly the role and scope of audit committees' responsibilities. In doing so, it seeks to promote a commonality of understanding, and in turn to encourage a consistency of approach.

A7.C3. The guidance, which recognises that TLBs and Agencies operate in different business environments and that the circumstances under which losses and special payments arise are often different, is not overly prescriptive. Instead, it offers wide ranging advice on the type of issues which an audit committee may encounter during a systematic review of losses and special payments. It advocates the identification and dissemination of best practice, as well as the importance of learning from experience, both of which are fundamental to maintaining and/or improving the effectiveness of internal controls.

A7.C4. A summarised guide to the list of actions which an audit committee should consider is provided at Sub Appendix C-1-1. Sub Appendix C-2-1 provides a checklist of information and evidence which is needed to support the closure of losses and special payments.

BACKGROUND

A7.C5. In voting money or passing specific legislation, Parliament does not include provision for losses or special payments. Such transactions are therefore subject to greater control than other payments. Public sector organisations should only consider writing off losses after careful appraisal of the facts (including whether all reasonable action has been taken to effect recovery) and should be satisfied that there is no feasible alternative. In dealing with individual cases, departments must always consider the soundness of their control systems and the efficiency with which they have been operated. Departments must take the necessary steps to put failings right.

A7.C6. To provide visibility of the value and number of losses and special payments that are occurring, departments are required to provide an annual accountability statement, which lists individual losses and special payments above £250k, and also provides a summation of the number and value of all losses, regardless of their value. This statement is included within the Departmental Resource Accounts and is subject to NAO audit. Categories of losses and special payments are explained at Sub Appendix C-3-1.

A7.C7. The NAO's Good Governance Programme seeks to promote the improved management of risk and the more effective delivery of public services and stewardship of resources. As part of this, the NAO has reviewed the Department's management of losses and special payments and has made a number of recommendations, all of which the Department has accepted. One of these recommendations is the need to clarify and extend the role of audit committees in the management of losses and special payments.

A7.C8. The guidance, which follows, outlines the areas in which audit committees can most effectively engage. It also supports the requirement, referred to in JSP 472, for TLBs to involve their audit committees in reviewing losses and special payments. By extending the ambit of their review, audit committees can ensure that any systemic control issues are identified early and that appropriate corrective action is taken. This will in turn provide the appropriate assurance for inclusion in the Process Owners Report, or if necessary the TLB Holder's Annual Assurance Report to the Accounting Officer.

ROLE OF THE AUDIT COMMITTEE

A7.C9. Recognising that the system of internal control is designed to manage risk to a reasonable level, rather than to eliminate all risk of failure, audit committees should concentrate on a high level review of significant losses and special payments. Generally speaking, this should become a standing agenda item which focuses on areas that are fundamental to a TLB's/Agency's particular business. However, where a TLB/Agency has a relatively low number of smaller value losses and is satisfied that the losses statement is accurate and complete, it may consider a regular review of its position to be sufficient.

A7.C10. In reviewing losses and special payments data, audit committees should select a random sample of cases, based on a materiality level which is appropriate to their TLB or Agency. To ensure accuracy and completeness of data they should also receive data on numbers and value of all losses and special payments. In both cases they should consider whether, for example:

a. any trend appears to be emerging in terms of the value, number and/or type of loss occurring, as this may help to detect problems arising from a large number of relatively small value losses. In addition, when losses and special payments are based on the whole population but aggregated at a higher level, whether the trend shows the TLB/Agency to be consistently managing its losses and special payments effectively;

b. any particular trigger factors can be identified, and if so, whether it was appropriate for a loss or a special payment to have been made. In addition, whether common factors are giving rise to losses and special payments and whether there are lessons to be learned;

c. there is any culpability involved and, if so, whether appropriate safeguards have been implemented to prevent similar circumstances arising in the future;

d. there are any particular factors which are giving rise to fruitless payments and, if so, whether appropriate management controls are now in place to reduce/eliminate them;

e. all possible recovery action has been taken. Where recovery action is in hand, a progress report should be requested;

f. any fraud is involved, and if so, the details of it, likewise whether any of the losses are novel, unusual or complex. This is particularly important where there is likely to be public interest because of the nature of the fraud or the individuals involved;

g. all unsupported asset balances have been identified, written off and included in the TLB/Agency losses reports.

A7.C11. Audit committees should ensure that losses are reported up the chain of command at the earliest opportunity and that their declaration in the note to the accounts is not delayed pending audit committee consideration.

A7.C12. Since the occurrence of both single large losses and groups of smaller but related losses may be linked to defects in organisation, administration, management, supervision or inadequate systems, audit committees should consider whether adequate action is being taken by management to prevent or reduce the risk of similar occurrences in the future. This should include identifying best practice that can be brought to bear from elsewhere, as well as testing whether any parts of the organisation are failing to apply examples of best practice previously identified. Audit committees should assure themselves that a satisfactory process is in place for promulgating lessons learned.

A7.C13. As a starting point, audit committees should challenge the adequacy of losses understanding, also questioning the degree to which the practice of identifying, promulgating and acting upon lessons learned has been embedded within the organisation. If there is no central source of TLB/Agency expertise, audit committees should recommend that one be created and that it should consist of appropriately trained staff, as well as up to date and consistent guidance. They should also ensure that the organisation has taken the requisite steps to let staff know of its existence and that it is readily accessible.

A7.C14. Audit committees should ensure that management is making appropriate use of project management techniques for progressing losses cases. By requesting an aged listing of losses cases, audit committees will be able to monitor progress towards closure and will also be able to use it to highlight any cases where action needs to be accelerated.

A7.C15. Where any deficiencies are identified, audit committees should consider whether it is appropriate to secure Management Board level support for any corrective action which is to be implemented, as this will demonstrate commitment from the highest level of the organisation.

A7.C16. In such cases, audit committee members should provide a progress update at subsequent Board meetings. If progress appears to be stalling, they should join forces with the Board in demonstrating the leadership required to ensure that momentum is restored. The use of resources such as internal and external expertise, as well as project management techniques should be considered.

A7.C17. Above all, audit committee members should satisfy themselves that any action taken will result in resources being controlled more effectively in the future. A statement to this effect should be included in their report to the Board, as it will provide a level of assurance as to the effectiveness of risk management and internal controls. Such evidence can then be used to inform TLB holders' Annual Assurance Reports and Agency Chief Executives' Statements on Internal Control.

A7.C18. Although audit committees will generally be concentrating on a high level review of losses and special payments, the HM Treasury Audit Committee Handbook questions how an audit committee can know whether losses have been suitably recorded or how confident it can be that assurances have drawn appropriate attention to material weaknesses or losses which need to be addressed. This means that, in some instances, there may be losses which warrant closer attention, such that the audit committee will wish to be satisfied that:

a. The value of the loss can be supported.

b. The loss has been correctly recorded in the losses register.

c. The authorising officer had the appropriate delegation for writing off the loss.

d. Appropriate documentation has been prepared to support the formal losses write-off procedure for any case, where the value of the loss has already been reflected as a write-off in the general ledger.

A7.C19. Where it is decided that a significant loss (i.e. one whose value exceeds £250K) does not require disclosure because, for example, the expenditure has been incurred in assessing the viability of a project which has been rejected on the grounds of value for money, the audit committee concerned should satisfy itself that the decision is valid and can be adequately supported. As such decisions will set the precedent for future cases, it is important that a clear decision-making audit trail is maintained. Equally important is the need for the audit committee to confirm that best practice is being applied to the management of such losses.

A7.C20. Audit committees should also consider whether the culture of the organisation is such that there may be a reluctance to report losses, either because people are unwilling to admit responsibility or TLBs do not wish to have a write-off in their accounts. Although this may be difficult to detect, it is nevertheless recommended that audit committees remain alert to this possibility, as the Department could usefully rely on an independent assessment of this risk. Should there be any perception that this is occurring, the audit committee must bring it to the attention of the TLB's/Agency's Management Board.

A7.C21. Experience has shown that there are a number of common factors which give rise to losses and special payments (e.g. industrial shortcomings; poor specifications; changes in requirements; human error and accidents). Therefore, it is of great importance not only that lessons are learned, but also that they are widely promulgated. To test TLBs' effectiveness in this area, audit committees should review where this information is kept; how accessible it is and how frequently it is updated. Ideally, they should encourage the use of a "learning from experience" website, which should include access to losses guidance, as well as a list of names and telephone numbers of people who can provide additional help such as training.

A7.C22. After each review of losses and special payments, audit committees should include in their report to the TLB holder an assessment of any strengths and weaknesses in control, also making suggestions as to how these weaknesses should be addressed. They should also offer an opinion as to the effectiveness of the system used to manage losses and special payments, as this will provide the TLB holder with independent and objective evidence which can be included in the TLB's Annual Assurance Report or the Chief Executive's Statement on Internal Control. It can also be used by TLB holders to provide assurance to the Accounting Officer, via the DAC, that losses and special payments have been adequately reviewed, and that where any areas of concern exist, appropriate remedial action is in place to prevent any further occurrence.

USEFUL REFERENCE DOCUMENTS

A7.C23. The following can be obtained via your secretariat:

a. NAO Good Governance Programme. MoD Management of Losses and Special Payments. This report was published for use by the Department. Therefore, although NAO has not published either the report or the summary version on its external website, it has made copies available to Non-Executive Directors at various meetings which it has attended;

b. the Losses and Special Payments Note to the Department's Annual Report and Accounts;

c. HM Treasury Audit Committee Handbook;

d. Managing Public Money.

Sub Appendix 1 to Appendix C

ACTIONS TO BE CONSIDERED BY TLB AND AGENCY AUDIT COMMITTEES IN THEIR REVIEW OF LOSSES AND SPECIAL PAYMENTS

A7.CS1-1. Audit committees should seek assurance as to the accuracy and completeness of losses statements. They should also ensure that losses and special payments are reported up the chain of command at the earliest opportunity; and that the declaration in the note to the accounts is not delayed pending audit committee consideration.

A7.CS1-2. Audit committees should generally concentrate on a high level review of significant losses and special payments, making this a standing agenda item which focuses on areas that are fundamental to a TLB's/Agency's particular business. However, where a TLB/Agency has a relatively low number of smaller value losses and is satisfied that the losses statement is accurate and complete, a regular review of its position may be sufficient.

A7.CS1-3. The use of project management techniques, as well as the use of internal and external expertise, should be adopted for progressing losses cases.

A7.CS1-4. Audit committees should routinely request an aged listing of losses cases, as this will help them to monitor progress towards closure and also identify cases which need to be accelerated.

A7.CS1-5. Audit committees should select a random sample of cases and, during their review of each, should consider whether, for example:

a. any trend appears to be emerging in terms of the value, number and/or type of loss occurring. To ensure accuracy and completeness of data, they should receive data on numbers and values of all losses and special payments;

b. any particular trigger factors can be identified, and if so, whether it was appropriate for a loss or special payment to be made. They should also review the management action being taken to eliminate these triggers;

c. there is any culpability involved and, if so, whether appropriate safeguards have been implemented to prevent similar circumstances arising in the future;

d. there are any particular factors which are giving rise to fruitless payments and, if so, whether appropriate management controls are now in place to reduce/eliminate them;

e. all possible recovery action has been taken. Where recovery action is in hand, a progress report should be requested;

f. any fraud is involved, and if so, the details of it; also whether there are any losses which are novel, unusual or complex, particularly where there is likely to be public interest because of the nature of the fraud or the individuals involved;

g. all unsupported asset balances have been identified, written off and included in the TLB/Agency losses reports.

A7.CS1-6. Audit committees should consider whether there is any best practice that can be brought to bear, and also whether any parts of the organisation are failing to apply examples of best practice previously identified.

A7.CS1-7. Audit committees should challenge the adequacy of losses awareness training, also questioning the degree to which the practice of identifying, promulgating and acting upon lessons learned has been embedded within the organisation. They should review the process for disseminating examples of best practice, as well as lessons learned.

A7.CS1-8. If there is no central source of TLB/Agency expertise, audit committees should recommend that one be created. They should also confirm that the organisation has taken steps to advertise its existence as widely as possible, satisfying themselves that it holds up to date; consistent and easily accessible guidance.

A7.CS1-9. Where any deficiencies are identified, audit committees should consider whether it is appropriate to secure Management Board level support for any corrective action which is to be implemented, as this will demonstrate commitment from the highest level of the organisation.

A7.CS1-10.Audit committee members should satisfy themselves that any action taken will result in resources being controlled more effectively in the future. A statement to this effect should be included in their report to the Board, as it will provide a level of assurance as to the effectiveness of risk management and internal controls.

A7.CS1-11.Where losses cases warrant closer attention, audit committees should draw on the evidence which TLBs/Agencies are required to produce to support a losses case, satisfying themselves (at a minimum) that:

a. the value of the loss can be supported;

b. the loss has been correctly recorded in the losses register;

c. the authorising officer had the appropriate delegation for writing off the loss;

d. appropriate documentation has been prepared to support the formal losses write-off procedure for any case, where the value of the loss has already been reflected as a write-off in the general ledger.

A7.CS1-12.Where TLBs/Agencies decide that a significant loss (i.e. one whose value exceeds £250K) does not require disclosure, audit committees should satisfy themselves that the decision is valid and can be adequately supported.

A7.CS1-13.Audit committees should ensure that a clear decision-making audit trail is maintained and should confirm that best practice is being applied to the management of such losses.

A7.CS1-14.Audit committees should remain alert to the possibility that the culture of the organisation may discourage losses from being reported, and where there is any perception of this occurring, should bring it to the attention of the TLB's/Agency's Management Board.

A7.CS1-15.To test TLBs'/Agencies' effectiveness in learning from experience, audit committees should review where this information is kept; how accessible it is and how frequently it is updated.

A7.CS1-16.Audit committees should encourage the use of a "learning from experience" website, which should include access to losses guidance, as well as a list of names and telephone numbers of people who can provide additional help such as training.

A7.CS1-17.After each review of losses and special payments, audit committees should include in their report to the TLB holder:

a. an assessment of any strengths and weaknesses in control, also making suggestions as to how these weaknesses should be addressed;

b. an opinion as to the effectiveness of the system used to manage losses and special payments.

Sub Appendix 2 to Appendix C

A7.CS2-1. CHECKLIST OF INFORMATION/EVIDENCE TO SUPPORT THE CLOSURE OF LOSSES AND SPECIAL PAYMENTS

Information Requirements
Description of the loss/special payment.
Category of loss/special payment, using its full definition.
Date or period of loss/special payment.
Gross value of loss. Amount of recovery. Value of benefits that have/will be transferred to other projects.
Value of the loss/special payment charged to a control account. Name of control account. Date cleared. Resource Account Code against which the loss has been charged. TLB and UIN information.
Details of any prosecution or disciplinary action.
Details of lessons learned.
Details of new procedures or preventative actions that have been implemented to avoid future recurrence.
Confirmation as to whether of not the Accounting Officer has been notified.
Confirmation as to whether or not the Senior Finance Officer has been notified.
Confirmation that the loss has already been reported to the CFAT team.
Confirmation that the TLB Senior Finance Officer has been notified.

Evidence Required
A copy of the approving officer's letter of delegation.
Documentary evidence to support the calculated value of the loss or special payment.
Written agreement from the Senior Finance Officer for the loss to be written off/special payment made.
For special payments, proof that payment has been made.
A schedule recording key dates for progressing the case.
A draft note suitable for inclusion in the Annual Accounts.
A press brief for use when the Annual Accounts are published.

Sub Appendix 3 to Annex C

CATEGORIES OF LOSSES AND SPECIAL PAYMENTS

A7.CS3-1. MOD has delegated authority to write off all losses and special payments up to £100m which fall into Group 1, unless they are novel or contentious, in which case approval must be sought from HM Treasury.

A7.CS3-2. Authority to write off Group 2 losses and special payments can only be given by HM Treasury.

Type	Sub-Type	Description	Delegation Group
A	A(i)	**Cash losses:** Physical losses of cash and cash equivalents (e.g. bank notes, credit cards, electronic transfers, payable orders).	1
	A(ii)	**Bookkeeping losses:** Losses arising from un-vouched or incompletely vouched payments, including missing items, or because of charges to RfRs to clear inexplicable or erroneous debit balances.	1
	A(iii)	**Exchange rate fluctuations.** Losses arising from fluctuations in exchange rates or revaluations of currencies.	1
	A(iv)	**Losses of pay, allowances and superannuation benefits** paid to civil servants, members of the armed forces and non-departmental public bodies employees:	
		• overpayments due to miscalculation, misinterpretation, or missing information;	1
		• unauthorised issues - e.g. inadmissible payments;	1
		• losses arising from other causes, e.g. non-disclosure of full facts by the beneficiary, short of proven fraud.	2
	A(v)	**Losses arising from overpayments** of social security benefits, grants, subsidies, etc, arising from miscalculation, misinterpretation or missing information.	2
	A(vi)	**Losses arising from failure to make adequate charges** for the use of public property or services.	2
B	B(i)	**Losses of accountable stores:** Losses are the result of proven or suspected fraud, theft, arson or sabotage, or any other deliberate act (including repairable damage caused maliciously to buildings, stores, etc. even where a legal claim is not possible).	1
	B(ii)	**Losses of accountable stores:** Losses arising from other causes.	1
C	C(i)	**Fruitless payments**	1
	C(ii)	**Constructive losses**	1
D		**Claims waived or abandoned:** **Up to £250,000** **£250,000 and above**	 1 2

Description	**Delegation Group**
Special payments: extra-contractual and *ex gratia* payments to contractors.	**2 (and see Note 1)**
Special payments: other *ex gratia* payments: Up to £250,000 £250,000 and above	 **1** **2**
Special payments: special severance payments	**2**
Special payments: compensation payments: Compensation payments made on legal or other professional advice up to £250,000 Other compensation payments	 **1** **2**
Special payments: extra-statutory and extra-regulatory payments: Up to £250,000 £250,000 and above	 **1** **2**

Note 1: Extra-contractual payments to contractors, not exceeding £1,000,000, involving Departmental default and made other than on legal or other appropriate professional advice fall into Delegation Group 1.

ANNEX 8: NON-CURRENT ASSET NON-FINANCIAL DATA STANDARDS

A8.1. 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 Single Balance Sheet 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.
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.