Scotland's Colleges

# Finance CoP

# Briefing Paper

## Shared Services

September 2012

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# 1. INTRODUCTION

This paper follows on from the previous paper prepared on shared services "Guide To Shared Services" where the differences between shared service models such as collaboration, informal arrangements, partnering, outsourcing and in-sourcing were considered.

The purpose of this paper is to consider the accounting, tax, VAT and legal implications of each of the shared service models to a College who may enter into a shared services arrangement.

## Background

Shared services is a concept which has gathered momentum over the past few years. The biggest contributing factor to the increased use of and discussion surrounding shared service comes from the government funding cuts for public sector organisations, in particular Colleges. In an effort to reduced costs a number of Colleges have been exploring the idea of shared services and the various models in which a shared service may take.

Once the decision has been made to share services with other Colleges or other external parties the College must decide on the most appropriate model in which the sharing of resources should take. In making this decision the College must weigh up the various accounting requirements, tax, VAT and legal implications. If the wrong method is selected there is a risk that the cost savings made in sharing services are eroded by the increased resources required in complying with the accounting rules, tax rules, VAT rules and legal requirements.

# 2. COLLABORATION

## Description

The collaboration shared service model may take a number of forms.

- It could involve a joint procurement exercise;
- the creation of a network of Colleges;
- forming a separate entity to provide services (this is discussed further in section 4).

Joint procurement involves Colleges working together to jointly procure for provision of services to all of the Colleges involved. Upon deciding the successful supplier, contracts are drawn up between the supplier and each individual College. This is the current practice of many Colleges in Scotland who use APUC for joint procurement.

As well as having an external body procuring on behalf of the Colleges, another option could be to have a group of Colleges (A, B and C) come together in joint procurement where one College (A) enters into a contract with an external supplier and then enters into a sub-contract with the other Colleges (B and C) with re-charges being agreed between Colleges A and B and A and C.

The creation of a network of Colleges could be used to procure services jointly and/or provide services to the network members from other Colleges within the network, for example, College A provides services to College B.

## Accounting Treatment

## Joint Procurement

Colleges which have collaborated in a joint procurement exercise and the contract with the supplier is with the individual college, can treat this transaction on the same basis as any other supplier contract with no additional accounting entries required.

Should one College (A) enter into a contract with an external supplier on behalf of several Colleges (A, B and C), there may be agreements between the Colleges (A and B and A and C) to recharge Colleges B and C's share of the costs. The re-charge calculation should be agreed in writing. This will require to be calculated and College A will issue sales invoices to College's B and C. College's B and C should be set up as a customer within the accounting system of College A. College's B and C will receive invoices from College A and College A should be set up as a supplier within the accounting system of College's B and C.

## Collaboration Network

It is important to note that the creation of a collaboration network does not involve the creation of a new separate entity but is a joint arrangement. The Accounts Direction Handbook 2010/11 explains:

*"The following are examples of joint arrangements that are not separate entities:*

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

Colleges sharing resources meet the definition of a joint arrangement as there is no separate entity for which profits or losses can occur and be distributed among the College members.

Where the members of a collaboration network have an agreement in place the lead College may incur all of the costs for the operating of the service provided but is recharged the percentage used by the other college members. In operating this service the lead college may have the assets and liabilities necessary

to perform this function. As a result these assets and liabilities should be recognised proportionately by the other College members as collectively they are responsible for the assets and liabilities. The Accounts Direction Handbook 2010/11 provides an example of where this would occur and how the individual colleges should account for this situation:

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

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

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

*Each College will record within its operating activities:*

- *Its contribution to running cost;*
- *The costs of developing learning materials;*
- *Depreciation on its share of assets;*
- *Its share of release of deferred capital grant.*

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

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

As a result of this treatment each College will reflect the appropriate assets, liabilities and expenditure within their accounts. This will aid the College to assess if they are actually achieving the cost savings set out when they set up / joined the collaboration network. An example of this accounting treatment can be found at appendix A.

## Direct Tax Implications

Joint procurement, where the contract is between the supplier and the individual college would have no particular tax implications.

Where one college, A, enters into a contract with an external supplier on behalf of Colleges B and C and A recharges B and C, then the activity may amount to a trade in College A. In order for the trade not to be taxable within College A, one of the exemptions would have to apply.

The possible exemptions (which all have as a pre-condition that the income is applied for charitable purposes) are:

1. Trading exercised in the course of carrying out a primary purpose, for example the provision of educational services. This exemption is extended to cover trading which is ancillary to the carrying out of a primary purpose. An example given by HMRC is the sale of goods, or provision of services, for the benefit of students by a college. However, where the services provided are more in the nature of management (for example the provision of an HR or Finance function) reliance would almost certainly have to be placed on the "small trading" exemption set out in 3. below.
2. Trading mainly carried out by beneficiaries. As this is unlikely to apply, we have not explored this exemption further.
3. "Small trading" – where turnover does not exceed £5,000 or, if turnover is greater than £5,000, where it does not exceed 25% of the college's total incoming resources, subject to an upper limit of £50,000.

If these limits are likely to be exceeded, consideration would have to be given to the use of a subsidiary as set out in Section 4 "Partnering: Creation of Third Party Entities".

## VAT Implications

We consider the Joint Procurement of HR services between 3 colleges whereby College A enters into a contract with an external HR provider and then enters a sub contract with two other Colleges (College B and College C). The VAT implications are as follows:

- College A receives an invoice from the HR provider who charges Output VAT as the HR provider is VAT registered; and
- College A reclaims some of the VAT it incurs in full. If we assume that college A receives 20% of the services for itself and recharges 80% to Colleges B and C, College A can reclaim 80% of the VAT in full and accounts for the remaining 20% through their business / non business and partial exemption calculation as this element (20%) is an overhead cost. College A is able to reclaim 80% of the VAT it incurs from the external HR provider as it is going to make an onward taxable supply to Colleges B and C , i.e. College A charges VAT on their invoice to College B and to College C. College B and College C process this VAT charge in accordance with their business / non business and partial exemption calculation.
- We now consider the implications for each College if the collaboration network is funded by a grant and this grant is received by the lead College (College A) in this instance. The VAT implications are as follows:
- College A receives the grant and accounts for 33.33% of income it receives via its normal VAT accounting procedures (for grants);
- As College A then passes 33.33% to College B and the same to College C this element of the grant (received by College A, to pass on to College B and College C) is excluded from College A's business / non business and partial exemption income as it is not their income. College A is only acting as a conduit for passing the grant (to College B and College C); and
- This income in the books of College B and College C is processed via its normal accounting procedures (for grants) i.e. in the same manner as College A treated the 33.33% it retained.

## Legal Implications

There are unlikely to be significant employment law implications where Colleges collaborate in the absence of a new entity being set up (again this is discussed in section 4).

The only potential issue that could arise in a general collaboration would be if a particular employee of one college becomes solely responsible for the procurement process for all colleges within the collaboration. The 2 specific issues this could raise are:

- Would the employee, through custom and practice, be found to be jointly employed by all colleges in the collaboration?
- Could the reliance on an employee of one particular college result in a redundancy situation within the other colleges, as a result of those colleges no longer requiring to employ someone to perform that work?

These considerations would also arise in a model whereby College A directly provides services to College B and others. However, there is one further issue which would arise from such a model that creates a potentially bigger issue.

This relates to the service provision change rules contained in the Transfer of Undertaking (Protection of Employment) Regulations 2006 (about which more detailed guidance was given in the Finance CoP Briefing Paper issued in March 2012). These create a situation whereby a TUPE transfer should take place where there is a transfer of activities from one organisation to another and there is an organised grouping of employees who perform those activities. This would seem to create 2 possible issues:

- Employees who, up to the collaboration being formed, performed specific procurement activities for College B, asserting that they should be transferred to College A along with the work;
- Alternatively, employees of College B having to be made redundant; and
- Employees employed by College A asserting that they should transfer to any 3rd party who becomes responsible for the procurement work should the collaboration come to an end.

# 3. INFORMAL AGREEMENTS

## Description

Informal agreements for shared services could come in a variety of arrangements including loose non-contractual arrangements, for example the sharing of information between Colleges or a written agreement such as a service level agreement.

## Accounting Treatment

### Verbal arrangements

Colleges which share services through a verbal arrangement have no obligation to provide services or information to the other party in the arrangement. As a result there is no specific accounting treatment for this type of arrangement. The provision of services should be treated as any other supplier transaction.

### Written arrangements

Where Colleges have written arrangements in place, depending on the wording of this agreement, there could be an argument that this constitutes a contract. In instances where the agreement is considered a contract and such contract straddles the period/year end a disclosure note is required to be included detailing this commitment. An example of this type of disclosure is included in Appendix B. Other than this disclosure there is no other specific accounting treatment for this type of arrangement. The provision of services should be treated as any other supplier transaction.

### Direct Tax Implications

Whether an agreement is written or verbal makes no difference to the tax position. It is the particular facts of the situation that determine the tax treatment, although a written agreement would be useful in helping to establish the evidence in relation to the facts.

### VAT Implications

VAT is a transaction based tax and each transaction must be looked at individually. Where there is no payment (payment is known as 'consideration' in VAT terms) there is no supply for VAT purposes. Where there is no supply there is no VAT charge applied. However, where there is a Service Level Agreement in place there may be the increased likelihood of HMRC believing a service is being supplied by one college and received by another. Therefore Colleges should consider carefully if Service Level Agreements are necessary for informal arrangements.

### Employment Law Implications

There are unlikely to be any employment law implications where an informal agreement is in place.

# 4. PARTNERING: CREATION OF THIRD PARTY ENTITIES

## Description

This model is a variation of outsourcing and involves the creation of a separate entity to allow the provision of one or more services to be outsourced. The separate entity can take many different legal forms but most common used for shared services is a limited company. The new entity would then provide the specific services e.g. HR function, finance function for the Colleges that have set up the new entity.

## Accounting Treatment

If a number of Colleges set up a new entity the Colleges are effectively introducing a joint venture into their organisational structure. The joint venture vehicle could take one of the following forms:

- Company Limited by Shares;
- Company Limited by Guarantee; or
- Limited Liability Partnership.

## Joint Venture

FRS 9 Associates and Joint Ventures describe a joint venture as:

*"An entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by the reporting entity and one or more venturers under a contractual arrangement."*

Joint control is considered to exist when collectively the Colleges can make decisions on the operation of the entity but where none of the Colleges individually would have control of the organisation.

The creation of a joint venture would involve each of the Colleges contributing an agreed proportion of the equity and assets into the newly formed company.

The Colleges may be required to consolidate the joint venture into College using the equity method of consolidation. FRS 9 *Associates and Joint Ventures* specifically prohibits the use of proportional consolidation.

If the joint venture is consolidated, the investment is brought into the College accounts by taking the amount of equity contributed by the College and debiting this amount to investments whilst either the payment/creditor is credited to balance the journal.

*"If the partnership is deemed to be a joint venture, then the following treatment should be applied on consolidated accounts:*

- *The share of the joint venture income should be shown as a deduction from group income (which will include it);*
- *The share of operating surplus of the joint venture should then be added back in; and*
- *The share of assets and liabilities of the joint venture should be shown on the balance sheet under investments."*

By performing these adjustments the College is accurately reflecting the surplus or deficit made by the joint venture which is attributable to the College as well as incorporating the proportion of assets and liabilities for which the College is responsible for.

The Statement of Recommended Practice: Accounting for Further and Higher Education (2007 SORP) explains the circumstances where consolidation of a subsidiary is not required:

*"FRS 2 (revised) requires that a subsidiary undertaking should be or is permitted to be excluded if:*

- *Inclusion is not material for the purposes of giving a true and fair view;*
- *The institution's rights over the assets, or the management of the subsidiary undertaking, are severely restricted; or*
- *Subsequent resale of the subsidiary undertaking was intended at the time of acquisition and the subsidiary undertaking has not previously been included in the consolidated financial statements."*

The College is not required to consolidate a joint venture if it believes that the entity is immaterial and would not hinder the true and fair view of the accounts. In this case a disclosure is required explaining this treatment. Again the Statement of Recommended Practice: Accounting for Further and Higher Education provides guidance on the information to be included within this disclosure:

*"Where an associate or subsidiary undertaking is excluded from consolidation, provided that this exclusion complies with FRS 2 (revised), the notes to the accounts must disclose (in accordance with the requirements of FRS 2 (revised) and, where an institution is incorporated as such, the Companies Act):*

- *The name of the associate or subsidiary undertaking excluded;*
- *Any qualification contained in the auditors' report on the associate or subsidiary undertaking's financial statements for the relevant financial year;*
- *The aggregate amount of the associate's or subsidiary undertaking's capital and reserves at the end of its relevant financial year and its profit or loss for the period, unless the associate or subsidiary undertaking is included in the consolidated financial statements using the equity method;*
- *The reasons why the associate or subsidiary undertaking is not dealt with in the consolidated financial statements;*
- *Details of balances and transactions between the excluded associate or subsidiary undertaking(s) and the rest of the group;*
- *The nature and extent of transactions of the excluded subsidiary undertakings with the rest of the group;*
- *Any guarantees or indemnities given by the group or a member of it in respect of the associate or subsidiary undertaking."*

An example of such disclosure is set out in appendix C.

As noted above, a joint venture could take a number of legal forms. The most common legal forms are noted below:

## Company Limited by Shares

A company limited by shares is the legal form of most trading companies. Each of the College's involved would be required to purchase a number of shares in the company which will determine their voting power.

The Colleges would be able to obtain any surplus made by the company by way of dividends paid to each College which is likely to be based on the proportion of shares they own. Allocation of shares and related dividends could be set out in the company's memorandum and articles of association.

## Company Limited by Guarantee

A company limited by guarantee mirrors the form of a company limited by shares but does not have share capital and therefore does not have any shareholders but member Colleges who control it. Companies limited by guarantee are widely used for not-for-profit organisations. They follow the rules surrounding companies limited by shares but do not pay out dividends. Instead the College could receive any surplus in the form of gift aid from the joint venture.

The company would be subject to corporation tax on any profit. Any gift aid would require to be paid within 9 months to help shelter the company from corporation tax.

## Limited Liability Partnership (LLP)

A LLP is an entity set up where all partners have limited liability. Within a partnership agreement one College would not be responsible for another College's misconduct or negligence. Similar to companies the College may have to consolidate their percentage of ownership into consolidated accounts. Per the Statement of Recommended Practice Accounting by Limited Liability Partnerships, the College would be entitled to *"any share of profits arising from a division of profits that is discretionary on the part of the LLP (i.e. where the decision to divide the profits is taken after the profits have been made)"*.

## Charitable Status

As all Colleges are registered charities, the board members (trustees under charities legislation) are under obligation to ensure that the best use is made of the charities funds. If the charity supports the joint venture financially, the charity must be able to justify the support they are giving a trading subsidiary as an appropriate investment of the charity's resources. In all cases the interests of the charity must be paramount.

The College must be able to demonstrate that the creation of the new subsidiary is to benefit the College. If this subsidiary subsequently finds itself in financial difficulty the College must consider the interests of the College ahead of the joint venture.

As a result of this the College would require to closely monitor the performance of the subsidiary to ensure that it is not relying on additional funding from the Colleges i.e. over and above the costs of providing the service.

## Direct Tax Implications

A subsidiary company (whether limited by shares or guarantee) is a separate entity for tax purposes. The company would be subject to corporation tax on any profits. Taxable profits can be reduced by charitable donations. Dividends paid by the company would not be taxable in the recipient college, but the company would not receive tax relief on dividends, which are payable out of taxed profits.

Care must be taken to ensure that the subsidiary retains sufficient funds for working capital purposes. Charitable donations accrued in any accounting period can be retained for up to 9 months following the company's year end and tax relief will be given in the year of accrual. This is useful for cash flow purposes. However, if the company is only able to operate due to funding by the college (or colleges if jointly owned) then this may affect the charitable status of the college(s). Therefore, it may not always be possible for the subsidiary to make a charitable donation of all of its profits every year. And any loan from a college to the subsidiary would have to be carefully considered.

The initial share subscription in, and subsequent funding of, the subsidiary would be investments of the

college. In order to ensure that the college does not lose its charitable exemptions, investments must be for charitable purposes only, for the benefit of the charity and not for the avoidance of tax. Investments are made for charitable purposes and for the benefit of the charity if they are commercially sound. Normally, a loan would have to be adequately secured, carry a commercial rate of interest and be made under a formal agreement which included reasonable repayment terms.

Colleges may be unlikely to receive normal security for loans to trading subsidiaries. If so, HMRC may request the business plan, cash flow forecast and other business projections that informed the college's decision to make the investment or loan. HMRC would be particularly concerned with subsidiary companies which donated all of their profits every year to the college and would be unable to retain sufficient funds required to carry on business. A pattern of frequent injections of funds by the college might result in the college's tax exemptions, and the tax deduction for the donations by the company, being put at risk. The subsidiary may therefore have to retain some profits each year, rather than donate all of them to the college.

To summarise, both the initial investment by the college in a subsidiary and its subsequent funding must be commercially sound in order to ensure that the tax benefits to the college continue. HMRC may require evidence of the investment decision making process.

Of further concern are the "tainted charity donations" provisions which can result in charitable donations by a company being disallowed for corporation tax purposes. Very broadly, the provisions apply where arrangements are entered into whereby the donor obtains a financial advantage from a charity and it is reasonable to assume that the donation would not have been made and the arrangements would not have been entered into independently of one another.

The provisions are very widely drawn, however they are not intended to catch donations by trading subsidiaries of charities. Therefore, there is an exemption from the provisions for companies which are wholly owned by one or more charities, at least one of which is in receipt of the donation. It is important to note that the exemption only applies where the company is **wholly** owned by a charity or charities. If any co-owner is not a charity, then the exemption cannot apply.

If the joint venture is undertaken by an LLP, it is not regarded as a separate entity for tax purposes. Instead, a share of the activities of the LLP is deemed to be undertaken by each partner. Therefore, if the LLP is trading, this trading activity will be deemed to be undertaken by each college partner. Consequently, in order not to have adverse tax implications to the colleges concerned, one of the exemptions set out in Section 2 above (Collaboration) would have to apply to each college partner.

## VAT Implications

There is a VAT cost in 'Collaboration' arrangements (see section 2), in 'Outsourcing' (see Section 5), 'In-Sourcing' (see Section 6) and potentially in 'Informal Agreements' (see section 3) i.e. where there is a Service Level Agreement. However if a Partnering arrangement (creation of a Third Party Entity) is set up correctly there is no additional VAT costs and the Partners still achieve the economies of scale via a new third party entity. This Partnering Arrangement has been introduced and is known in VAT vernacular as the 'Cost Sharing Exemption'.

The VAT legislation (VATA 1994, Sch 9, Group 16) was amended with effect from 17 July 2012 to introduce this 'Cost Sharing Exemption'. Although the benefits of this new legislation are only available to certain types of organisations, one of these is Educational Institutions.

This introduction of a new VAT exemption for cost-sharing arrangements is a welcome development. After years of pressure from charity groups and other organisations, HMRC recently completed a consultation exercise on the introduction of the new exemption. This resulted in the new VAT legislation being introduced to implement the exemption.

This introduction by HMRC is not purely a result of altruism on their part. EU law has contained a mandatory exemption for cost sharing arrangements since the 1970s although the British courts have not been asked to enforce it over the last three decades. An important point to make clear is that it will not automatically make transactions between eligible persons exempt from VAT. A number of conditions must be fulfilled for the exemption to apply.

The exemption applies when two or more organisations (whether businesses or otherwise) with exempt and/or non-business activities join together on a cooperative basis to form a separate, independent entity, a cost sharing group (CSG), to supply themselves with certain services at cost and exempt from VAT. As a result a 'cooperative self-supply' arrangement (a term the EU Commission use) is created. The CSG is a separate taxable person from that of its members. It is therefore able to make supplies for VAT purposes to its members. These supplies will be exempt if the relevant conditions are met. This type of arrangement enables the creation of the same economies of scale for smaller businesses and organisations as larger businesses and organisations naturally enjoy. Thus the more members of a CSG there are the greater the potential savings and lower the costs per member of operating the relevant CSG.

It should be noted that the exemption applies to the supply of services and not to the supply of goods unless the goods are an ancillary element of a single supply of services. There are five conditions that require to be met for the exemption to apply, as follows:

- There must be an 'independent group of persons' (a CSG) supplying services to persons who are its 'members';
- All the members must carry on an activity that is exempt from VAT or one which is not a business activity for VAT purposes;
- The services supplied by the CSG, to which the exemption applies, must be 'directly necessary' for a member's exempt and/or non-business activity;
- The CSG only recovers, from its members, the members' individual share of the expenses incurred by the CSG in making the exempt supplies to its members; and
- The application of the exemption to the supplies made by the CSG to its members is not likely to cause a distortion of competition.

For avoidance of doubt, all five conditions must be met for a supply to be exempt. Therefore if one or more of the conditions is not satisfied, the supplies will be taxable.

Further details on this new Cost Sharing Exemption will be provided via a presentation at the *Scotland's Colleges* Seminar for Finance Directors of Scottish Colleges in Stirling on 28 September 2012 as it represents an opportunity for Colleges to take advantage of economies of scale and not incur an additional VAT cost which was present prior to the Cost Sharing Exemption being added to VATA 1994, Sch 9, Group 16. Should an individual be unable to attend, they can obtain further information from the presenter Gary Moore of VAT Services Limited. (contact details are on page 23).

## Employment Law Implications

This option is the one which will have the most significant employment law consequences, no matter what legal entity is decided upon. Again, the service provision rules will need to be considered as they will inevitably apply to a more straightforward transfer. There would be little room to argue as to whether employees worked in an "organised grouping" or not, so as to escape the provisions of TUPE.

As the functions will be transferring from colleges to the new entity, this, out of all the potential models for shared services, will more clearly fall with the definition of a service provision change and create obligations under TUPE. This would result in:

Those employees who are employed by the colleges involved in the joint venture and who provide the services to be taken over by that joint venture having their employment transferred;

- The new entity having to consider whether all of the employees who transfer are required. This would seem unlikely given the principle behind shared services is to reduce costs. This would then result in redundancies having to be made. Careful consideration would need to be given to the costs of those redundancies and what funds are available to meet statutory redundancy, notice and other payments.

# 5. OUTSOURCING

## Description

Outsourcing involves the provision of services by a separate service provider. The College will specify the services provided and the provider is paid a fee for performing these services. The most common example of outsourcing in the College sector is the outsourcing of Internal Audit.

## Accounting Treatment

In most cases this type of transaction is a normal supplier contract and can be treated on the same basis as any other supplier contract with no additional accounting entries required.

## Direct Tax Implications

There are no particular tax implications.

## VAT Implications

The supply of 'outsourced' services such as an HR or IT function to a College is a supply of services. It is likely that the organisation providing these services will be VAT registered. As these services are taxable, the College will incur a VAT cost of 20% for these services.

## Employment Law

As stated in section 2, any transfer of activities may be subject to the service provision change rules set out in TUPE. Those principles apply to outsourcing in the same manner as they would do to a change of contractor.

The issue to be considered is, again, whether any employees who perform the work in question would assert that they should be transferred to the service provider at the point in time there is a transfer of the work to that service provider. There are technical requirements that would need to be established for TUPE to apply, particularly showing that a college had an "organised grouping" of employees who provided the services in question and that the individual employee was essentially dedicated to working in the provision of the services. Depending on the nature of the services in question, such an issue may be difficult to determine.

Again, if an outsourcing arrangement was terminated at a later date, and a college wished to bring the provision of those services back in house, the service provision rules may operate so as to oblige the college to take on the employment of any organised grouping of employees employed by the service provider, whose work saw them essentially dedicated to providing services to the college.

# 6. IN-SOURCING

## Description

The in-sourcing model allows the College to maintain the provision of services in-house along with an external consultant to provide their expert skills and knowledge in areas available within the College. For example, a College might use ICT consultants in the development of an ICT infrastructure to provide expertise in systems integration.

## Accounting Treatment

Colleges which use consultants will have a contract with the external consultant which will be treated in the same manner as any other supplier. The contract could be for a project where payment is made in stages as works/services are completed. In the situation where this project spans the accounting year end the College is required to account for this project based on contract accounting rules. Accounting standards use the matching accounting principle which states that income and expenditure for an accounting period be matched within the same period. In the example noted above where payment is received in stages it is likely that the expenditure paid to the consultant does not match the amount of work performed to the year end. The College is therefore required to estimate the percentage of the project complete at the year-end and using this percentage the College can then calculate the amount of the contract price which should be recognised in the accounts. An example is provided at Appendix D.

## Tax Implications

One issue which may arise in relation to this model is the employment status of the consultant. The College must be aware of the differences to ensure that they correctly treat the individual for income tax purposes. In considering whether an individual is employed or self-employed the issues noted at Appendix E describe the areas which HMRC consider when evaluating whether an individual is employed or self-employed. It may be helpful to utilise the Employment Status Indicator (ESI) tool on the HMRC website, although the ESI does not apply to all circumstances and is only a guide.

Particular attention should be taken in the instance where the consultant is contracted to perform further work after the initial project is completed for example, where the ICT infrastructure has been developed and the consultant is now contracted to maintain the ICT network. Although correctly classified as a contractor during the development of the ICT infrastructure, the consultant's employment status may have changed to employee, according to HMRC rules, on inception of the maintenance contract.
The consequences of getting this classification wrong is the potential for a large PAYE and NIC liability with interest and penalties being owed to HMRC.

## VAT Implications

The VAT implications for 'in-sourcing' is the same as that for 'outsourcing'. The supply of 'in-sourced' services such as an HR or IT function to a College is a supply of services. It is likely that the organisation providing these services will be VAT registered. As these services are taxable, the College will incur a VAT cost of 20% for these services.

## Employment Law Implications

Again, the service provision rules in TUPE would potentially apply to the in sourcing of any services. As set out in section 4, if a college brought services back in house, they may have to accept the transfer of employment of the employees employed by the service provider who were essentially dedicated to the provision of those services. If there was such a transfer, the college would become responsible for the financial burden of those transferring employees wages, etc. and may also need to consider whether the influx of new employees created a potential redundancy situation, if existing college employees are already in place to do that work.

# APPENDIX A

## Accounting Treatment of Collaboration Network

Colleges A, B, C and D have entered into an agreement to create a network for the provision of a construction course. Students from Colleges B, C and D will attend the course at College A where facilities have been developed to provide this course. Due to the nature of the course College A have had to purchase a large amount of tools, equipment and learning materials to provide this course for which Colleges B, C and D have contributed in equal proportions. Below is the Income and Expenditure account and balance sheet for the course.

| | £ |
|---|---|
| **Income** | 40,000 |
| | |
| **Expenditure of course:** | |
| Staff costs | 20,000 |
| Electricity | 5,000 |
| Books | 3,000 |
| Stationery | 1,000 |
| Sundry | 1,000 |
| **Running costs** | **30,000** |
| | |
| Depreciation | 5,000 |
| | |
| Surplus | 5,000 |

| **Balance Sheet extract** | £ |
|---|---|
| Fixed Assets | |
| Equipment | 20,000 |
| | |
| Deferred capital grants | 20,000 |

All equipment is depreciated over its useful economic life with the principal annual depreciation rate being 4 years straight line for all equipment.

All of these items are already through College A's accounts including the receipts from College B, C and D.

Colleges B, C and D will record within its operating activities:

- 25% of the income (being their equal share)
- 25% of the running costs (being their equal share)
- 25% of depreciation
- 25% of release of deferred capital grant
- 25% of the value of the fixed assets owned by the partnership

This will produce the following journals:

| | £ | £ |
|---|---|---|
| DR Bank | 10,000 | |
| CR Income | | 10,000 |

*Being the College B, C & D proportion of income*

| | | |
|---|---|---|
| DR Running costs | 7,500 | |
| CR Bank (payment to lead college) | | 7,500 |

*Being the College B, C & D proportion of running costs*

| | | |
|---|---|---|
| DR Depreciation | 1,250 | |
| CR Accumulated depreciation | | 1,250 |

*Being College B, C & D proportion of depreciation on shared assets*

| | £ | £ |
|---|---|---|
| DR Deferred capital grant | 1,250 | |
| CR Release of deferred capital grant | | 1,250 |

*Being College B, C & D proportion of release of deferred capital grant*

| | | |
|---|---|---|
| DR Fixed Asset cost | 5,000 | |
| CR Bank (payment to lead college) | | 5,000 |

*Being College B, C & D proportion of fixed assets purchased by College A to run the course*

# APPENDIX B

## Disclosure of revenue commitment

When a College has committed to a contract to pay for services which spans over the year end the nature and amount of this commitment should be disclosed in the financial statements. The notes to the College financial statements should include a schedule of contracts separated into amounts payable in less than one year, in one to five years, and in more than five years. See below an example of a commitment disclosure note.

## Commitments

The College had commitments under non-cancellable agreements as set out below:

| Year | Property | Other |
|---|---|---|
| | £ | £ |
| Within one year | - | 32,140 |
| In the second to fifth years inclusive | 146,905 | - |
| After five years | - | - |
| | 146,905 | 32,140 |

# APPENDIX C

## Consolidation disclosures

### Accounting Policies

The accounting policies note should include a detail regarding the basis of consolidation and what subsidiaries have been included within the consolidated accounts. For example:

### Basis of Consolidation

The Income and Expenditure Account and Balance Sheet consolidate the financial statements of the College and its joint venture Shared Services Limited.

### Investment Note

| **Share of assets** | **£** | £ |
|---|---|---|
| Share of fixed assets | XX | XX |
| Share of current assets | XX | XX |
| | XX | XX |
| **Share of liabilities** | | |
| Due within one year or less | XX | XX |
| **Share of net assets** | XX | XX |

### Share of net assets

College A holds 50 per cent of the capital of the joint venture. The share of assets and liabilities as at the balance sheet date are detailed above.
Investments in joint ventures are held at cost.

### Subsidiaries not consolidated

The College owns 25 per cent of the issued ordinary £1 shares of XYZ Limited, company incorporated in Scotland. At the year end, XYZ Limited had total share capital of £X and reserves of £Y. The subsidiary has not been consolidated with the College accounts on the grounds of materiality.

The notes to the accounts should detail the investments held at the year-end as shown below:

| | College 2012 | College 2011 |
|---|---|---|
| **Investments** | £'000 | £'000 |
| Investment in joint venture | 1 | 1 |
| **Total** | 1 | 1 |

The College owns 25 per cent of the issued ordinary £1 shares of ABC Limited, a company incorporated in Scotland and 25 per cent of XYZ Limited, a company incorporated in Scotland. The principal business activity of ABC is the provision of human resources and payroll services. The principal business of XYZ Limited is the provision of IT support.

The above represents example disclosures when you consolidate a joint venture and when you do not consolidate.

# APPENDIX D

## Accounting for contracts

College A has agreed a contract with Consultant A for the provision of services in regards to the development of the College ICT infrastructure. The basis of the payment is on the percentage complete of the contract as noted below:

| Percentage complete: | Payment: |
|---|---|
| 25% | £10,000 |
| 50% | £15,000 |
| 75% | £20,000 |
| 100% | £25,000 |
| | |
| **Total** | £70,000 |

The contract is expected to last 2 years and will therefore straddle the College's year end 31 July. At 31 July Year 1 the College has paid £10,000 as 25% of the project was completed at 31 March. The project is estimated to be 45% completed at 31 July Year 1. If we made no adjustment the income of £10,000 would not match the amount of work performed and liability owed at the year-end.

We would calculate the value of the work completed as 45% of the total contract price which equates to £31,500. However the College has already paid and accounted for £10,000, therefore an additional liability amounting to £21,500 should be incorporated into the accounts as an accrual.

# APPENDIX E

## Employee or Contractor?

Below is a table of the issues which HMRC reviews when considering whether an individual is employed or contracted by a company. The College should be aware of this when deciding on an individual's employment status with the College.

| **Employment** | **Self-Employment** |
|---|---|
| 1. You can tell them what work to do, as well as how, where and when to do it. | 1. They can decide what work is done and when, where or how it is done. |
| 2. They have to do their work themselves. | 2. They can hire someone else to do the work you have given them, or take on helpers at their own expense. |
| 3. You can move the worker from task to task. | 3. Once the task is complete the individual has completed the contract and no other tasks are immediately provided. |
| 4. They are contracted to work a set number of hours. | 4. You pay them a fixed price – it doesn't depend on how long the job takes to finish. |
| 5. You pay them overtime pay or bonus payments. | |
| 6. A fixed salary is agreed with the individual. | 5. They can make a profit or a loss. |
| 7. You provide the employee with the equipment required to perform the task. | 6. They use their own money to buy business assets, pay for equipment used to complete the work and running costs. |
| 8. You are responsible for putting right any unsatisfactory work. The individual will do this during their normal working hours. | 7. They are responsible for putting right any unsatisfactory work, at their own expense and in their own time. |

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