Audit Committee, 14 June 2017

Review of capitalisation, depreciation and amortisation policy

Executive summary and recommendations

Introduction

The Audit Committee's terms of reference include considering and making recommendations to Council on accounting policies. Following the NAO recommendation on the change of accounting treatment for review projects and the expected increase in capital spending from April 2017 on the 186 Kennington Park Road and Registration projects, Audit Committee is asked to review the HCPC's capitalisation, depreciation and amortisation policies.

In May 2017, a revised Reserves Policy was approved by Council, which sets a target range of free reserves. Free reserves are calculated as total reserves less the net book value of fixed assets. The levels of total reserves and free reserves are therefore affected by the capitalisation, depreciation and amortisation policies.

Decision

Audit Committee is asked to review and discuss the capitalisation, depreciation and amortisation policies.

Financial implication

These policies impact on budgeted and reported surplus and deficit levels. These policies have no direct impact on cash, but where budgets are balanced, policies which capitalise more expenditure and depreciate it slower will tend to lead to higher cash outflows than policies which capitalize less expenditure and depreciate it faster.

Resource implication

None

Appendices

Appendix: Capitalisation, depreciation and amortisation policies

Date of paper

02 June 2017

Appendix:
Capitalisation, depreciation and amortisation policy by asset class

Tangible fixed assets and depreciation

Freehold land and buildings

- Measured at fair value less accumulated depreciation on buildings and impairment losses in respect of both land and buildings recognised after the date of the revaluation.
- Capitalisation threshold for subsequent improvements is £5,000. The 186 Kennington Park Road refurbishment project has been assessed as to how much will be capitalised and how much will be treated as operating costs, and the split is expected to be approximately two thirds capital, on third operating costs.
- Depreciation for freehold buildings is on straight-line basis over 50 years. Land is not depreciated
- Revaluations are performed with a maximum interval of 5 years (in practice done annually) by Chartered Surveyors.
- Any revaluation surplus is credited to the assets revaluation reserve, except to the extent that it reverses a revaluation decrease of the same asset previously recognised in the Statement of comprehensive net expenditure, in which case the increase is recognised in the Statement of comprehensive net expenditure.
- A revaluation deficit is recognised in the Statement of comprehensive net expenditure except to the extent that it offsets an existing surplus on the same asset recognised in the asset revaluation reserve.
- Accumulated depreciation as at the revaluation date is eliminated against the gross carrying amount of the buildings and the net amount is restated to the revalued amount of the buildings.
- Valuation basis is market value for existing use. This is normally less than open market value, which would reflect the potential for change of use.
- The valuers estimate the split of the valuation between the value of the land and the value of the buildings, as the basis for our depreciation calculations. In recent years they have estimated a 50/50 split. Splitting the value is somewhat arbitrary but the impact of a different split would be limited because of the 50 year useful life of the buildings, and because the valuation is in practice repeated and the depreciation restarted each year
- As at 31 March 2017, we hold the following for 184 and 186 Kennington Park Road:

184 Kennington Park Road inc 20-26 Stannary Street		
Historical costs	**Revalued as at 31.3.17**	**Surplus held in revaluation reserves**
1,806,397	2,840,000	851,052
186 Kennington Park Road		
Historical costs	**Revalued as at 31.3.17**	**Revaluation deficit write off to SOCNE**
2,097,579	1,775,000	332,579

- Park House and 186 Kennington Park Road have up till now been treated as separate assets for the purpose of revaluation surpluses and deficits, but in the 2017-18 accounts, once the project is completed and the two buildings have been joined, they will be treated as a single asset and the revaluation surplus or deficit will be assessed on the aggregate historical cost vs the overall valuation.

Leasehold improvements

- Stated at historical cost less accumulated depreciation and impairment losses.
- Threshold for capitalisation of work is £5,000.
- Depreciation for leasehold improvements is over the shorter of the remaining minimum term of the lease or the expected useful life.
- As at 31 March 2017, we hold the following leasehold improvement assets:

405 Kennington Road	6 years to break clause
33 Stannary Street	4 years to break clause

Leasehold restoration and dilapidation costs

- Our lease on 405 Kennington Road includes an obligation at the end of the lease to restore the building to its pre-fit out state, removing the partitioning and flooring we had installed, together with obligations to redecorate. We had been accounting for those obligations through a monthly accrual to build up a provision to cover the estimated cost by the time of the break clause in 2021. During the 2016-17 external audit, it was identified that the obligation to remove the partitioning etc should instead be recognised in full now, as an asset as per IAS16, and a matching liability.
- The cost of the removal of the partitioning etc has been estimated by our professional advisors at £170k including fees and VAT.
- That value will be depreciated over the same period as leasehold improvements – over 6 years to break clause.

Office furniture and equipment

- Office furniture and equipments are stated at historic cost of acquisition less accumulated depreciation and impairment losses as a proxy for fair value.
- Depreciation of office furniture and equipment is on a straight-line basis over 4 years.
- Depreciation starts when the equipment is ready to use – effectively, when it is bought
- Threshold for capitalisation of furniture and equipment is £5,000 per item.

Computer equipment

- Computer equipment are stated at historic cost of acquisition less accumulated depreciation and impairment losses as a proxy for fair value.
- Depreciation of computer equipment is on a straight-line basis over 4 years.
- Depreciation starts when the equipment is ready to use – effectively, when it is bought
- Threshold for capitalisation of computer equipment is £5,000 per item.
- Carrying value of the assets are assessed annually for impairment.

Intangible fixed assets and amortisation

Software licences

- Software licences are stated at historic cost of acquisition less accumulated amortisation and impairment losses.

- Amortisation is provided on a straight-line basis over 3 year based on estimated useful life.
- Amortisation starts when the software is brought into use.
- Threshold for capitalisation of software licences is £5,000 for the combined cost of the licences (i.e. sum of all individual user licence).
- Carrying value of the software licences are assessed annually for impairments.

Software system development costs

- Capital costs incurred from projects such as consultancy fees for design and build of the system, testing and licences are being stated on historical cost of acquisition less accumulated amortisation and impairment loss.
- Initial research phases of software development projects are now expensed in the Statement of comprehensive net expenditure. This was a change in treatment agreed this year, arising from the NAO's interim audit
- Capitalisation threshold for system development costs is £5,000 for the total project cost, based on the contract value or PO value.
- Amortisation is provided on a straight-line basis over 3 year based on estimated useful life.
- This is a relatively short or cautious estimate: several HCPC systems eg NetRegulate and Charter have remained in use for longer than 3 years.
- Amortisation starts when the system is fully developed and ready to use. This would mean that projects such as the new registration system will not start to be amortised for another 2-3 years' time, when the system is brought into use.
- HCPC currently hold 10 projects with Net Book Value of more than £nil within its intangible assets. To illustrate the gap between purchase and commencement of depreciation, below is the three of the largest project we current hold:

	Commencement of purchase	Depreciation start date
Education system Build	Feb-13	Mar-15
HR & Partner Build	Dec-14	Dec-16
Registration Transformation & Improvements	Oct-15	N/A

Relationship with free reserves

- Free reserves are those which are held in cash or other net current assets, so the capitalisation, depreciation and amortisation policies do not *directly* affect the level of free reserves. For a given set of asset purchases, the free reserves of an organisation will be the same whether those assets are expensed immediately, capitalised and depreciated over 3 years, or depreciated over 10 years.
- But within a balanced budget, for a given level of income, the more purchases that are capitalised and the slower they are depreciated, the more budget will be available for other operating spending, and the lower free reserves will therefore tend to be.
- Therefore the relatively short asset lives within our current policies help to support free reserves and sustainable budget setting.

Fixed assets held by HCPC as at 31.3.17

Tangible assets

	Freehold land*	**Freehold property***	**Leasehold improvement with dilapidation**	**Office furniture and equipment**	**Computer equipment**	**Total tangible assets**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Gross cost as at 31.3.17	2,308	2,308	1,029	154	500	6,299
NBV as at 31.3.17	2,308	2,308	739	30	117	5,502
Budgeted capital expenditure for 2017-18	-	1,851	-	-	92	1,943
Budgeted depreciation for 2017-18	N/A	(62)	(156)	(1)	(77)	(296)
Depreciation policy	N/A	Straight line (SL) over 50 yrs	SL over minimum lease period	SL over 4 yrs	SL over 4 yrs	

*Revalued cost as at 31.3.17

Intangible assets

	Software licences	**Education system build project**	**HR & Partner Build Project**	**Registration Transformation & Improvements**	**Other projects**	**Total intangible assets**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Gross cost as at 31.3.17	496	887	269	4,183	1,284	7,119
NBV as at 31.3.17	55	294	245	714	133	1,441
Budgeted capital expenditure for 2017-18	92	-	178	643	482	1,395
Budgeted amortisation for 17-18	(31)	(275)	(191)	(19)	(95)	(610)
Amortisation policy	SL over 3 yrs	SL over 3 yrs	SL over 3 yrs	SL over 3 yrs	SL over 3 yrs	