



# HM TREASURY

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**DAO(GEN)07/05**

Dear Accounting Officer

27 June 2005

## **CLAWBACK: DISPOSAL OF PUBLICLY FUNDED ASSETS**

**This letter sets out revisions to the guidance in *Government Accounting* about the terms on which departments and non-departmental public bodies give grants for the acquisition or improvement of assets. These changes follow a review of the existing guidance when applied to third sector bodies. The guidance attached will ultimately be incorporated in chapter 24 of *Government Accounting*.**

### **Action**

2. Accounting Officers are asked to draw this guidance to the attention of all staff dealing with grant applications for the acquisition of assets. They are also asked to draw it to the attention of their sponsored bodies - such bodies may both receive grant funding from government departments and also receive grant applications for the acquisition of assets. This guidance comes into effect immediately and will be incorporated in *Government Accounting* in due course. The guidance in the letter will also be followed up in the planned revisions to [Guidance for Funders](#)<sup>1</sup>. Funding bodies may consider how far these principles can apply to existing grants administratively and whether it is practicable to change any existing charges agreed administratively with ones having legal force, but should only make changes if these are proportionate to the value of any existing grants.

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<sup>1</sup> *Guidance for Funders* has the express aim of helping the partnership between the public and the third sectors, with particular regard to understanding government funding mechanisms and the financial planning process.



## Contacts

3. General questions about the terms of this guidance should be addressed to Jim Duncan, Treasury Officer of Accounts team (email: [jim.duncan@hm-treasury.gov.uk](mailto:jim.duncan@hm-treasury.gov.uk); phone 020 7270 4833).

## Review of the clawback rule

4. The changes now proposed reflect the outcome of a review, the conclusions of which were announced by the Treasury on 24 February at the Third Sector Summit.

5. The main conclusions of the review were that:

- *Government Accounting* should be revised to make clear that funders may agree a period over which they expect to retain an interest in publicly funded assets on the basis of outcomes rather than purely on the life of the asset;
- grant funded bodies should be able to use grant funded assets to generate revenue or secure borrowing, with suitable safeguards;
- in some circumstances, and with Treasury agreement, it can be acceptable for departments and NDPBs to support third parties through clean break endowments, provided that these can demonstrate value for money.

6. It also concluded that the guidance in *Government Accounting* needs revision to reflect the changing ways of delivering public services. Whilst it is important to maintain the principle of securing good value for the use of public money, imposing restrictive terms on grants may not deliver value for money, if they frustrate the ability of grant funded bodies to deliver the government's objectives in the round. Moreover, it needs to reflect better the increasing practice of public sector funders working in partnership with bodies operating in the third sector, including voluntary and community bodies, to deliver public and community services. It now makes sense to encourage more flexible funding arrangements in the general public interest.

7. The key principle set out in the guidance in annexes A and B to this letter is that departments and NDPBs should set appropriate terms and conditions for grants intended for the acquisition of assets. Particular care may be needed when making grants to charities – see annex B.

8. Terms and conditions should be tailored to the circumstances, taking appropriate legal advice on the scope for recovery of the proceeds of sales. They should also be agreed at the outset, so that both parties have a clear and common understanding about what is expected under the terms of the grant offer. It will often make sense, therefore, to set terms which limit the period over which funders can exercise such a charge, or which progressively diminish the extent to which a charge should operate. Funders should try to avoid unnecessarily onerous terms and conditions since these can decrease the willingness and ability of recipients to cooperate with the government's policy objectives.

## **Legal Charges**

9. The examination by the Committee of Public Accounts (PAC) of fifteen Arts Council projects noted that third parties' creditors could have had a benefit at the expense of the Exchequer if grant recipients became insolvent. It recommended<sup>2</sup> that this risk could be reduced if public sector funders had a legal charge over any publicly funded assets. The Treasury undertook to advise departments about this and this is covered in the guidance attached. The main principle in it is that a legal charge may be the securest safeguard and that some circumstances may warrant setting terms and conditions for grants that entail legally enforceable charges over the proceeds of disposals of publicly funded assets.

## **Good practice**

10. In addition to the attached guidance, those consulted about the guidance have said it would be helpful to illustrate good practice. For example:

- a community centre in the West Derby New Deal for the Community (NDC) body based in a local pub: there was the recognition that the pub was at the heart of the community and that it therefore could be acquired by the NDC to be a community centre. The pub also generates hire income (at a market rate) for the centre. Such income can legitimately be retained by the centre/owning body;
- Hoxton Apprentice – Shoreditch NDC: this was a dilapidated school purchased by Shoreditch NDC with support of funding by government, the City of London and others. The building is now used to provide apprenticeships for catering students, support for people starting out small enterprises, local services in terms of high quality restaurant food at locally affordable prices. The scheme also provided two privately owned flats, the proceeds from which were returned back to the wider NDC project.
- Yorkshire-Forward (Y-F) social enterprise funding: Y-F has a charge over the asset, but it is limited to the value of grant paid and for a definite period. The length of the period is based on the grant payer making a sound and robust assessment based on when the benefits will be derived. Over time, as market value increases and assuming grant was no more than original market value when paid, the enterprise may use increasing equity (in this case, the difference between original grant after taking account of inflation and latest market value) to support its borrowing. Y-F has adapted its clawback conditions in order to help VCS bodies move away from a 'grant culture', and sets a clawback condition in such a way that will enable assets to be used later as security for lending.

11. The revised guidance attached is intended to allow these and more flexible kinds of funding arrangements.

## **Consistency**

12. Grant receiving bodies commented during the review that the existing rules on clawback were not applied consistently within departments and between

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<sup>2</sup> <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmpublic/253/25302.htm>

them. The good practice models in this covering letter, and the options approach in the annex, are intended to help provide clarity and consistency. The revisions to *Guidance for Funders* later this year will also help. It will be written for both public and third sector bodies so the third sector will have a better understanding of the considerations that funding bodies need to bear in mind.

**Yours sincerely**

**Brian Glicksman  
Treasury Officer of Accounts**

## CHARGES OVER PUBLICLY FUNDED ASSETS

### Introduction

1. Public bodies should take suitable and proportionate steps to safeguard their financial interests and those of the Exchequer when giving funds to others to acquire or develop assets. In addition, departments should satisfy themselves that their sponsored bodies handle grants to beneficiaries appropriately.
2. Bodies providing such funding should carefully consider setting conditions on their grants that are realistic and proportionate to the value of the grant, the use of the asset being publicly funded and the potential future value, thus safeguarding the funder's financial interest over the asset. Annex B gives guidance on giving grants to charities to acquire assets.

### Introducing a charge or clawback over the asset

3. The most common way of safeguarding financial interests is to set a condition on the grant that gives the funding body a charge over the asset, ie the right to be consulted about the asset being sold or put to an alternative use. On occasions, such a condition could be expressed as the funded body agreeing to refund the grant or, more usually to return the proceeds from the sale of the asset to the donor, (ie for the donor to *clawback* the proceeds). When setting a clawback condition, the donor should also consider setting out the circumstances in which it would consider the proceeds being retained or recycled back to the recipient.
4. There is no single correct model for clawback. There are a number of different types of public sector funders, and considerable diversity in the population of funded bodies, including various types of bodies outside the public sector such as third sector bodies. The common thread is that grants are given with the aim of improving public and community services. The terms of grants need to be adjusted to suit the circumstances of the case, allowing as much flexibility as seems sensible, particularly where public funding can enhance recipients' capacity to develop and provide services over the longer term or to become independent of public funding. Terms on grants need to be set in ways that enhance funded bodies' ability to work with government bodies to deliver services: over-rigorous terms may militate against this and therefore not achieve overall value for money. This is particularly so in the case of funding assets acquired by third sector bodies. The third sector includes the voluntary and community sector, social enterprises, charities, community interest companies<sup>3</sup> and New Deal for the Community bodies.

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<sup>3</sup> The concept of a new corporate vehicle, a Community Interest Company (CIC), was introduced in the Companies (Audit Investigation and Communities Enterprise) Act 2004. A CIC is a business whose profits and assets are to be used for the benefit of the community. There will be a statutory "lock" on the profits and financial assets of CICs and, where a CIC is limited by shares, power to impose a "cap" on any dividend. Companies wishing to become a CIC are required to pass a community interest test and to produce an annual report showing that they have contributed to community interest aims.

5. In setting these terms, funders need to consider the different circumstances in which assets may be disposed of, and the purpose of the government support underlying the original grant. The terms of clawback should therefore reflect the extent of public funding, the nature and expected life of the asset being developed, and how to assess when the agreed objectives for the funding have been delivered. The objectives should be agreed at the outset as part of the process of assessing the application for grant. For example, a funded body may agree to ensure that the asset delivers community benefits for a certain period: once the benefits have been delivered and the agreed period has expired, it would make sense for the funding body's charge, and hence right to clawback, to expire, even though the asset remains in use and has a value.

**When does a funder have a reasonable claim?**

6. When introducing a charge over the asset and/or a clawback condition, funders need to consider how far it could reasonably and proportionately lay claim to all, or part, of the proceeds of a sale and for how long any such claim should last. It is reasonable to lay claim to an asset where the donor wants to:

- a. be satisfied that the grant for acquisition or development of the asset would not be diverted without its endorsement; or
- b. avoid giving the recipient an uncovenanted benefit by using public funds to acquire or maintain an asset that was sold shortly thereafter.

7. Charges and clawback terms, and their duration, need to take account of:

- a. the nature and purpose of the payments to the body in question;
- b. the type of assets, if any, acquired or created by the funded body;
- c. the use to which these assets are put;
- d. the objectives for the funding and the relation of the asset to securing these objectives;
- e. the proportion of the funded body's total expenditure covered by government grants;
- f. how long it is reasonable for the donor to maintain an interest in the asset (see paragraph 20); and
- g. whether the recipient is an asset-locked body, eg a charity or CIC.

8. In addition, funders should consider seeking legal advice about any conditions they want to set. Legal advisers will need to consider the conditions from the perspective of both UK and EU law, including any implication for state aid.

## **Nature of funding and whether to have a charge**

9. Funding by public bodies can take place in several different ways, and not all would lead to a charge over the asset. For example, it would be reasonable to have a charge over the following:

- a. tangible or intangible assets financed directly, whether wholly or partly by grants or grants in aid; or
- b. tangible or intangible assets developed by the funded body itself, financed indirectly by a grant for a related purpose or by grant in aid.

10. Laying claim to the full value of assets after sale is not appropriate if the original funding only financed part of the full value of the asset when acquired.

11. Charges or clawback terms are not applicable in certain circumstances, for example:

- a. procurement of goods and services - any liability would have been adequately discharged once the goods and services have been provided. This is likely to be true even where the service provider had purchased assets to deliver the goods and services;
- b. similarly, if a department provided grants for research and not specifically for the creation of physical asset, the successful conclusion of the research might, depending on the circumstances, be regarded as an adequate return.

## **What to include in conditions**

12. Funders should consider whether conditions of grant should deal with the circumstances in which assets may be disposed of, the potential for change in value and the method of disposal, as well as the treatment of receipts, for example:

- a. whether property may be sold;
- b. when it may be sold;
- c. how it may be sold;
- d. how to get the best price;
- e. to whom it may be sold;
- f. whether the property may be disposed of by way of gift and/or to whom;
- g. whether the property may be sold to another body at a price less than the best price reasonably obtainable<sup>4</sup>;
- h. whether there is a "lock" over the asset, eg because it is owned by a charity or CIC.

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<sup>4</sup> The "best consideration reasonably obtainable" is the market value of the property plus "special value" and also taking into account the capital value of any voluntary conditions imposed by the vendor where appropriate – see GA 24.2.6

13. Funders should also consider whether conditions of grant should deal with the circumstances in which the *use* of assets may change and hence whether the funded body would need to consult the funder. The funder and grant recipient should agree *at the outset* the nature of the charge over the asset and whether any clawback would apply. Any such condition should be consistent with the agreed objectives being delivered. The charge over the asset may also include taking into account the range and the potential value of assets that the recipient might create, particularly intellectual properties, which may be of considerable value to potential purchasers.

14. In setting terms and conditions for grants, funders should consider the feasibility of enforcement, with due regard to the legal powers available. Funders should also consider whether conditions should be imposed to cover the position if the funded body were wound up or went into liquidation, so that the funder would have priority over unsecured creditors.

15. In some cases, the grant may have been paid to improve the asset rather than to acquire it. In such cases, funders should consider whether it would be prudent for the asset to be valued before and after the improvements have been made to provide a basis for calculating any repayments to the funder.

#### **Making a claim on the asset enforceable**

16. In order for the charge to be enforceable when the funded body disposes of an asset or changes the terms of its use, the funder should ensure that the terms of the grants include appropriate requirements. Examples of these are:

- a. imposing suitable conditions at the time when the grant is paid in, for example, offer letters; or
- b. introducing such conditions in the Financial Memorandum and Management Statement<sup>5</sup> ;
- c. introducing a formal legal charge on the asset – see paragraph 17 below.

17. Funders may, if they think necessary and appropriate, secure a formal legal charge on the asset, in particular where giving funds to enable others to acquire land and/or buildings. This is particularly suitable for high-risk projects or where departments want to minimise the risk of third party creditors deriving a benefit which otherwise would have been returned to the funding body. Legal charges are normally taken to mean a registered charge on land in the terms of the Land Registration Act 2002 and the Rules under it. In addition, where a grant recipient is a company under the Companies Act 1985, a donor might wish to consider securing a sum as a charge on the book debts of the company, ie a registered charge under the Companies Act 1985.

18. Funders should seek legal advice if they want to introduce formal legal charges. In addition, they should satisfy themselves that terms and conditions of

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<sup>5</sup> *Government Accounting* ([www.government-accounting.gov.uk](http://www.government-accounting.gov.uk)) gives a model Management Statement and Financial Memorandum at annexes 9.2 and 9.3 respectively. Paragraphs 75 to 77 of the model FM cover clawback

grant are effective and proportionate to the risks and the funding. They should seek legal advice to ensure that any condition that they include in a financial memorandum is legally enforceable and is within the terms of any relevant statutory powers. Legal advisers may also want to consider the application of EU law to any legal charges (for example whether there are any state aid implications).

### **Duration of Charge or Clawback conditions**

19. The terms and conditions of funders' grants should reflect the likely change in value of the assets over time to ensure that there is no uncovenanted benefit from the use of public funds. The terms might specify that if a given asset were sold, the proceeds, or a specified part of them, would be paid to the donor

20. However, such terms can create a disincentive for the recipient to take on an asset. This can apply where the asset is dilapidated or in need of significant expenditure or both but where it is likely to appreciate in value. In particular, grant recipients in the third sector may find such terms a deterrent.

### **Options for determining charge and clawback periods**

21. There is no one preferred approach. Options can include:

- **Option I:** to set the terms of charge (including clawback if appropriate) relative to the period over which community services are expected to be delivered rather than relative to the life of the asset;
- **Option II:** as for option I, but also to agree that if the asset's market value increases (and assuming grant was no more than original market value at acquisition), a recipient might use the difference between the original grant – taking account of inflation if considered appropriate - and latest market value to support its borrowing. Where this approach is used, the donor's interest in the asset is relative to the market value of the asset thereby enabling the grant recipient to lever in funding from other sources over time;
- **Option III:** to agree that any amounts to be clawed back would decrease by an agreed proportion each year until they vanish to zero – for example, 10 years and reducing any potential amount of clawback by 10% each year, or for 5 years and by 20% each year;
- **Option IV:** as Option III but to base it on the estimated time of delivery of the agreed objectives of the grant rather than the life of the asset;
- **Option V:** to base the charge period on the life of the asset – this option is particularly appropriate when working with profit-making bodies and where the asset is assessed as being able to be used for a considerable length of time.

22. Funders may need to assess the risk of third party creditors gaining an uncovenanted benefit at their expense, and so set charge or clawback periods proportionate to that risk. They might also consider it appropriate to withhold agreement to the asset being used as collateral if the risks of uncovenanted benefits are too great. In addition, funders should consider:

- reaching agreement with the funded body that there should be a break clause that would allow the funder and recipient to agree that the objectives of the funding have been achieved and that therefore the funder can relinquish its interest over the asset;
- allowing for scope to retain the charge and review the clawback period if the project has not met the agreed objectives.
- enabling the funded body to use the assets as security for lending, once the charge or clawback period is agreed to have ended;
- being alert to the possibility of recycling any proceeds from sale in their budgets and, in the case of departments, whether any proceeds have to be recycled through their Supply Estimates (the appendix to this annex gives guidance on recycling proceeds in budgets and Estimates).

### **Using assets as collateral or to generate income**

23. Funders need to be satisfied that funded assets are used for their agreed purpose. But they may also take into account that using the assets as collateral may help the transition from a short-term social project to a viable third sector body. Equally funders may need to consider the appropriateness of giving grants to finance asset acquisition when it is being used solely to lever in income or provide security for lending. Funders should also be alert to the risk of third party creditors gaining a benefit at the expense of the funder, in the event of a funded body becoming insolvent and having used publicly funded assets as security. Therefore whilst they have a live charge or clawback clause over a public funded asset, funders should ensure the funded body seeks their agreement to publicly funded assets being used as security whilst the charge or clawback condition still applies.

24. Similarly, funders may set conditions on the ability of the recipient to generate income from the publicly funded asset. Such conditions should be proportionate and weigh up the balance between impeding a funded body's ability to be self-supporting against the appropriateness of using public funds for the body to acquire an asset solely for the purpose of generating income. It would be appropriate to allow a body to retain income if, for example, it was generated by using spare capacity.

### **Recording any charge over an asset**

25. It is advisable that bodies giving grants to others to acquire or develop assets should keep records of the agreed charge over the asset, irrespective of any usual document disposal rules. Similarly the body owning the asset should also keep a record of any charge it has. The best way of doing this, particularly if the charge is legally enforced, would be to register a land charge, as that ensures that it would be taken into account during the sale process.

### **Agreeing not to claw proceeds back once an asset is to be sold**

26. There may be occasions where a grant funded asset is to be sold but the funder considers that the proceeds should not be clawed back. In such cases the donor should make a deliberate and considered decision about how to proceed rather than letting the disposal go by default. The onus of proof in

justifying a proposal to allow a funded body to retain proceeds will be on the funder concerned. In such cases, funders should ensure that sums to be reinvested are subject to the same controls (e.g. in terms of investment appraisal and costs) as investments requiring new grants. An alternative approach may be for the funder to agree not to recover the grant but to deduct a similar amount from other future grants it may make.

27. If a department decides to waive a clawback condition, it should consider whether it needs to report that waiver as a gift. If so, it should follow the gift reporting requirements set out in chapter 25 of *Government Accounting*.

### **Sale of body as a going concern and recovery**

28. Where the body owning the assets is being sold as a going concern, funders should take legal advice on whether they can recover the proceeds. They may also take into account whether the potential purchaser is one that has its assets locked and whether its objectives (charitable or as a social enterprise) are in line with the original owner's. Funders should consider carefully whether any other steps could be taken. For example, if a department is in a position to influence the decision to sell, its endorsement of the sale should be taken consciously in the light of all the facts. See also annex B.

### **Funding asset creation and maintenance through endowments or dowries**

29. In general, funders should provide cash on the basis of need in a particular financial year. Exceptionally, there may be a case for considering funding by way of endowment or dowry, that is, making a one-off grant which will often represent a clean break between the donor and funded body whilst enabling a funded body to set up a fund from which to draw down over several years.

30. Where funders consider such funding appropriate they should first consult the Treasury (via their relevant spending team). Funders may seek the Treasury's agreement for an appropriate delegated authority from their relevant Treasury spending team for such proposals. In assessing particular proposals or when seeking a delegated authority, funders will need to provide an assessment of the overall value for money of such funding, including an assessment of:

- the opportunity costs of locking public funds into a particular endowment, using investment appraisal techniques;
- the value of the particular programme or project against others. The Treasury will need to be satisfied that such funding would not protect any low-value programmes or projects from proper expenditure scrutiny;
- the sustainability of the funded body and whether such funding decreases reliance on public funding or not;
- whether there are clear objectives, outputs and outcomes of the funding; and
- the risk of further call on public funds (eg because the endowed funds have not grown at the expected levels).

31. Where a donor decides, with Treasury agreement, to make an endowment or dowry, its terms should:

- provide clarity – the funded body should know where it stands and not have to approach the donor for annual funding;
- maintain clean boundaries between the funder and the grant recipient.

32. However, funders should also ensure that such payments:

- are based on genuine need for funding;
- are based on an assessment that the grant recipient has the necessary competence to preserve or increase the value of the endowment over time; and
- do not skew public funding away from other projects that have genuine cash needs.

## **Impact of recycling clawed back proceeds**

### **Departmental and NDPB budgets**

1. In relation to budgets, if a department considers that it wants to recycle the proceeds, it should:
  - for grants to bodies others than NDPBs: record the proceeds as negative capital DEL and show the recycling as capital grants in DEL; and
  - for grant to NDPBs: record the sale of the asset as negative capital DEL with a matching acquisition also as capital DEL;
2. If there are timing differences (eg because the proceeds arise in one year, but the formal recycling does not happen until the next), the proceeds, as negative capital DEL, would need to be part of the department's overall calculation of end-year flexibility (EYF).

### **In departmental Estimates**

3. Departments, as funded through Supply and Estimates, should reflect any decisions to return any surrendered proceeds to a funded body in their Estimates if the proceeds would be over £1 million. The funding department's Estimate should reflect the recovery of proceeds as Consolidated Fund Extra Receipts (CFERs) or the responsible department may seek the Treasury's approval to appropriate in aid the proceeds against voted expenditure. If it is agreed that the department may recycle the proceeds, its Estimate should contain provision for a matching amount of financial support to the funded body to enable it to use the recycled amounts.
4. If the department requires a Supplementary Estimate to secure adequate provision to use the recycled proceeds, it will only be able to proceed in that year if there is time to seek a Supplementary Estimate. If that is not possible, the department may surrender the proceeds as CFERs in the year received and seek authority in its Estimate for the next year to increase funding to the funded body (eg grant in aid or grant) and to include the equivalent cash amounts in its Net Cash Requirement. Similar arrangements would apply if the use of the recycled proceeds were planned to take place in a later year.

### **Publicly funded Assets and Charities**

1. Many charities operate under trust law. Case law shows that, in making decisions, the trustees of such charities are bound to consider the interests of the intended beneficiaries of the charity's trust deed. The same may also be true of charities which are incorporated as companies: see the case of *Liverpool and District Hospitals v. AG* [1981] Ch 193 in which it was held that a charitable company was in a position analogous to that of a trustee and that the assets of the charity could only be used to further the charitable objectives of the company.
2. In practical terms, this means that any grant funded charity may be under an obligation to give priority to its charitable objectives unless the terms of the grant include legally enforceable conditions specifying otherwise. So public sector funders to charities should be aware that the charity's obligation to further its objectives may supercede its obligation to repay funders, and act accordingly. It is important for prospective funders to seek legal advice on this point.

### **Payments of grants by NDPBs to third parties with charitable status**

3. Departments should also ensure that, where NDPBs which they sponsor pay (or plan to pay) grants to charitable bodies out of money the NDPB has received by way of Exchequer grants or grants in aid, the same considerations are applied. Moreover, in general, departments should satisfy themselves that their sponsored bodies handle grants to beneficiaries appropriately.

### **Before sale as a going concern of all or part of the assets of a charitable body**

4. Where the assets of all or part of a charitable body are sold as a going concern, the funder's interest and that of the Exchequer should be considered at the outset. In all such cases, funders should take legal advice on the question of whether the proceeds of disposal could lawfully be surrendered to the Consolidated Fund. The Charity Commission should also be consulted in writing at the outset.
5. In the light of the legal advice, all possible steps should be taken to protect the position of the funding body and hence the Exchequer before disposal is decided on. For example, if a department is in a position to influence the decision to sell, its endorsement of the sale should be taken consciously in the light of all the facts.