



HM TREASURY

Financial Reporting Advisory Board Paper

Charging for the Cost of Capital in financial statements

Issue:	Discussion paper to consider the rationale behind the cost of capital charge, and debate its inclusion in financial statements.
Impact on guidance:	None as yet.
UK GAAP adaptation?	Yes.
IAS/IFRS compliant?	N/A.
IPSAS compliant?	N/A.
Impact on budgetary regime?	Yes.
Recommendation:	Cost of Capital Charge continues to be included in financial statements.
Timing:	N/A

DETAIL

Background

1. All capital has a cost, in the sense that employing capital in any asset involves an opportunity cost, equivalent to the cost of financing the asset. This can be roughly measured as the cost of financing the debt that supports the capital employed (say the interest paid on Gilts issued to build a hospital). More accurately it should include the cost of the risks associated with the asset, and can therefore be defined and measured as the opportunity cost of capital: that is the return the market would expect from capital employed in a given way, equivalent to the return that a debt or equity provider would wish to see earned on the investment in a given project (for example the cost of making risky investments in certain sectors of the economy). The Government as a whole incurs an interest cost for borrowing to finance investments by departments. To improve transparency and ensure the full cost of services is reflected in departmental accounts, this cost has been devolved to departments as a 'cost of capital charge'.

2. Since the Government introduced full resource accounting and budgeting, the cost of capital charge has been reflected in departmental planning and budgets, and within financial reporting, by its inclusion within Departmental Expenditure Limits (DELs) and financial statements. The cost of capital charge applies to all assets and liabilities on the balance sheet, with liabilities attracting a negative charge (i.e. a credit). In general the charge to resource accounts is at a standard rate (currently 3.5%), but varies with risk. The charge does not entail a cash transaction.

3. With several years experience of operating resource accounting and budgeting, it is now an appropriate time to reflect on the original rationale lying behind the cost of capital charge, to establish whether it continues to remain a sound basis for the charge, and to debate the future inclusion of the cost of capital charge within financial statements.

Rationale for the Cost of Capital charge

4. The 'capital charge' is viewed as the basis for estimating the cost of using capital within government, i.e. the opportunity cost of the Government financing investments made by departments.

5. The application of the capital charging system is based¹ on meeting a number of objectives relating to the provision of cost information, promotion of management incentives and facilitating Value for Money in investment, which remain as valid today as when capital charging was introduced under Resource Accounting and Budgeting.

Cost Information.

6. Capital charging provides valuable full cost information to management on the cost of using capital, i.e. the opportunity cost of capital. The capital charge recognises the full cost of outputs of the reporting entity and reports this to stakeholders relying on the information contained within the financial statements. Capital charging also improves the quality of information on the cost of services provided by an entity, particularly important where the entity must recoup its full operating costs by levying fees and charges to its customers.

Management Incentives

7. Capital charging promotes effective asset management, including working capital management, by emphasising to managers that capital is a scarce resource, aiding decision making linking use of capital to maintaining service delivery in pursuit of objectives, and promoting more informed decision making in capital investment.

Value for Money

8. Capital charging facilitates benchmarking of public sector outputs against other government and non-government providers and supports reasonable pricing of agency outputs where appropriate. It also promotes service delivery on a Value for Money basis.

¹ Based on research undertaken by New South Wales Treasury and CIPFA/LASSAC Capital Accounting Review Workshop Discussion Paper March 2003

Nature of the Cost of Capital charge

9. A fundamental question relating to the cost of capital charge is whether it represents a notional charge or an economic event? The Exposure Draft on the *Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities*, published by the ASB on the 11 August 2005², provides latest guidance on notional transactions.

10. The proposed Interpretation notes that if neither a transaction nor an event has occurred there will be no changes in the reporting entity's assets and liabilities and consequently no gain or loss to recognise. This conclusion is based on a discussion of the recognition process applying to financial statements, the starting point of the process being the effect that the transaction or other event has had on the reporting entity's assets and liabilities.

11. The conclusion reached in the Interpretation suggests that a non-cash capital charge, which would not have an effect on the assets and liabilities of the reporting entity, and with no transaction or event having taken place, would meet the effective definition of a notional transaction, and consequently would not be recognised in financial statements. To do so would represent a departure from UK GAAP.

Should the Cost of Capital charge be included in financial statements?

12. There are arguments for and against the inclusion of a cost of capital charge in financial statements.

Arguments for inclusion

13. Transparency of full costs. The cost of capital charge disclosed in departmental resource accounts provides transparency on the full cost of resource usage by the reporting entity to deliver its objectives. It informs stakeholders and users of the financial statements accordingly. Not to include the cost of capital charge in financial statements could lead to accusations of understating the true costs of operating a government entity.

14. Recovery of full costs. For some government entities, including some Executive NDPBs and public corporations, HM Treasury Fees and Charges rules require the delivery of services to customers to be charged at full cost, including an element to cover the cost of capital charge. To avoid a mismatch between income and expenditure reported in the financial statements, and to ensure the legality of recovery, it would be necessary to include the cost of capital charge in the reporting entity's financial statements.

15. Resource budgeting implications. Resource budgeting involves using the information in resource accounts as the basis for planning and controlling public spending. Embedded within resource budgeting is the requirement for departments to more effectively manage their resources, particularly assets. The cost of capital charge is an important control element in incentivising better asset management, and ensuring that public corporations earn a return equivalent to their cost of capital. The budgeting treatment normally follows the accounting treatment within resource accounts. Not to include the cost of capital charge within financial statements would lead to a divergence between resource accounting and budgeting.

² Available from <http://www.asb.org.uk/asb/press/pub0853.html>

16. National Accounts. Whilst National Accounts are mostly consistent with the UK GAAP basis under which we draw up departmental resource accounts, there are some differences, notably that national accounts do not include a cost of capital charge. However, it is possible that in the future the System for National Accounts are likely to move to include a measure of capital services – cost of production, similar in principle to a cost of capital charge.

Arguments against inclusion

17. UK GAAP. The cost of capital charge has no basis in UK GAAP, and its inclusion within financial statements would represent a departure from UK GAAP. However departments do not pay debt service costs (or pay a return on equity) in the way that any other reporting entity does that employs capital.

18. Are financial statements the right place to include the Cost of Capital? As noted above there is strong argument for the role of capital charging in the budgeting regime, but potentially under UKGAAP a less convincing case for its inclusion within financial statements, where the cost of capital charge may be viewed more as a comparative year on year measurement rather than an in year management control and tool, which is carried out elsewhere and reported within internal management accounts. However, all items in accounts are about showing year on year comparatives and performance measures, as opposed to in year control – so the issue here is whether this particular aspect of cost performance, which appears in departmental budgets, should be reported in outturn in the financial statements, or not.

Related issues

19. Whilst the rationale for a Cost of Capital charge remains firm, there are several related issues which warrant discussion, as detailed below.

Is it consistent to include all assets and liabilities within the calculation for the cost of capital charge?

20. The cost of capital charge applies to all assets and liabilities in the balance sheet, with liabilities attracting a negative charge (i.e. a credit). However, for some assets and liabilities the charge is at a nil rate, e.g. for donated assets, certain heritage assets, cash balances with the Office of HM Paymaster General, amounts due to or from the Consolidated Fund, and in respect of advances outstanding from the Contingencies Fund.

21. Applying the capital charge to all assets and liabilities on the balance sheet ensures application of the principle of a consistent and appropriate return on the taxpayers' equity (capital and reserves) on the balance sheet. The setting of a nil rate of return permits adjustment where the application of the real rate of return, set by HM Treasury and currently 3.5%, would cause perverse incentives or be inappropriate, for example because taxpayer cash hasn't been used in the acquisition of a donated asset, or because the cash balance at the Office of the Paymaster General is available to reduce overall levels of public sector debt, which is actively managed by the Debt Management Office to reduce debt service costs.

Should the inclusion of large pension liabilities be included within the calculation for the cost of capital?

22. There are a number of ways in which pension costs impact on liabilities in accounts of public bodies and therefore have an impact upon the calculation of the cost of capital. The issues are

slightly different for each, but essentially there are two main concerns related to a small number of bodies with wholly unfunded schemes and those with funded schemes.

23. Wholly unfunded schemes. There are a number of bodies where the pension costs are entirely met on a pay as you go basis. They generally have net liabilities and by including the pension liability in the cost of capital calculation it will result in a continual negative charge, i.e. a credit. This credit will go some way to abating the interest charge on the scheme liabilities.

24. Funded schemes. There are a number of central government bodies that are members of the Local Government Pension Scheme (LGPS) for some or all of their staff. The LGPS is a funded scheme administered as separate elements by administering authorities covering one or more local authorities, plus up to 200 other admitted bodies. The schemes are mostly in deficit and are treated as defined benefit schemes in resource accounts.

25. As funded schemes, one of the most significant movements in the net deficit position each year is due to changes in asset values, principally caused by movements on the stock market, which can be volatile. Under the FReM bodies include their share of the net deficit of the pension scheme in the cost of capital in their accounts, and by implication in their budgets. However, this can lead to some perverse consequences, e.g. if the stock market rises by more than assumed when the budget was prepared (presumably a good thing), then the net deficit will fall, the cost of capital credit will be lower, and potentially a body fails to meet its resource budget limit and could end up with an excess vote. Conversely, if the stock market falls more than anticipated then the cost of capital credit will increase giving the body more resources (though not cash) to spend.

26. This process requires bodies to predict future movements in the stock market and then base their financial performance around the eventual outcome, which can produce an adverse consequence. For this reason the current Manual requirements are currently not being applied by several Scottish bodies, in that they are not viewed as adding any real accountability for resources.

27. The funded and wholly unfunded schemes, discussed above, raise issues about whether these pension liabilities should be excluded from the cost of capital calculation, or alternatively should attract a nil rate of charge.

Should 'hard charging' be an option?

28. Within central government the non-cash cost of capital charge represents a notional transaction in financial statements. However, in investments in public sector bodies such as Trading Funds and NHS Trusts, the cost of capital charge entails a cash transaction, equivalent to the rate of return required from the body, and recognised as income in parent departments' financial statements, in the form of loan interest and dividends. Any under or over payment of the return due is reflected in the net operating cost of parent departments. Whilst hard charging for the cost of capital charge represents an option for central government bodies, it is debatable whether this would provide any improvement in accountability for resource usage not already achieved under the current resource budgeting regime.

Summary and recommendation

29. The rationale for the cost of capital charge appears as valid today as when the charge was introduced under full resource accounting and budgeting arrangements. For budgeting purposes the cost of capital charge is an essential tool in delivering the objectives of the budgeting system, i.e.

good micro economic management and offering appropriate levers to help control the overall fiscal position.

30. As a notional charge for central government bodies, the cost of capital charge has no basis in UK GAAP, and its continued inclusion in financial statements would represent a continued departure from UK GAAP. Notwithstanding the strong desire for the public sector to follow UK GAAP whenever appropriate, on balance, the arguments for the continued inclusion of the cost of capital charge in financial statements are viewed as outweighing the arguments against inclusion, although there are some related issues discussed in this paper which require further consideration. HM Treasury would welcome the FRAB's view on the conclusion reached.

HM Treasury

September 2005