



# HM TREASURY

## Financial Reporting Advisory Board Paper

### Classification of PDC

<b>Issue:</b>	An update to the FRAB's previous consideration of the classification of PDC.
<b>Impact on guidance:</b>	Not at present. Amendments to chapter 7 of the FReM, to specify the treatment of PDC and dividends in the accounts of trading funds, will be required in due course.
<b>UK GAAP adaptation?</b>	N/A
<b>IAS/IFRS compliant?</b>	N/A
<b>IPSAS compliant?</b>	N/A
<b>Impact on budgetary regime?</b>	N/A
<b>Recommendation:</b>	Approve in principle the proposals below for the classification and treatment of PDC
<b>Timing:</b>	Changes to the FReM would be proposed for the year in which FRS 25 and related standards are first to be applied.

### DETAIL

#### Background

##### *FRSs 21 & 25*

1. The FRAB has in the last year considered the potential impact of changes in accounting standards on Public Dividend Capital (PDC) and related dividends, particularly the requirements of:

- a. FRS 21 (IAS 10) *Events after the Balance sheet Date* to recognise as liabilities at the balance sheet date only dividends on equity instruments declared before then (FRAB (69) 02);
- b. FRS 25 (IAS 32) *Financial Instruments: Disclosure and Presentation* to present dividends on equity instruments as movements on reserves rather than in the income and expenditure account (FRAB (71) 02).

2. In its report for 2004-05, the FRAB accepted that the Treasury, together with the Department of Health and Monitor, needed to clarify the classification of PDC before the Board could discuss final proposals.
3. Further analysis has been undertaken and legal advice received. It has become clear that PDC does not come under the scope of FRSs 21 and 25. This is because these standards apply only to financial instruments as defined in FRS 25, and such financial instruments are contractual whereas PDC is statutory.
4. In relation to trading funds generally, relevant extracts from the standards and the Government Trading Funds Act 1973 are given in the annex to this letter (paragraphs 1 –5). Treasury Legal Advisors have confirmed that PDC is statutory rather than contractual so that, for example, obligations to repay PDC do not arise from a contract.
5. Monitor has received legal advice that PDC is a type of public sector equity finance based on the excess of assets over liabilities i.e. the net assets of a public benefit corporation, such as an NHS Trust. The net assets are deemed to be financed in the form of PDC and, in the case of NHS Trusts, this PDC was provided by the Secretary of State for the Department of Health to the NHS Trust under the 1990 Act. PDC is not debt. The 1990 Act, the Health and Social Care (Community Standards) Act 2003 and the Government Trading Act 1973 all distinguish between PDC and debt. Further, the legal status of PDC continues to be the same under the 2003 Act as it was under the 1990 Act.

#### *Other FRSs*

6. Consideration has also been given to the requirements of other accounting standards, particularly FRSs 5, 12 and 4.
7. PDC is not a liability to be recognised under FRSs 5 or 12 (annex, paragraph 6). This is because statute does not of itself give rise to an obligation to transfer benefits. It merely confers powers on the responsible Minister to reduce or extinguish the PDC of a trading fund by making payments from the trading fund into the Consolidated Fund (annex, paragraph 7).
8. FRSs 5 and 12 may, however, require dividends on PDC to be recognised as liabilities. This is because statute (annex, paragraph 8) obliges trading funds to pay such dividends as the responsible Minister may determine, and such a determination may have been made by the balance sheet date.
9. Dividends on PDC are not required to be accounted for under FRS 4 *Capital Instruments* (as amended by FRS 25). This is because FRS 4 prescribes the treatment of costs associated with a capital instrument that is classified as a liability, which PDC is not. This is notwithstanding that it is anyway possible to view PDC as not being a capital instrument under FRS 4, because PDC is not an instrument issued by a trading fund (annex, paragraph 9) and is statutory instead.
10. No other accounting standards appear to have any relevant requirements.

### *Classification and treatment of PDC and dividends*

11. Based on the above we propose that:
- a. PDC can be classified as, and can continue to be presented as, a form of financing in the bottom half of the balance sheet along with the accumulated reserves;
  - b. Dividends on PDC can continue to be presented in the income and expenditure account and to be accounted for where appropriate as liabilities in the balance sheet.

### *FRS 25 and loans*

12. Trading funds' long-term loans are currently presented as part of financing in the bottom half of the balance sheet. Under FRS 25, these will be required to be presented instead as liabilities in the top half of the balance sheet. When this occurs, the link will no longer be as direct between the balance sheet and the capital employed used for calculating trading funds return on capital employed, effectively being PDC plus long-term loans. Extra disclosure of the composition of capital employed may be required to maintain the transparency of this link.

### **Summary and recommendation**

13. PDC can be classified as a form of financing that is not affected by developments in accounting standards. Our recommendation, supported through consultation with trading funds and related departments, the Department of Health and Monitor, is for the FReM to be amended when FRS 25 and related standards are implemented (the timing of which is the subject of a separate FRAB paper), to require the current accounting treatment of PDC and dividends to continue and to require extra disclosure for capital employed as appropriate.

HM Treasury  
16 September 2005

## **Classification of PDC**

1. FRS 25, para 4: "This standard shall be applied to all types of financial instruments ... [except those accounted for under other standards]."
2. FRS 25, para 11: "A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability of another entity".
3. FRS 25, para AG 12: "Assets and liabilities that are not contractual (such as income taxes that are created as a result of statutory requirements that are imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in FRS 16 'Current Tax' and FRS 29 'Deferred Tax'. Similarly, constructive obligations, as defined in FRS 12 'Provisions, Contingent Liabilities and Contingent Assets', do not arise from contracts and are not financial liabilities."
4. FRS 21, para 12: "If an entity declares dividends to holders of equity instruments (as defined in FRS 25 (IAS 32) Financial Instruments: Disclosure and Presentation) after the balance sheet date, the entity shall not recognise those dividends as a liability at the balance sheet date."
5. Government Trading Funds Act (GTFA) 1973, section 2A(1): "An order providing for any assets and liabilities to be appropriated as assets and liabilities of a trading fund may provide for any part of the amount by which the values of the assets exceed the amounts of the liabilities to be treated as public dividend capital of the fund."
6. FRSs 5 & 12 define liabilities as "An entity's obligations to transfer economic benefits as a result of past transactions or events."
7. GTFA 1973: The responsible Minister may make payments out of a trading fund to reduce or extinguish PDC by virtue of:  
Section 2(3) where loan finance is provided to the trading fund under section 2B;  
Section 4A where any of the operations of a trading fund are to cease to be funded operations.  
These sections are too long to be reproduced here – see link to the Act below  
[http://www.opsi.gov.uk/acts/acts1990/Ukpga\\_19900030\\_en\\_1.htm](http://www.opsi.gov.uk/acts/acts1990/Ukpga_19900030_en_1.htm)
8. GTFA, section 2A(5): "For any financial year in which a trading fund has public dividend capital, there shall be paid out of the fund into the Consolidated Fund such sums (if any) by way of return on that capital and its reserves as the responsible Minister may determine, with Treasury concurrence, having regard to any balance in the fund at the end of that year and the amount of the balance which appears to the responsible Minister and the Treasury to be in the nature of distributable profit."
9. FRS 4, para 2 defines capital instruments as "All instruments that are issued by reporting entities as a means of raising finance, including shares, debentures, loans and debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments."