



HM TREASURY

Financial Reporting Advisory Board Paper

Charging for the Cost of Capital in financial statements

Issue:	Discussion paper to consider further the nature of the cost of capital charge and its base, and the presentation of the charge in financial statements.
Impact on guidance:	None as yet
UK GAAP adaptation?	No
IAS/IFRS compliant?	N/A
IPSAS compliant?	N/A
Impact on budgetary regime?	Yes
Recommendation:	The Cost of Capital Charge continues to be included in financial statements as per the existing presentation, calculated on the most appropriate base.
Timing:	N/A

DETAIL

Background

1. At its meeting on the 7 February 2006, the FRAB debated FRAB paper (77) 05, a discussion paper which considered the rationale and base for the cost of capital charge, and which provided alternative options on how the cost of capital charge might be presented in financial statements. In its deliberations at the February meeting the Board accepted the usefulness and necessity from the public sector perspective of including the cost of capital charge in financial statements, but asked for further consideration on how the charge should be best described and presented in financial statements. This paper addresses the Board's request and re-enforces the Board's discussion on the nature of the cost of capital charge.

Nature of the Cost of Capital charge

2. At the FRAB meeting on the 7 February, the Board had an extensive discussion on the nature of the cost of capital charge and concluded that due to the resource budgeting framework the effect of the charge on departments was real in nature rather than notional. The cost of capital charge forms part of the resource Estimate approved by Parliament and forms part of the budgetary framework that impacts on departments. This is illustrated in a simple example below.

Example of the budgetary effect of the charge

3. In a department's budget it has a Treasury set resource departmental expenditure limit (DEL), comprising cash and non-cash of 100, which comprises a planned cost of capital figure of 5, leaving a resource DEL limit of 95 available for other resource expenditure, i.e.

Resource DEL	100
Planned COC charge (non cash)	<u>(5)</u>
Balance of Resource DEL available	<u>95</u>

4. However, when there is a variance of the actual to the planned cost of capital charge, i.e. a favourable or adverse variance, this has a real effect on department's budgets and spending ability, illustrated below.

<u>Adverse variance</u>		<u>Favourable variance</u>	
Resource DEL	100	Resource DEL	100
Actual COC charge	<u>(10)</u>	Actual COC charge	<u>(3)</u>
Balance of Resource DEL available	<u>90</u>	Balance of Resource DEL available	<u>97</u>

5. The above simple example illustrates that for the public sector the cost of capital charge although described as a notional charge, actually has a real impact on departmental spending, as reported in financial statements. Consequently there is a strong argument that the inclusion of the cost of capital charge in resource accounts does not represent a departure from UK GAAP.

Presentation of the cost of capital charge in financial statements

6. The existing presentation of the cost of capital charge in financial statements is illustrated at Annex A. In this typical example the cost of capital charge is shown as line items in Note 10 (Other Administration costs) and Note 11 (Programme costs) and within the Operating Cost Statement (OCS) under the relevant headings.

7. The fact that the cost of capital charge is real in nature, with the current presentation in financial statements accepted by departments, and preferred under the budgetary framework, strongly

supports the view that it should remain unchanged, as illustrated at Annex A. It is emphasised that the existing presentation supports what the users of accounts and departments find most useful.

8. The FRAB will note also that the existing presentation provides full cost information in accounts for management purposes and facilitates the appropriate setting of fees and charges in recovering full costs, and is consistent with the resource budgeting framework. It also actively promotes effective asset management, including working capital management, by emphasising within accounts that capital is a scarce resource, which is not a free good, and so conforms to good management practice.

The Cost of Capital charge base

General application of the Standard rate, exceptions and inconsistency

9. FRAB paper (77) 05 provided detail on the general application of the standard rate of charge. The paper also detailed the exceptions to the standard rate, and the inconsistency resulting from the existing capital charge base in relation to pension liabilities reported in financial statements under FRS 17. At the February meeting the Board did not reach a conclusion on the inconsistency issue relating to the existing capital charge base.

10. To inform the Board in its deliberations on the capital charge base, alternative options are considered below.

Alternative options for the cost of capital charge base

11. Three options are considered for the cost of capital charge base. They are described below.

Option 1 – The existing base of Total Net Assets (Taxpayer's Equity)

12. This option is when the capital charge applies to all assets and liabilities in the balance sheet with all liabilities attracting a negative charge (i.e. a credit). As the capital charge base is effectively on the total net assets of the entity, it includes fixed assets and net working capital (i.e. net current assets) plus creditors falling due after more than one year, and all provisions for liabilities and charges.

13. Applying the charge to all assets and liabilities on the balance sheet ensures an appropriate return on the Taxpayer's Equity (Capital and Reserves). However, as previously reported to the Board, there is inconsistency in the application of the charge to pension liabilities. The Board previously noted that the major unfunded pension schemes, reported in separate pension scheme statements, do not receive a capital charge credit on net pension liabilities. Conversely, those wholly unfunded pension schemes reported in departments or Executive NDPBs' accounts are subject to a capital charge (credit) as appropriate; as do departments' share of funded schemes reported in a number of central government bodies' accounts where they are members of the Local Government Pension Scheme for some or all of their staff.

14. Whilst retaining this option for the cost of capital base may support the general budgetary control framework, it would nevertheless continue the inconsistent treatment of pension liabilities. The original rationale for excluding the major public sector pension schemes was that the principal budgetary control would continue to be the participating employers' contributions to the pension schemes, because no benefit would be gained from capital charging. If this rationale is not viewed as remaining valid, then for reasons of consistency of treatment, consideration should be given to either including or excluding all pension liabilities from the capital charge base.

Option 2 – Capital charge based on Total Assets less current liabilities

15. This option is where the capital charge base is set as a minimum on fixed assets plus net working capital. This option would exclude long-term liabilities such as creditors and provisions, including pension liabilities, and therefore would result in the consistent application of the charge. However, this option would exclude longer-term creditors, which under the original rationale for the cost of capital charge should in principle be included.

Option 3 – Capital charge based on Total Assets less current liabilities, plus long term creditors

16. This option would include all assets and liabilities on the balance sheet with the exception of pension liabilities and provisions.

17. Adopting this option may be more consistent with the underlying rationale for the cost of capital charge, removing any potential for inconsistent or inappropriate application of the charge, which could result in odd or perverse results, such as that currently applying to pension liabilities.

Favoured options

18. Of the options, Option 1 and Option 3 represent the most viable from the perspective of the budgetary control framework. Option 1 would continue with the inconsistent, albeit possibly appropriate treatment of pension liabilities, unless it was viewed necessary to include or exclude all pension liabilities. Option 3 may better represent the underlying rationale for the charge, and may result in its more consistent application.

Summary and recommendations

19. The cost of capital charge applied to the public sector although described as a notional charge within the budgetary framework, does actually have a real impact on departmental spending as reported in financial statements. Consequently, there is a strong argument that the inclusion of the cost of capital charge in resource accounts does not represent a departure from UK GAAP.

20. Due to the real rather than notional impact of the charge, and the acceptance of the existing presentation by HM Treasury, departments and users of the accounts, it is strongly recommended that the existing presentation, illustrated at Annex A, is retained.

21. The adoption of a cost of capital base which removes any inappropriate inconsistencies in the application of the charge is recommended. Options 1 and 3 are the more viable options from a budgetary control perspective.

22. HM Treasury seeks the FRAB's agreement on the recommended presentation in financial statements, and welcomes the Board's views on the most appropriate base for the charge.

HM Treasury

20 March 2006