



HM TREASURY

Financial Reporting Advisory Board Paper

Charging for the Cost of Capital in financial statements

Issue:	Discussion paper to consider the rationale and base for the Cost of Capital charge, and debate how it should be presented in financial statements.
Impact on guidance:	None as yet
UK GAAP adaptation?	Possibly
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 calculated on an equal base for pension liabilities, and that the FRAB considers the alternative options for disclosure.
Timing:	N/A

DETAIL

Background

1. At its meeting on the 28 September 2005, the FRAB debated the inclusion of the cost of capital charge in financial statements. The Board concluded that the cost of capital charge was a useful item to include in financial statements, but requested a paper considering what the cost of capital charge is and does, its base, and how it might be alternatively presented in financial statements to make it as UK GAAP compliant as possible. This paper addresses the Board's request.

Nature of the Cost of Capital charge

2. Within central government the cost of capital charge is a non-cash notional charge which scores within departmental budgets, and is measured and reported in resource accounts. Its classification as a notional cost is re-affirmed by the recent Exposure Draft on the *Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities* published by the ASB on the 11 August 2005, and which provides the latest guidance on notional transactions.

3. 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 in financial statements. This 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.

Rationale for the Cost of Capital charge in resource accounts and budgets

4. The purpose of resource accounts is to measure and report the financial resources consumed by or at the request of central government and its related bodies. In any given period, financial resources are consumed through the following activities:

- a. paying cash to purchase goods and services for use in, or to settle obligations arising in, the current period;
- b. using up valuable assets acquired in previous periods, and
- c. incurring liabilities to make payments in future periods.

5. To the extent that resources are consumed by activity (a), the resource consumption is matched by an equivalent outflow of cash in the period. In simple terms, to the extent that resources are consumed by activities (b) or (c), the cash outflow occurs, respectively, before or after the resource consumption. We can regard the time at which the cash outflow occurs as the point at which resources are committed.

6. When resources are committed before they are consumed (or vice versa), government bears (or saves) the opportunity cost of not being able to employ those resources elsewhere until (or from the time when) consumption takes place. This opportunity cost (saving) is reflected in resource accounts by means of the cost of capital charge (credit).

7. In resource budgeting, departments are effectively subject to a cost of capital charge for holding assets. This reflects the fact that assets held by departments have an 'opportunity cost' in that they could be put to an alternative productive public sector use. The cost of capital charge is set equal to the Social Time Preference Rate (STPR).

What is the Social Time Preference Rate?

8. Social Time Preference is society's preference for consumption sooner rather than later. The STPR expresses this preference as an annual percentage rate. That rate is set at 3.5% (real) by HM Treasury's – *The Green Book: Appraisal and Evaluation in central Government*. Annex 6 of the Green Book explains how that 3.5% rate is derived. To summarise, it is the sum of three elements:

- **Catastrophe risk:** The possibility that there will be some event so devastating that all returns from policies, programmes or projects are eliminated, or at least radically and unpredictably altered;
- **Pure time preference:** Individuals' or society's innate preference for consumption now, rather than later;
- **The impact of economic growth:** When an individual becomes richer, the additional enjoyment or utility conferred by additional consumption is reduced.

Why is the Cost of Capital charge equal to the Social Time Preference Rate?

9. *In principle*, the public sector would be expected to embark on all projects that yield a social rate of return in excess of the STPR, and no others. In that case, marginal investments (those which government only just decides to go ahead with) would yield an expected rate of return of 3.5%. Therefore, by holding assets such as buildings or cash, departments can be seen as effectively preventing those marginal investments from going ahead. This means it is appropriate to set the cost of capital charge at 3.5%.

10. *In practice*, for valid reasons, Net Present Value is not the only criterion used in the decision-making process. Government is also subject to a budget constraint and will not fund all investments that yield an expected social rate of return of over 3.5%. However, it is not clear where the cut-off point is below which investments would not be funded. Setting the cost of capital charge at 3.5% represents a pragmatic solution to this problem.

What does the Cost of Capital charge achieve?

11. Capital charging provides valuable full cost information to management on the cost of using capital, i.e. the opportunity cost of capital. This capital charge recognises the full cost of outputs of the reporting entity and reports this to stakeholders relying on the information contained within financial statements. Capital charging also improves the quality of information on the full 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.

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

13. Capital charging facilitates the 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.

The Cost of Capital charge base

General application of the standard rate

14. All entities covered by the requirements of the Government Financial Reporting Manual, with the exception of Trading Funds, recognise a notional cost of capital. Trading Funds are required to earn and pay over an agreed rate of return to their sponsoring departments or directly to the relevant

authority. 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). Applying the capital charge to all assets and liabilities ensures an appropriate return on the taxpayers' equity (capital and reserves) on the balance sheet.

15. The cost of capital charge is normally set at a real rate by HM Treasury, currently the standard rate is 3.5% for all assets and liabilities. There are however some exceptions which permit the setting of a nil or other rate where the standard rate would cause perverse incentives or be inappropriate.

Exceptions to the standard rate - Investments

16. For investments represented by public dividend capital or other forms of equity investment, either with or without voted loans, the charge will be the higher of the standard rate or the rate used for the purposes of calculating the body's target rate of return on capital employed applied to the underlying net assets of the body.

17. For investments, other than trading funds, represented by public dividend capital or other forms of equity investment, either with or without loans from the National Loans Fund, the charge will be the higher of the standard rate or the rate used for calculating the body's target rate of return on capital employed applied to the underlying net assets of the body in question less any interest payable to the National Loans Fund.

18. For investments in trading funds represented by public dividend capital, either with or without loans from the National Loans Fund, the return will be the higher of the standard rate or the rate used for the purposes of calculating the trading fund's target rate of return on capital employed applied to the underlying net assets of the trading fund in question. For trading funds which are not set a return on capital employed target, the charge is simply the return as agreed between the department and HM Treasury.

19. Investments comprising only loans (either voted or from the National Loans Fund) the return will equate to the interest due from the body, calculated using the National Loans Fund rate of interest appropriate to a loan with the same date of issue and same repayment terms.

Exceptions to the standard rate – Other exceptions

20. Certain other exceptions will bear a nil rate of charge and include:

- Donated assets;
- Additions to heritage collections where the existing collection has not been capitalised;
- Cash balances with the Office of HM Paymaster General;
- Balances with the Bank of England provided that the balances are formally included in the "Exchequer pyramid" which allows such monies to be used to reduce government borrowing;
- Amounts due from, or due to be surrendered to, the Consolidated Fund;

- Liabilities in respect of advances outstanding from the Contingencies Fund.

Odd or perverse results from the existing capital charge base

Pension liabilities under FRS 17

21. 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 inconsistencies in when the cost of capital credit is applied to pension liabilities, as follows:

- *Major unfunded public sector pension schemes.* These schemes, e.g. The Principal Civil Service Pension Scheme, are reported in separate scheme statements where there is no recognition of a cost of capital credit on net pension liabilities.
- *Wholly unfunded pension schemes.* There are a small number of departments and Executive NDPBs where the pension costs are met entirely on a pay as you go basis. These bodies generally have net liabilities and by including the pension liability in the calculation for the cost of capital it results in a continual cost of capital credit within their individual financial statements (i.e. resource accounts or income and expenditure accounts).
- *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 schemes by administering authorities covering one or more local authorities plus up to 200 other admitted bodies. Most of these schemes are in deficit. The schemes are able to identify the share of assets and liabilities of each employer and accordingly are treated as defined benefit schemes in resource accounts. Because they are funded schemes one of the most significant movements in the net deficit position each year is changes in asset values, principally the stock market, which can be quite volatile. In accordance with the FReM bodies should include their share of the net deficit of the pension scheme in the cost of capital calculation in the accounts (and by implication in their budgets), however in practice this does not always occur due to the problem of volatility in assets. The volatility in asset values leads to some perverse consequences. For example, 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 and ends 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.

What changes ought to be considered to the capital charge base?

22. To bring consistency in where the cost of capital (credit) is applied to pension liabilities it is recommended that either:

- The cost of capital credit be applied to all net pension liabilities, or;

- The cost of capital credit not be applied to all pension liabilities, by way of exemption from the standard rate.

Differences between accounts and budgets on cost of capital charges

23. The cost of capital charge base is generally the same between accounts and budgets, with a small number of exceptions, detailed below.

Public Corporations

24. In accounts departments bear a cost of capital charge only for those public corporations where they have an investment (loans or equity) in the relevant body. From the application of new budgeting rules from 2006-07 departments will bear a cost of capital charge in respect of nearly all their public corporations, even when there is no departmental investment.

Assets funded by Local Authority grants

25. In accounts assets funded by Local Authority grants are subject to a cost of capital charge. In budgets such assets do not attract a cost of capital charge.

Assets outside budgets

26. In accounts all assets are subject to a cost of capital charge, including assets outside budgets, e.g. EU income shown as a debtor in accounts. Cost of capital charges on such assets do not currently score in budgets, but will do so from 2006-07.

Alternative presentations of the cost of capital charge in financial statements

27. There are four alternative options for presenting the cost of capital in financial statements. These are considered in turn.

Option 1 - Existing presentation in financial statements

28. This is the status quo option with an example at Annex A. In this 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.

29. The existing presentation provides the advantages of full cost information in accounts for management purposes, it facilitates the appropriate setting of fees and charges in recovering full costs, and is consistent with resource budgeting, although the base for the accounting should mirror that for budgeting. The existing presentation 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.

30. The disadvantage with the existing presentation is that it is not GAAP compliant.

Option 2 - Reversal of the cost of capital charge in financial statements

31. This option is illustrated at Annex B. As for the existing presentation, the cost of capital charge is shown as line items in Note 10 (Other Administration costs) and Note 11 (Programme costs) and within the OCS under the relevant headings. Where this option differs from existing practice is that

within the OCS below the Totals line a new heading of 'Gross Operating Cost' is introduced (essentially equating to the existing 'Net Operating Cost'), the capital charge is then reversed, and the resultant 'Net Operating Cost' figure no longer includes the cost of capital charge.

32. This option has the advantage of being similar in practice to the way that Executive NDPBs account for the cost of capital charge whilst arguably remaining GAAP compliant. Whilst it does not preclude the identification of full cost information within the accounts, it does not so clearly support the budgeting regime control aspects as well as Option 1.

33. The disadvantages are that with reversing the charge within the primary statement there is a real risk that bodies may not take the cost of charge sufficiently seriously and there would be inconsistency between accounting and budgeting, i.e. the Net Operating Cost figure would not be consistent with resource budgeting.

Option 3 - Excluding the cost of capital charge - disclosure in financial statements for administrative purposes only

34. This option is illustrated at Annex C. It does not include the cost of capital charge as line items within Notes 10 and 11, but merely provides disclosure narrative following the Note totals that the total figures transferred to the OCS exclude the cost of capital charge. On the face of the OCS the cost of capital charge figures are disclosed and highlighted for administrative purposes by boxing the figures, but they do not form part of the Net Operating Cost total.

35. This option has the advantage of being more GAAP compliant.

36. It has the disadvantages of being potentially confusing to readers of the accounts and is not good presentationally. It would also be inconsistent with resource budgeting and it would be more difficult for account users to determine full cost information. It would consequently fail to promote sound management of assets, including working capital, and charging/recovery schemes.

Option 4 - Disclosure of cost of capital charge by way of Note to the accounts only

37. This option would involve the mere disclosure of the cost of capital charge by way on Note to the accounts, which would not be transferred to or disclosed in the OCS.

38. Though this option would be more GAAP compliant, it is considered less favourable and informative than the other options. It is unlikely to be taken seriously by departments, it would not be compliant with resource budgeting, and it would not easily provide full cost information on the reporting entity.

Favoured option

39. For the reasons provided above, the favoured option is Option 1, the existing presentation, despite it not being GAAP compliant. It is recognised however that Option 2, illustrated at Annex B, would provide currently available information albeit in a different format, and although this has distinct disadvantages, it could possibly be seen to provide an alternative and arguably more GAAP compliant solution.

Summary and recommendation

40. The rationale for the cost of capital charge continues to remain valid and there are strong reasons for the continued inclusion of the cost of capital charge within financial statements.

41. Whilst the capital charge base also remains generally valid there are some concerns over some odd or perverse results occurring in the context of applying the standard rate of charge (credit) to pension liabilities. As a consequence, it is recommended that for reasons of consistency that pension liabilities in entirety be subject to the cost of capital credit, or excluded in entirety by way of exemption from the standard rate. In principle the cost of capital base for accounting should follow that for budgeting.

42. In respect of the presentation of the cost of capital charge in financial statements, the favoured option is Option 1 - the existing presentation, illustrated at Annex A. However, the option of reversing the capital charge in financial statements, illustrated at Annex B, could possibly be seen to provide an alternative, although it is arguable whether it would be GAAP compliant.

43. HM Treasury would welcome the FRAB's views on the conclusions reached.

HM Treasury

7 February 2006