

## **Classification Paper; Capital and Financial Transactions**

### **Purpose of the document**

This note provides guidance on the definition, scope and classification of capital expenditure and financial transactions. It provides guidance on what transactions are treated as capital or financial transactions in the national accounts under the European System of Accounts (ESA95), and in addition provides guidance on the treatment of these transactions in the Resource Accounting and Budgeting framework. It replaces CLASS (2000) 2, which itself replaced CLASS(98)1.

The Financial Reporting Manual (FReM) gives more information on the treatment of capital expenditure in resource accounts.

For detailed guidance on budgeting for capital or financial transactions departments should see the consolidated budgeting guidance. The paper does not provide guidance on the valuation of capital assets, write-downs, impairment and depreciation (which are covered in the FReM).

For further advice, departments should approach in the first instance their normal Treasury spending team division contact. Treasury spending teams are invited to discuss classification issues with Russell Coleman (Tel 020 7270 5337) or Robert Spinks (Tel 020 7270 5338). Difficult cases will be referred by HM Treasury to the Office for National Statistics for a determination.

### **Introduction - Capital and financial transactions in the national accounts**

#### **Capital**

Capital Expenditure can have a different scope depending on the context. This paper covers in the first instance capital expenditure in the national accounts, which are used to define and measure the fiscal position and fiscal rules. The paper also addresses the treatment in the resource accounts.

The following three components form capital expenditure in the national accounts.

#### **1) Purchases, less sales, of non-financial assets:**

Acquisitions less disposals (measured at the open market) of non-financial produced and non-produced assets, including land and buildings etc. Non-financial assets are described more fully in the section below. Acquisitions of valuables are included here also.

#### **2) Expenditure on capital grants:**

Grants from government to the private sector, which are used by the recipient to acquire a capital asset, are classified as capital grants. See section below for further guidance.

#### **3) Net-stock building:**

Net stock building increases net investment. This is a cash to accruals adjustment in resource accounts.

The sum of the three components above is termed **gross capital formation**. **Public Sector Net Investment** is the sum of the above, net of (i.e. less) depreciation on the stock of public sector assets in the period.

### Note on the terms Gross and Net

Note that the terms "gross" and "net" can have different meanings when applied to capital expenditure outside the context of national accounts. Capital expenditure can be recorded before or after capital asset sales; and it can be before or after the deduction of depreciation on capital assets. In the national accounts, "gross capital formation" as above is net of asset sales but before (gross) the deduction of depreciation. The fiscal measure "net investment" is net of asset sales and net of depreciation. Occasionally in government publications capital spending is presented gross of asset sales and gross of depreciation.

### **Financial transactions and Policy lending**

Financial transactions do not add to capital expenditure, as they are not spending transactions. Financial transactions consist of the transformation of one type of financial instrument into another – so cash into deposits for example. Policy lending is defined as transactions in financial assets, such as loans and shares, which are acquired to further the policies of a department. Policy lending excludes financial assets acquired to manage liquidity (such as bank accounts). Policy lending increases fixed assets on the departmental balance sheet but is not an item in net investment. Policy lending contributes to the overall stock of financial debt, as measured by the aggregate Public Sector Net Debt.

### **FIXED CAPITAL - Types of assets**

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. In this context, 'future economic benefits' means that the asset will contribute in some way to the provision of services or other outputs by departments.

Assets can be financial (bank deposits, bonds, loans, shares, accounts receivable) or non-financial (land, buildings, vehicles, equipment, machines, rights to use physical structures or information, goodwill and other intangibles, stocks and valuables).

For non-financial assets, access to economic benefits can be obtained in various ways. Usually it is obtained by legal ownership of goods. Sometimes similar access to economic benefits may be obtained without legal ownership, for example where goods are leased by way of a finance lease. In these circumstances, the asset may be barely distinguishable in terms of financial commitment and opportunity for 'risk and reward' from that obtained through legal title.

Capital expenditure includes expenditure to acquire non-financial fixed capital assets. This section describes different types of assets.

### **Tangible fixed assets**

A tangible non-financial asset is an asset that has physical substance and is used to produce or supply goods and services, for rental to others, or for administrative purposes on a continuing basis for more than one year. Fixed capital expenditure is the creation or purchase, net of sales, of fixed assets. It includes:

- acquisition, reclamation or laying out of land;
- acquisition, construction, preparation or replacement of buildings and other structures and their associated fixtures and fittings;
- acquisition, installation or replacement of movable or fixed plant, machinery, vehicles and vessels.

The expenditure should be recorded on an accruals basis

Expenditure on assets under construction should be recorded when payments become due.

Stockpiled fixed assets should be treated in the same manner as conventional fixed assets. So the purchase of capital assets for later use or sale would be recorded as capital expenditure, except stockpiled single use military equipment (see later section).

## Intangible fixed assets

Intangible non-financial assets are defined as non-financial assets that do not have physical substance but are identifiable and are controlled by the entity through custody or legal rights. Examples of intangible assets are: scientific or technical knowledge in order to produce new or substantially improved materials; copyright; and intellectual property rights.

Development is the use of scientific or technical knowledge in order to produce new or substantially improved materials, devices, products or services, to install new processes or systems prior to the start of commercial production or commercial applications, or to improve substantially those already produced or installed. Development may be treated as capital expenditure if at the time it is incurred it meets all the criteria below

- there is a clearly defined project
- the related expenditure is separately identifiable
- the outcome of the project has been assessed with reasonable certainty as to:
  - its technical feasibility
  - it resulting in a specific product or service that will eventually be brought into use
  - adequate resources exist, or are reasonably expected to be available, to enable the project to be completed and to provide any consequential increases in working capital.

Otherwise, development expenditure should be recorded as current expenditure.

For further details of see the FReM.

## Software

Major items of software such as operating systems and substantial applications packages are included in capital expenditure. Routine expenditure on maintenance and updating will usually be current. Where customers place a contract for a specific piece of software to be developed to meet their particular needs then expenditure on the contract may be regarded as capital expenditure if the conditions above are satisfied.

The treatment of expenditure on software licenses may be treated as:

- **current** expenditure where the licenses are paid on a recurrent basis, even where the period between repayments is more than a year; and
- **capital** expenditure where a single payment is made covering the use over the expected life of the software and where there is no opportunity for the vendor to seek renewal payments. In effect the software has been purchased.

For further information see the FReM.

## Databases

Apply the same rules as for other assets created in-house or purchased.

## **Military assets**

Under ESA95, expenditure on the acquisition of, or enhancement to:

- **dual purpose** military goods, will be treated as *capital* expenditure. These are assets of a kind that could be used by civilian organisations for the production of goods and services. Examples are airfields, docks, roads and hospitals. Expenditure on almost all fixed structures should be treated as capital expenditure as would that on types of equipment which have alternative non-military uses - such as transport equipment, computers, communication equipment and hospital equipment.
- **single purpose** military goods, e.g. weapons and the equipment which supports and delivers such weapons - warships, submarines, fighter aircraft, tanks, missile carriers and launchers - will be treated as *current*.

For resource accounting and budgeting, all expenditure on the acquisition of, or enhancement to, military assets, regardless of its treatment in national accounts, is treated as capital. The expenditure on single use military assets is therefore recorded separately on the COINS database using distinct SCOA codes so that an adjustment can be made in national accounts.

## **Heritage assets**

Heritage assets are those assets which are intended to be preserved in trust for future generations because of their cultural, environmental or historical associations. Heritage assets include historical buildings, archaeological sites, military and scientific equipment of historical importance, and works of art.

Under resource accounting departments are required to attest annually to the ongoing heritage credentials of its heritage assets. There are certain characteristics which, whilst they may be present in other assets as well, are often displayed by heritage assets. For heritage assets, typically:

- their value to government and the public in cultural, environmental, educational and historical terms is unlikely to be fully reflected in a financial value derived from a market mechanism or price;
- established custom and, in many cases, primary statute and trustee obligations impose prohibitions or severe restrictions on disposal by sale;
- they are often irreplaceable and their value may increase over time even if their physical condition deteriorates;
- they may require significant maintenance expenditure so that they can continue to be enjoyed by future generations;
- their life is measured in hundreds of years.

Operational heritage assets are those which, in addition to being held for their characteristics as part of the nation's heritage, are also used by the entity for other activities or to provide other services for which it is responsible. An example is a historical building used for both ceremonial occasions and office accommodation.

There is likely to be no expenditure on the construction of new heritage assets since they have to meet the criteria above. However some might undergo substantial renovation to extend their life: this should be recorded as capital expenditure.

In resource accounting, the creation, purchase or improvement of new heritage assets would be added to the balance sheet. National accounts applies the same rules as per any other asset.

## **Land**

This economic category includes

- the purchase, net of sales, of natural assets over which ownership may be enforced and transferred; and
- taking steps to increase the value of natural assets realised by the productive activity of economic entities.

In the case of the sale and purchase of *land*, costs of ownership transfer should be identified and recorded separately if this can be done without disproportionate cost. These costs include professional fees and stamp duty paid. Separate identification is needed for national accounts because the costs of ownership transfer count as capital formation, while the purchase of land itself does not. Land purchases and sales are however capital transactions.

In national accounts "natural assets" are called "tangible non-produced and non-financial assets" and include sub-soil minerals, the electro-magnetic spectrum, and in-land water in those cases where ownership rights can be enforced.

## **Valuables, works of art, jewellery**

The acquisition of works of art, jewellery, precious stones and antiques is capital expenditure. In national accounts this can be classified as either:

- capital formation, if the assets are used to produce services, or as
- the acquisition of valuables – if they are acquired as a store of value, like an investment.

It is assumed that Government departments do not buy valuables as an investment but in order to produce heritage – to be displayed in museums for example. They are therefore recorded in the same economic category (E15) / SCOA as the acquisition of plant and machinery.

For further information see the FreM.

## **Work in progress/ under construction**

Work on assets under construction are recorded in national accounts in either of two ways:

- as the capital expenditure of the eventual owner of the asset
- as the addition to the constructor's stocks of unfinished goods.

If the asset is being constructed specifically for an owner known in advance – typically under a construction contract - then the work should be recorded as the capital expenditure of the eventual economic owner. Valuing such work can present problems: the pragmatic solution is to say that the value of the work equals the value of any stage payments made under the contract. Under such contracts it is often the case that ownership of the incomplete asset passes to the eventual owner when stage payments are made. If actual data are available on the increasing value of the asset under construction then those data can be used as the capital expenditure of the future owner, if there is no doubt that the construction work is adding to the purchaser's liabilities.

If the asset is being constructed for eventual sale but not under a contract to an eventual owner known in advance, the work is recorded as the addition to the stocks of the constructor's unfinished goods.

Resource accounts are consistent with the national accounts approach: capital expenditure is recorded when economic ownership transfers or when payments are made for work in progress on assets under construction if no actual information is available. Such payments lead to the creation of an asset in the departmental balance sheet.

For on-balance sheet PFI assets where the constructor takes construction overrun risk then the capital expenditure is recorded when the asset becomes operational, as it is not until that point that economic ownership passes to the public sector.

For further information see the FReM

## **CAPITAL GRANTS**

### **General issues**

Grants are unrequited payments. Grants are given with no expectation of any financial return to the donor, and without any goods or services being supplied to the donor in return. Grants can be given on condition that the recipient undertakes certain action or expenditure: for example to keep a museum open or educate students. Grants are recorded as capital grants if they are for the purpose of financing the recipient's acquisition of capital assets as agreed by the grant donor.

Grants for the acquisition of financial assets such as bank deposits should generally be recorded as a current transfer. Such financial assets include pre-payments for goods and services - a grant to a market body for this purpose would be a subsidy not a capital grant. Grants to finance long-term financial assets may be treated as capital, such as grants to fill accumulated deficits in pension funds, or financial assets used to generate a long-term return.

Grants to write-off debts owed by the recipient to either the donor or a third party are to be treated as capital grants.

Capital grants are treated as part of capital expenditure in the national accounts and they are part of the fiscal aggregate net investment, as they usually represent capital formation in the economy financed by the public sector.

Capital grants score as resource expenditure in resource accounts (in the Operating Cost Statement), as they do not lead to an asset on the department's balance sheet, and so are treated as an operating expense in the departmental accounts.

### **Gifts of assets**

Where a department gifts an asset to a third party this should be treated as a capital grant and disposal of the asset by way of sale (the view is that the capital grant is given to the recipient, who uses the proceeds to finance the purchase of the asset from the department).

Where a department receives a donated asset it will show the acquisition of the fixed asset on the balance sheet matched by a donated asset reserve.

### **Investment grants**

Investment grants are a type of capital grant given for the purpose of accruing fixed assets.

## Grants paid abroad

Grants paid abroad should be divided between current and capital depending on the intended use of the grant.

## Debt cancellation

Suppose a department agrees with a debtor that they no longer need to repay a debt owed to the department. For example this might happen with loans for overseas development; or in the case of a loss-making public corporation. In such cases a capital transfer is imputed in the national accounts, and the recipient is shown as using the proceeds of that grant to repay the debt. In effect, there is gift to the debtor to pay off the debt.

This type of debt cancellation is termed **debt cancellation by mutual consent**. Debts that simply turn bad, for example where a trade debtor goes bust, are termed **unilateral debt cancellation**. In unilateral debt cancellations no capital transfer is imputed and the value of the balance sheet of the creditor is restated so as to reflect the lower asset value.

Both types of debt cancellation have the same effect on the fiscal rules. The overall level of debt is irrevocably worse off. Both types of debt cancellation are treated the same way in resource accounts; where a cost is shown in the operating cost statement as a debit (cost) and the asset is reduced on the balance sheet (a credit).

However the distinction between unilateral write offs and those by mutual consent needs to be maintained so as that the correct spending and borrowing numbers can be derived in the national accounts. Therefore different SCOA codes are maintained on the COINS system to maintain this distinction.

## Receipts of grants

Capital grants can be received by Government as well as given. For example there are grants from the EU to Government research establishments and local authorities, and museums might receive grants for the purpose of acquiring a specific work of art or building. Receipts of capital grants are netted-off inside capital expenditure in the national accounts.

Where a department is gifted an asset then for the purposes of the national accounts the receipt of a capital grant should be imputed and department should show the acquisition, via purchase, of a capital asset.

In departmental resource accounts receipts of capital grants are shown as income in the operating statement. Where a department receives a donated asset it will show the acquisition of the fixed asset on the balance sheet matched by a donated asset reserve.

## EU investment grants

Investment grants from the EU paid under structural funds do not reduce net investment, or TME, as structural fund transactions are not treated as transactions with government, but rather transactions between the institutions of the EU and citizens of the EU.

They are included in the OCS in resource accounts.

## STOCKS

### Types of stocks

Stocks include:

- goods or other assets purchased for resale
- consumable stores
- raw materials and components purchased for incorporation into products for sale
- finished goods;
- products and services in intermediate stages of completion (work in progress);
- long-term contract balances
- the natural growth of cultivated timber

Central government has categories of stocks that are unique to Government. These include:

- stockpile goods and military reserve stocks;
- confiscated, seized, forfeited and foreclosed property;
- goods held under price support programmes (intervention stocks).

In national accounts net stock building is part of gross capital formation. Specifically the purchase of stocks adds to gross capital spending and so TME and PSNI. When stocks are taken from store and used in the production process this scores as negative capital spending and reduces net investment. The actual consumption of those stocks scores in the current budget as a cost.

When stocks are produced by the public sector, and stockpiled rather than sold, this scores as a benefit to the current budget and as a cost to the capital budget. The subsequent cash receipt on disposal of the stocks is treated as capital.

Stock write offs do not effect expenditure in the national accounts, rather they are treated as a change in the value of the balance sheet in the transaction-less other volume changes in non-financial assets account.

### **Stocks of current assets in resource accounts**

In resource accounts changes in stocks are an accruals to cash adjustment. The accounts record the consumption of resources, and production of goods and services for sale. This will take account of consumables drawn from stocks irrespective of when they were bought, and finished goods added to stocks irrespective of when they are sold. Additions to stocks of consumables, and sales of stocks of finished goods, are cash transactions unrelated to the consumption of resources and production of goods and services. So they are recorded as accruals to cash adjustments.

### **Stocks of capital assets in resource accounts**

Expenditure on capital assets to be held as stocks of capital assets, rather than used in production, are added to fixed assets in resource accounts. So they are treated as capital expenditure like any other acquisition of a capital asset.

## **FINANCIAL TRANSACTIONS**

### **Financial investments**

This is sometimes called net lending or policy lending. It includes loans given and shares purchased, net of repayments and sales of shares. Policy lending transactions are not in capital expenditure as they are financial, as opposed to non-financial (i.e. spending), transactions. Policy lending excludes financial assets acquired to manage the department's liquidity such as bank deposits and balances at the Office of Paymaster General (OPG).

Policy lending adds to net debt, and increases assets on the department's balance sheet. Net lending scores in the capital budget – see the consolidated budgeting guidance.

## **Equity injection/withdrawal**

Some payments by Government might be called capital injections, equity subscriptions, investments, or participations, or some other title suggesting that the payment leads to the acquisition of share capital in the recipient.

Some equity injections give the right to future dividends and the equity can be sold or value realised in some other way in the future. These cases should be recorded as financial transactions since they represent the acquisition of a financial asset.

Sometimes an equity injection is made with no expectation of receiving anything in return for the payment. In these cases the payments should be recorded as capital grants. The grant is classified as capital on the assumption that it leads to capital formation or the acquisition of long term financial assets to improve the recipient's balance sheet. If the payment is simply to support the in year costs of the body then it should be scored as current.

An equity withdrawal is when a public corporation makes a payment to Government funded from accumulated reserves (profits accumulated over 2 or more years) or the sale of assets. It is recorded as a financial transaction in national accounts. Payments by public corporations to the department funded out of current profits are classified as dividends – current receipts.

In resource accounts equity withdrawals can be treated as income in the operating statement if there is no loan, share or PDC capital being redeemed. These are termed super-dividends but are nonetheless equity withdrawals and so financial transactions in the national accounts.

## **Sales of shares**

A sale of shares in a private sector company counts as negative net lending.

A public corporation can become a private company when government sells shares such that it no longer has a majority of the shares or control of the body (a privatisation). Such a company is judged to become a private company just prior to the shares being sold. So in a privatisation the share sale is negative net lending, and the cash receipt reduces Public Sector Net Debt.

A sale of shares in a public corporation that still leaves the government with a majority shareholding (a minority sale), or with control over the body, counts as borrowing from the private sector by the public corporation.

## **Student loans**

Student loans are policy lending. The policy lending scores as an addition to Public Sector Net Debt. These loans carry, in effect, a rate of interest equivalent to the rate of inflation; they are presented as interest-free loans, with students making payments equivalent to inflation. The difference between the debt interest paid in year by the student, and the debt interest that government pays on the Gilts issued to finance the loan to the student, is a cost in the current budget.

The resource accounts reflect that interest rate support given to the student by recognising a liability upfront on the day the loan is issued.

For information on treatment in resource accounts, including the inflation adjustment, see RAM 3.11.10

## **Working capital / changes in debtors / creditors**

Changes in working capital affect the department's net cash requirement and impact on Public Sector Net Debt.

## **SOME ACCOUNTING AND MEASUREMENT ISSUES**

### **Sale of assets: profit/loss**

The FReM states that the actual proceeds from the sale of an asset should be split into two parts:

- the book value of the asset currently recorded in the balance sheet;
- the difference between the book value and actual proceeds (the profit/loss on sale).

The first item is (negative) capital expenditure; and the second is a resource item in the OCS (a credit (benefit) for a profit, a debit (cost) if a loss).

However the national accounts treats the full open market value (OMV) as the receipt. Usually this would be the cash received, or the value realised in the case of a barter type transaction. In effect there is a revaluation in the national accounts prior to sale that restates the balance sheet value to the OMV.

### **Barter deals and other non-cash transactions**

Non-Cash transactions in assets need to be recorded as if there had been a cash payment at the market price. Examples of non-cash transactions are:

- Government exchanges some land that it owns worth £15m for some buildings also worth £15m, the records should show (a) a sale of land and (b) a purchase of buildings. Where both parts of the barter have (a) the same value and (b) the same asset class, nothing needs to be recorded as the two transactions cancel out;
- Government makes a transfer in kind, e.g. a gift say of a building worth £15m, the records should show: (a) a grant to the recipient of £15m and (b) a sale of a building for £15m. Receipt of a gift of a building worth £15m should be recorded as (a) receipt of a cash donation of £15m and (b) purchase of a building for £15m.
- Government accepts a low price for the sale of a building on the understanding that it will be able to occupy it for a low rent in the future. Both the asset sale and rents should be recorded at market prices.
- Government agrees to write-off a debt owed to it. This is recorded as capital transfer and a repayment of the loan, see section on debt write offs in this paper.

For a detailed description of a barter deal and associated transactions see the Consolidated Budgeting Guidance.

### **Leases and the Private Finance Initiative**

Accounts and budgets should reflect the economic substance of transactions rather than the legal form. For all complex transactions, including PFI, the department's accountants would apply the principles contained in the FReM. These guidelines determine whether a lease is a finance lease or an operating lease. If it is an operating lease the payments are recorded as payments for services.

If, however, it is a finance lease then the national accounts would record capital expenditure matched by borrowing. In effect taking out a loan from the contractor to purchase the asset. The regular payments of the unitary charge to the contractor are then treated as repayment of the borrowing and interest, with possibly a service charge element too.

For detailed advice on how to deal with on-balance sheet PFI transactions in accounts and budgets see the Consolidated Budgeting Guidance.

## **Public corporation capital expenditure**

PC capital expenditure includes all categories of capital - expenditure on fixed assets, intangibles, stocks, valuables etc. It would be rare for a PC to provide to capital grants, as grants are not market activity, and departments should speak to HMT where they believe this to be the case, as it may be appropriate for the national accounts to re-route the transaction through general government.

## **BORDERLINE BETWEEN CURRENT AND CAPITAL EXPENDITURE**

### **Grouping of assets**

If treated singly, an asset may well fall below the capitalisation threshold. Several small value assets of a similar nature may be purchased at once, for example as part of the same project. If so, it is the value of the purchase of all the assets that determines whether expenditure falls above or below the capitalisation threshold.

For example, a new chair, costing £300, would be current expenditure; whereas a programme of replacing all the chairs (each costing £300) in a particular building would be capital expenditure, even though individually these chairs were below a capitalisation threshold.

The question of grouping typically applies to the purchase of information technology equipment or office furniture.

For further information see the FReM.

### **Call-off contracts**

These are when a department has a single contract with a supplier, and logs many individual orders against the contract. Contracts might be settled by a single payment against a single monthly invoice. Call-off contracts should not be seen as intrinsically grouped purchases. Instead, the individual items or groups of items paid for by way of call-off contracts should be classified separately. So, suppose a department has a capitalisation threshold of £2,000 and buys personal computers at £1,000 each via a call-off contract:

- a series of individual orders for single PCs would each count as current expenditure, even though the total bill exceeds £2,000;
- an order for twenty PCs to re-equip a team would count as capital expenditure, as the total is a grouped purchase and the total cost exceeds £2,000.

### **Capitalisation thresholds**

Departments may set capitalisation thresholds for fixed assets to suit their own circumstances.

When setting capitalisation thresholds, departments should, subject to materiality, take into account the following factors:

- **practicality:** keeping the maintenance of asset registers within manageable proportions;
- **flexibility:** different threshold limits might be appropriate for different types of fixed asset, between different parts of the departmental group, and also between

programme assets (e.g. infrastructure) and operating assets (e.g. IT equipment, office furniture);

- **consistency**: departments should ensure an appropriate degree of consistency within the departmental group for the production of consolidated departmental resource accounts;

Any changes in thresholds will have to be notified to the Treasury at a prescribed point prior to spending reviews.

For further information see FReM.

## **Routine maintenance v capital expenditure**

Subsequent expenditure to ensure that a tangible fixed asset maintains its previously assessed standard of performance should be recorded as current expenditure. Subsequent expenditure on a tangible fixed asset should be recorded as capital expenditure in any of these four circumstances:

- where it provides an enhancement to the economic benefits of the asset in excess of the previously assessed standard of performance;
- where a component of the asset, having been treated separately for depreciation purposes and depreciated over its individual useful life, is replaced or restored;
- where it relates to a major inspection or overhaul of the asset that restores the economic benefits of the asset that have been consumed by the entity and have already been reflected through the depreciation charge.
- where it substantially lengthens its useful life beyond that conferred by repairs and maintenance

Examples of expenditure to be treated as capital are:

- major refurbishment of a building which takes the building to a higher standard than it had when it was first built or last refurbished;
- replacing old railway track along an entire route;
- major enhancement to a computer system to extend its use beyond the original life expectancy.

For further information see the FReM.

## **Renewals maintenance**

Where an asset is maintained in a steady state it may be appropriate to account for that asset and maintenance under the renewals accounting methodology. Departments should speak to their usual Treasury and with Classification branch. Major additions or enhancements to that asset would be considered as capital formation.

## **In-house capital formation**

Department's can employ their own staff and other resources to produce capital assets, rather than buying them from external suppliers.

In other cases, the purchase of a capital asset might require a department to undertake other expenditure necessary to procure and commission the asset. Such internal costs will include own employees' (e.g. site workers', in-house architects' and surveyors') salaries and expenses arising directly from the construction and acquisition of the specific tangible fixed asset. Administration and other general overhead costs should be excluded. Employee costs not related to the specific asset (such as site selection activities) are not to be recorded as

capital. Only those costs that are directly attributable to bringing the asset into working condition for its intended use should be recorded as capital expenditure.

Costs incurred in the early stages of a project to acquire or create a capital asset should only be recorded as capital if at the time they are incurred:

- there is a clearly defined project; and
- the costs are separately identifiable; and
- it is reasonably certain that the project will be completed and will result in an asset that will eventually be brought into use.

Where a department's own staff are involved in the acquisition, construction or development of a tangible fixed asset (such as a piece of internally generated computer software), the relevant proportion of the internal costs relating to those staff should be recorded as capital if material and if the criteria above are met.

Internal costs should not be recorded as capital if they relate to activities which can only be carried out by in-house staff, i.e. which for the sake of good internal administration could not be purchased from an outside party.

Cost of capital charges relating to assets that are used to produce other capital assets (such as a computer used by staff writing software that will be capitalised) should not be recorded as capital; neither should any actual financing costs.

For further advice see the FReM.

## **Costs of ownership transfer**

Capital expenditure includes the cost associated with transferring ownership such as legal expenses and stamp duties that are directly attributable to the acquisition of an asset.

## **Consultant's fees**

Capital expenditure includes any architects' and surveyors' fees where they are an integral part of, and specific to, the acquisition or the construction of a building. This also applies to consultancy costs in procuring other capital assets.

Expenditure on consultancy to help decide whether a capital acquisition or project should go ahead is current. Expenditure to determine what sort of asset is required, or to specify the performance and other characteristics of the asset, should be also be classified as current.

Expenditure on research and development consultancy is current.

Capital expenditure should include only the incremental costs that would have been avoided if the capital asset had not been produced or bought. It is not appropriate to treat as capital expenditure a portion of the time of staff associated with a capital project if they would have been employed in any event.

## **Capital injections/subscriptions**

Some payments by Government might be called capital injections, equity subscriptions, investments, or participations, or some other title suggesting that the payment leads to the acquisition of share capital in the recipient.

In some of these cases these payments give the right to future dividends and the equity can be sold or value realised in some other way in the future. These cases should be recorded as financial transactions since they represent the acquisition of a financial asset.

In other cases there is no expectation of receiving anything in return for the payment. In these cases the payments should be recorded as capital grants where they are used for capital purposes.