HM Treasury

Class (2013) 3:

Capital and financial transactions

August 2013

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1 Introduction

Purpose of this document

1.1 This note provides guidance on the definition, scope and classification of capital expenditure. It provides guidance on what transactions are treated as capital in the National Accounts under the European System of National Accounts (ESA95), and in addition provides guidance on the treatment of these transactions in the Resource Accounting and Budgeting framework.

1.2 Guidance is also provided on the classification and treatment of financial transactions, especially where the transactions will have an impact on the Public Sector Finances.

1.3 The paper does not provide guidance on the valuation of capital assets, write-downs, impairments and depreciation (which are covered in the FReM).

Background

Who decides

1.4 In the vast majority of cases, capital spending in National Accounts (and by extension in budgets) is recorded at the same value and with the same timing as departmental accounts.

1.5 However, the independent Office for National Statistics (ONS) currently makes decisions on the treatment of a given transaction in the National Accounts according to standards laid down in the European System of Accounts (ESA95). Where differences arise between departmental accounts and National Accounts, budgeting rules will follow National Accounts. The ONS should only be approached via HM Treasury – departments should consult their Spending Team with their classification queries. HM Treasury may settle more straightforward cases without reference to the ONS.

1.6 A new set of National Accounts rules set out in the European System of Accounts 2010 (ESA10) are expected to replace the ESA95 rules from 2014. The rules governing capital and financial transactions in ESA10 are largely expected to remain very similar to the existing ESA95 rules.

Status of the note

1.7 This is a publicly available document. The contents have been agreed with the ONS. It does not represent any fundamental change in how capital and financial transactions should be classified in the National Accounts. It supersedes all previous versions of this paper.

1.8 This document contains technical guidance on capital and financial transaction classification and is intended to inform departments when planning the public finance consequences (if any) when undertaking either capital or financial transactions.

1.9 The guidance should not be seen as a substitute for the rules set out in ESA95 and its accompanying manuals.

Further guidance

1.10 Departments should contact in the first instance their normal Treasury Spending Team. The Spending Team will put further questions on classification to the Classifications Branch, Andrew Evans (020 7270 4623), Alex Cole (020 7270 4743) or Lesley Neill (020 7270 5338) in the General Financial Reporting (GFR) team.

1.11 Other guidance includes:

- the Consolidated Budgeting Guidance (CBG) sets out how capital and financial transactions should be treated within the Department's own budgets and
- the Financial Reporting Manual (FReM) gives more information on how the treatment of capital expenditure is recorded in departmental accounts.

2 Capital transactions

Capital

2.1 Capital expenditure can have a different scope depending on the context. This paper covers in the first instance capital expenditure in the National Accounts. The National Accounts are used to define and measure the fiscal position and the fiscal rules. The paper also addresses the treatment in departmental accounts.

2.2 The following three components form capital expenditure in the National Accounts;

Gross capital formation

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

2. Net-stock building. Net increases to inventories held by public sector bodies. This is a cash to accruals adjustment in departmental accounts.

Capital transfers

3. 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.

2.3 Public Sector Net Investment is the sum of the 3 components above, net of (i.e. less) depreciation on the stock of public sector assets in the period. Expenditure on PSNI increases Public Sector Net Borrowing (PSNB) and Debt (PSND).

Note on the terms 'gross' and 'net'

2.4 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

2.5 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.

2.6 Because policy lending does not contribute to PSNI it also does not increase PSNB. However it may increase the overall stock of financial debt, as measured by the aggregate PSND. Chapter 3 contains further details of the treatment of financial transactions.

Asset classes

2.7 Assets are entities owned by institutional units, from which economic benefits may be derived by their owners by holding them or using them for a period of time. In this context, 'future economic benefits' usually means that the asset will contribute in some way to the provision of services or other outputs by departments.

2.8 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).

2.9 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 assess to economic benefits may be obtained without legal ownership, for example where goods are leased by way of 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.

Fixed assets

Tangible fixed assets

2.10 A tangible fixed 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, vehicle and vessels.

2.11 The expenditure should be recorded on an accruals basis.

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

2.13 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 below).

Military assets

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

- dual use military equipment 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;

- expenditure on dual use military equipment assets under construction should be recorded at the time of delivery of the goods; and
- single use military equipment, 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 expenditure.

2.15 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 OSCAR database using distinct CoA codes so that an adjustment can be made in National Accounts.

Heritage assets

2.16 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 (see later section for further details of valuables and works of art).

2.17 In departmental accounts, 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; and
- their life is measured in hundreds of years.

2.18 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.

2.19 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.

2.20 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.

Intangible fixed assets

2.21 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.

2.22 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; and
- the outcome of the project has been assessed with reasonable certainty as to:
    1. it's technical feasibility;
    2. it resulting in a specific product or service that will eventually be brought into use; and
    3. 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 intangible assets see the FReM.

Software

2.23 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

2.24 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

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

Valuables, works of art, and jewellery

2.26 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

- the acquisition of valuable – if they are acquired as a store of value, like an investment.

2.27 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 (E101)/ CoA as the acquisition of plant and machinery.

For further information see the FReM

Stocks

2.28 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; and
- the natural growth of cultivated timber.

2.29 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; and
- goods held under price support programmes (intervention stocks).

2.30 In National Accounts net stock building is part of gross capital formation, whereas in departmental accounts they are accruals to cash adjustments. In both cases current expenditure is scored when stock is consumed.

Table 2.A:

	Departmental accounts	**National accounts**
Stocks purchased	Movements in working capital with no SoCNE implications	Addition to capital spending increasing PSNI and TME
Stock consumed	Expenditure recorded in the SoCNE	Negative capital spending and positive current expenditure
Stocks written off	Expenditure recorded in the SoCNE (non-cash in budgets)	No effect on expenditure. Treated as a change in the value of the balance sheet in the 'other changes in volume account'
Stocks produced and stockpiled	Increase in working capital	Benefit to the current budget and an addition to capital spending (subsequent disposal is a capital benefit)

2.31 In National Accounts recurrent wastage or expected levels of pilfering are not stocks written off, but should be recorded as consumption

2.32 In most cases budgeting rules follow the treatment in departmental accounts; this is to reduce compliance costs. However, there are exemptions to this where the item being acquired for stock would be regarded as fixed capital were it not being acquired for stock (land is the most common example of this). To find out how this is applied refer to the Consolidated Budgeting Guidance.

Stocks of capital assets in departmental accounts

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

Work in progress

2.34 Work on assets under constructions falls under the broader heading of stocks/inventories. It is recorded in National Accounts in either of two ways:

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

2.35 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.

2.36 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 contractor's unfinished goods.

2.37 Departmental 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.

2.38 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.

Non produced assets

2.39 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.

Tangible non produced assets

2.40 In National Accounts 'natural assets' are called 'tangible non-produced and non-financial assets' and include sub-soil minerals, the electro-magnetic spectrum, and inland water in those cases where ownership rights can be enforced.

Land

2.41 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.

Intangible non produced assets

2.42 Assets which are constructs of society are described as "intangible non-produced assets". These include leases and transferrable contracts, patents and purchased goodwill.

2.43 Where government licences and activity (e.g. fishing) the licence itself will fall into this category. This does not imply that the transaction to purchase such a licence should be viewed as capital in nature, acquisition of licence could be a capital transaction but it could also be a purchase of service, a form of tax or an economic rent depending on what activity the licence covers. For more details on this type of transaction refer to Class (2013)2 – Classification of Receipts.

Capital grants

2.44 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.

2.45 Grants typically score as current expenditure; however grants may be recorded as capital grants if they are explicitly for the purpose of financing the recipient's acquisition of capital assets or stocks referred to above. Where grants may be spent on both current and capital expenditure, the whole sum should be treated as a current grant.

2.46 Grants to acquire:

- financial assets such as bank deposits should generally be recorded as a current transfer;
- 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 (such as endowment funding); and
- grants to write-off debts owed by the recipient to either the donor or a third party are to be treated as capital grants.

2.47 Unlike the assets discussed above capital grants/capital transfers do not form part of gross capital formation in the National Accounts. However, they are included in the capital account within the National Accounts and therefore form part of capital expenditure in the National Accounts. This treatment is on the basis that they usually represent capital formation in the economy financed by the public sector.

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

Gifts

2.49 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 given to the recipient, who uses the proceeds to finance the purchase of the asset from the department). See Chapter 4 for full details on the recording of gifts.

2.50 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.

Grants paid abroad

2.51 Grants paid abroad should be divided between current and capital according to the same rules governing domestic capital grants.

Debt cancellation

2.52 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 a gift to the debtor to pay off the debt.

2.53 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.

2.54 Both types of debt cancellation have the same effect on the government's balance sheet, the overall level of debt is irrevocably worse off. Both types of debt cancellation are treated the same way in departmental accounts; where a cost is shown in the Statement of Comprehensive Net Expenditure as a debit (cost) and the asset is reduced on the balance sheet (a credit).

2.55 However the distinction between unilateral write-offs and those by mutual consent need to be maintained so that the correct spending and borrowing numbers can be derived in the National Accounts. Therefore different CoA codes are maintained on the OSCAR system to maintain this distinction.

Receipts of grants

2.56 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.

2.57 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 departmental accounts should show the acquisition, via purchase, of a capital asset.

2.58 In departmental 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

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

They are included in the SoCNE in departmental accounts.

3 Financial transactions

Financial investments

3.1 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 in the Government Banking Service (GBS).

3.2 Policy lending to the private sector adds to public sector net debt (PSND). Consequently net lending to bodies outside the budgeting boundary score to a department's capital budget – see the Consolidated Budgeting Guidance for full details of the treatment within budgets.

Equity injection / withdrawal

Equity injection

3.3 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.

3.4 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.

3.5 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 a current grant.

Equity withdrawal

3.6 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.

3.7 In departmental accounts equity withdrawals can be treated as income in the SoCNE 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

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

3.9 Sale of shares in public corporations will increase government's financial liabilities, so is similar to borrowing. However the equity liabilities of public corporations do not score in net debt and the net impact of this transaction would be to reduce PSND.

3.10 However it is worth noting that, in most cases where government sells a majority stake in a public corporation the body would be reclassified to the private sector. If only a minority shareholding is disposed of then the body would normally remain in the public sector. Classification under privatisation is explored in more detail in Class (2013) 1 – Sector Classification

Student loans

3.11 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.

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

Debtors / creditors

3.13 Changes in debtors and creditors do not score as transactions in National Accounts or departmental accounts; they are just movements in working capital. They will however affect the department's net cash requirement in Estimates and impact on Public Sector Net Debt.

3.14 In some cases it is more appropriate to treat long-term debtors, or prepayments, as policy lending rather than movements in working capital. If a transaction fulfils both or the following criteria then it should be treated as net lending and capitalised on the balance sheet

- first, the transaction is either:
  - a a long-term debtor or prepayment (long-term in this case is anything that will last over 12 months); or
  - b a short-term debtor or prepayment where there is the expectation that it will be renewed so that the effect is long-term; and
- second, the total value of the debtor / prepayment involved is above £20 million.

4 Accounting and measurement

Borderline between current and capital expenditure

Grouping of assets

4.1 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.

4.2 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 the capitalisation threshold.

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

Call-off contracts

4.4 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; and
- 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

4.5 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); and
- consistency: departments should ensure an appropriate degree of consistency within the departmental group for the production of consolidated departmental accounts.

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

Routine maintenance v capital expenditure

4.6 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 economic benefits to the asset that have been consumed by the entity and have already been reflected through the depreciation charge; or
- where it substantially lengthens its useful life beyond that conferred by repairs and maintenance.

4.7 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; and
- major enhancement to a computer system to extend its use beyond the original life expectancy.

For further information see the FReM.

In-house capital formation

4.8 Departments can employ their own staff and other resourced to produce capital assets, rather than buying them from external suppliers.

4.9 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 services) 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.

4.10 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;
- 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.

4.11 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.

4.12 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.

4.13 Actual financing costs 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.

For further advice see the FReM.

General measurement issues

Sale of assets profit / loss

4.14 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 the actual proceeds (profit / loss on sale).

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

4.16 However the National Accounts treats the full open market value (OMV) as the receipt – the sum of the two items above. 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

4.17 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 for some buildings of equal worth, the records should show:
  1. a sale of land; and
  2. a purchase of a building.

  Where both parts of the barter deal have the same value and same asset class, nothing needs to be recorded as the two transactions cancel out.
- government makes a transfer in kind, e.g. a gift of say a building, the records should show:
  1. a capital grant to the recipient equal to the open market value of the asset being gifted;
  2. sale of a building equal to the net book value of the asset; and

3. profit / loss on disposal, equal to the difference between 1 & 2. When open market value is equal to book value there will be no need for anything to be recorded.

- receipts of a gift of a building should be recorded as:

  1. receipt of a cash donation equal to the open market value of the building; and

  2. purchase of a building at open market value.

- where 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, the disposal of the asset should be recorded at open market value and the difference between this and the actual disposal price should be recorded on the balance sheet as a prepayment asset. In future periods this prepayment unwinds as a benefit, and rent is recorded equal to the cash payment plus a component for the unwinding of the prepayment. For detailed description of a barter deal and associated transactions see the Consolidated Budgeting Guidance; and

- 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 chapter.

Leases and the Private Finance Initiative

4.18 Departmental accounts and National Accounts aim to 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.

4.19 Whilst National Accounts guidance contains standards on the classification of leases, it is suitably similar to the accounting standards that the guidance included in the FReM is a suitable proxy for measurement. As such all PFI contracts (and similar lease arrangements) are classified according to accounting standards for the purposes of departmental accounts, National Accounts and budgets.

4.20 If the transaction is determined to be an operating lease in accounts then subsequent payments are recorded as payments for services. No further charges are necessary as the transaction stays off the balance sheet.

4.21 If, however, it is a finance lease then accounts would record capital expenditure matched by borrowing. In effect this is taking out a loan from the contractor to purchase the asset, and so the balance sheet would show acquisition of a capital asset with matching finance lease liability. 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.

4.22 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

4.23 PC capital expenditure includes all categories of capital – expenditure on fixed assets, intangibles, stocks, valuables etc. It would be rare fir a PC to provide 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.

Overage

4.24 When a department disposes of surplus property, it will enter into an agreement with the purchaser; it is common for these agreements to contain a clause on overage / clawback. The intention of an overage clause is to allow the department to gain some benefit if the purchaser should sell the property in the future for a profit above that envisaged at the time.

4.25 This clause represents a financial asset, in both departmental accounts and National Accounts, and should be recorded on the department's balance sheet accordingly. The amount and timing of this financial asset will be subject to uncertainty, and departments may find it difficult to value. In these circumstances departments should refer to the FReM and use the same valuation in budgets – in many circumstances this valuation may be zero.

4.26 Since this financial asset comprises part of the value of the property being disposed of it, in effect, allows the public sector to retain part of the value of the property. So on disposal the recording should be:

- total OMV of the disposed asset (capital receipt); and
- the OMV of the overage agreement (capital expense)

These two effects together will benefit the department's capital budget by the amount of the agreed sale price.

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This document can be downloaded from www.gov.uk

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