Capital expenditure policy

Aim and scope

Aim

Ofwat's initial investment in capital assets is funded by HM Treasury through the parliamentary system. These assets are then depreciated over their useful economic life and depreciation charges subsequently recovered as part of the licence fees paid by water companies, which they collect from consumers. As our money comes from taxpayers we have a duty to demonstrate proper use of these funds and that our investment delivers strategic benefits and achieves value for money.

The aim of this capital expenditure policy is to summarise Ofwat's position in relation to our capital budgets, how and when we will make capital investments and what happens at the end of an asset's life. This policy builds on the content of the following corporate documents:

- Governance framework;
- Budget management guidance;
- Asset management policy; and
- Information assets policy.

The aim of the policy is to set out Ofwat's approach to:

- the definition of capital expenditure;
- how expenditure is classified;
- how capital budgets are set; and
- disposal/impairment of existing capital assets.

Scope

This policy applies to:

- Ofwat employees;
- Secondees working within Ofwat; and

- People on loan from another government organisation.

All employees should be aware of this policy.

Employees who work on the Compliance and Assurance and Business Transformation programmes need to be fully conversant with this policy's content.

- treat our internal and external stakeholders fairly;
- empower our people;
- hold our people to account;
- make sound, proportionate decisions; and
- have appropriate checks and assurance in place.

Further information

If you have any questions relating to this policy please contact:

- Rob Powell, Director of Finance; or
- Samantha Bache, Principal Finance.

Definitions

What is capital expenditure

A common definition of capital expenditure is as follows:

"Capital expenditure is expenditure that results in the acquisition or construction of a capital asset (land, building, vehicle, equipment) or the enhancement of an existing capital asset."

Capital expenditure at Ofwat is essentially the investment in IT equipment, office machinery, and improvement to office space, software licenses or software development, where the use or benefit of the investment is for longer than one financial year.

There are two types of capital assets:

- **Tangible**: a physical asset that can be seen, such as a IT server; and
- **Intangible**: where the asset cannot be seen, such as a software licence.

How Ofwat accounts for capital expenditure

Following International Accounting Standards, as adapted by HM Treasury's Financial Reporting Manual, Government Departments are required to account for their revenue expenditure and capital expenditure separately.

Generally speaking, capital expenditure results in the creation of a **non-current asset** which is then reported on Ofwat's balance sheet. This asset will remain on the balance sheet until it is no longer owned or in use by Ofwat. This treatment is different to general expenditure, which is reported through the annual income and expenditure statement.

The period of time we anticipate an asset to be owned and delivering a benefit to Ofwat for is referred to as the **useful economic life**. The value of an asset sitting on the balance sheet is written down each year of its useful economic life - this write down is known as the **depreciation charge**. This depreciation is charged to the income and expenditure statement each year until the asset reaches the end of its useful economic life, or is disposed of (whichever occurs first).

Classification of expenditure

How is capital expenditure classified

It can sometimes be difficult to distinguish easily between capital and revenue expenditure, and the classification process is governed by international accounting standards, HMT guidance and Ofwat's accounting policies which interpret them. Our classification of revenue and capital expenditure is subject to external audit each year.

There are a number of ways that expenditure should be considered in order to identify what is capital and what is revenue.

Revenue expenditure is expenditure incurred for the purpose of Ofwat's day-to-day activities. For example employees' pay, travel expenses and IT consumables are all deemed to be revenue expenditure.

When first considering whether expenditure could be capital you should make your initial assessment against the following criteria:

- Is the purchase cost of the asset in excess of £2,500? This **capitalisation threshold** includes any VAT charge, installation, delivery costs and professional services that are required to bring the asset into first use.

- Will Ofwat received a benefit from the asset for longer than 12 months? The benefit is perceived to be generated by the asset being in use.

- Does Ofwat carry the risk of the asset malfunctioning, being stolen or being damaged? For example, do we take out our own maintenance contract?

If **all** the answers to the above assessment are yes, then it's <u>highly likely</u> expenditure would be classified as being capital expenditure.

Enhancement expenditure

Distinguishing between expenditure on existing assets that <u>maintains</u> the use or value of that asset and expenditure that <u>improves</u> use or value can be difficult and judgement will always be required. Maintenance costs are generally classified as revenue while enhancement is typically capital.

To be classified as an enhancement, and therefore capital expenditure, the purchase or work undertaken must either:

- substantially lengthen the useful life of the asset beyond the original assessment of its useful life. This could include the upgrade of a processor in a piece of IT equipment which would enable it to be kept in use for two years beyond its original useful life;
- substantially increase the market value of the asset. For example, if the resale price of the asset were to be valued substantially higher after the enhancement work; or
- substantially increase the extent to which the asset can or will be used for or by Ofwat. For example installing data cabling into a leased space that previously had no network coverage, enabling employees to now occupy and work from that space.

The following key words can be useful indicators of whether expenditure is more likely to be capital or revenue expenditure.

Key words indicating capital expenditure	Key words indicating revenue expenditure
Enhance	Repair
Upgrade	Maintain
Extend	Replace
Improve	Like-for-like
Construct	Remedial
Purchase	Renew

Capitalisation threshold

For reasons of materiality and consistency capitalisation thresholds are applied, below which any expenditure will be treated as revenue. Ofwat's capitalisation threshold is currently £2,500 including VAT. This threshold should be applied at total project/whole asset level, rather than on an invoice-by-invoice basis.

If treated singly, an asset may fall below the capitalisation threshold. When several small value assets of a similar nature are purchased at once, for example as part of the same project, the group capitalisation threshold needs to be considered. Ofwat's group capitalisation threshold is currently £500,000 including VAT. It is the value of the purchase of all the assets that determines whether expenditure should be classified as capital expenditure. For example, a laptop is purchased at a total cost of £2,400 including VAT so would ordinarily be treated as revenue. However this laptop is part of Ofwat's desktop refresh project that is replacing all laptops, monitors, docking stations and peripherals. The total cost of the desktop refresh project is £550,000 and therefore above the group capitalisation threshold and should be classified as capital expenditure.

Software licences

Software licenses may only be classified as capital expenditure if they are a permanent (perpetual) licences, in excess of the capitalisation threshold and granted for a period of at least 1 year. Annual licences or subscription charges are treated as revenue expenditure.

Any professional services charges associated with bringing a new permanent software licence into first use is classified as capital expenditure. By comparison, professional service charges incurred to make amendments to a system already in operation will be classified as revenue expenditure.

Getting classification correct

It is really important that classification of expenditure between capital and revenue is correct. Ofwat has a very limited annual capital budget and a misclassification of expenditure could easily lead to a breach of our capital budget which could lead to an excess vote and qualification of Ofwat's accounts. Finance Partners can be contacted for advice on classification queries, and you should always do so if there is any doubt prior to committing Ofwat to expenditure which may be capital.

In addition, we have developed a capital decision tree tool to assist you in making a decision on the classification of expenditure which you can access here.

Capital budgets

How the capital budget is set

An outline capital business case will need to be prepared in support of our Comprehensive Spending Review (CSR) submission, usually covering a 4 year period. HM Treasury will provide a template for completion and Ofwat will be expected to be able to demonstrate a positive investment appraisal as part of this submission. Our request for capital budget will be carefully considered by HM Treasury's Spending Team against competing bids from other government bodies. Capital budget will only be awarded if the outline capital business case is strong enough to demonstrate business criticality, value for money and a positive investment appraisal.

Programmes are responsible for identifying any developmental capital expenditure as part of the PID process. This will be consolidated across the portfolio as part of the business planning process.

The Principal Technology and Infrastructure is responsible for programme co-ordination to efficiently plan and budget for all capital renewal requirements, to ensure there is a clear plan and programme for capital investment that utilises the available budget effectively. The asset management policy provides further information on how Ofwat monitors and plans for both our capital and non-capital asset renewals.

Capital business cases

For each individual capital project an Ofwat business case must be completed via the business case portal. This template will assist you in presenting a value for money case that demonstrates that the requirement is business critical to deliver Ofwat's strategic priorities. The questions reflect the key components of HMT's guidance on investment appraisal, which is known as the 'Green Book'.

Further guidance on submission a capital business is available on the Business Case Portal site. Finance and Procurement Partners are available to support you in the business case process.

An investment appraisal is expected for all developmental capital projects, as opposed to capital renewals, and an excel template is available for you to complete. A copy of this appraisal must be appended as supporting information in your Bubble business case seeking approval of capital expenditure. Finance Partners can assist you with completing the investment appraisal process.

Capital budget increases

Capital budgets can only be increased if HM Treasury approve a claim on the Reserve. It is extremely unlikely that a capital reserve claim would be approved by HM Treasury, even if we could demonstrate a strong value for money business case.

It is therefore very important that your requirement for capital expenditure is planned well in advance and that you are able to demonstrate a positive investment appraisal as part of Ofwat's periodic CSR submission, or to inform discussions about the annual estimate process.

Virement of capital budgets

You are unable to vire money between capital and revenue budgets.

In managing the annual capital budget allocation the Programme Director can vire money between their individual capital projects. Before any virement is completed between capital projects you will be expected to revisit the original investment appraisal to demonstrate that the project is still viable.

Depreciation budgets

Depreciation is charged to the revenue budget, which is held by the financial governance work stream in the Compliance and Assurance Programme. This is a ring fenced budget set at the level agreed by HM Treasury. Any surplus budget in this line cannot be vired to support other areas of Ofwat's portfolio.

Loss on disposals

When we dispose of a capital asset before the end of its useful economic life this will usually generate what is known as a loss on disposal (against the asset's book value at the time of disposal). A loss on disposal has two effects on the financial statements:

- Increase in non-cash charges – should you become aware of a requirement to dispose of an asset that has not reached the end of its useful economic life you must set out an explanatory note of ‘justification to dispose’. The Principal Finance can assist you with information on the loss value and financial impact. The completed ‘justification to dispose’ will then be referred to the Finance Director for approval.

- The value of any loss on disposal will be added to the capital budget for that financial year. This is in line with HM Treasury’s Consolidated Budgeting Guidance and enables you to re-invest the book value of the disposed asset into capital plans for that year.

Where a disposal is made at no loss to Ofwat, the Principal Technology and Infrastructure is responsible for approval, and will advise on any additional recording keeping requirements, as set out in the asset management policy.

Profit on disposals

Where we sell on an asset to a third party it is possible that a profit on disposal could be achieved where income is in excess of the book value.

Any income received in the sale of an asset is not available for re-investment by the programme requesting the disposal. We measure our income against our agreed CSR targets and rules on income retention set out in HM Treasury’s Consolidated Budgeting Guidance.

Capital asset register

The register

An asset register is held within the Financial Governance work steam of the Compliance and Assurance Programme. This is a central organisational record of all the capital assets held on Ofwat's balance sheet.

This record will detail the original purchase cost, any additional enhancement costs, depreciation charged and the current book value. The asset register is reviewed annually by our auditors.

Annual asset physical verification and impairment review

The Principal Technology and Infrastructure is required to complete an annual physical verification audit of all capital assets held on the register as well as reviewing if assets owned are still in operational use.

The purpose of this physical exercise is to ensure that the asset is still owned by Ofwat and have not been lost or stolen. Any assets identified as no longer in use should be reported to the Finance Hub who will completed an impairment calculation.

If an asset cannot be found, in the first instance an investigation should be completed and every attempt to recover the asset made. If this is unsuccessful the loss of the asset should be reported to the Finance Director and a review against the information assets register made to ascertain if there is any risk to loss of personal data. The asset will be removed from our asset register.

An impairment to an asset is the calculation of the financial consequence of an asset reaching the end of its useful economic life earlier than anticipated. The will result in the current book value being charged to the non-cash budget in the financial year the impairment occurs.

Disposing of a capital asset

Capital assets must be disposed of in line with the asset management policy which details the process to be followed for redeployment and disposal of Ofwat's assets.

The Principal, Technology and Infrastructure is responsible for ensuring that a notification of a capital asset disposal is provided to the Finance Hub. This will enable the relevant financial transactions to be processed and to update the asset register.

A1 Examples of capital and revenue expenditure

Examples of capital expenditure	Examples of revenue expenditure
New lighting scheme for leased office	Replacement of light bulbs
New carpet for leased office	Cleaning or repair of existing carpet
Perpetual software licence	Annual software licence
New partitioning and decoration within leased office	Redecoration of office
Project management fees, architects', surveyors' and engineers' fees where directly attributable to an office regeneration	Legal fees relating to stamp duty charges
Installation of new kitchens or toilet facilities	Repairs to existing kitchen or toilet facilities
Development costs to bring a new perpetual licence into first use	Professional services relating to a system change for a perpetual licence already in use.
Upgraded processor for a piece of IT equipment	Replacement of like for like part that has failed on a piece of IT equipment
Equipment leased under a finance lease arrangement	Buildings leased under an operating lease arrangement
Data cabelling for a new leased office space which we will occupy for more than one year	Data cabelling for a temporary office space which we will occupy for less than one year.

Document control

Version history

Version	Status	Date	Author	Summary of changes
0.1	Draft	July 2016	S Bache	
1.0	Final	August 2016	S Bache	Inclusion of hyperlinks and re-formatting into house style

Sign off

Name	Date	Version No.	Date of Next review
Rob Powell	August 2016	1.0	August 2018