

2008/09 Financial review

BASIS OF PREPARATION

This financial review is based on our Financial Management Reporting framework as updated in our Business Plan 2009/10, and set out in Box 12 in this section. We use this framework for internal management purposes to help monitor and manage our resources. The framework is also designed to reduce the impact on fees of short term volatility of our costs, including those created by pensions accounting. Under this framework, our net costs are identified as those of our Ongoing Regulatory Activities (ORA).

Table 5.1 shows £15.9m of expenditure relating to implementing more outcomes-focused regulation. In 2007/08 we explained our intention to spend up to £50m, in addition to our ORA, over a number of years on a programme of change across the organisation. This investment will lead to benefits that will be realised over a longer period and will contribute to our move to a more outcomes-focused regulatory approach. The 2008/09 expenditure includes staff costs, such as redundancy, retention payments and additional staff (£4.5m), computer development work (£3.6m), and the costs of making the working space in our head office more flexible and efficient.

Table 5.1

Reconciliation of statutory accounts to the financial review

	£m
Net cost for the year per the statutory accounts	346.5
Add: Taxation	0.9
Net costs for the year (including taxation) per the statutory accounts	347.4
Add: difference between accounting charges for provisions in the statutory accounts and the related cash costs of pension contributions paid	6.0
Less: scope change	(2.5)
Less: costs of implementing more outcomes-focused regulation (formerly more principles-based regulation)	(15.9)
Net costs for the year of our Ongoing Regulatory Activities (ORA)	335.0

In addition to our ORA expenditure of £335.0m and transition costs of £15.9m, we also spent £2.5m for items that represented additional scope for the FSA. This expenditure on increased scope included work on the Payment Services Directive, Sale and Rent-back schemes, and Unclaimed Assets.

NET EXPENDITURE

Cost of our Ongoing Regulatory Activity (ORA)

The original budget published for 2008/09 of £323.0m was adjusted during the course of the year. The FSA Board approved an additional expenditure of £13.6m for the Supervisory Enhancement Programme (SEP) and a required

change in accounting treatment for the building maintenance (Lifecycle) costs (£1.8m), leading to a revised budget of £338.4m.

Our net costs for the year (excluding costs associated with more outcomes-focused regulation and scope changes) were £335.0m. This is £3.4m less than the revised budget and brings our ORA reserves to £nil, as we have taken the opportunity to maximise the write off of our remaining deferred IS costs of £3.4m. The tables on page 58 analyse in more detail the actual and budgeted total costs for 2008/09, by cost type and function.

Net expenditure by type

Staff costs were £3.2m higher than budgeted in the year. This is mainly due to higher than expected spend on contractors brought in to meet workload demand in both supervisory areas and projects. Partially offsetting this were lower training costs, reflecting both the deferral and more efficient delivery of training activities.

Accommodation, office services and depreciation was £2.9m under budget, as timing of projects resulted in lower depreciation charges.

Professional fees for projects were under budget by £5.2m due to the timing of certain projects and lower than planned spend on Financial Capability. This was partially offset by additional expenditure on professional fees for services, which were higher than budget by £1.3m.

Sundry income primarily relates to application fees (£12.2m) and interest earned on deposits (£5.7m), with the balance mainly due to transaction reporting fees, the sale of publications, and training services.

In our 2009/10 Business Plan, we stated that we were deferring an estimated £9.5m of capital expenditure relating to elements of Knowledge Infrastructure and Sabre II projects from 2008/09 to 2009/10. The 2008/09 budget has accordingly been reduced by this amount. Actual capital expenditure was £2.4m lower than this reduced budget, mainly due to a reduction in refurbishment expenses of £1.7m and overall underspends for projects and infrastructure of £0.7m.

Expenditure by business unit

Overall, we have kept our costs within the total revised budget by allocating resources to our highest priorities, such as SEP, and funding this by reducing spend on other activities.

Table 5.2
Net expenditure by type

	2008/09 Actual £m	2008/09 Budget £m	2008/09 Variance £m
Staff Costs (inc. travel, training, recruitment and pension scheme deficit reduction contributions)	249.6	246.4	(3.2)
Accommodation, office services and depreciation	44.8	47.7	2.9
IT costs (including IT delivery outsourcing)	26.9	26.7	(0.2)
Professional fees – services	15.3	14.0	(1.3)
Professional fees – projects	16.8	22.0	5.2
Printing, publications and other	6.2	4.8	(1.4)
	359.6	361.6	2.0
Sundry income	(24.6)	(23.2)	1.4
Total ORA	335.0	338.4	3.4

Table 5.3
Expenditure by business unit

	2008/09 Actual £m	2008/09 Budget £m	2008/09 Variance £m
Retail Markets Business Unit	161.1	162.1	1.0
Wholesale and Institutional Markets Business Unit	88.8	86.8	(2.0)
Operations Business Unit	30.2	33.4	3.2
Direct Reports Business Unit	43.7	43.6	(0.1)
Enforcement	35.8	35.7	(0.1)
	359.6	361.6	2.0
Sundry Income	(24.6)	(23.2)	1.4
Total ORA	335.0	338.4	3.4

The Retail Markets Business Unit made savings in non-supervisory areas that offset higher costs in their core supervisory activities. The Wholesale Business Unit spent slightly more than expected on specific supervisory activities.

The Operations Business Unit shows a favourable variance to budget reflecting lower depreciation charges due to timing of IT projects.

Direct Reports and Enforcement costs were broadly in line with budget.

Enforcement costs and penalties

Our Enforcement costs were £35.8m for 2008/09 (£29.4m 2007/08), which included the cost of external accountants and lawyers (£3.8m in 2008/09; £0.9m in 2007/08), brought in to help us with large or complex enforcement cases.

As in previous years, we neither budget for penalties arising from disciplinary cases nor use them to fund our activities. During 2008/09 we collected penalties of £28.4m (2007/08: £4.5m), which will be used to reduce the amounts payable to us by relevant fee blocks in future years.

Panel costs

Panel costs include the cost of the Consumer Panel (£0.7m) and the combined cost of the Practitioner and Smaller Businesses Practitioner Panels (£0.5m). These figures include the costs of staff that support the Panels' work, independent research, Consumer and Small Business Practitioner Panel members' fees and expenses, and costs associated with the preparation of the Panels' annual reports. The costs of both these panels were in line with budget.

Complaints Commissioner

The FSA provides funding for the Office of the Complaints Commissioner (OCC), which incurs costs mainly comprising of the Commissioner and his staff, accommodation and ancillary services. In 2008/09, the OCC's costs totalled £0.5m, which was in line with budget.

Funding

We are funded by fees payable by the organisations we authorise, recognise, register or list. During 2008/09, £324.4m in fees were raised directly from those fee-payers. The shortfall in fees shown in table 5.4 reflects the fact that fees were set before the budget was revised to fund the additional SEP and Lifecycle costs.

BALANCE SHEET

Financial Strength

The statutory accounts show that we had net liabilities of £123.1m at 31 March 2009, primarily as a result of pension liabilities of £88.9m, calculated under International Accounting Standard 19: Employee Benefits (IAS 19). The pensions liabilities will not crystallise for many years and our approach to managing them, and to funding our pension deficit, is explained on pages

Table 5.4
Funding the FSA's net expenditure

	2008/09 £m	2007/08 £m
Total net costs for the year per the Financial review	335.0	298.1
Under spend against budget (see reserves movement table 5.5)	3.4	3.6
(Shortfall)/excess of fees over budget (see reserves movement table 5.5)	(14.0)	1.6
Fees raised in the year	324.4	303.3

59 to 60. Despite the large deficit currently reported, we believe that we remain able to meet our liabilities as they fall due because of our statutory power to raise fees. Accordingly, our financial statements have been prepared on a going concern basis. Excluding the pensions deficit measured on an IAS 19 basis, we had a net deficit of £34.2m, some of which was generated by the extra budget approved for SEP and Lifecycle costs. These will be recovered by fees in 2009/10.

During 2008/09, our cash balance averaged £56.2m (2007/08: £92.8m), and totalled £0.2m at the year end (2007/08: £24.8m).

During 2006/07, we investigated options to improve the management of the risks to our balance sheet and to our fee-payers. As a result of that work, we paid an additional £20m into the Pension Plan and arranged a £100m revolving credit facility with Lloyds Banking Group to fund the costs we expect to incur in delivering more outcomes focussed regulation and overhauling our IT delivery and technical infrastructure. This allows us to spread the costs to fee-payers over several years. The price of that facility appropriately reflects the strength of our financial covenant. The revolving credit facility with Lloyds Banking Group remained in place during 2008/09 and, following the continuation of our capital investment programme, we had to draw down on the facility to

fund a short term deficit in our liquid resources towards the end of the year.

Based on the activities in our 2009/10 Business Plan, we identified the need to extend our credit facility. Accordingly, we have recently entered into a similar revolving credit facility arrangement with HSBC for a further £100m facility.

Financial management of the FSA's pension costs

Our pension scheme has two sections, Final Salary and Money Purchase. The Final Salary scheme has been closed to new members, other than staff transferring from previous regulators whose activities we have taken on, since 1 June 1998. At 31 March 2009, 495 staff (31 March 2008: 538) were in the Final Salary scheme and 2,127 (31 March 2008: 1,876) in the Money Purchase scheme. The Final Salary scheme is relatively immature compared to many such schemes, in that just under 16% of members of the scheme are pensioners.

In our Annual Report for 2007/08, we committed to making a minimum additional pension deficit reduction contribution of £3.8m to our Final Salary pension scheme during 2008/09. Following discussions with our actuary and the Trustee of the Pension Plan, we increased this to £5.8m. We also raised £2.5m to fund repayment of the £20m additional

contributions we made from our reserves during 2006/07. Key factors impacting the value of our pension deficit included:

- the increase in the corporate bond discount rate from 6.0% to 6.6% reduced the deficit by £49.4m; and
- a decrease in the retail price inflation assumption from 3.4% to 3.0% reduced the deficit by a further £26.5m.

Other factors affecting the value of our pension deficit included interest costs, expected return and an actuarial loss on our assets. After taking all those factors into account, the deficit decreased by £2.7m to £88.9m, as measured using IAS 19.

We continue to work with the Final Salary pension scheme Trustee to secure the pension benefits of our employees and mitigate the risks arising from our Final Salary pension scheme. In particular, in March 2008 we agreed with the Trustee both the results of the Scheme Specific Valuation (SSV), performed as at 31 March 2007, and the basis on which we shall pay contributions until the next three-yearly valuation is completed. The SSV showed a deficit of £29m. In 2008/09, we committed to making additional pension deficit reduction contributions of £3.8m a year (approximately 13.1% of pensionable earnings). In the event, we made pension deficit reduction contributions totalling £5.8m (19.9% of pensionable earnings) in 2008/09. We remain committed to clear the deficit over the ten-year period to 2019 by making additional

pension deficit reduction contributions. We have committed to raise our deficit contribution to £9.8m in 2009/10, and make payments of £11.8m a year, beginning in 2010/11. We believe that our approach to the management of our pension costs strikes an appropriate balance between our obligations to our staff and fee-payers. We will keep our approach under review.

Movement in the FSA's reserves

We believe that our total revolving credit facilities (£200m) provide sufficient financial capacity to allow us to meet any likely unforeseen expenditure. Consequently, we target a level of reserves (that is the cumulative excess of our fees over our costs) of £nil (+/-2%) of the cost of our ORA. We have taken the opportunity within our ORA reserves to maximise the write off of our remaining deferred IS costs of £3.4m, which reduces the recovery and fees charged for 2009/10. As a result, our final ORA reserves at 31 March 2009 were £nil (2007/08: £4.5m) and our total reserves (excluding pension liability) were a deficit of £34.2m. The items that make up the total reserve deficit of £34.2m (as shown in table 5.5) reflect costs incurred that will be recovered in future years.

In our Business Plan 2007/08, we introduced two new components in the calculation of our Annual Funding Requirement, and so now hold reserves or deficits against them. They are:

- A three-year transition programme as part of our move towards more outcomes-focused regulation. At 1 April 2008 we had established reserves of £5.0m to fund the cost of that work. We plan to recover the cost of this work (which is expected to cost not more than £50m in total over the three year period) over a period of 10 years. So, during 2008/09 we raised £5.0m to fund those costs, taking the total raised to £25.2m. We incurred costs of £15.9m during the year, bringing the total incurred to £31.1m, leaving negative reserves of £5.9m at 31 March 2009.
- A £20m pension deficit reduction contribution was made in 2006/07. In 2008/09, we collected £2.5m, leaving a net prepayment of £10.2m at 31 March 2009.

In addition, scope changes (£2.5m specific to 2008/09) have been separately identified and their accumulated expenditure (£2.7m) will, in future, be recovered from appropriate fee blocks.

Further to this, as mentioned earlier, the Board approved an additional expenditure of £15.4m for SEP and Lifecycle costs, which will be recovered in 2009/10.

<p>Box 12</p> <p>Financial Management and Reporting Framework</p>	<p>The scope of activities falling within our remit is wide and varied. This includes some activities which are intended to be temporary in nature and/or which are subject to considerable variation from year to year. We cannot forecast these with the same reliability as regular recurring activities. We will continue to:</p> <ul style="list-style-type: none"> • exert sound financial management and budgetary control over all areas of our expenditure and income; and • seek to manage any unavoidable volatility to minimise the impact on fee-payers from year to year. <p>Our Board believes that it is helpful to have a framework within which to manage and report on our costs and funding. The following 'streams' of activities, which have distinct cost and funding characteristics, have been identified.</p>
<p>ONGOING Regulatory Activity (ORA)</p>	<p>These are core operating activities that are subject to year-on-year management as part of our budget process. The cost of ORA is the key figure, along with explanations of any material movements, which shows how we have met our obligation to be economic and efficient in using our resources.</p>
<p>Changes in Scope (increase or decrease)</p>	<p>Parliament may legislate to change the scope of the activities that we regulate. Any scope changes, as with our other core operating activities, are subject to financial management as part of our budget process. However, in the first financial year affected by the change in scope, and until the new supervisory process is fully established, we believe material activities resulting from a scope change are best controlled separately so they are individually identifiable. In the longer term, when the ongoing supervisory requirements of the scope change have stabilised, typically after the new scope has been in place for at least a full year, we include these activities as part of the cost of our ORA.</p>
<p>Exceptional items</p>	<p>We will include the costs of exceptional items within the cost of our ORA, and will report on any material movements from year to year.</p>
<p>Enforcement costs</p>	<p>Total enforcement costs depend on the number of cases and their complexity. We will continue to manage these costs and seek to optimise the mix of internal and external enforcement resources when we do this. We have included these costs within the cost of our ORA and we will report on any material movements from year to year.</p> <p>While we will maintain strong financial management of these costs, the actual amounts may be materially higher or lower than the budgeted level set in advance of the financial year. If this happens we will review any excess or reduction in costs from budgeted level and may seek to smooth the impact on fee-payers over a three-year period, subject to us being able to maintain satisfactory reserves.</p>
<p>Panel costs</p>	<p>The Financial Services Consumer Panel and the Practitioner Panel have a status under FSMA that guarantees their independence from the FSA. These bodies and the Smaller Businesses Practitioner Panel control their own costs against budgets. They are, however, subject to our approval and are funded through our fees. These costs are included within the cost of our ORA.</p>
<p>Complaints Commissioner</p>	<p>FSMA requires that an arrangement be in place for the investigation of complaints against the FSA. The Complaints Scheme was introduced in September 2001. FSMA requires us to ensure that the Complaints Commissioner has at his disposal the resources to conduct a full investigation of any complaints. The Complaints Commissioner controls his own costs against a budget, which is subject to our approval, and is funded through our fees. These costs are included within the costs of our ORA.</p>
<p>Pension scheme deficit reduction contributions</p>	<p>The amounts required to reduce this deficit over time are inherently variable and depend on a number of factors including current investment values and projected investment returns. We have plans in place to reduce this deficit to nil over the ten-year period to 31 March 2019.</p>
<p>Transition costs</p>	<p>The changes necessary to improve the effectiveness of our people and move towards a more outcomes-focused regulatory approach will be controlled separately over a three-year period until 31 March 2010. We have set up a separate multi-year budget of £50m for that expense.</p>
<p>Reserves</p>	<p>In line with our Treasury Management Policy, we target ORA reserve (that is the cumulative excess of our fees over our costs) levels of £nil, plus or minus 2% of the costs of our ORA. With the exception of the pension deficit, all other reserve deficits represent costs that have been incurred that will be recovered in future years.</p>

<p>FINANCIAL RISK MANAGEMENT</p>	<p>In the ordinary course of business, our operations expose us to a number of financial risks including credit risk, liquidity risk, inflation risk and the risk arising from the provision and management of our Final Salary pension scheme. We have in place a risk management programme that seeks to limit the adverse effect on our financial performance by monitoring those risks and taking appropriate mitigating action where required. The FSMA provides us with the power to make rules to levy fees to fund our operations. In doing so, we seek to ensure that we operate with due regard to our economy, efficiency and effectiveness as well as seeking to minimise any unnecessary volatility in those fees.</p> <p>The Board has delegated the responsibility of monitoring financial risk management to the Audit Committee. The policies set by the Board of Directors are implemented by the finance function (concerning the manner in which transactions are accounted for and the overall management of financial risk) and by our Operations business unit (concerning the financial transaction processing cycles, for example fee invoicing and collection).</p>
<p>Credit risk on the collection of our periodic fees</p>	<p>We charge fees to the persons we authorise, the bodies we recognise, the companies we list and the entities we register. The consultation process we go through in order to set our fees is designed to help ensure that they are set at a level which both reflects the regulatory activity involved and are affordable to all fee-payers, large or small. In addition, many of our smaller fee-payers use facilities offered by Premium Credit Limited, an independent credit provider, to finance the payment of our fees. In such instances Premium Credit Limited bears the credit risk, rather than the FSA. The level of unpaid debts is monitored on a regular basis.</p>
<p>Liquidity, price and cash flow risk</p>	<p>The Board has approved a policy for the management of any surplus cash balances that we may hold above the level needed to manage our short-term liquidity requirements. Such balances are invested by our agents, until January 2007 Royal Bank of Scotland, and then Lloyds Banking Group, in high-quality, liquid deposits (thus eliminating any price risk) with a range of counter-parties in such a way as to avoid an excessive concentration of our investment with any specific counter-party. The concentration and the return on those investments, and the identity of our counter-parties, are monitored daily.</p> <p>Since January 2007, we have had a £100m revolving credit facility contract with Lloyds Banking Group, which is run alongside and operates in conjunction with the agency treasury service, allowing us to manage our net finance costs. Based on the activities in our 2009/10 Business Plan, we identified the need to extend our credit facility. Accordingly, we have recently entered into a similar revolving credit facility arrangement with HSBC for a further £100m facility.</p>
<p>Final salary pension scheme</p>	<p>Our most significant financial management risk is that the benefits our Pension Plan offers to its Final Salary members will not be matched by the assets available to the Plan. In that case, the residual cost will be met by the FSA. What we are doing to manage those risks is set out on pages 59 to 60.</p>
<p>Leases</p>	<p>Under the terms of the lease for our premises at 25 The North Colonnade, for the period from 4 November 2008 to 3 November 2018, the rent that we pay each year will increase in line with retail price inflation (RPI), subject to a minimum annual increase of 2.5% and a maximum of 5.0%. Given that cap and our current assumptions concerning the future levels of RPI, we do not consider it necessary to take further action to manage our potential exposure to an increase in RPI on the cost of this lease.</p>
<p>Currency risk</p>	<p>We do not run any significant exposure to currency risk.</p>

