payments and crypto network

<u>Q: Do cash balances comprise part of the Capital held?</u>

The FCA's Approach Document (Chapter 9) provides some helpful details regarding what constitutes "Capital" (also referred to as "Own Funds"), including diagrams summarising what should be included in the calculation.

The composition of the Own Funds held by a firm are described in terms of Tier 1 and Tier 2 capital and can get quite complicated as well as include certain deductions. However, the majority of firms will only need to consider Tier 1 capital (and potentially some deductions, such as losses for the current financial year).

Tier 1 capital is illustrated in one of the FCA's diagrams (see extract below):

<u>CET1 (Common Equity Tier 1) Items</u>

[CRR 26, 27, 28, 29 & 30]

(a) Capital instruments (e.g. ordinary shares)
(b) Share premium accounts
(c) Retained earnings
(d) Accumulated other comprehensive income
(e) Other reserves

The definition is clear and <u>does not</u> include cash balances.

When referring to "cash balances" we include cash, bank balances and short-term liquid investments. These are obviously important for a business to manage, for a number of reasons, including:

- To ensure that the business can remain a "going concern" - an accounting term that essentially means being able to pay liabilities when the fall due. If you can't do this you have a problem, and potentially a qualified audit opinion in your financial statements; and
- As part of the wind-down planning process when, for example, calculating the amount of "adequate financial resources" which are required to enable an orderly (not disorderly) wind down of the business.

So why the confusion regarding whether cash is included?

It might seem logical to include cash balances in the calculation of capital, but consider the objective of holding the required level of capital. The FCA Approach Document states:

> *"Capital is required to be held as a buffer, absorbing both unexpected losses that arise while a firm is a going concern as well as the first losses if a firm is wound up".*

This requirement is essentially to maintain a strong Balance Sheet that is capable of withstanding difficult times.

With the above objective in mind, in addition to cash, why not also include debtors that can be collected and fixed assets that can be sold (obviously, less the liabilities that will require payment)? If you are not familiar with double entry accounting, or the structure of a Balance Sheet, the text and diagram below should help answer this question.

Fixed assets, debtors and liabilities are all Balance Sheet items, as shown by A, B and C below. The sum of these assets (A + B in the table below) and liabilities (C) are the net assets that are held by the business (A + B + C). This could be referred to as the top half of the Balance Sheet.

If your Balance Sheet balances, which it should, the net assets figure will equal the “Capital and Reserves” of the business, as shown in the bottom half of the Balance Sheet (D + E + F). I.e. the top and bottom halves of the Balance Sheet are equal (i.e. in balance) meaning that (A + B + C) = (D + E + F).

Fixed Assets	A
Trade Debtors Other Debtors Cash and investments	B
Trade Creditors Other Creditors	C
Net Current Assets	B + C
Net Assets	**A + B + C**

Share Capital	D
Share Premium	E
Retained P&L Reserve	F
Share Capital and Reserves	**D + E + F**

The Own Funds held by the business, per the above example and in accordance with FCA requirements, would be D + E + F. This is equivalent, due to double-entry accounting and a balancing Balance Sheet, to A + B + C. As such, you could therefore view cash as being implicitly included, alongside the other assets and liabilities of the business. Essentially two sides of the same coin. Thinking in terms of cash, whilst it may seem logical, does not provide the full picture of the strength of the business and would be misleading.

Note that holding the requisite amount of capital should not be confused with the safeguarding of customer funds which does require cash being held in an account (in a dedicated Safeguarding Bank Account). This is often a point of confusion.

Also, it is worth noting that a low level of cash resources is not necessarily a bad thing, provided going concern and the level of adequate financial resources is maintained. It is also not necessarily an indication of a weak firm. Arguably, keeping cash at bank, earning low rates of interest, is not a good use of company resources – a stronger business would likely seek to invest cash funds into its business to build further value rather than hold as (excess) cash resources earning little return for shareholders. Conversely, a higher cash balance is not an indication of a healthy or string business!