

**FINANCIAL REPORTING ADVISORY BOARD
TO THE TREASURY**

**FIRST REPORT ON THE RESOURCE
ACCOUNTING MANUAL**

July 1997

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FOREWORD

Resource Accounting is the biggest single development in government accounting this century and it is crucial to its success that it is carefully planned and implemented. Resource accounting will improve reporting of public finance, giving Parliament and managers the information they need to ensure the tax-payer's money is safeguarded and used properly.

The Financial Reporting Advisory Board was set up as an independent Board with representatives from the accountancy profession in the private and public sectors; from academia and government bodies. Our role has been to advise the Treasury on the application of financial reporting principles and standards contained in the Resource Accounting Manual, which will be used to guide the preparation of departmental resource accounts. We have been concerned to ensure that the principles of resource accounting accord with Generally Accepted Accounting Practice (GAAP) as far as possible and that the best possible reporting is achieved by Resource Accounting. This process has inevitably taken time. The Board has had an immense task in reviewing the Resource Accounting Manual which covers all aspects of accrual accounting as well as reporting costs against departmental aims. This formidable task has required the Board to meet twice a month over the last year. We have examined the Manual in great detail and have received papers and representations from a wide range of interested parties. We have carefully deliberated over some complex issues relating to key accounting policies including accounting for the effects of changing prices, the valuation of infrastructure and heritage assets, and the departmental boundary.

In carrying out our work our aim has been to ensure that the accounting standards and practices adopted in the private sector have been applied or adapted to the central government sector as appropriate. This has at times involved considerable debate about the extent to which central government differs from the private sector. In the main there have been few major departures from the principles adopted by GAAP.

In commenting on the Manual we have been keen to ensure that, where GAAP is not applied, this is because it would not be relevant in central government rather than because of any practical

difficulties of implementation. However, we have also recognised the enormity of the challenge facing many government departments as they move from the well understood approach of cash accounting to the less familiar one of accrual accounting. We have recommended many changes to the draft Manual which the Treasury has accepted willingly. The main changes have been the endorsement of a pilot study for accounting for changing prices, the principle of capitalising some heritage assets, arrangements to provide a proxy for depreciation of infrastructure assets, notional insurance charges not to be included in the primary statements of executive agencies, and the inclusion of the Statement of Recognised Gains and Losses as a primary statement. These, and numerous instances of fleshing out of details, have made the Manual more effective and relevant.

Resource accounting promises much for the public sector in better financial reporting. Our report on the Manual is designed to help achieve this. But for many departments this will entail a major upheaval of their accounting systems. It will therefore be essential for the Board to review how successful, in practice, the Manual has been after the first dry run accounts and audits planned for the financial year 1997-98. The Board will then be able to take into account the practical application in recommending any future changes to the Manual.

The Board wishes to thank the Treasury Secretariat headed by Mr Chris Richards for all their hard work and invaluable support which has enabled us to deliver this report timeously.

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EXECUTIVE SUMMARY

Introduction

The Financial Reporting Advisory Board (FRAB) was set up in order to provide the Treasury with independent advice on the application of financial reporting principles and standards in respect of the central government sector, against the background of the introduction of resource accounting. This report sets out the results of the Board's main task to date, which has been to examine the Resource Accounting Manual. Our aim has been to help to ensure the best possible financial reporting. In particular, it has been our role to ensure that, as far as possible, departmental resource accounts will follow Generally Accepted Accounting Practice (GAAP). In carrying out our work, we have been conscious of the distinct nature of resource accounts, in particular the 'non-for-profit' nature of most central government activity and the fact that the Government intends to make resource accounts a component of the planning and control of public expenditure. These distinctions have justified some departures from or modifications to GAAP.

2. **In general, we accept the changes from GAAP which have been proposed by the Treasury, and endorse the Resource Accounting Manual as the basis on which resource accounts should be prepared.** However, we retain concerns on a number of issues : the departmental boundary; the interaction with resource budgeting; accounting for the effects of changing prices; and the incomplete application of the Greenbury Code to salary and pension disclosures. These are summarised below, followed by an outline of the results of our examination of other major issues.

Issues of Concern

The Departmental Boundary (Paragraph 2.2 of our Main Report)

3. Under resource accounting, it is proposed that the bodies to be consolidated into departmental resource accounts are those over which a department is deemed to exercise in-year

budgetary control. This explicitly excludes from consolidation some classes of bodies such as Trading Funds. This differs from the accounting treatment under GAAP, which is determined on the degree of influence which a body exercises over other entities. In practice, departments may exercise influence over such bodies by virtue, among other things, of their funding and it is arguable that the same criteria as used under GAAP should also be applied to resource accounts.

4. For the present, in the interests of the timely introduction of resource accounting, we are content to accept the Manual definition of the departmental boundary and that accounts should be constructed on that basis. We expect, however, to re-examine this issue in the light of emerging experience.

Compatibility with Resource Budgeting (Paragraph on 2.3)

5. Our examination of the Resource Accounting Manual has been carried out to date in advance of a detailed specification of the proposed new planning and control system. We recognise that perverse incentives for inefficient resource use and uneconomic asset disposal can be generated by any accounting system if adequate care is not exercised in the design of the related budgeting system.

6. We urge the Treasury to pay careful attention to the development of the new planning and control system to ensure that such perverse incentives are not generated.

Accounting for the effects of changing prices (Paragraph 2.4)

7. The Treasury proposes that accounts should be prepared on the basis of Modified Historical Cost Accounting (MHCA), in order to recognise the revaluation of fixed assets and stocks. The Treasury further proposes to carry out a pilot study with departments to determine the appropriateness of methods of accounting for changes in the value of assets less liabilities, measured against general inflation. Depending on the outcome of the study, the Treasury would propose to introduce such a form of accounting.

8. We recognise the Treasury's rationale for wishing to account for the effects of changing prices and accept that there is a case in theory, for such accounting treatment but we remain cautious about the possible introduction of such an accounting treatment. The Treasury proposal to carry out a pilot study is a welcome response to our concerns and we will await the results, before reaching a view.

Salary and Pension Disclosures (Paragraph 2.10)

9. The Greenbury Code, published in 1995, contained a proposed Code of Best Practice on directors' remuneration. During our consideration of the Manual, we were advised that the previous Government had decided not to apply the Code's provisions to disclosures on remuneration to the top levels of the Civil Service, and to disclosures on pension entitlements to both top civil servants and Ministers.

10. We recognise that some disclosure on remuneration already takes place, but our view is that this decision should be reconsidered, on the grounds that the principles of openness and transparency should apply equally in the public and private sectors. We intend to return to this issue after the Treasury has held discussions with the Cabinet Office.

Other Main Issues

Valuation of Fixed Assets and Consumable Stocks (Paragraph 2.5)

11. In accordance with GAAP, fixed assets are valued at the lower of replacement cost and recoverable amount, which in turn is the higher of net realisable value and value in use. In a commercial environment, value in use will reflect future income. The 'not-for-profit' nature of the vast majority of central government activities means that value in use is not measurable in terms of income. In order to allow for this, the Manual proposes that the assessment of value in use for fixed assets, and the net realisable value of consumable stocks, will be based on whether

or not they can or will be used, rather than on future income to be earned from those assets. **We agree that these are sensible adaptations of GAAP in the context of resource accounting.**

Heritage Assets (Paragraph 2.6)

12. We have considered the view that, in principle, heritage assets should be valued and put on departments' balance sheets in the same way as other fixed assets. This is because of the importance of providing information on the assets the nation owns and the need to ensure good stewardship of those assets. We recognise, however, that because of the nature of these assets, there could be difficulties in putting this into practice, in particular for those non-operational assets which are held solely for their heritage use. Such assets should be valued only if they meet the criteria relating to the cost effectiveness of obtaining valuations and the reliability of those valuations. **In order to take this forward, we have asked the Department for National Heritage to provide additional information on the cost of obtaining valuations for selection of heritage assets and we intend to return to this when we have received this information**

Decommissioning Costs (Paragraph 2.7)

13. **We consider that the issue of whether the currently specified 6% real rate of interest is the appropriate discount factor for computing the present value of future decommissioning costs other provisions will need to be kept under review. The estimation of provisions will need to be carefully monitored to avoid Departments using creative accounting opportunities to reduce their net capital charges.**

Pension Scheme Statements (Paragraph 2.8)

14. The Manual proposes the preparation of scheme statements in respect of the various pension schemes administered by departments. These will generally follow the formats in the Statement of Recommended Practice for financial reports of pension schemes. **We endorse this approach.**

Charging for the Cost of Capital (Paragraph 2.9)

15. In order to recognise the cost of capital employed by departments, the Manual includes the policy of levying a cost of capital charge based on the value of all assets and liabilities (with a few exceptions, such as donated assets). **We accept the Treasury's rationale for including a capital charge in resource accounts. We consider, however, that this policy may lead to some change in the relationship between parent departments and the public sector bodies in which they have investments.**

Private Finance Initiative (PFI) (Paragraph 2.11)

16. Detailed guidance is being developed by the Public Sector and Not-for-Profit Committee of the Accounting Standards Board. **We accept that, for the time being, the Manual can give only a broad indication of the accounting treatment, but we will return to this when more detailed guidance is available.**

Financial Statements (Paragraph 2.12)

17. **In general, we acknowledge and find acceptable the reasons for the forms of financial statements proposed and are satisfied that they are capable of providing a true and fair view of departments' operations and financial position.** [Want to mention Statement of Recognised Gains and Losses?] **We acknowledge, however, that Parliament has a strong interest in the usefulness of these statements and that its views will need to be taken into account in due course.**

The Audit Opinion (Paragraph 2.13)

18. Under GAAP, adherence to accounting standards is generally required to give a true and fair view. For resource accounting, the Manual is the authoritative interpretation of accounting standards and compliance with it will in all but exceptional circumstances be necessary for the

resource accounts to be give a true and fair audit opinion. **We are pleased that the Treasury has accepted this.**

Future role of the Board (Paragraph 3)

19. This report is the first stage in the Board fulfilling its remit. Some of our conclusions and recommendations will require us to return to a number of issues in due course for example the results of the pilot study on the impact of changing prices.

20. **We believe it is essential that the Board has an on-going role in reviewing the Manual in the light of experience and to consider any proposals for material change. It will be important for the Treasury to ensure that there are mechanisms for providing the Treasury and the Board with adequate feedback on implementation.**

21. We have not formally considered any possible changes to the Board's role but consider that there would be advantages in exploring whether the Board's remit should be extended so that all central government bodies apply the same principles and standards.

MAIN REPORT

1. Introduction

1.1 The Board's aim has been to help ensure that the best possible financial reporting is achieved by Resource Accounting. As part of this we have aimed as far as possible to ensure that departmental resource accounts¹ are governed by UK Generally Accepted Accounting Practice (GAAP) and that departures from or modifications to GAAP are fully explained. This is consistent with the White Paper "Better Accounting for the Taxpayer's money: The Government's Proposals - Resource Accounting and Budgeting in Government" (Cm2929), which stated that resource accounts would be based on GAAP to the extent that it was appropriate and meaningful in the public sector context (paragraph 3.13).

1.2 This remit was emphasised subsequently by recommendations from both the Committee of Public Accounts (9th Report of Session 1996-97) and the Treasury Committee (5th Report of 1995-96) for close adherence to GAAP, subject to the particular circumstances of central government.

1.3 Our report sets out the general criteria we have applied in reviewing the Treasury's proposals and the main areas where the treatment prescribed in the Resource Accounting Manual either departs from GAAP or puts a particular interpretation on it. It also draws attention to those areas which are set out only provisionally or incompletely, pending further examination or practical experience. We propose to review these areas further in due course.

1.4 In section 2 below we comment on the main issues arising from our consideration of the Manual, and in section 3 put forward our views on the future role of the Board. Annex A describes the terms of reference and composition of the Board, and how we carried out our task. Annex B describes other modifications to GAAP not covered in our main report.

¹ The use of the word 'department' in this context is taken to include other entities which come within the departmental boundary, such as On-Vote Agencies and Non-Executive NDPBs accounted for on-vote. For full details, see section 1.6.1 of the Manual.

2. **Resource Accounting Manual: Main Issues Arising**

2.1 **Modification of GAAP**

2.1.1 GAAP has been developed primarily in the context of the reporting requirements for commercial enterprises. In considering the Treasury's proposals, set out in the Resource Accounting Manual, we have recognised the distinctive nature of resource accounting. We have acknowledged that the non-commercial nature of most of central government activity, and the 'not for profit' context in which any commercial activity takes place, makes some GAAP treatments and requirements irrelevant, or makes alternative treatments more relevant and useful. Also the policies set out in the Manual will have an effect on the preparation of forward plans and annual estimates. These policies, together with the accounts, will feed in to the planning and control of central government expenditure with effect from 1 April 2001, if Parliament agree.

2.1.3 We have therefore judged the acceptability of proposals in the Manual in the light of these distinctions. We have nevertheless been concerned to ensure that the fundamental principles of GAAP - going concern; accruals/matching; consistency; and prudence are applied fully. We have also attempted to ensure that the degree of disclosure in resource accounts is comparable to GAAP - even if such disclosures are sometimes achieved in a different way. In general we consider the modifications to GAAP proposed by the Treasury to be appropriate, and, therefore, endorse the Manual as the basis on which resource accounts should be prepared. However, we retain concerns on the following points: the departmental boundary (paragraph 2.2); the interaction with resource budgeting (paragraph 2.3); accounting for the effects of changing prices (paragraph 2.4); the recognition of heritage assets (paragraph 2.6) and the incomplete application of the Greenbury Code to salary and pension disclosures (paragraph 2.10). These are discussed in the following paragraphs, together with other comments as appropriate on other sections of the manual.

2.2 Departmental Boundary (Manual, Section 1.5)

2.2.1 This section sets out those departmental entities which are to be consolidated to form a department's resource account. Under GAAP, all the entities over which a body exercises a dominant influence would be treated as its subsidiaries and would be fully consolidated into a set of group accounts. For resource accounts, the bodies to be consolidated are those over which a department is deemed to exercise in-year budgetary control. This explicitly excludes from consolidation some classes of entity including Trading Funds, and executive Non-Departmental Public Bodies (NDPBs) except where the Treasury has been decided that 'for good control reasons' they should be consolidated. It also makes the accounting for associated undertakings and joint ventures dependent on 'spending control requirements' rather than the GAAP tests of influence.

2.2.2 In practice, departments may exercise either dominant or significant influence over many such bodies by virtue, among other things, of their funding. Since much of the Government's outputs are delivered through those bodies it is arguable that they should be treated as subsidiaries or associated undertakings and the appropriate form of consolidation should be applied.

2.2.3 For the present, in the interests of the timely introduction of resource accounting, we are content to accept the Manual definition of the boundary and that accounts should be constructed on that basis. We would, however, like to re-examine these issues in the light of emerging experience.

2.3 Compatibility with Resource Budgeting (Manual, Paragraph 2.2.17)

2.3.1 The Board believes that it is very important that careful attention is given to the proposed Resource Budgeting system for public expenditure planning and control if the benefits of the combined Resource Accounting and Budgeting system are to exceed the costs that it involves. Our examination of the Resource Accounting Manual has been carried out to date in advance of a detailed specification of the proposed new planning and control system. We recognise that

perverse incentives for inefficient resource use and uneconomic asset disposal can be generated by any accounting system if adequate care is not exercised in the design of the related budgeting system. This is particularly so given the element of sunk costs that is involved in many capital assets and the differences that can arise between the opportunity costs of retaining assets and their net book values. Whether or not an asset is considered surplus to use may also depend upon the tightness of the resource budget that is imposed, so that there may be interactions between the process of valuation and the process of resource budgeting. In addition, asset disposals may in some cases involve a loss of public amenity value or other environmental considerations which are not fully reflected in balance sheet values.

2.4 Accounting for the Effects of Changing Prices (Manual, Paragraph 2.3.1)

2.4.1 GAAP provides (under the Companies Act) for accounts to be prepared on a historical cost basis, or on a basis modified to recognise the revaluation of fixed assets and stocks. Where accounts are prepared on that modified basis - referred to as Modified Historical Cost Accounting (MHCA), the accounts should also disclose the historical cost figures. The proposals for resource accounting are that accounts should be prepared on an MHCA basis, but that historical cost figures will not be disclosed. We acknowledge the greater relevance of asset figures expressed in current values under MHCA and can accept that the inclusion of historic cost figures would add little to the intended purposes of the accounts.

2.4.2 The Treasury further proposes to carry out a pilot study with departments to determine the appropriateness of methods of accounting for changes in the value of assets and liabilities, measured against general inflation. Depending on the outcome of the study, the Treasury would propose to introduce such a form of accounting. The reasons are that it would reflect expenditure in the same terms that investment decisions were made by departments; that it would more accurately represent the costs of assets consumed; and that it would reflect the basis on which costing and pricing calculations were made in the private sector.

2.4.3 We recognise the Treasury's rationale for wishing to account for the effects of changing prices and we accept that there is a case in theory for such accounting treatment. We also

recognise, however, that the introduction of such a convention could have considerable repercussions and, under some methods, costs for departments which may not be worthwhile and that there is debate about the appropriate methodology. We consider that accounts prepared on such a basis might present difficulties for budgeting and Parliamentary control. The Board has discussed this issue at length, and the Treasury proposal to carry out a pilot study is a welcome response to our concerns. We remain cautious about the possible introduction of such an accounting treatment and we will await the results of the pilot study before reaching a view.

2.5 Valuation of Fixed Assets and Consumable Stocks (Manual, Sections 3.2 and 3.12)

2.5.1 In accordance with GAAP, where accounts are produced on an MHCA basis (see paragraph 2.4.1 above) fixed assets are valued at the lower of replacement cost and recoverable amount, which in turn is the higher of net realisable value and value in use. In a commercial environment value in use will reflect future income. As long as the future earning potential of an asset exceeds its replacement cost, the latter will be the basis of valuation. Where the earning potential is lower there will be an impairment in the value of the asset and its value will have to be written down.

2.5.2 The not for profit nature of the vast majority of central government activities means that value in use is not measurable in terms of income. In order allow for this the Manual has placed an interpretation on GAAP by assuming that value in use will be at least equal to an asset's replacement cost unless there has been a reduction in its service potential. For example if the purpose for which the asset was acquired is no longer carried out and the asset has no alternative use.

2.5.3 Similarly, under GAAP, stocks are valued at the lower of cost (or current cost) and net realisable value. Again, as net realisable value in central government is generally not measurable in terms of income the Manual interprets on this as values of consumable stocks will only be written down to net realisable value where stocks cannot or will not be used.

2.5.4 We agree that these are sensible adaptations to GAAP in the context of resource accounting.

2.6 Heritage Assets (Manual, Section 3.5)

2.6.1 The Board discussed the accounting treatment of heritage assets at some length. They cover a wide range, and include, for example, historic buildings and monuments, parks, works of art, and museum artefacts. We have considered the view that, in principle, they should be valued and put on department balance sheets in the same way as other fixed assets. This is because of the importance of providing information on what the nation owns and the need to ensure good stewardship of those assets. We recognise, however, that because of the nature of these assets, there could be difficulties in putting this into practice. The difficulties arise mainly in connection with non-operational heritage assets, which are held solely for their heritage use, rather than with operational heritage assets which are used for non-heritage purposes. Valuations might be expensive compared with the benefits of including the assets on the balance sheet. In addition, some valuations may not be sufficiently reliable.

2.6.2 We agree with the Treasury that the Manual should set out the broad principles of the accounting treatment. Firstly, all operational heritage assets should be valued and put on balance sheets. Secondly, non-operational heritage assets should be valued and put on balance sheets only if they meet criteria related to the cost effectiveness of obtaining valuations and the reliability of those valuations. The broad criteria need to be developed in consultations between the Treasury and the heritage owning departments. In order to take this forward we have asked the Department of National Heritage to provide additional information on the cost of obtaining valuations for a selection of heritage assets. We intend to return to this issue when we have received the additional information.

2.7 Decommissioning Costs (Manual, Section 4.4)

2.7.1 We agree with the method of accounting for these liabilities detailed in the Manual. We consider, however, that the issue of whether the currently specified 6% real rate of interest is the

appropriate discount factor for computing the present value of future decommissioning costs and other provisions will need to be kept under review. The estimation of provisions will need to be carefully monitored to avoid departments using creative accounting opportunities to reduce their net capital charges.

2.8 Pension Scheme Statements (Manual, Section 4.5)

2.8.1 Central government administers various unfunded pension schemes covering its own employees (the Principal Civil Service Pension Scheme and Armed Forces Pension Scheme) and employees mainly from other public sector bodies (covering teachers and the NHS). GAAP guidance contained in the Statement of Recommended Practice for financial reports of pension schemes does not apply to public sector and unfunded schemes. Nevertheless the Manual requires departments administering them to prepare scheme statements, in addition to their resource accounts, following the format in the Practice Statement as far as it is applicable. The Manual also requires resource accounts to include the pension costs of staff employed, according to GAAP principles. We endorse this approach.

2.9 Charging for the Cost of Capital (Manual, Section 6.4)

2.9.1 In order to recognise the cost of capital employed by departments, the Manual includes the policy of levying a cost of capital charge based on the value of all assets and liabilities held (with a few exceptions such as donated assets). In general the charge to resource accounts will be at a standard rate determined by the Treasury and will not entail a cash transaction. However, for investment in public sector bodies such as Trading Funds and NHS trusts the cost of capital charge will be equivalent to the return required from the bodies in question. Parent departments of the bodies concerned will recognise as income in their resource accounts the actual return, in the form of loan interest and dividends. Any over- or under-payment by these bodies of the return due will, therefore, be reflected in the net operating cost of parent departments.

2.9.2 We accept the Treasury's rationale for including a capital charge in resource accounts. We consider, however, that this policy may lead to some change to the relationship between parent departments and the public sector bodies in which they have investments.

2.10 Salary and Pension Disclosures (Manual, Section 7.5)

2.10.1 The Greenbury Report, published in July 1995, contained a proposed Code of Best Practice on directors' remuneration. The report responded to concerns about the remuneration of company directors. During our consideration of the Manual we were advised that the previous Government had decided not to apply the Greenbury Code, regarding the disclosure of remuneration, to the top levels of the Civil Service although some disclosure already took place as set out in 2.10.4 below. Our view, however, is that this decision should be reconsidered.

2.10.2 While we recognise that top civil servants do not receive the same range of benefits available to directors in the private sector, we consider that the principles of openness and transparency should apply with equal force in central government. Accordingly we would like to see Greenbury disclosures of the remuneration and also pension entitlements in respect of the equivalent, in each government department, of the board of directors of a listed company. That equivalent ought to be ministers, the permanent secretary, and other members of the senior management board.

2.10.3 The Manual only sets out, therefore, the disclosure requirements within the confines of the prescribed policy. Ministers' actual salaries will be shown, but the salaries of the permanent secretary of a department and other members of the senior management board will only be disclosed within £5,000 salary bands. There is no provision as recommended by Greenbury for disclosure of pension entitlements for either ministers or senior civil servants, which the Treasury is due to discuss with officials in the Cabinet Office. We intend to return to this issue in the light of the outcome of that discussion.

2.11 Private Finance Initiative (PFI) (Manual, Section 8.3)

2.11.1 The application of GAAP to PFI projects is a complex subject. Detailed guidance is being developed by the Public Sector and Not-for-Profit Committee of the Accounting Standards Board. We accept that, for the time being, the Manual can only give a broad indication of the accounting treatment, but will return to this when detailed guidance is available. In the meantime, the guidance in paragraph 4.13.4 of the Manual should be followed.

2.12 Financial Statements (Manual, Chapter 11)

2.12.1 GAAP calls for four primary financial statements and prescribes their form and content. Accounts prepared under GAAP comprise a Profit and Loss Account; a Statement of Total Recognised Gains and Losses; a Balance Sheet and a Cash Flow Statement. Resource accounts will include all these statements, although the Profit and Loss Account is entitled an Operating Cost Statement (which more accurately describes its nature) and the Statement of Total Recognised Gains and Losses is, instead, a Statement of Gains and Losses because it excludes the net cost of operations. Resource accounts will also include two additional statements - a Summary of Resource Outturn and a statement of Resources by Departmental Aims - further details on this is provided below.

Summary of Resource Outturn - Schedule 1

2.12.2 The purpose of this non-GAAP statement is to provide Parliament with a comparison between the sums voted in Estimates and the resources and cash actually consumed. It is unique to resource accounting and will only become relevant on the introduction of resource-based Supply which, subject to Parliamentary approval, will take place from 2001-02. We have made suggestions for this statement, which the Treasury has accepted, but it will be for Parliament finally to decide whether it meets its needs. Although not provided for by GAAP, the statement was designed to provide additional relevant information, consistent with the other financial statements, and we are accordingly content on that basis.

Operating Cost Statement - Schedule 2

2.12.3 This statement does not follow the form prescribed for the Profit and Loss Account by GAAP (in the Companies Act). It is designed mainly to meet the Treasury's budgetary control needs and potentially those of Parliament (as and when resource accounts supersede Appropriation Accounts). It primarily distinguishes between Administration costs and other 'Programme' costs, and in order to present each of these as net costs it discloses and offsets income against relevant expenditure, programme by programme. Accordingly, some of the disclosures which would otherwise be made on the face of the account under GAAP are instead made in notes to the accounts. This is to enable allocations of all forms of expenditure and income to be made across administration and relevant programmes and avoid complexity in the statement itself. It means that items such as interest payable and receivable, depreciation and losses or gains made on asset disposals are disclosed only through notes.

2.12.4 The statement is also unusual in that it has three 'bottom line' figures; one for Net Operating Cost; one for Outturn against Resource Budget and a third for Net resource Outturn. 'Net Operating Cost' is the straightforward total of all operating expenditures incurred by the department, offset by all operating income. It is the same total as that arrived at in the statement of Resources by Departmental Aims (schedule 5) referred to later. The 'Outturn against Resource Budget' is for Treasury control purposes and is the net operating cost adjusted so that only the components of income and expenditure lying within the Treasury's Control Total for public expenditure remain in the Outturn figure. The adjustment removes those expenditure items that fall outside the Control Total (such as cyclical social security expenditure), and adds back expenditures that have been funded by receipts from the European Union as well as income that is not classified as appropriations in aid and is not offset against public expenditure. The 'Net Resource Outturn' figure is for Parliamentary control purposes and represents net expenditure on the same basis as the Parliamentary Supply grant. It is arrived at by adjusting the Outturn against Resource Budget to remove expenditure not funded from 'Supply' and other adjustments.

2.12.5 The Operating Cost Statement potentially has considerable usefulness, but at the expense

of some complexity and the relegation of information to the notes for which GAAP would require a more prominent disclosure. We must therefore await the final judgement of users, including Parliament. Meanwhile we have been content to accept the format for the purposes it sets out to achieve, on the understanding that refinements are likely to be made in the light of its application. Among these refinements we consider that the terminology used in the adjustments between the three 'bottom line' figures, and the meaning of those figures, should be explained more clearly. We have suggested to the Treasury that an explanation of the three totals would be useful, and should be included in the illustrative accounts.

Statement of Recognised Gains and Losses

2.12.6 This statement - appended to the Operating Cost Statement - displays only the gains or losses arising on asset revaluation and any other gains or losses reported through Reserves. It omits the operating results for the year, and is accordingly not entitled a Statement of **Total** Recognised Gains and Losses - as it would be under GAAP. The Treasury's reason for presenting the Statement in this way is it would be misleading to include the net operating costs as a 'loss', firstly because it is not a 'loss' in the commercial sense of the word. The net expenditure shown in the Operating Cost Statement will have been incurred to obtain, in the main, non-financial benefits - otherwise the expenditure would not have been incurred. Secondly, the costs would be fully funded by Parliament. We have been content to accept this argument for the time being. The final version of the Statement of Recognised Gains and Losses will depend upon the inflation accounting treatment that is ultimately adopted.

Balance Sheet - Schedule 3; Cash Flow Statement - Schedule 4.

2.12.7 The balance sheet (Schedule 3) is in conventional form, which we have been content to accept. However, changes in terminology have been introduced to reflect the central government context, including the term 'Taxpayers' Equity' in place of 'Shareholders Funds'. Similarly the Cash Flow Statement (Schedule 4) is in conventional GAAP form which we accept.

Resources by Departmental Aims - Schedule 5

2.12.8 This is the second statement unique to resource accounting. It re-analyses operating expenditure and income according to the aims and objectives it is intended to serve. These aims and objectives will also be the basis for the annual Output and Performance Analysis report, which departments are to produce as part of resource accounting but publish separately from the accounts. As with the Summary of Outturn Statement, we can accept this additional statement on the basis that it provides additional relevant information, consistent with the rest of the statements.

2.12.9 In summary, we acknowledge and find acceptable the reasons for the forms of financial statements proposed and are satisfied they are capable of providing a true and fair view of departments operations and financial position. We acknowledge, however, that Parliament has a strong interest in the usefulness of these statements and that its views will need to be taken into account in due course.

2.13 The Audit Opinion (Manual Chapter 13)

2.13.1 The White Paper expressed a preference for a 'presents fairly' audit opinion if a 'true and fair' basis could not be appropriately applied (paragraph 3.13). Both the Treasury Committee and the Committee of Public Accounts indicated strong support for a 'true and fair' view form of opinion, because of the additional assurance this would provide. Under GAAP, adherence to accounting standards is generally required to give a true and fair view. For resource accounting the Manual is the authoritative interpretation of accounting standards and accordingly compliance with it will generally give, and be necessary to give, a true and fair view. Accordingly, compliance with the Manual will in our opinion, in all but exceptional circumstances, enable resource accounts to receive a 'true and fair' audit opinion. We are pleased that the Treasury has accepted this. It meets the Treasury's concern at the potential for audit qualifications of departments' resource accounts if 'true and fair' was not linked to the provisions of the Manual. We consider it appropriate and necessary that the accounting policies note to the accounts should record that the accounts have been prepared in accordance with the Manual. We note that the

Manual (paragraph 1.3.3) rightly allows for departures from the Manual if in exceptional circumstances compliance is inconsistent with a true and fair view.

3. **Future Role of the Board**

3.1 Our terms of reference envisage the Board having an ongoing role in reviewing the Manual and considering any proposals for material change arising from the experience of its implementation or changes to GAAP. We believe it is essential that the Board undertake this role. It also is important that the Board reviews the success of the implementation of the Manual after its first year of operation and beyond. The Board will need to consider changes to the Manual arising in the light of its use and re-examine those issues which require further development such as accounting for changing prices, heritage assets, pension fund disclosures and PFI. It will be important for the Treasury to ensure that there are mechanisms for providing the Treasury and the Board with adequate feedback on implementation.

3.2 We have not formally considered any possible changes to the Board's role but we have considered whether there would be advantages in exploring whether the Board's remit should be extended so that all bodies covered by the central government budgeting and accounting apply the same principles and standards. We expect to review the results of the pilot study on accounting for the effects of changing prices referred to in paragraph 2.4.2 of this report

3.3 Another area of possible input by the Board is the potential development of a consolidated whole of Government accounts. In the White Paper the Government accepted that the Treasury and the National Audit Office (NAO) should research jointly how the income and expenditure and assets and liabilities of central government could be brought together. Depending on the outcome of this work, the Board, within its terms of reference, could examine the results of such research and we look forward to the opportunity to comment on the joint findings of the Treasury and the NAO at an appropriate time.

OPERATION OF THE FINANCIAL REPORTING ADVISORY BOARD

Introduction

1. The Financial Reporting Advisory Board was set up in the summer of 1996 against the background of the introduction of resource accounting for government departments, on the terms set out in the appendix to this Annex. Its purpose was to introduce an independent element into the process of setting financial reporting standards for government.

Terms of Reference

2. The Board's terms reference were to advise the Treasury on the application of financial reporting principles and standards in respect of central government bodies for which the Treasury has responsibility for issuing or approving accounts directions.

3. The Board's main task was the examination of the Resource Accounting Manual and any proposals for significant changes to this guidance. It would also keep the Manual under review and consider any future proposals for material change. The Treasury would ensure that all relevant matters were drawn to the attention of the Board and consider all advice received from the Board. In addition they would forward to Parliament a report on the Board's activities, setting out the resource accounting policies to be adopted and subsequent material changes together with the views of the Board.

Composition

4. The Board is independent of government and has a wide membership drawn so as to represent the relevant spread of interests. Members are drawn from the private sector, academia, the public sector audit bodies, Parliament and government departments as follows:

Chairman:

Elwyn Eilledge - Chairman of BTR plc and former senior partner at Ernst and Young. A former member of the Accounting Standards Board.

Members:

Roger Jackling (until 5 September 1996), Deputy Under Secretary for Resources Programmes and Finance, Ministry of Defence

Colin Balmer (from 19 September 1996), Deputy Under Secretary of State, Ministry of Defence

Mike Barnes, Associate Director of Audit Support Audit Commission

David Deaton (until 20 March 1997), Head of General Expenditure Statistics Team, HM Treasury

Caroline Slocock (from 9 April 1997), Senior Policy Expenditure Adviser, HM Treasury

Heather Jackson, Director of Finance, HM Land Registry

Graham Jenkinson, Director, National Expenditure and Income Division, Office for National Statistics

Caroline Mawhood, Assistant Auditor General, National Audit Office

Professor David Mayston, Professor of Public Sector Economics, Finance and Accountancy, University of York

Ken Wild, Deloitte & Touche, Member of the Accounting Standards Board and Chairman of its Public Sector and Not for Profit Committee

Observer:

Tim Smith (from 21 May 1996 until 24 April 1997), former MP and Member of Committee of Public Accounts.

The Treasury provided a secretariat headed by Chris Richards with support from David Greenfield who in November 1996 was replaced by Sue Gamble.

Proceedings

5. The inaugural meeting of the Board was held on 8 May 1996 and from September the Board, upon receipt of the draft Manual, met twice a month to examine it in detail. It held twenty substantive meetings to complete this consideration on 15 May 1997.

6. The draft Manual covered all aspects of accounting principles and policies in relation to:

- balance sheet assets and liabilities;
- operating income, expenditure and financing;
- consolidation;
- the primary statements including resources by departmental aims (schedule 5);
- note disclosures;
- the foreword and annual report, and
- audit and publication.

7. The task thus entailed reviewing the applicability of the entire range of Accounting Standards and the Board accordingly considered the Manual in detail - chapter by chapter, section by section. The head of the Treasury's Resource Accounting and Budgeting Team, Mrs Rosamund Dunn, attended most meetings to answer Board members' questions. Other members of the Treasury, either responsible for, or having an interest in, specific sections of the Manual, also attended for particular agenda items - Mr Nick Bailey, Mr Richard Knight, Ms Jeannie Okikiolu, Mr Michael Parsonage, Mr Paul Randall and Mr Ian Robinson. Mr John Kempzell, Head of Accountancy at the Department of National Heritage, attended one of the discussions on the treatment of heritage assets. Mr John Constantine, audit partner in Ernst and Young (one of the authors of their paper 'Implementation of Real Terms Accounting' prepared for the Treasury) attended for one of the discussions on the adoption of a 'real terms' accounting convention.

8. The Treasury provided the Board with additional papers on the following subjects:

- accounting for the effects of changing prices (also termed 'real terms accounting' or 'financial capital maintenance');
- national accounts, the definition of public expenditure, and the departmental boundary;
- public expenditure control under resource accounting and budgeting;
- application of the 'Cadbury Code' for corporate governance reporting;
- application of the 'Greenbury Code' for disclosures relating to Ministers and senior Civil Servants' pay and pensions.

9. The Board also considered papers and letters from its members and officials on:

- the relationship between the European System of Accounts classification of fixed assets, and the classifications to be applied in resource accounting (Mr Graham Jenkinson)
- the potentially 'perverse' incentives created by writing down assets for permanent diminutions in value ('A Note on the South Sefton Example' by Professor David Mayston)
- the accounting treatment of heritage assets (Mr John Kempzell and the Heritage Assets Sub-Group; and, separately, from Mr David Deaton)
- alternative approaches for accounting for the effect of changing prices (Mr Ken Wild and, separately, 'Financial Capital Maintenance - A Note' by Professor David Mayston).

10. The Board proceeded by examining each section of the Manual in the light of these additional written or oral explanations and arguments as appropriate. It raised questions about proposed treatments or drafting as it proceeded and made suggestions for amendment. The Treasury's representatives were either able to agree there and then to such suggestions or undertook to consider them further, and subsequently amended the Manual to the extent that they considered appropriate. These changes were then considered by the Board and further changes made where necessary until there was a unanimous or majority agreement to the resulting text. This iterative process has resulted in a more effective and relevant Manual. The Board considers that it has added significant value by the approach it has taken.

**THE TERMS OF REFERENCE OF THE FINANCIAL REPORTING
ADVISORY BOARD TO THE TREASURY - 8 FEBRUARY 1996**

1. Context

1.1 The primary aims of financial reporting by central government bodies are to demonstrate to the public and their representatives in Parliament:

- that public monies have been used for the purposes intended by Parliament;
- the financial performance of the bodies; and
- their stewardship of public funds and assets;

and to provide Parliament with information which is reliable and sufficient as a basis for

- its consideration and approval of the levels of finance voted to services; and
- its examination of performance in carrying out policies, functions, programmes and projects.

1.2 Financial reporting is also intended to underpin the Government's planning, monitoring and management of public expenditure.

1.3 The authority to develop financial reporting requirements is delegated to HM Treasury.

1.4 The Government has decided that financial reporting by central government bodies should be based on Generally Accepted Accounting Practice (GAAP) adapted where appropriate to take account of the public sector context.

2. Reasons for establishing the Board

2.1 The Board will introduce an independent element into the process of setting financial reporting standards for government.

2.2 The Board will help ensure that:

- (i) as far as possible departmental resource accounts are governed by GAAP;
- (ii) departures from, or modifications to, GAAP are fully explained.

3. Terms of Reference

3.1 The Board will advise HM Treasury on the application of financial reporting principles and standards in respect of central government bodies for which the Treasury has responsibility for issuing or approving accounts directions.

3.2 The Board

- (i) will examine the Resource Accounting Reference Manual and any proposals for material changes to this guidance;
- (ii) will keep the Manual under review and consider any proposals for material change.

3.3 HM Treasury will:

- (i) ensure that all relevant matters are drawn to the attention of the Board;
- (ii) consider all advice received from the Board;

- (iii) forward to Parliament a report on the Board's activities, setting out the resource accounting policies to be adopted and subsequent material changes, together with the views of the Board.

4. **Membership**

4.1 The Board will comprise:

1 member nominated by the Chief Accountancy Adviser to the Treasury

1 member nominated by the Comptroller and Auditor General

1 member nominated by the Audit Commission

2 members nominated by the Principal Finance Officers of government departments and Finance Directors of Executive Agencies.

1 member nominated by the Head of the Government Statistical Service

1 member nominated by the Accounting Standards Board

1 member, an independent economist, nominated by the Head of the Government Economic Service

4.2 In addition, an independent Chairman of the Board will be nominated by the Chief Accountancy Adviser.

4.3 The Board will meet as required in each year to discuss matters relating to financial reporting as they arise.

5. **Future Developments**

5.1 The accounting policies contained in the Reference Manual are designed to meet the particular circumstances of the public sector. As such, they may have persuasive force in other areas where bodies produce accounts which are not covered by their own accounting code.

5.2 As other bodies come within the boundary of resource accounting principles, the membership of the Board may be increased to reflect this wider community.

5.3 The Government has accepted that research on "whole of government" accounts should be taken forward as suggested by the Treasury and Civil Service Committee and Committee of Public Accounts, reporting in due course. Depending on the outcome of this work, the remit of the Board would widen to include such accounts.

OTHER MODIFICATIONS TO GAAP

1. Reference in the Manual to Exposure Drafts and Discussion Papers of the Accounting Standards Board

Where appropriate, in cases where GAAP is silent, the Manual refers to these (eg 3.9.1 and 4.3.1). Although not part of GAAP they are relevant to resource accounting where specified.

2. Asset Recognition

The GAAP definition of an asset has been modified so that 'future economic benefit' means that the asset will contribute in some way to the provision of services or other outputs by departments. 'Control' in this context means the ability to obtain those benefits in fulfilment of the aims and objectives of the entity and to restrict the access of others (3.1.2).

2. Mid-year Revaluations of Fixed Assets

In accordance with modified historical cost accounting, asset values will be reviewed annually. To satisfy the requirements of resource budgeting the review should take place during the course of the year so that information on new valuations will be available by the end of September. This will enable departments to assess their likely depreciation and cost of capital charges for the year (3.2.15).

3. Infrastructure Assets - Use of Normalised Maintenance Charge as a Proxy for Calculating Depreciation

The depreciation of infrastructure assets (eg the trunk road network in Great Britain) may be calculated by way of a 'normalised' maintenance charge. This is the estimated average annual

capital expenditure required to maintain the asset in its existing condition. The charge should be determined from an asset management plan covering an appropriate period (3.6.3).

4. Assets Financed by Government Grants Receivable

If an asset is financed by grant from government, including inter-governmental agencies, the grant should not be deducted from the asset acquisition cost, as permitted under GAAP, in order to show the full capital employed. Instead of treating the grant as deferred income, as permitted under GAAP, it should be credited to a government grant reserve, in order to be compatible with the accounting treatment of other fixed assets (3.8 and 4.12).

5. Disallowance of Extraordinary Items

There will be no extraordinary items in resource accounting. The definition of ordinary activities in GAAP will be deemed to cover all activities of bodies within departmental resource accounts (6.5.2).

6. Supplementary Statements

Departments should provide supplementary statements in respect of any investments not held to further departmental objectives, but held on behalf of Government more generally (3.11.5), and in respect of taxation receipts (11.1.15). Although these fall outside the scope of departmental resource accounts, the supplementary statements will maintain transparency and accountability for these assets and receipts.