ADOPTION OF IFRS BY CENTRAL GOVERNMENT
BRIEFING NOTE BY THE HOUSE OF COMMONS SCRUTINY UNIT

Key Points

- Departments' resource accounts will adopt International Financial Reporting Standards (IFRSs) from 2009-10 onwards. This will affect the way PFI schemes, leases and financial instruments are accounted for.
- The IFRS changes will also have an impact on departmental resource requirements and budgets, and on the Estimates, in terms of terminology, presentation and the figures included.
- The main changes to Estimates and budgets will be processed in the November 2009 Winter Supplementary Estimates.
- The Scrutiny Unit's work for select committees on these Winter Supplementary Estimates will address the IFRS-driven changes, including whether the Treasury fully adjusts departments' budgets to reflect any additional costs.

What are IFRSs?

1. IFRSs are a single set of accounting standards for all countries and all sectors. Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in financial statements.
2. Once IFRSs have been adopted, they will supersede the previous UK-based Generally Accepted Accounting Practice (UK GAAP).
3. The Annex to this paper briefly describes those IFRSs currently in place.

Why the change to IFRS?

4. IFRSs are designed to make it easier to compare the performance of organisations in different countries, rather than each country maintaining its own GAAP, which makes such comparisons difficult.
5. All listed EU companies have been required to use IFRSs since 2005. The adoption of IFRSs by the private sector is expected to have various benefits for both companies and investors, including:
    a. IFRSs will remove the need for companies with foreign subsidiaries to translate the accounts for consolidation with the parent company accounts.
    b. It will be easier for investors to make informed decisions about the performance of companies in different countries because of the increased transparency and a better understanding of financial statements.

6. UK government accounts are moving to IFRS to remain in line with industry through using one common set of standards.

When will UK Central Government accounts be affected?

7. The Chancellor announced in the 2007 Budget that central government would adopt IFRSs. In the 2008 Budget he announced that their introduction would be postponed from 1 April 2008 to 1 April 2009.

8. Government departments will prepare their 2008-09 financial statements in line with UK GAAP. However, for 2008-09 they will also produce ‘shadow accounts’ using IFRSs.

9. From 2009-10 onwards departments will produce only IFRS-based financial statements.

10. HM Treasury, which is ultimately responsible for IFRS implementation across government, has set a number of Trigger Point dates to help departments make the transition to IFRS.

    a. **Trigger Point One** (30 September 2008) required departments to have:

        i. implemented three ‘financial instruments standards’ for the first time in 2008-09 and identified reliable estimates for the impact on the Balance Sheet and Operating Cost Statement of them;[1] and

        ii. restated the 31 March 2008 Balance Sheet on an IFRS basis.

    b. **Trigger Point Two** (31 December 2008) required the NAO to have completed a dry-run audit of the 31 March 2008 Balance Sheet restatement and a review of the impact of implementing the financial instruments standards.

    c. **Trigger Point Three** (10 September 2009) will require departments to:

        i. complete their 2008-09 shadow accounts and send HM Treasury any update of their assessment of the impact of IFRS on their budgets;

        ii. finalise budgets and use the 2009-10 Winter Supplementary Estimates to take their Estimates onto and IFRS basis.

    d. **Trigger Point Four** (31 December 2009) will require the NAO to complete its dry-run audit of the 2008-09 shadow accounts.

What impact will the change to IFRS have for parliamentary scrutiny?

11. The move to IFRS will have an impact on departmental resource requirements, resulting from differences between the accounting requirements under UK GAAP and under IFRS. The effect on Estimates will be on terminology, presentation and the figures themselves, because to some extent Estimates reflect accounting treatments. Similarly, departmental budgets will also be affected because some aspects of budgets relate to commercial-style accounting concepts in order to encourage departments to manage their assets to provide value for money.

12. HM Treasury intends that departments will make adjustments arising from the adoption of IFRS through Supplementary Estimates:

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[1] A financial instrument is “any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”. The UK Financial Instrument standards that were adopted (FRS 25, FRS 26 and FRS 29) are effectively the same as their IFRS counterparts (IAS 32, IAS 39 and IFRS 7).

a. In 2008-09 departments had to take account of three financial instruments standards for the first time, as a step towards the full adoption of IFRSs. Those departments that were affected made the necessary adjustments in their 2008-09 Spring Supplementary Estimates.

b. Departments will make any other changes to budgets as a result of the final switch to IFRS in the 2009-10 Winter Supplementary Estimates. The Scrutiny Unit's review of these will address the IFRS-driven changes, including whether the Treasury fully adjusts departments' budgets to reflect any additional costs so that the changes are budget-neutral.

What impact will the change to IFRS have for departments?

13. In general IFRSs will be less prescriptive and increase the use of:

a. **Fair value**. This is the market price for which an asset could be exchanged or a liability settled. Under UK GAAP, the value of Balance Sheet items is generally based on their original cost, and the value of assets is depreciated over time through charges made in the Operating Cost Statement. In contrast, fair value requires regular revaluations of Balance Sheet items, without reference to the original purchase price. Any change in value is recorded directly to the Operating Cost Statement. Whilst fair value gives users of the accounts more up to date information about the current value of Balance Sheet items, it could introduce volatility into the accounts which departments may need to explain, and in some cases it may be difficult to arrive at a valuation.

b. **Substance over form**. This is the principle that transactions are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form. For example, if an organisation leases a piece of equipment over three years at a stated monthly rental, and at the end of the lease period can buy the item for a nominal sum (say £1), the economic substance of this arrangement is a purchase rather than a lease. Accordingly, in the accounts the item should be treated as an asset on the Balance Sheet and its value depreciated over time, rather than treated as a rented item with rental costs being charged to the Operating Cost Statement.

14. The Financial Reporting Advisory Board (FRAB) has identified several areas where it expects that financial reporting by central government bodies under IFRS will be materially different to that under UK GAAP. [2] These include accounting for:

a. PFI assets;

b. infrastructure assets;

c. non-current assets, such as fixed assets, held for sale;

d. intangible assets; and

e. financial instruments.

[2] Financial Reporting Advisory Board, *11th Report: Report for the period April 2007 to March 2008* (HC 705) paras. 2.15 to 2.28 (http://www.hm-treasury.gov.uk/d/frab_report11.pdf).

15. In February 2009 the NAO reported on its dry run audit of departments' returns (see Trigger Point Two above). Two major departments, the Ministry of Defence and Department of Health, had negotiated exemptions from the requirements of Trigger Point One and will perform the necessary work to a later timescale. The NAO gave 23 of the remaining 47 dry-run resource accounts a clear audit opinion. For the remaining 24, the NAO found that either evidence supporting the restated Balance Sheet was substantially incomplete, or material disagreements arising from the IFRS restatement remained unresolved.[3]

16. The areas identified by the NAO as needing most work by departments when they adopted IFRS included:

    a. valuing and accounting for derivative financial instruments at fair value;

    b. recognising and categorising other financial instruments in accordance with the IFRS based financial instrument standards;

    c. reconsidering the accounting treatment for Private Finance Initiative and other Public Private Partnership arrangements, with the result that more of the assets and liabilities associated with these arrangements are being recognised on the public sector bodies' balance sheets; and

    d. reconsidering the accounting treatment of leases to identify which party bears the bulk of the risks and rewards incidental to ownership of the leased assets.[4]

17. The NAO has concluded: 'Whilst many departments have a significant amount of work to do to ensure that their accounts can be prepared on an IFRS basis…the work completed by departments represents significant progress and provides a good basis for the move to formal statutory IFRS based accounts to be achieved in time for the resource accounts for 2009-10'.[5] Similarly, FRAB has concluded that progress to date is satisfactory and that 'the IFRS timetable remains achievable'.[6]

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[3] National Audit Office, *Financial Reporting and Financial Management: General report of the Comptroller and Auditor General 2008* (HC 133 2008-09), para. 1.28.
[4] *Ibid*, para. 1.29
[5] *Ibid*, para. 1.31
[6] Financial Reporting Advisory Board, *12th Report: Report for the period April 2008 to March 2009* (HC 671), para. 2.10

Annex: International Financial Reporting Standards list

International Accounting Standards (IAS) were issued up to 2001. From 2001 International Financial Reporting Standards (IFRS) replaced some IAS and new IFRSs were introduced. The Table below provides a quick reference summary of those international accounting standards considered by the Financial Reporting Advisory Board (FRAB). The Table indicates:

- Those standards which FRAB has agreed the public sector will apply in full (**F**);
- Those standards that FRAB has 'adapted' for the public sector (**A**).

It also shows which standards FRAB has 'interpreted' for the public sector.

FRAB provides information on individual adaptations, and the rationale for their agreement, in its 10th and 11th Annual Reports.[7]

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IAS 1 – Presentation of financial statements	To prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.	**F**	●
IAS 2 – Inventories	To prescribe the accounting treatment of inventories.	**A**	●
IAS 7 – Cash Flow Statements	To require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.	**F**	

[7] Financial Reporting Advisory Board, *10th Report: Report for the period April 2006 to March 2007* (HC 664), paras. 2.18 to 2.24 and *11th Annual Report: Report for the period April 2007 to March 2008* (HC 705), paras. 2.29 to 2.35. For FRAB Annual Reports, see: http://www.hm-treasury.gov.uk/psr_reporting_statistics_frabreports.htm

[8] More detailed summaries of IASs and IFRSs are available on the International Accounting Standards Board website: http://www.iasb.org/IFRS+Summaries/IFRS+and+IAS+Summaries+English+2008/IFRS+and+IAS+Summaries+English.htm

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors	To prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors.	**F**	
IAS 10 – Events after the balance sheet date	To prescribe: (a) when an entity should adjust its financial statements for events after the reporting period; and (b) the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.	**F**	●
IAS 11 – Construction Contracts	To prescribe the accounting treatment of revenue and costs associated with construction contracts.	**F**	
IAS 12 – Income Taxes	To prescribe the accounting treatment for income taxes. For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits.	**F**	
IAS 16 – Property, plant and equipment (excluding Infrastructure assets)	To prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment.	**A**	●
IAS 17 – Leases	To prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.	**F**	

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IAS 18 – Revenue	The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised.	**F**	
IAS 19 – Employee Benefits	To prescribe the accounting for and disclosure of employee benefits. Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.	**A**	●
IAS 20 – Accounting for government grants and disclosure of government assistance	To prescribe the accounting for and disclosure of government grants and other forms of government assistance.	**F**	●
IAS 21 – The effects of changes in foreign exchange rates	To prescribe how to include foreign currency transactions and foreign operation in the financial statements of an entity and how to translate financial statements into a presentation currency.	**F**	●
IAS 23 – Borrowing costs	To provide guidance on the accounting treatment for borrowing costs. Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.	**F**	●
IAS 24 – Related party disclosures	To ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.	**F**	●
IAS 26 – Accounting and Reporting by Retirement Benefit Plans	To be applied in the financial statements of retirement benefit plans where such financial statements are prepared.	**A**	●

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IAS 27 – Consolidated and Separate Financial Statements	To be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.	**A**	
IAS 28 – Investments in associates	To be applied in accounting for investments in associates. However, it does not apply to investments in associates held by: (a) venture capital organisations; or (b) mutual funds, unit trusts and similar entities including investment-linked insurance funds.	**A**	
IAS 29 – Financial reporting in hyper-inflationary economies	To be applied to the financial statements, including the consolidated financial statements, of any entity whose functional currency is the currency of a hyperinflationary economy.	**F**	●
IAS 31 – Interests in joint ventures	To be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of ventures and investors, regardless of the structures or forms under which the joint venture activities take place.		●
IAS 32 – Financial Instruments: Presentation	To establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.	**F**	●
IAS 33 – Earnings per share	To prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same rep orting period and between different reporting periods for the same entity.	**F**	
IAS 34 – Interim Financial Reporting	To prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period.	**F**	

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IAS 36 – Impairment of Assets	To prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset.	**F**	●
IAS 37 – Provisions, Contingent Liabilities and Contingent Assets	To ensure that appropriate recognition criteria and measurement are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.	**F**	●
IAS 38 – Intangible Assets	To prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. An intangible asset is an identifiable non-monetary asset without physical substance, such as computer software, patents or databases.	**F**	●
IAS 39 – Financial Instruments: Measurement, Recognition and De-recognition	To establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.	**F**	●
IAS 40 – Investment Property	To prescribe the accounting treatment for investment property and related disclosure requirements.	**F**	●
IAS 41 – Agriculture	To prescribe the accounting treatment and disclosures related to agricultural activity.	**F**	
IFRS 1 – First time adoption of IFRS	To ensure that an entity's first IFRS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that: (a) is transparent for users and comparable over all periods presented; (b) provides a suitable starting point for accounting under IFRS; and (c) can be generated at a cost that does not exceed the benefits to users.	**F**	●

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IFRS 2 – Share-based payments	To specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.	**F**	
IFRS 3 – Business combinations	To enhance the relevance, reliability and comparability of the information that an entity provides in its financial statements about a business combination and its effects.	**F**	
IFRS 4 – Insurance contracts	To specify the financial reporting for insurance contracts by any entity that issues such contracts (described in this IFRS as an insurer) until the Board completes the second phase of its project on insurance contracts.	**F**	
IFRS 5 – Non-current Assets Held for Resale and discontinued operations	To specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations.	**F**	●
IFRS 6 – Exploration for and evaluation of mineral resources	To specify the financial reporting for the exploration for and evaluation of mineral resources.	**F**	
IFRS 7 – Financial Instruments: Disclosures	To require entities to provide disclosures in their financial statements that enable users to evaluate: (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.	**F**	●

International Standard	Objective of the Standard[8]	Outcome of FRAB consideration	Interpreted for public sector by FRAB
IFRS 8 – Operating Segments	The core principle is that an entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.	**F**	●