

INTERNATIONAL CONVERGENCE AND THE UK PUBLIC SERVICES

Introduction

The European Union (EU) requirement that companies listed on EU exchanges should use International Financial Reporting Standards (IFRS), as adopted by the EU, in their group financial statements from 1 January 2005 has led to much discussion of the impact of international convergence on the private listed sector. There has been particular emphasis on the overall state of preparedness for meeting the 1 January 2005 deadline, the impact of IFRS adoption on the bottom line and the extent to which entities have sought to explain variations to figures previously reported under UK Generally Accepted Accounting Practice (UK GAAP) to analysts.

Rather less has been made of the forthcoming impact of international convergence on the UK public services. There are broadly two routes by which IFRS might influence the financial reporting requirements of the UK public services- a fast track route and a medium term route. The fast track route would involve parts of the UK public services directly adopting IFRS. The second would see IFRS requirements having an impact as they are more gradually imported into UK GAAP as part of the UK Accounting Standards Board's (ASB) Convergence Strategy. Thus far the UK public services have been moving down the latter route, an approach, which, for some time at least, allows this sector to continue to rely on UK standards which have no international counterpart or which are more appropriate for the circumstances of bodies which are not primarily profit-seeking. However, there have more recently been signs that the Financial Reporting Advisory Board (FRAB), which oversees Treasury's standard-setting activities and reports independently to

Parliament would prefer to see a more rapid adoption of IFRS. There is also a possibility that the ASB might accelerate its own convergence strategy. Either of these eventualities are likely to bring forward the impact of IFRS for UK public services.

This Briefing Paper seeks to highlight some of the issues that public sector accountants need to be aware of as the pace of convergence accelerates. It aims to dispel the comforting, but erroneous, view that international convergence is only of relevance to the private sector and that its impact on the public services can be ignored for a few more years. The truth is that international convergence is already starting to have an impact and that impact will grow very quickly in a very short period.

The paper provides a short survey of the landscape for international convergence. In particular it:

- Highlights the role of the International Accounting Standards Board (IASB)
- Discusses the introduction of IFRS in Europe
- Considers the UK ASB's approach to convergence
- Discusses HM Treasury's approach to IFRS
- Gives an overview of the International Public Sector Accounting Standards Board's (formerly the International Federation of Accountants Public Sector Committee) Standards Programme
- Briefly discusses a few technical areas where the requirements of IFRS might have a significant effect on existing reporting approaches
- Highlights some useful websites

The Objectives of the International Accounting Standards Board in Publishing International Financial Reporting Standards

The IASB was established in 2001 as the successor to the International Accounting Standards Committee. The IASB's objectives are:

- (a) to develop in the public interest a single set of high quality understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions
- (b) to promote the use and rigorous application of those standards
- (c) to work actively with national standard-setters to bring about convergence of national accounting standards and IFRSs to high quality solutions.'

IFRSs are designed primarily for the general-purpose financial statements of profit-oriented entities. However, it is recognised that public benefit entities may also find them appropriate. In this Briefing Paper the term 'IFRS' embraces not only standards issued by the IASB but also International Accounting Standards (IAS) issued by the IASB and interpretations issued by the Standing Interpretations Committee (SIC) and its successor, the International Financial Reporting Interpretations Committee (IFRIC).

Currently some 90 countries have adopted IFRS in whole or in part. This includes China and most of the 10 recently admitted member states of the European Union as well as many developing countries. Certain other countries currently accept financial statements prepared under IFRS only if reconciled to their national accounting requirements. These include the United States, Canada and Japan. One of the main aims of the convergence project with the US standard-setter, the Financial Accounting Standards Board (FASB), is to allow entities listed in the USA to file statements complying with IFRS without a requirement for reconciliation.

The Introduction of IFRS in Europe from 1 January 2005

For accounting periods beginning on or after 1 January 2005, all European Union listed companies will have to prepare their group financial statements under IFRS as adopted by the European Union. Member states have the option of extending this requirement on a permissive or a mandatory basis to single entity financial statements and/or to unlisted entities. In the UK, the Government has announced that it will allow entities to choose to adopt IFRS, with some exceptions (notably charitable companies).

The adoption process for the European Union has both a technical and political dimension. Technical recommendations are made by a group of experts, the European Financial Reporting Advisory Group (EFRAG). Political input is provided by officials on the Accounting Regulatory Committee (ARC). Whilst the majority of standards have been adopted with little difficulty, adoption is far from a formality, as the very public debate over the adoption of the two international standards on financial instruments - IAS 32, Financial Instruments: Presentation and Disclosure and IAS 39, Financial Instruments: Recognition and Measurement - has shown. In the event, a compromise resulted in an amended version of IAS 39 being adopted, which means that listed groups in some countries in the European Union will be using a different version of the Standard from those in non-EU countries and possibly from that used by non-listed companies within Europe.

The UK Accounting Standard Board's Convergence Project

The ASB consulted on its strategy for convergence in a Discussion Paper, UK Accounting Standards: A Strategy for Convergence with IFRS, issued in March 2004. As well as setting out its general approach, it outlined its intentions with regard to each of the existing UK Standards, draft Standards and accounting issues on which standards were being developed or considered. The Discussion Paper took as its starting point that there can be no case, in the medium term, for the use of two sets of different accounting standards in the UK, and that UK accounting standards should be brought into line with IFRS. 'Medium term' is not defined but a reasonable interpretation might be three to five years.

Under the Government's proposals for the implementation of the European accounting regulation, the vast majority of UK companies are likely to continue to use UK GAAP for a considerable time. UK standards will therefore need to be developed and improved to keep pace with international equivalents. In accordance with its view that there is no medium term case for divergent standards, however, the ASB would not develop new standards which are inconsistent with IFRS.

Convergence will be achieved by a gradual replacement of existing UK Standards with those based on IFRS. It is the ASB's intention that separate UK Standards should be no more demanding or restrictive than IFRS since IFRS will be used by those entities most important for the capital markets. Where existing UK Standards are already more demanding than IFRS they are likely to be maintained until the relevant IFRS is tightened up. UK specific standards may be less demanding than IFRS as they will be used mainly by smaller entities. However the differences are likely to take the form of less onerous disclosures or later effective dates rather than essential principles.

In accordance with the convergence strategy the ASB has issued in mid-2004 UK standards on Share-based Payment (FRS 20) and Events after the Balance Sheet Date (FRS 21), which implement IFRS into UK GAAP. In December 2004 the ASB issued five further Financial Reporting Standards (FRS) based on international equivalents. These include FRS 25 and FRS 26 on financial instruments.

There are two important areas where UK approaches had no international equivalent: smaller entities and Statements of Recommended Practice (SORPs). IASB is currently consulting on a project to reduce the burden of applying IFRSs on smaller entities. In the meantime ASB intends to retain the Financial Reporting Standard for Smaller Entities (FRSSE) and has issued an exposure draft of a one stop FRSSE, which incorporates Companies Act requirements.

In the Discussion Paper the ASB stated its intention to continue its support for the development of Statements of Recommended Practice (SORPs). SORPs interpret accounting requirements for specialised sectors and have no international equivalent. Compliance with SORPs cannot be mandatory for entities following European adopted IFRSs since this would amount to an additional requirement which member states are not allowed to impose: the Regulation is what is known as a 'maximum harmonisation' measure.

However, SORPs are particularly significant for the public benefit sector – the annual financial reporting of local government, charities, further and higher education and the registered social housing sector are all governed by SORPs. These SORPs will need to be revised to reflect changes in UK GAAP, including changes introduced as a result of the convergence process.

At consultation there was a general support for a programme of convergence. However, in the light of views that the pace of convergence might be quicker the ASB will revisit its convergence programme to see if a more rapid timetable can be adopted. The ASB is also preparing a Policy Statement outlining its role, activities and technical plan.

H M Treasury's Strategy on Introduction of IFRS

The Treasury sets accounting requirements for the central government sector and related sectors such as non-departmental public bodies, trading funds and public corporations. In conjunction with the NHS Executive the Treasury also sets accounting requirements for the health sector. The attitude of Treasury is therefore hugely significant in determining the line of travel of the UK public sector to IFRS. The Whole of Government Accounts project - leading to published and audited financial statements for UK PLC in 2006-7 following two dry-runs- of course reinforces this influence. Treasury's policy has been to follow the ASB's convergence approach rather than to adopt directly IFRS.

Three factors can be highlighted as significant in Treasury's approach. First, a view that in some areas of key importance to the public sector UK GAAP is either more complete than IFRS or provides approaches, which are more appropriate for public sector circumstance. Thus the financial reporting arrangements for the Private Finance Initiative (PFI) have been specifically addressed in Application Note F to FRS 5, Reporting the Substance of Transactions. The approach in that Application Note has not only governed the treatment of PFI in the UK, but has also been used to develop approaches in parts of such leading edge jurisdictions as Australia. It is only recently that IFRIC has focused on PFI type arrangements in its service concessions project. The concept of value-in-use in FRS 15, Tangible Fixed Assets, underpins the approach to physical assets in the Resource Accounting Manual (RAM). Both of these issues are considered in a little more detail in the section of this Paper on Technical Issues.

Second, Treasury has expressed reservations about the number of changes in accounting policies that might follow an early decision to adopt IFRS. This is because the IASB's body of standards is undergoing significant modification, particularly in order to achieve the aim of a harmonisation with the pronouncements of the US Financial Accounting Standards Board.

Third, Treasury has highlighted the uncertainty that has prevailed over much of 2004 over the extent to which IFRS would be adopted by the European Commission (EC). As we have seen in the case of IAS 39, such misgivings have been well founded, with the EC carving out key sections of that standard in

its adoption process. However, the ASB has given strong backing to the IASB over IAS 39 and has recommended that all UK companies should adopt the full version of that standard, where possible. If the UK public sector was to decide to move directly to IFRS there is a question where it would follow the EC's modified adoption approach to IAS 39 or the full adoption recommended by ASB.

It appears possible that Treasury may modify its approach following comments made by FRAB. In its latest report in June 2004 FRAB expressed disappointment that "Treasury does not feel the time is right to move to IFRS alongside the listed company sector." Whilst more emphatically, FRAB stated that "it appreciates the reasons for [this] stance and welcomes the Treasury's commitment to adopting IFRS in the medium term" FRAB noted that there will be discussions on whether the Government could adopt IFRS in advance of the completion of the ASB convergence strategy.

A recent development is that the Government Resources and Accounts Act 2000 has been amended to enable Treasury to specify the use of IFRS (as adopted by the EC) to underpin both resource accounts and whole of government accounts.

There have been few indications that other components of the UK public benefit sector will move to a direct adoption of IFRS. In the case of charitable companies the Department of Trade & Industry has explicitly stated that it does not think that there is a case for moving to IFRS.

Local government financial reporting requirements are governed by the Code of Practice on Local Authority Accounting in the United Kingdom (the Local Authority SORP), which is developed and maintained by the CIPFA/LASAAC Joint Committee under the auspices of the ASB. Like other SORPs in the public benefit sector the current approach is that the SORP will be affected by international GAAP as it is reflected into UK GAAP through the convergence programme rather than as a direct adoption of IFRS. Of course, if the ASB decides to accelerate the convergence programme the impact of IFRS will be felt more quickly than initially presumed.

The International Public Sector Accounting Standards Board (formerly the IFAC PSC)

The International Public Sector Accounting Standards Board (IPSASB) is one of the standing committees of the International Federation of Accountants, the umbrella body of global accountancy organisations. Previously known as the IFAC Public Sector Committee (IFAC PSC) it was renamed the IPSASB in November 2004. For the sake of uniformity the term IPSASB is used to indicate the approach of the IPSASB in both its new incarnation and its previous existence as the IFAC PSC.

Based on a view that there is a need for high quality global standards to promote and enhance sound and consistent financial reporting, the IPSASB launched its Standards Programme in 1996. At this time it was decided to focus on the full accruals basis of accounting and also to address the needs of constituents on the cash basis, which is still the reporting basis for the large majority of governments globally.

The first phase of the Standards Programme was completed early in 2002 and comprised the publication of 20 accruals based International Public Sector Accounting Standards (IPSASs) and allied guidance on the migration from the cash basis to the accruals basis. These IPSASs, which are available free of charge from the IFAC website, are based on IAS in existence in August 1997. The IPSASB has subsequently approved the issue of a further IPSAS on Impairment of Non-Cash Generating Assets. Impairment is a complex area for not-for-profit entities because the approach in the international standard, IAS 36, Impairment of Assets is based on the identification of cash-generating units and the projection of and discounting of future cash flows. This IPSAS, the scope of which is limited to physical assets on the historical cost model, is likely to be published early in 2005. The IPSASB also published early in 2003 an integrated standard on the cash basis of reporting, which is becoming influential in the developing world and transitional economies. It has already been used in India, the world's largest democracy.

In 2002 the IPSASB initiated the second phase of the Standards Programme. This constitutes three components. First, the IPSASB continues to address the public sector implications of developments in international GAAP since 1997. This is a very challenging task, because the full time nature of the IASB and its very busy forward agenda mean that a much smaller body, with more limited resources will always be catching-up in addressing new developments..

The second component addresses public sector specific issues such as accounting for the social policies of government, accounting for non-exchange revenue and budget reporting. Such topics are central to sound public sector financial reporting and accountability. They consider issues such as when public sector entities should recognise taxation streams, how they should account for appropriations and what liabilities should be recognised in relation to state pension schemes and other state benefits and service provision. Because these issues are often not relevant in the private sector they are not addressed directly in IFRS. The PSC issued Invitations to Comment on these topics in early 2004 and will develop them further into Exposure Drafts in 2005.

The third component of the IPSASB's second phase work programme is the identification of differences in approach between GAAP reporting and statistical forms of reporting such as the System of National Accounts and the Government Financial Statistics Manual produced by the International Monetary Fund. The aim is to eliminate some of these differences and to provide reconciliations where elimination is not feasible. This component is particularly significant for Australia where the differences between the two systems of reporting have proved confusing for users and also in the UK, which is seeking to use actual accounting information such as depreciation for statistical reporting purposes.

IPSASs have been adopted by some international bodies, such as the North Atlantic Treaty Organisation and the Organisation for Economic Co-operation and Development. Although they have not been directly adopted by national governments they have been influential in other ways. Some countries and supra-national organisations have used them to inform their own standard-setting processes as they move to the full accruals basis of reporting. For example the European Commission has used IPSASs as the basis for the development of its accounting policies for its daunting objective of migrating to the full accruals basis in 2005. Jurisdictions which have been on the full accruals basis for some time have used the approaches and thinking on public sector specific issues to inform their accounting policies in these areas, because neither IFRS nor national GAAP give firm steers as to the appropriate approaches. In the UK the FRAB has been particularly keen to follow the emerging approaches to the treatment of tax revenues and the state pension and has highlighted the work of the IPSASB on these issues in its last Report to Parliament.

Additionally the UK ASB's project on a proposed interpretation of the Statement of Principles for Financial Reporting for Public Benefit entities is considering many of the issues that have also exercised the IPSASB. These include the interpretation of the concept of constructive obligations in the recognition of liabilities in the public sector, the treatment of voluntary services and time requirements for grants to public benefit bodies.

Some Significant Technical Areas

Thus far we have highlighted the institutional aspects of standard-setting. However, what are the practical implications of a reliance on IFRS (or in UK standards that implement IFRS) rather than existing UK GAAP? In many cases the requirements of IFRS are very similar to existing UK standards, so changes to existing approaches are likely to be small. However, in other areas adoption of IFRS may have more significant consequences. This section of the Briefing Paper highlights a few of those areas where adoption of IFRS might have significant technical implications for UK public services. It is certainly not an exhaustive list and does not go into detailed discussion. Some of the areas highlighted are likely to be further investigated by CIPFA and its stakeholders in 2005. In some areas there is no consensus as to how, and to what extent, existing approaches might change as a result of requirements for the public services being based on IFRS rather than existing UK GAAP. The issues highlighted are:

- Accounting for PFI Arrangements
- The future of Renewals Accounting
- Value-in Use for Property, Plant and Equipment
- Financial Instruments

Accounting for PFI Arrangements

It has already been noted that the approach to accounting for the private finance initiative in the UK has been underpinned by the specifically developed Application Note F to FRS 5, Reporting the Substance of Transactions. There is no international equivalent to FRS 5. However, as part of its project on service concessions IFRIC will shortly issue three draft interpretations addressing accounting for PFI style arrangements. These interpretations are likely to focus on the operator rather than the grantor of the

concession and rely on the concept of control rather than the risk and rewards approach, which underpins FRS 5. They appear to assume that in all but a highly limited number of cases physical assets used in service concession arrangements will be recognised on the balance sheet of the grantor rather than the operator. In a public sector context this would mean that most physical assets would be recognised on the balance sheet of the public sector body.

Renewals Accounting

The central government approach to the determination of depreciation for infrastructure assets has been underpinned by the provisions in FRS 15, Tangible Fixed Assets relating to renewals accounting. In essence renewals accounting allows for the projected annual expenditure on the maintenance of an infrastructure asset, as detailed in an asset management plan, to be recognised as the depreciation charged for the accounting period. Actual expenditure is capitalised as incurred. The international equivalent of FRS 15, IAS 16, Property, Plant & Equipment does not contain provisions on renewals accounting. Therefore the continued use of renewals accounting under IFRS seems uncertain. Some consider that continuing to use renewals accounting approaches to the recognition and measurement of depreciation would not be permissible under IAS 16. Others argue that renewals accounting is merely an estimation technique and that its continued use could be sustained.

Value-in-Use for Property, Plant and Equipment

The concept of value-in-use, also known as the value to the business or deprival value concept, has underpinned the UK approaches to the measurement of physical assets that are on a revaluation model rather than the historical cost model. Because most of the UK public sector uses the revaluation model for operational property, plant and equipment the value-in-use concept has been particularly important and has led to a widespread reliance on depreciated replacement cost.

IAS 16 relies on fair value—the amount for which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction— as the measurement attribute for assets on the revaluation model rather than value-in-use. IAS 16 states that if there is no market-based evidence of fair value because of the specialised nature of property, plant and

equipment, and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or depreciated replacement cost approach.

Some consider that the provisions in IAS 16 are sufficient to allow the continued use of depreciated replacement cost in a public benefit context, regardless of the broader question of the survival of the value-in-use concept in the new environment of international standard-setting. Others have suggested that evidence can be found of the market-based value of almost anything, particularly if "distressed values" are accepted. They foresee a situation where an over-reliance on market values might lead to misleadingly high carrying values-in the case of land in select residential areas- or misleadingly low carrying values- in the case of specialised property and equipment for which a limited market exists.

Financial Instruments

Financial instruments is a huge area and its capacity to provoke controversy clearly illustrated by the deliberations on EU adoption that have been highlighted elsewhere in this Briefing Paper. Much of the content of IAS 32 and IAS 39 (and their new UK counterparts FRS 25 and FRS 26) relates to complex instruments, many of them derivatives, which are unlikely to be commonplace in the public services. Nevertheless the scope of these standards is broad: FRS 25 in particular is wider in scope than FRS 13 which it replaces. The new standards encompass simple instruments such as cash and receivables as well as much more complex instruments. Furthermore, the extent of disclosures and the potential volatility in performance statements engendered by a much more widespread use of fair value are likely to pose challenges for the public services.

Conclusion

There can be no doubt that international convergence will have a major impact on the determination of accounting policies for the UK public services. As this briefing paper has acknowledged the full implications of convergence are not yet entirely clear. During 2005 CIPFA will be working with other stakeholders to assess the impact.

Useful Websites

The ASB's website is at www.frc.org.uk/asb and contains Inside Track the ASB's quarterly newsletter.

The IASB's website is at www.iasb.org. This site contains Updates on IASB activities and also IFRIC Updates

The IPSASs produced by the International Public Sector Accounting Standards Board and other IPSASB publications are available on the IFAC website at www.ifac.org/publicsector

The Treasury's website is at www.hm-treasury.gov.uk A separate website on the whole of government accounts project is at www.wga.gov.uk. This website contains news and details of key communications related to the whole of government accounts project.

The websites of the Big 4 audit firms contain a great deal of accessible information. They can be accessed at:

PricewaterhouseCoopers UK: www.pwcglobal.com
KPMG: www.kpmg.co.uk
Deloitte:www.deloitte.com
Ernst & Young:www.ey.com

CIPFA's website is at www.cipfa.org.uk

The websites of the Audit Commission (www.audit-commission.gov.uk) and the National Audit Office (www.nao.org.uk) are also worth consulting on public sector accounting issues.

www.cipfa.org.uk

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