2 Accounting principles

Chapter 2 Contents

2.1 Application of generally accepted accounting practice

General

2.1.1 The accounting policies contained in this Manual follow generally accepted accounting practice (GAAP) to the extent that it is meaningful and appropriate in the public sector context. Although the term 'GAAP' has no statutory or regulatory authority, for the purposes of this Manual, GAAP is taken to be:

a) the accounting and disclosure requirements of the Companies Act 2006 (the Companies Act);

b) pronouncements by or endorsed by the International Accounting Standards Board (IASB), including the *Framework for the Preparation and Presentation of Financial Statements,* the accounting standards – international accounting statements (IAS) and international financial reporting standards (IFRS) – and interpretations thereof issued by the Standards Interpretations Committee (SIC) or its successor, the International Financial Reporting Interpretations Committee (IFRIC);

c) for charities registered in the United Kingdom, regulations issued under charities legislation and, where applicable, the Statement of Recommended Practice (SORP) *Accounting by Charities* issued by the Charity Commission. If they are both registered companies and charities, they must comply with the Companies Act 2006 and the Charities SORP; and

d) the body of accumulated knowledge built up over time and promulgated in (for example) textbooks, technical journals and research papers.

2.1.2 For the purposes of accounting by the reporting entities covered by this Manual, GAAP is taken to mean primarily those items listed under (a), (b) and (c) above, interpreted as necessary in the light of the body of accumulated knowledge under (d).

2.1.3 In addition to the general principles underlying GAAP, reporting entities and reportable activities covered by the requirements of this Manual need to apply two additional principles – parliamentary accountability and regularity. These principles are explained in the context of the relevant authorities in the separate guidance on handling public funds.

Accounting convention

2.1.4 Financial statements should be prepared under the historical cost convention, modified by the revaluation of non-current assets, and, where material, current asset investments and stocks to fair value as determined by the relevant accounting standard.

No exemptions for smaller entities

2.1.5 The International Financial Reporting Standard for Small and Medium-sized Entities brings together those accounting standards and requirements that are applicable to small and medium-sized entities. Adoption is not available to any entity covered by the requirements of this Manual. Subject to the provisions of the Manual, the disclosure exemptions permitted by sections 381 to 383 of the Companies Act 2006 will not apply unless specifically approved by the relevant authority.

Practical application of guidance

2.1.6 The following chapters refer to practical guidance on the application of GAAP where the relevant authorities, in consultation with the preparers of financial statements, feel that such guidance will assist in preparing the financial statements. The guidance is available on the Manual's dedicated website. This is practical guidance and it is for the relevant authority to determine whether entities are required to apply it. Relevant authorities might provide additional guidance on request.

2.2 Preparation and Presentation of Financial Statements

IASB's Framework for the Preparation and Presentation of Financial Statements (the Framework)

2.2.1 The *Framework* sets out the principles that the IASB believes should underlie the preparation and presentation of general purpose financial statements. In particular, preparers should be familiar with the objective of financial statements. The financial statements of reporting entities and reportable activities should provide information about their financial position, performance and changes in financial position. The presentation of the information should meet the "common needs of most users".

2.2.2 The key users of the information in the financial statements of reporting entities and for reportable activities are the relevant authority and Parliament (the Westminster Parliament, the Scottish Parliament, the National Assembly for Wales and the Northern Ireland Assembly) (the latter as representatives of the public as well as the voter of resources). Other users include the entity's management board, the entity's audit committee, and the taxpayer.

2.2.3 In presenting information in their financial statements, preparers should also be familiar with:

- the qualitative characteristics of financial statements;
- the elements of financial statements;
- recognition of the elements of financial statements; and
- measurement of the elements of financial statements.

2.2.4 The *Framework* notes that financial statements cannot meet all the information needs of users, but that there are needs that are common to all users. The provision of financial statements that meet the requirements of the relevant authority and Parliament will also meet most of the needs of other users.

2.2.5 Some of the entities covered by the requirements of this Manual will prepare general purpose financial statements that are sufficient for the needs of the key users. However, where departments are required by the relevant legislation to demonstrate accountability to Parliament, they should prepare a statement on parliamentary accountability, which, within the meaning of the *Framework*, can be seen as a special purpose financial report.

Financial statements must give a true and fair view

2.2.6 All financial statements prepared in accordance with the requirements of this Manual (excepting the National Insurance Fund cash accounts and those parts of the Consolidated Fund accounts that are prepared on a cash basis):

a) should give a true and fair view of the state of affairs of the reporting entity or reportable activity at the end of the financial year and of the results for the year; and

b) where, in exceptional circumstances, an entity concludes that compliance with a requirement in the FReM would be so misleading that it would conflict with the objective of the financial statements set out in the Framework it shall depart from that requirement following the principles set out at paragraphs 20-24 of IAS 1. Any material departure from the Manual should be discussed in the first place with the relevant authority (through sponsoring bodies where appropriate). Particulars of any departure, the reasons for it and its effects should be disclosed in the financial statements.

2.2.7 Section 393 of the Companies Act 2006 and paragraphs 15 to 24 of IAS 1 *Presentation of Financial Statements* apply as interpreted.

Objectives of section 393 of the Companies Act 2006

2.2.8 The objectives of section 393 of the Companies Act 2006 are to ensure that directors of a company do not approve accounts unless they are satisfied that those accounts give a true and fair view of the assets, liabilities, financial position and profit or loss either of the company or of the group as a whole, as appropriate. Section 393 also requires the auditor of a company, in carrying out his functions under the Act, to have regard to the directors' duty.

Interpretation of section 393 of the Companies Act 2006 for the public sector context

2.2.9 In applying section 393 of the Companies Act 2006, preparers of financial statements should be aware of the following interpretations for the public sector context:

a) any references to 'directors' and 'company' should be read to mean, respectively, the 'Accounting Officer' or other person who is required to approve financial statements and the 'reporting entity or reportable activity'.

IAS 1: Presentation of Financial Statements (paragraphs 15 to 46)

Applicability

2.2.10 Paragraphs 15 to 46 of IAS 1 apply as interpreted to all entities covered by this Manual.

Objectives of paragraphs 15 to 24 of IAS 1

2.2.11 Paragraphs 15 to 46 of IAS 1 outline the 'general features' entities must take into account when preparing financial statements.

2.2.12 Paragraphs 15 to 24 provide guidance on 'fair presentation'. Application of IFRS is presumed to result in financial statements that achieve fair presentation. In the extremely rare circumstances where management concludes that compliance with a requirement in a Standard or an Interpretation would conflict with the objective of financial statements as set out in the *Framework,* IAS 1 requires that the entity departs from the requirement unless departure is prohibited by the relevant regulatory framework. In either case, the entity is required to make specific disclosures.

2.2.13 Paragraphs 25 to 46 provide guidance on the wider factors entities should take into account when preparing financial statements: Going Concern; Accruals Basis of Accounting; Materiality and Aggregation; and Offsetting.

Interpretation of paragraphs 15 to 24 of IAS 1 *for the public sector context*

2.2.14 In applying paragraphs 15 to 24 of IAS 1 preparers of financial statements should be aware of the following interpretations for the public sector context:

a) references to 'present fairly' and to 'fair presentation' should be read to mean 'give a true and fair view' and 'truthful and fair presentation' to comply with the requirements of the Companies Act 2006; and

b) in addition to naming the legislative authority for producing the accounts, the Notes to the Accounts shall disclose, in the note on accounting policies, the basis of preparation of the financial statements as being in accordance with this Manual as follows:

"The financial statements have been prepared in accordance with the [financial year] Government Financial Reporting Manual (FReM) issued by [the relevant authority]. The accounting policies contained in the FReM apply International Financial Reporting Standards as adapted or interpreted for the public sector context. Where the FReM permits a choice of accounting policy, the accounting policy which is judged to be most appropriate to the particular circumstances of the [reporting entity] [reportable activity] for the purpose of giving a true and fair view has been selected. The particular policies adopted [by the reporting entity] [for the reportable activity] are described below. They have been applied consistently in dealing with items that are considered material to the accounts."

Interpretation of paragraphs 25 to 46 of IAS 1 for the public sector context

2.2.15 In applying paragraphs 25 to 46 of IAS 1, preparers of financial statements should be aware of the following interpretations of *Going Concern* for the public sector context.

a) For non-trading entities in the public sector, the anticipated continuation of the provision of a service in the future, as evidenced by inclusion of financial provision for that service in published documents, is normally sufficient evidence of going concern. However, a trading entity needs to consider whether it is appropriate to continue to prepare its financial statements on a going concern basis where it is being, or is likely to be, wound up.

b) Sponsored entities whose statements of financial position show total net liabilities should prepare their financial statements on the going concern basis unless, after discussion with their sponsors, the going concern basis is deemed inappropriate.

c) Where an entity ceases to exist, it should consider whether or not its services will continue to be provided (using the same assets, by another public sector entity) in determining whether to use the concept of going concern in its final set of financial statements.

2.3 IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

Applicability

2.3.1 IAS 8 applies in full to all reporting entities and reportable activities covered by this Manual.

Objective of IAS 8

2.3.2 The objective of IAS 8 is 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 correction of errors

Other Requirements

2.3.3 The following requirements should be observed.

a) Preparers should consult the relevant authorities (through sponsoring bodies where appropriate) about any novel or contentious accounting policies they are considering adopting to reflect their specific circumstances.

b) Where preparers consider it necessary to adjust retrospectively for changes in accounting policies or material errors, they should first contact the relevant authority (through sponsoring bodies where appropriate) to ensure that the budgeting and Estimates implications have been properly considered.

Uniform accounting policies in preparing consolidated financial statements

2.3.4 IAS 27 *Consolidated and Separate Financial Statements* states that uniform group accounting policies should generally be used in preparing the consolidated financial statements. If members of the group use accounting policies other than those adopted in the consolidated financial statements, appropriate adjustments are made when preparing the consolidated financial statements. Reporting entities that fall within the remit of this Manual and that fall within a consolidation boundary will be expected to observe the broad principles and policies set out in this Manual. Observance of the Manual should therefore result in sufficient uniformity to satisfy the requirements of the standard, but it is for preparers of the consolidated financial statements to ensure an appropriate degree of consistency within their reporting group. This does not preclude variation in the specific application of policies – for example, the selection of appropriate useful economic lives for calculating depreciation – in order to reflect the particular business circumstances of individual reporting entities.

2.3.5 Compliance with the requirements of this Manual as set out above will provide sufficient convergence of accounting policies for the purposes of Whole of Government Accounts (see also chapter 14).

2.4 The budgeting system

The fiscal framework

2.4.1 The budgeting system is a set of HM Treasury rules for the control of public spending in support of the fiscal framework. Under the Code for Fiscal Stability, the fiscal framework comprises two key elements:

a) to borrow only to invest. That is, over the economic cycle the costs of current expenditure will be met by current income (the Golden Rule); and

b) to ensure that public sector net debt will be held over the cycle at a stable and prudent level (the Sustainable Investment Rule).

2.4.2 As set out in PBR 2008 major economic shocks have hit every country in the world. The Government's objectives for fiscal policy in the face of these shocks remain unchanged. To achieve its objectives, and as provided for in the Code for Fiscal Stability, the Government announced it will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.

2.4.3 Consistent with the Code for Fiscal Stability, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

2.4.4 Performance against the fiscal framework is measured using national accounts aggregates. National accounts are prepared by the Office for National Statistics in line with internationally agreed rules, which are different from GAAP. That is one of the reasons why transactions might score differently in budgets and in accounts.

Resource and capital budgets, departmental expenditure limits and annually managed expenditure

2.4.5 Departments have a Resource Budget and a Capital Budget. These budgets are divided into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). DELs are firm, three-year plans set in biennial spending reviews. AME is expenditure that cannot be made subject to firm, three-year plans, and is subject to review twice a year. All expenditure is in DEL unless HM Treasury has specified otherwise.

2.4.6 The budgeting system applies to the public sector as a whole: central government, local government and public corporations. A department's budgets will normally include:

- the expenditure of the department, its agencies and its non-departmental public bodies on an accruals basis;
- certain income of these bodies that is within budgets, for example income from the sale of services;
- government grants to local authorities and supported capital expenditure (revenue); and
- support to public corporations by way of grants and loans.

Reporting performance against budgeting rules

2.4.7 Departments send reports on a budgeting basis to HM Treasury on a regular basis through the Combined Online Information System (COINS). HM Treasury publishes high level and detailed information in publications such as *Public Expenditure Statistical Analyses*. Departments publish budgetary information in Departmental Reports; they publish reconciliations to budgets in their Supply Estimates; and they are required to report in Note 3 to their resource accounts the outturn against Estimate and outturn against the Administration Budget (see paragraph 3.2.6).

2.4.8 Departments are also required to provide in the Management Commentary a reconciliation of resource expenditure between Estimates, Accounts and Budgets (see chapter 5 of this Manual).