



9th Report  
*of the*  
Financial Reporting  
Advisory Board

Report for the period  
April 2005 to March 2006

# Financial Reporting Advisory Board

**Report for the period  
April 2005 to March 2006**

This report of the Financial Reporting Advisory Board has been prepared in accordance with Section 24(3) of the Government Resources and Accounts Act 2000 and Section 20(2) of the Government Resources and Accounts Act (Northern Ireland) 2001

Presented by the Treasury to the House of Commons (the Committee of Public Accounts and the Treasury Select Committee) pursuant to Section 24(4) of the Government Resources and Accounts Act 2000

Laid before the Northern Ireland Assembly under Section 20(3) of the Government Resources and Accounts Act (Northern Ireland) 2001 by the Department of Finance and Personnel

The report is laid before the Scottish Parliament and presented to the Audit and Finance Committees of the Scottish Parliament by agreement with the Scottish Ministers

The report is laid before the National Assembly for Wales by agreement with Assembly Ministers

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*Ordered by The House of Commons to be printed 6th June 2006*

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HC 1113

SE/2006/76

NIA 297/03

London : The Stationery Office Limited

£10.00



Top row (l to r): David Heald, David Thomson, David Watkins (Secretary), Alastair Matthews, Mike Ashley, John Thornton, Ken Wild, Miranda Carter, Martin Evans, Martin Sinclair.

Bottom row (l to r): Russell Frith, Maureen Wellen, Elwyn Eilledge (Chairman), Anne Rylatt, Kerry Twyman, Robin Lynch, Michael Romberg, Gillian Fawcett.

**Financial Reporting Advisory Board: meeting on 20 March 2006**

# Chairman's Foreword

When I accepted, back in 1996, the invitation to chair the Financial Reporting Advisory Board, one of the selling points was that the Board would need to meet only infrequently. Today, as the Board celebrates its 10th anniversary, it is meeting for the 79th time. As chapter 1 of this report notes, the Board spent its first year or so – and 22 meetings – examining the proposals put forward in the *Resource Accounting Manual*. And more than half (42) of the Board's meetings took place before the Treasury obtained statutory powers in 2000 to require departments to produce resource accounts.

In 1996, no-one could have anticipated the enormous amount of change that we have witnessed in the accountancy world during the past ten years. These changes have meant that the Board has had, and continues to have, an important role in ensuring that the government maintains its commitment to the highest standards of financial reporting. This is not always easy to do – partly because the types of transactions and events we are dealing with are unique to government and are not replicated in the commercial world. It is also partly because of the constant and various pressures to report those transactions and events, without any real understanding by many readers of whether they are reportable under generally accepted accounting practice – or, indeed, in the National Accounts.

I believe that an average reader should be able to understand government accounts – and not only what is included in the accounts, but also what is not reportable under generally accepted accounting practice. The style of communication is, therefore, important. In this context, I welcome very much the Treasury's publication *Delivering the benefits of accruals accounting for the whole public sector*<sup>1</sup>. In particular, the explanation of how accruals based accounts interact with the National Accounts and comprehensive projections should help financially-literate readers to understand the expected costs of government in the future and how they will be financed. But this is not enough. As we move into the next decade of the Board's existence, I would like the Treasury to give more thought to the needs of the general users of government financial statements, and to consider ways of clarifying the information contained in them.

My Forewords in the past have normally recognised progress in areas of concern to the Board, and I have commented on topics that particularly interest me. In this 10th anniversary year, I would like to acknowledge the continued efforts of the Treasury and others to meet the Board's concerns in many areas. In some areas, the Treasury has been able fully to address the Board's concerns. In others, as you will read in this report, I believe that the Board's persistence has, slow step by slow step, achieved some improvements, although there is still some way to go before all the issues are resolved to the Board's satisfaction.

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<sup>1</sup> See paragraphs 4.10 and 4.11 of the Report.

Finally, I would like to thank all those who have served on the Board over the last ten years for the time they have freely given to the important task of ensuring the highest standards of financial reporting in government. I hope that they feel, as I do, that our time has been well spent.

Elwyn Eilledge

8 May 2006

The Financial Reporting Advisory Board is an independent body fulfilling the statutory role as the 'group of persons who appear to the Treasury to be appropriate to advise on financial reporting principles and standards'<sup>1</sup> for government. The Board acts as an independent element in the process of setting accounting standards for government and exists to promote the highest possible standards in financial reporting by government and to help to ensure that any adaptations of, or departures from, generally accepted accounting practice are appropriate.

The Board's main focus is on examining proposals for amending current, or implementing new, accounting policies in the accounting guidance for departments, executive agencies, non-departmental public bodies and trading funds. The Board also advises the Treasury on the implementation of accounting policies specific to whole of government accounts.

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<sup>1</sup> Government Resources and Accounts Act 2000, section 24.



# Executive Summary

This report, its ninth, celebrates the tenth anniversary of the Financial Reporting Advisory Board (the Board). It is addressed to the Committee of Public Accounts and the Treasury Select Committee in the Westminster Parliament, to the Northern Ireland Assembly, to the Scottish Ministers and to the National Assembly for Wales. The report covers the year April 2005 to March 2006. It looks back over the ten years of the Board's existence, and discusses new accounting standards, other accounting and reporting issues considered by the Board, and looks ahead to the coming year. The following paragraphs summarise some of the key points discussed in the report.

The Board's primary objective is to promote the highest possible standards of financial reporting by government and it believes that it has achieved, and is continuing to achieve, this objective. Over the last ten years, the Board has played an important role in the successful application of generally accepted accounting practice (GAAP) in resource accounts (paragraphs 1.3 to 1.9), ensuring that the standards and policies used in resource and other accounts continue to conform to GAAP with any departures fully justified and properly explained.

The Board has noted in previous reports its view that the government should take the lead in adopting international financial reporting standards (IFRS) in line with the decision by the European Commission to require listed groups to prepare their consolidated accounts under IFRS from 1 January 2005. The Board reluctantly accepted the Treasury proposal to follow the Accounting Standards Board's (ASB) phased convergence strategy. In 2005-06, the ASB issued only two new standards, which the Board considered (paragraphs 2.8 to 2.11 and 2.19). The Board also considered the four exposure drafts issued by the ASB (paragraphs 2.12 to 2.18).

The exposure drafts reflect the proposals of the International Accounting Standards Board. Those in FRED 39 *Amendment to FRS 12 Provisions, Contingent Liabilities and Contingent Assets*, were they to be implemented, would have a major impact in central government accounts. The proposals are significantly different from existing accounting standards, moving probability from being a recognition criterion to a factor in the measurement of provisions. The proposals are controversial, but the Board welcomes the Treasury's decision to carry out an impact assessment of the likely consequences should the proposals become incorporated into an IFRS (paragraphs 2.12 to 2.14).

During the year, the profile of the convergence strategy was heightened by the ASB's decision to abandon its phased approach in favour of a 'big bang' perhaps in 2009. The Board is optimistic that the Treasury's response to this decision will be to move to adopt IFRS in the shorter term. However, the Board acknowledges that the timing has to be right for the government in terms of, for example, the comprehensive spending review. Nevertheless, the Board expects the Treasury to move to IFRS no later than the ASB's proposed 'big bang', which, in practice, means the Treasury needs to plan for an implementation date of 2008-09 (paragraphs 2.3 to 2.6 and 5.2 to 5.4).

The Board has also considered other accounting and reporting issues during the year (see, generally, chapters 3 and 4). In particular, the Board expresses its deep disappointment that the Treasury could not report real progress on extending the departmental boundary to include non-departmental public bodies (paragraphs 4.2 to 4.4). However, on a positive note, the Board welcomes the government's commitment to providing appropriate levels of narrative reporting in resource and other accounts with the retention of the need for Management Commentary in the Annual Report (paragraphs 4.5 to 4.8).

The Treasury has assured the Board that the whole of government accounts programme is well advanced. The Board notes, with some disappointment, that full consolidated central government accounts have not been published for 2003-04. Significant advances in accounting for central government funds and flows have, however, been achieved over the last four to five years: the Board notes that the central fund accounts are now prepared on an accruals basis, and that the main revenue accounts for 2004-05 were prepared and published on an accruals basis. This is a major achievement in the context of public sector accounting. (Paragraphs 1.10 to 1.17, and 5.6 to 5.9.)

The report notes that the Board has considered certain topics each year for the last ten years. As a result of this continued interest, improvements have been made in dealing with some complex issues, and the Board looks forward to further progress being made. One of these areas of interest is accounting for transactions financed by the Private Finance Initiative (PFI). The report notes the Board's belief that its continued interest in PFI has ensured a steady, if slow, improvement in the standards of accounting by departments. Concerns remain, however, about the consistency of accounting treatment across the public sector and the Board has had to take issue with the Treasury this year on the lack of progress on improving matters. The Board continues to take this issue very seriously and will maintain its pressure on the Treasury for progress (paragraphs 1.19 to 1.20 and 3.14 to 3.18).

The Board is clear that better guidance on PFI accounting is required if consistent accounting treatments are to be achieved across the public sector. It had hoped that, following generally critical comments, the International Financial Reporting Interpretations Committee would extend the scope of its draft Interpretations on accounting for service concessions to include public sector entities. This is unlikely to be the case when the Interpretations are issued later in 2006. Experience shows, however, that the public sector will be expected to review its accounting treatment in the light of the Interpretations, and the Board looks forward to discussing whether the Interpretations might signal a change to the Treasury's accounting guidance (paragraphs 3.19 to 3.23).

Other national and international public sector developments are likely to affect domestic public sector accounting. Accounting standards are generally written in the context of a conceptual framework. The ASB's *Statement of Principles for Financial Reporting* was published in 1999; a Discussion Paper on a proposed Interpretation for public benefit entities was published in 2003, and an Exposure Draft in August 2005. The Board welcomed the opportunity to comment on the proposals. The main area

that needs clarification in the Board's view is the principles underlying the recognition and measurement of liabilities (paragraphs 3.2 to 3.8).

That this is a complex subject in the context of government accounting is borne out by the difficulties faced by the International Public Sector Accounting Standards Board in developing Exposure Drafts on accounting for the social policies of governments (paragraphs 5.10 to 5.12). The original Invitation to Comment, which was reviewed in the Board's eighth report, demonstrated the range of views on what constitutes a government liability under generally accepted accounting practice.



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# Chapter 1

## 10 YEARS OF ACHIEVEMENT

- 1.1 The Financial Reporting Advisory Board (the Board) held its first meeting on 8 May 1996 and celebrated its 10th anniversary at its meeting on 8 May 2006. In this introductory chapter to its ninth report, the Board considers some of the achievements and the challenges of the last ten years.
- 1.2 The Board believes that its reports<sup>1</sup> demonstrate clearly that it has achieved, and is continuing to achieve, its objectives. There are, as discussed later in this chapter, recurring topics, which the Board considers on an annual basis. But it is precisely because of the Board's tenacity in dealing with these complex areas that the UK has high standards of financial reporting and is among the world leaders in public sector accounting.

### Successful application of generally accepted accounting practice in resource accounts

- 1.3 When the Board first met in 1996, the Treasury was in the early stages of introducing resource accounting in the United Kingdom. The Board was set up before the existence of the statutory requirement (in the Government Resources and Accounts Act 2000) for resource accounts to conform to generally accepted accounting practice (GAAP) subject to such adaptations as are necessary in the context<sup>2</sup>. The Board spent the first year of its existence reviewing the *Resource Accounting Manual* in detail, and considering some complex accounting issues, including the valuation of infrastructure and heritage assets and the departmental boundary. The Board's aim in carrying out that work was to ensure that GAAP adopted in the public sector has been applied or adapted to the central government sector as appropriate. The Board reported in July 1997 that there had been few major departures in the *Resource Accounting Manual* from the principles adopted by GAAP.
- 1.4 The Government Resources and Accounts Act 2000 requires resource accounts to comply with GAAP and to have regard to relevant guidance issued by the Accounting Standards Board (ASB). Resource accounts (and the accounts prepared by other entities falling within the remit of the Board) follow UK GAAP. At about the time the Act was passed, the International Public Sector Accounting Standards Board (IPSASB – a Board of the International Federation of Accountants) issued eight International Public Sector Accounting Standards (IPSAS) based on international financial reporting standards (IFRS). Although there are now 21 IPSAS, and IPSASB's aim in the medium-term is to mirror all IFRS for the public sector, IPSAS are insufficiently developed to form the basis for UK public sector accounting. Nevertheless, the Board follows the work of

<sup>1</sup> The Board's reports can be found on the Board's website at <http://www.frab.gov.uk/>.

<sup>2</sup> Government Resources and Accounts Act 2000, s5(3)(b).

IPSASB with interest (see chapter 5), and examines Treasury proposals for public sector accounting in the light of both IFRS and IPSAS. The report discusses convergence of accounting standards generally in chapters 2 and 5.

- 1.5 The Board is proud to have played an important role in the successful introduction of resource accounting into central government. It is also pleased that it has a continuing role in advising on the application of new financial reporting principles and standards for government. The Board quickly established itself as an independent, authoritative and credible voice of public sector accounting. Its members, drawn from the public and private sectors, have a wealth of experience to bring to the Board's deliberations. Its success is founded on its approach to considering proposals put forward by the Treasury: an understanding of the sector, a recognition that some issues might be complex in the government context, and a firm conviction that any proposal to depart from GAAP should be treated with caution. The Board has, over the last 10 years, persistently pursued its concerns with the Treasury in several areas (examples include accounting for student loans, accounting for pension liabilities and accounting for projects financed by the Private Finance Initiative), refusing to endorse initial proposals that would have required a departure from GAAP and requiring the Treasury to re-think its approach.
- 1.6 The Board's standing has been recognised, as evidenced by the way in which the Board's remit has grown over the years (see Annex 3). The Scottish Executive and the Department of Finance and Personnel, Northern Ireland invited the Board to advise them on accounting matters. The Treasury asked the Board to oversee the accounting guidance for non-departmental public bodies and trading funds. The Department of Health and Monitor, the independent regulator of NHS Foundation Trusts, look to the Board for advice on the accounting guidance for NHS and NHS Foundation Trusts. The Board accepted these invitations to provide advice and is therefore in a position to promote consistent application of GAAP across this wide range of government activity.
- 1.7 The publication in early April 2005 of the new *Government Financial Reporting Manual* (the FReM)<sup>3</sup> consolidated the existing sources of accounting guidance for departments and executive agencies (the *Resource Accounting Manual*), non-departmental public bodies (the *Executive NDPBs annual report and accounts guidance*) and trading funds. (the *Trading funds accounts guidance*). The FReM is based on Companies Act requirements and on accounting standards issued by the ASB, and demonstrates clearly that the Treasury has felt the need to propose only limited departures from GAAP.

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<sup>3</sup> The Government Financial Reporting Manual, which is published by the Treasury and the Devolved Administrations, can be found on its website at <http://www.financial-reporting.gov.uk>.

- 1.8 The accounting manuals for NHS Trusts<sup>4</sup> are based on the requirements of the FReM. Monitor has issued the NHS Foundation Trust Financial Reporting Manual (FT FReM)<sup>5</sup>, which takes GAAP as its starting point, using the FReM for any interpretations relevant to NHS Foundation Trusts, and providing additional guidance where necessary.
- 1.9 The two main adaptations to GAAP relate to the departmental resource accounting boundary (chapter 2 of the FReM) and to the recognition and measurement of fixed assets (chapter 7 of the FReM)<sup>6</sup>. The question of the departmental boundary is introduced later in this chapter and discussed further in chapter 4. The adaptations relating to fixed assets include the removal of the option to measure at historical cost and a valuation framework that differs in detail from that required by Financial Reporting Standard (FRS)15 *Tangible fixed assets*.

### Whole of government accounts

- 1.10 The Government Resources and Accounts Act 2000 requires the Treasury to prepare whole of government accounts<sup>7</sup>. These accounts should present a true and fair view and conform to GAAP subject to such adaptations as are necessary in the context. In 1999, the Board accepted the additional role of considering the policies underlying the development of whole of government accounts, and first reported on its discussions in its fourth report (for 2000-01).
- 1.11 Whole of government accounts will comprise a consolidation of the underlying accounts of the whole of the public sector – central government, local government and public corporations (including trading funds). The Board's basic remit reaches across central government and trading funds, but does not extend to local government and public corporations.
- 1.12 Local authorities prepare their accounts in accordance with the Code of Practice on Local Authority Accounting, which is a Statement of Recommended Practice (SORP) prepared by a joint committee of the Chartered Institute of Public Finance and Accountancy and the Local Authority (Scotland) Accounts Advisory Committee (CIPFA/LASAAC). The ASB provides a 'negative assurance statement' on the local authority SORP each year. With the introduction of whole of government accounts, it is important that there is a consistent accounting framework across the public sector. The SORP and the FReM need to be closely aligned and the Board welcomed the Treasury's proposal that an observer from the CIPFA/LASAAC Secretariat be invited to attend Board meetings from November 2005.

<sup>4</sup> The NHS accounting manuals can be found at <http://www.info.doh.gov.uk/doh/finman.nsf>.

<sup>5</sup> The FT FReM is available at <http://www.monitor-nhsft.gov.uk/publications.php?id=883>.

<sup>6</sup> The FT FReM does not adapt FRS 15 in the same way ; the option to carry at historical cost is removed, but the valuation framework is as set out in FRS 15.

<sup>7</sup> Government Resources and Accounts Act 2000, s9(1).

- 1.13 Considerable improvements over recent years have brought the SORP more into line with GAAP and many of the differences between local government and the rest of the public sector have been eliminated. One significant difference between central and local government remains, however – the local authority road network is accounted for at historical cost, while the motorway and trunk road network is accounted for at current cost in central government accounts. Both approaches accord with FRS 15, and the Board looks forward to considering and commenting on the Treasury's response to this issue in time for the first published whole of government accounts closing balance sheet for 2006-07.
- 1.14 By contrast, there are few issues to concern the Board in relation to public corporations, since they generally apply UK or international GAAP. (The convergence of accounting standards is discussed in chapter 2.)
- 1.15 As part of the whole of government accounts programme, the Treasury has consulted the Board on the application of accounting standards to the central funds. Previously prepared on a cash basis, the Exchange Equalisation Account, the Debt Management Account and the National Loans Fund account are all now prepared on an accruals basis, using relevant accounting standards.
- 1.16 The Board was first consulted on the development of accruals-based accounting policies for the taxation revenues in May 2000, when it agreed that taxation revenues will be deemed to accrue evenly over the (tax return) period for which they are due, but will be recognised only at the point that they can be reliably measured. The Treasury kept the Board informed about progress in implementing that overarching principle. The Board is pleased to note that the 2004-05 accounts of direct taxes collected by the former Inland Revenue and of indirect taxes collected by the former HM Customs and Excise were prepared and published on an accruals basis.<sup>8</sup>
- 1.17 The Treasury has informed the Board that the whole of government accounts programme is well advanced, and the Board was pleased to receive a presentation by the Treasury on progress at its meeting in February 2006 (see chapter 4). The Board notes, with some disappointment, that full consolidated central government accounts have not been published for 2003-04, since it believes that they would help to inform general users about the public finances in a way that individual public sector accounts cannot. The Board does, however, acknowledge that certain key balances were published alongside the 2005 Pre-Budget Report<sup>9</sup>. It is, however, grateful for the Treasury's assurance that this will have no effect on the publication of whole of government accounts closing balance sheet for 2006-07 in Spring 2008.

### Recurring topics

- 1.18 The Board listed four "Issues of Concern" in its first report: accounting for PFI projects; the departmental boundary; salary and pension disclosures; and heritage assets. Each of these issues continues to present challenges to achieving the highest standards of financial reporting. The Board's

<sup>8</sup> The accruals-based Trust Statements for 2004-05 can be found on the HM Revenue and Customs website at <http://www.hmrc.gov.uk/about/reports.htm>.

<sup>9</sup> Copies of all publications associated with Pre-Budget Reports are available from the Treasury's website <http://www.hm-treasury.gov.uk>.

insistence that these issues should be resolved, and its requirement that the Treasury report to it each year on developments, have meant that progress has been made in resolving these difficult issues. The Board continues to focus attention on these areas, and expects further progress to be made.

### *Private Finance Initiative*

- 1.19 When the Board wrote its first report, the ASB was still considering detailed guidance on the accounting treatment of projects financed by the Private Finance Initiative (PFI), and the Board had little to say other than that it would return to the topic when more detailed guidance became available. The Board has had to return to the subject of PFI accounting every year since, and the Chairman has referred to it in his Foreword more than once – most lately in his Foreword to the eighth report, where he noted that the Treasury had made some progress in addressing the Board's concerns.
- 1.20 The Board believes that its interest in accounting for PFI has ensured that standards of accounting for PFI projects have improved in departments and this has led to better information about the public finances. But, 10 years after its first mention, PFI still looms large as an area where the Board continues to have misgivings about the consistent interpretation of accounting guidance across the public sector, and the Board remains deeply concerned about the 'missing assets' associated with those PFI schemes where the assets are on neither PFI partner's balance sheet. Commentary on the Board's discussion of PFI during this year is in chapter 3.

### *Departmental boundary*

- 1.21 In July 1997, the Board noted that resource accounts would exclude from consolidation some classes of bodies, such as trading funds, on the grounds that the department did not exercise in-year budgetary control over them. This treatment does not comply with UK GAAP, where consolidation is determined by the degree of influence which an entity exerts over other entities. The Board noted that, in practice, departments might exercise influence over other bodies and that there was an argument that the same criteria as used under GAAP should also be applied to resource accounts.
- 1.22 By the time the Board came to write its seventh report (for 2003-04), the Treasury had made some progress in addressing the Board's concerns. The Treasury reported in the following year that it needed to respond to departments' concerns about accountability arrangements between departments' Accounting Officers and non-departmental public bodies' Accounting Officers<sup>10</sup> before bringing proposals to the Board to extend the boundary to include non-departmental public bodies. The Board requested that the issue be resolved in 2005-06; see paragraphs 4.2 to 4.4 for developments this year.

### *Salary and pension disclosures*

- 1.23 The Chairman commented in his Foreword to the eighth report that resource accounts do not always contain all the information needed to hold public officials to account for their actions. He specifically noted that

<sup>10</sup> Accountability arrangements in respect of Accounting Officers in England and Wales are set out in chapters 4 and 8 of Government Accounting (<http://www.government-accounting.gov.uk/>). Similar arrangements exist in Scotland and Northern Ireland

some senior public officials refuse to provide for inclusion in the notes to the accounts details of their remuneration packages – salaries and fees, bonuses, and changes in accrued pension benefits. Company directors do not have the luxury of refusal, since disclosure is required by the Companies Act 1985.

- 1.24 The Board was able to report in 2004-05 that the situation within government departments had improved, to the extent that there are very few senior civil servants refusing to provide the relevant information and that new appointments carry with them the obligation to provide it. The Board notes that public servants can use the Data Protection Act to refuse disclosure, and has been informed by the Treasury and the Cabinet Office that this has caused delays in resolving the problems with non-disclosure in other public bodies.

### *Heritage assets*

- 1.25 The Board has been interested from its inception in the problems associated with accounting for heritage assets. The accounting policies for heritage assets have changed over the past 10 years, and are currently based on the Charity Commission's SORP on *Accounting and Reporting by Charities*. Existing collections can be exempted from capitalisation on cost-benefit grounds, but additions to collections, whether purchased or donated, are not.
- 1.26 The Chairman wrote to the ASB Chairman in 2000, questioning whether this policy was workable, and suggesting that a review of the policy should take place in late 2002. The ASB has now completed its review and, in January 2006, published a Discussion Paper *Heritage Assets: can accounting do better?*<sup>11</sup> The Board's initial consideration of the Discussion Paper is recorded in chapter 3 of this report.

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<sup>11</sup> The Discussion Paper, as well as accounting standards and exposure drafts, can be found on the ASB website at <http://www.frc.org.uk/asb/technical>.

# Chapter 2

## NEW ACCOUNTING STANDARDS

### Introduction

- 2.1 The Board has noted in previous reports its view that the government should take the lead in adopting international financial reporting standards (IFRS) following the requirement for listed companies to prepare their consolidated accounts in accordance with IFRS adopted by the EU<sup>1</sup>. The Treasury proposed, and the Board reluctantly accepted, that a phased programme of managed change would be achieved by following the ASB's convergence strategy. That is, that UK GAAP, already largely aligned with IFRS, would converge fully over a period of three to four years.
- 2.2 The Board requested that the Treasury continue to monitor developments in IFRS and discuss with the Board its conclusions on whether IFRS could be adopted in the public sector in advance of the ASB's convergence strategy. In December 2005, the ASB announced that it was halting its published strategy. This chapter reports on the Board's discussions with the Treasury in the light of that announcement, and looks at the convergence activity during the year.

### Convergence agenda

- 2.3 The Board's discussion with the Treasury about the potential impact on public sector accounting of the ASB's announcement took place in the context of the Board's view that the government should be taking the lead in adopting IFRS. The Board believes that the ASB's decision to replace its phased approach to convergence with a 'big bang' approach provides the Treasury with an opportunity to move ahead of the ASB in adopting IFRS.
- 2.4 This view is strengthened by the ASB's tentative conclusion that all publicly accountable entities should adopt IFRS. By any definition, the entities covered by the Board's remit are publicly accountable and so should adopt IFRS. The Board does not see the absence of a specific international accounting standard on accounting for PFI as a reason for delaying convergence.
- 2.5 The Board recognises, however, that the Treasury needs to determine when the time to switch to IFRS is right for the government in terms of, for example, the comprehensive spending review scheduled for 2007. The Board was encouraged by the Treasury's view that, while the comprehensive spending review needs to be based on current GAAP, that does not preclude a change to IFRS-based reporting early in the spending review period, with any amendments to budgeting treatments being handled as classification changes.

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<sup>1</sup> EU Regulation 1606/2002 is available from [http://europa.eu.int/comm/internal\\_market/accounting/ias\\_en.htm](http://europa.eu.int/comm/internal_market/accounting/ias_en.htm).

- 2.6 The Board has informed the Treasury that it expects firm proposals early in the next reporting period that will demonstrate the Treasury's commitment to introducing IFRS. The Board's view is that convergence should take place no later than January 2009, the earliest date for the ASB's 'big bang'. This will avoid the possibility of accusations that the government equates itself to non-publicly accountable entities, whose accounting requirements are likely to be far less rigorous than IFRS. In practice, therefore, the Board believes that the government's 'big bang' should be the financial year 2008-09.

### Convergence in 2005

- 2.7 In its eighth report, the Board noted that it had accepted the Treasury's argument that the complex areas of unique significance to government accounts meant that further consideration had to be given to these issues before the standards on financial instruments could be implemented. This section discusses the implementation of these standards, and also discusses issues arising from proposals put forward in four Financial Reporting Exposure Drafts (FRED) issued by the ASB in July 2005, based on the IASB's proposals on business combinations<sup>2</sup>.

#### *Financial Instruments*

- 2.8 The ASB issued one new Financial Reporting Standard (FRS) in the convergence programme in 2005. FRS 29 (IFRS 7) *Financial Instruments: disclosures* replaces the disclosure requirements of FRS 25 (IAS 32). The objectives of FRS 25 (IAS 32) *Financial Instruments: Disclosure and Presentation* and FRS 26 (IAS 39) *Financial Instruments: Measurement* are explained in the Board's eight report, together with a discussion of the reasons for the Board's agreement to defer implementation until issues had been resolved.
- 2.9 The first issue is the classification of Public Dividend Capital (PDC)<sup>3</sup>. An entity that has PDC (trading funds, for example) might be required to pay over a sum that represents a return on the PDC and the entity's reserves. The amount is determined by the responsible Minister, with Treasury concurrence. The Board concluded that a "dividend" has to be paid but, because the "dividend" is connected to reserves as well as to PDC, any link between it and the initial PDC is lost. The Board agreed, therefore, with the Treasury proposal that the "dividend" is a liability at the balance sheet date and should continue to be reported as expenditure in the year to which the "dividend" relates.
- 2.10 The second issue is the research that the Treasury, departments and other entities needed to undertake – first, to determine the extent to which guarantees, letters of comfort and other indemnities given by the government are financial instruments within the meaning of FRS 26, and, secondly, to determine the extent to which departments or other entities covered by the Board's remit engage in hedging activities to have derivatives embedded in contracts or other agreements.

<sup>2</sup> Information about the IASB's activities can be found on the IASB website at <http://www.iasb.org/current/iasb.asp>.

<sup>3</sup> Public Dividend Capital is finance provided by government to public sector bodies as an alternative to loan finance.

2.11 The Treasury has now informed the Board that the central funds and departments that trade in financial instruments (principally the Export Credit Guarantees Department) will implement FRS 25, FRS 26 and FRS 29 from 2006-07, with the exception of the Exchange Equalisation Account, which will adopt the financial instruments standards for 2005-06.

**FRED 39: Amendment to FRS 12 Provisions, Contingent Liabilities and Contingent Assets and amendment to FRS 17 Retirement Benefits**

2.12 FRED 39 reflects the IASB's proposals for amending IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and for amending parts of IAS 19 *Employee benefits*. The proposals are significantly different from extant accounting standards. In particular, contractual rights would be divided into two types: conditional and unconditional. The unconditional right or obligation meets the definition of an asset or a liability and would, therefore, be recognised. The uncertainties associated with the asset or liability (the conditional obligation) are reflected in its measurement. This would bring the treatment of "non-financial" liabilities into line with that of "financial" liabilities accounted for under FRS 26.

2.13 The Board notes that, were these proposals to be implemented, there would be a significant impact in central government. The Board also notes that there is considerable opposition to the proposals – from private industry, from accountancy firms, from the ASB and from Europe. Nevertheless, the Board supports the Treasury's decision to carry out an impact assessment so as to understand the likely consequences of a revised standard and to consider the need for any additional advice that might be required by entities covered by the Board's remit.

2.14 The Treasury proposed linking this research with that into the impact of implementing the financial instrument standards fully across the public sector (see paragraph 2.10). While the Board agrees that this is a sensible approach, it is concerned that the Treasury has not yet reported on progress. This delay affects the timing of the full implementation of FRS 25 and FRS 26 – on which the Board expects to be consulted during 2006.

**FRED 37 (IAS 38): Intangible assets and FRED 38 (IAS 36): Impairment of assets**

2.15 FRED 37 requires, rather than gives the option for, internally generated development expenditure to be capitalised. FRED 38 proposes an amendment to FRS 15 *Tangible fixed assets* that would eliminate the distinction between impairments due to consumption of economic benefits and other revaluation losses. The effect of this amendment would be to charge any impairment loss initially to the revaluation reserve to the extent that there is an available balance. The Treasury is concerned that this would weaken the link between GAAP-based accounts and National Accounts and might bring about a divergence between accounts and budgets.

- 2.16 To address this perceived problem, the Treasury suggested that either the current requirements of FRS 15 should be retained (an adaptation of GAAP), or additional disclosures about total impairment losses should be given in the notes to the financial statements. The Board questioned the need for an adaptation of GAAP, since the Treasury had not provided it with an assessment of the potential financial impact that the change would have, and asked the Treasury to report back to the Board with firm proposals after the ASB has concluded its consideration of the issues.

#### **FRED 36: Business Combinations**

- 2.17 FRED 36 *Business combinations* would implement in the UK IFRS 3 *Business combinations* with consequential amendments to FRS 2 *Accounting for subsidiary undertakings*. The implementation of IFRS 3 would bring changes to UK GAAP, but is unlikely to have a significant impact on accounting in the public sector. The Board shares the Treasury's view that combinations in the public sector rarely involve acquisitions, with Machinery of Government changes and other transfers of functions between entities covered by the FReM being combinations involving entities under common control. Such combinations should continue to be accounted for as mergers.
- 2.18 The Board acknowledges, however, that assets (and liabilities) might be transferred across different parts of the public sector and acknowledges in particular that transfers between local government and central government have caused problems in the past. The Board has raised this issue in its response to the ASB's Exposure Draft of the proposed Interpretation for public benefit entities of the *Statement of Principles for financial reporting* (see chapter 3).

#### **Other accounting standards**

- 2.19 The ASB also issued in 2005 FRS 28 Corresponding amounts to fill a gap left by amendments to the Companies Act 1985 which removed from that Act the requirement to provide corresponding amounts in the notes to the financial statements. The Treasury proposed to apply FRS 28 in full. The Board agreed, with the exception that decisions on whether to include corresponding amounts in disclosures that are specific to government departments and agencies will be taken on a case by case basis. The standard is not discussed further in this report.

## Chapter 3

### OTHER ACCOUNTING ISSUES CONSIDERED BY THE BOARD

#### Introduction

- 3.1 This chapter reviews other accounting issues considered by the Board during 2005-06. The Board has discussed most of these issues in previous years. The one new item this year is the development of guidance on accounting for the EC Greenhouse Gas Emissions Trading Scheme.

#### Statement of Principles – Proposed Interpretation for Public Benefit Entities

- 3.2 In May 2003, the ASB issued a Discussion Paper on the proposed Interpretation for public benefit entities of the Statement of Principles for Financial Reporting<sup>1</sup>. In its seventh report, the Board noted that it awaited the final version of the Interpretation with interest and looked forward to discussing with the Treasury how it might be incorporated into the accounting guidance. The ASB's Committee on Accounting for Public-benefit Entities (CAPE) spent much time considering the responses to the Discussion Paper and it was not until August 2005 that the ASB issued an Exposure Draft seeking further comment on proposals for the Interpretation.
- 3.3 In its response to the ASB<sup>2</sup> The Board recognised that interpreting the *Statement of Principles* for the public sector is a difficult task. The Board believes that the proposed *Interpretation* provides a significant contribution to achieving the aim of attaining the highest possible standards of financial reporting in the public sector, but that some clarification of the proposals as currently drafted is needed. The Board also took the view that some of the issues will continue to be debated into the future, and this ought to be acknowledged.
- 3.4 In particular, the Board felt that the principles underlying the recognition and measurement of liabilities needed clarification. The Board shares with IPSASB the view that it can be very difficult to determine exactly what governments' "liabilities" are under accounting standards, and that very careful consideration needs to be given to the nature of the "obligation" before taking decisions on whether it is something that should be recognised on balance sheet and, if so, how it should be measured.

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<sup>1</sup> The *Statement of Principles* and the Exposure Draft of the proposed *Interpretation* are available from the ASB's website: <http://www.frc.org.uk/asb/technical>.

<sup>2</sup> The full response is available on the Board's website at <http://www.frab.gov.uk>.

- 3.5 The Exposure Draft appears to suggest that the delivery of policy obligations to the beneficiaries of the policy can be characterised as analogous to executory contracts in that the benefit to the recipient is matched by the achievement of the entity's objectives. The Board shares the concerns of other commentators on the Exposure Draft that such an approach might have the unintended result of removing liabilities from public sector balance sheets.
- 3.6 During the presentation to the Board by the Deputy Chair of IPSASB, the point was made that any consideration of accounting for the social policies of governments is difficult because of the context with which the accountants are dealing. The old-age pension is an exemplar of this difficulty. The Board has reported (fifth report) that determining the correct accounting treatment for the basic state pension is complex. It has concluded that there appears to be no clear cut case under UK GAAP for making a provision.
- 3.7 The ASB's Exposure Draft of the proposed *Interpretation* says that, "for many of the population, the promise to pay an old-age pension is a general commitment that does not give rise to a liability". In its response, the Board noted that it could be argued that the "promise" is either a general commitment or an obligation that a government could not avoid. The definition of a liability as an "obligation of an entity to transfer economic benefits as a result of past transaction or events" leaves plenty of scope for discussion about how social policies of governments – the basic state pension in particular in the UK context – should be accounted for.
- 3.8 The Board believes that the arguments in the Exposure Draft need to be developed further for the proposed *Interpretation* to be a useful reference point in its future discussions with the Treasury about the complex area of accounting for the social policies of government. However, the Board understands and supports the ASB's desire to publish the *Interpretation* as soon as it can.

### Grants in Aid

- 3.9 In its eighth report, the Board questioned the validity of objections to the Treasury proposals to treat grants-in-aid for revenue purposes as financing in the financial statements of non-departmental public bodies. The Board asked the Treasury to provide more information for discussions during 2005, with a view to agreeing an accounting treatment to apply from 2006-07.
- 3.10 The additional information did not alter the Treasury proposal, nor the Board's view, that grants-in-aid for revenue purposes should be treated as financing unless it can be argued that the grant-in-aid is in exchange for the supply of goods or services. The Board also discussed the treatment of grants-in-aid for capital purposes, and concluded that they, too, should normally be accounted for as financing. The new policy will be implemented from 2006-07.

### Cost of Capital

- 3.11 In its first report, the Board accepted the Treasury's rationale for charging for the cost of capital in resource and other accounts. In general, the cost of capital charge in resource accounts is at a standard rate and does not

involve a cash transaction. However, for investment in public sector bodies such as trading funds the cost of capital charge will be equivalent to the required rate of return from those entities and will be an actual payment to the parent department, who will recognise the income in the form of loan interest or dividends.<sup>3</sup>

- 3.12 During this reporting year, in the light of commentary in the proposed *Interpretation* about the nature of transactions, the Board asked the Treasury to review whether or not the cost of capital charge (as a non-cash item and perhaps a 'notional' transaction within the meaning of the term as used in the Discussion Paper on the proposed *Interpretation*) has any place in resource or other accounts.
- 3.13 The Board has concluded that resource and other accounts should continue to account for the cost of capital. It has yet to complete its discussions with the Treasury about the base on which the charge should be calculated and the way in which it should be presented in financial statements.

### Private Finance Initiative

- 3.14 The Board believes that one would normally expect symmetry in the accounting treatment by the two parties to a PFI contract – that is, the assets appear on one balance sheet – not on both, nor on neither. The Board has raised with the Treasury over several years the question of inconsistencies in the accounting treatment being adopted by the private and public sectors in individual projects. The Board has also noted that there is some inconsistency of accounting treatment across sectors such as health, education and central government, although there is generally consistency within sectors.
- 3.15 The Board learned at its meeting in March 2006 that the Treasury and the Office for National Statistics (ONS) are working together to obtain details from the accounts of all (more than 800) PFI schemes. The Board was told that the ONS's main initial focus is on improving the measurement of public sector net debt in the public finance statistics, which the ONS hopes to do during summer 2006. The details of the work will also include information about the balance sheet treatment, and the Board believes that this will allow it, at last, to understand better the potential scale of the inconsistencies in accounting treatment. The Board was informed that the ONS started planning the exercise some four months ago and that data collection has started. The Board looks forward to discussing the results of this significant piece of work with the Treasury and the ONS.
- 3.16 The output from the joint exercise will be a useful tool not only in identifying the scale of the inconsistencies, but should also allow the Treasury to identify those sectors where corrective action is needed to impose proper accounting discipline. The Board does not accept the

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<sup>3</sup> More information about the cost of capital charge can be found in the FReM, 4.5 (<http://www.financial-reporting.gov.uk>).

Treasury view that inconsistent accounting treatment should be allowed to continue until an international accounting standard is developed, since there is no clear indication of when any such standard would be available. The Board believes action is required now. The Board does accept, however, that the findings from the joint exercise, due by early summer 2006, might influence revisions to *Technical Note No. 1: How to account for Private Finance Initiative Transactions*<sup>4</sup>.

- 3.17 In its eighth report, the Board expressed its disappointment that the Treasury had made no progress in amending the *Technical Note*. The Treasury did not, as agreed last year, report progress in early Summer 2005. At the Board's March 2006 meeting, the Treasury reported that it had prepared a draft revised *Technical Note*, and it was agreed that a group comprising the Treasury, the National Audit Office and the Audit Commission, with representation from the accountancy firms, would discuss how the *Technical Note* might be amended, and report to the Board. That group has subsequently informed the Board that options have been identified and that it will report more fully in Summer 2006.
- 3.18 The Board does not agree with the Treasury's main reasons for not having issued an amended *Technical Note* – the need to wait for international developments, the time it will take for the ASB to approve a revised *Technical Note*, and the burdens and additional expense associated with reviewing the accounting treatment of existing schemes in the light of any changes. The Board is, therefore, encouraged by the progress the group has made in identifying options and looks forward to considering them during 2006, with the aim of improving PFI accounting.

#### **IFRIC draft interpretation on service concessions**

- 3.19 The Board noted in its eighth report that the International Financial Reporting Interpretations Committee (IFRIC) (a committee of the IASB) had issued three draft Interpretations in March 2005. Given its interest in accounting for PFI, the Board considered the drafts and responded to IFRIC on 9 May 2005<sup>5</sup>.
- 3.20 Draft Interpretation D12 *Service concession arrangements – determining the accounting model* applies only to the accounting by operators for public-to-private infrastructure service concessions that involve public service obligations. While the Board welcomed IFRIC's contribution to the debate on accounting, it believes that the scope is severely limited and that the proposals in this draft are unlikely to meet the stated aim of the draft Interpretations of providing guidance on how service concessions should be accounted for. The Board also believed that the definition of public service obligations would lead to the exclusion, in the UK at least, of several important PFI projects that typically involved the transfer of office accommodation and other estates to the operator.
- 3.21 The Board noted that draft Interpretation D12 referred to the complexities and inconsistencies in lease classification arising from the risks and rewards model – which underpins accounting for leases and for PFI projects in the UK. The Board expressed its concern that, by opting to follow the control

<sup>4</sup> The *Technical Note* is available on the Treasury's website at: [http://www.hm-treasury.gov.uk/media/D75/C6/PPP\\_TTF\\_Technote1.pdf](http://www.hm-treasury.gov.uk/media/D75/C6/PPP_TTF_Technote1.pdf).

<sup>5</sup> The Board's response is available on its website <http://www.frab.gov.uk>.

model without considering risks and rewards, the accounting treatment will follow the legal form rather than economic reality. This might lead to the risk of manipulation of the legal form thereby resulting in assets being accounted for in a manner inconsistent with IFRIC's aims.

- 3.22 In its response, the Board commented that the control model favoured by IFRIC logically led to the two models put forward in draft Interpretation D13 *Service concession arrangements – the financial asset model* and D14 *Service concession arrangements – the intangible asset model*. But the Board was concerned that the identity of the payer as the key criterion in determining whether the asset is financial or intangible could lead to similar PFI projects being accounted for differently.
- 3.23 IFRIC plans to issue the final Interpretations in late 2006. The Board is disappointed to note that the scope of the Interpretations will not be broadened, because IFRIC believes it is where the operator is the service provider (and not a lessee or an owner) that guidance is needed. The Board looks forward to discussing with the Treasury in due course whether the Interpretations will have an impact on guidance on accounting for PFI projects in the UK.

### Heritage assets

- 3.24 Accounting for heritage assets presents some interesting challenges, and the Board welcomes the publication of the ASB's Discussion Paper *Heritage Assets: can accounting do better?*. The Board was also pleased to welcome the Chairman of CAPE to its meeting in March 2006 and to hear his views on the development of the proposals in the Discussion Paper.
- 3.25 The existing guidance<sup>6</sup> refers to non-operational heritage assets (heritage assets held in pursuit of an entity's overall objectives – museum and gallery collections, for example) and operational heritage assets (heritage assets that are also used by an entity for other activities or to provide other services – normally buildings). Under the existing accounting guidance for central government, only additions to collections post-2001 tend to be recorded on the balance sheet, generally at cost or donated value. Operational assets are generally carried at value based on existing use and disclosed in the same way as other assets of that type.
- 3.26 In his letter to the ASB Chairman in October 2000, the Chairman expressed the Board's view that the interpretation of FRS 15 in the Charities SORP would lead to the type of problems that the Discussion Paper now acknowledges: the accounting treatment is determined according to the date of acquisition; many museums' and galleries' balance sheets do not include their most significant assets; the balance sheet value of assets is unlikely to represent the total value of assets held; and the quality of disclosures about holdings of heritage assets is uneven.
- 3.27 The Board welcomes the proposals in the Discussion Paper; they preserve the principle of capitalisation of non-operational heritage assets where this is practicable, but allow for non-capitalisation where it is not. The proposals will remove the hybrid accounting treatment that currently exists. The Board will consider the proposals under the non-capitalisation

<sup>6</sup> See the FReM, 5.2.18 to 5.2.22 (<http://www.financial-reporting.gov.uk>).

approach for presenting financial information about collection activity. The Board also welcomes the proposals for better quality information about collections in the notes to the accounts, or in other information accompanying the financial statements. Taken together, the proposals will, if properly implemented, enhance financial reporting by the museums and galleries that fall within the Board's remit. The Board will respond early in the next reporting period to the questions raised in the Discussion Paper.

- 3.28 IPSASB has issued a consultation paper *Accounting for Heritage Assets under the accrual basis of accounting*. It contains the ASB's Discussion Paper, but notes that, in developing its own proposals to accounting for heritage assets, IPSASB will need to consider the wide range of different institutional and legislative requirements. The Board will consider and respond to the matters raised in the IPSASB consultation paper.

### EC Greenhouse Gas Emission Allowance Trading Directive

- 3.29 In January 2005, the European Union Greenhouse Gas Emission Trading Scheme (EU ETS) commenced operation, based on Directive 2003/87/EC, which came into force on 25 October 2003<sup>7</sup>. The Treasury informed the Board that certain central government bodies, including NHS Trusts and the Ministry of Defence, were registered in the scheme and had requested accounting advice.
- 3.30 In May 2003, the UK's Urgent Issues Task Force (UITF) had issued a draft Abstract on accounting for emission rights based on IFRIC's draft Interpretation D1 *Emission Rights*. In summary, allowances, whether allocated by government or purchased, should be recognised as intangible assets where held for use on a continuing basis and as current assets if not. Liabilities for delivering emissions allowances would be accounted for as provisions under FRS 12. However, the UITF had reservations about the different bases for measuring and presenting changes in the component assets and liabilities: entities could be measuring allowances on a cost basis and liabilities at current market value. The UITF did not issue a final version of the Abstract. IFRIC issued Interpretation 3 *Emission Rights* in December 2004, but the IASB withdrew it in June 2005 over reservations about the measurement mismatch.
- 3.31 The Board agreed, however, that notwithstanding the lack of UK or international accounting guidance, the UK central government sector had a real need for guidance. The Board approved the Treasury's proposal that the guidance should be based on the UITF's draft Abstract, noting that the measurement mismatches that concerned the UITF in respect of company reporting should not arise in the accounts of entities following the requirements of the FReM. The FReM was duly amended with immediate effect.<sup>8</sup>

<sup>7</sup> Information about the EU Greenhouse Gas Emissions Trading Scheme can be found on the website at <http://europa.eu.int/comm/environment/climat/emission.htm>.

<sup>8</sup> The guidance on accounting for the EU Greenhouse Gas Emission Allowance Trading Directive is in FReM 5.3.11 to 5.3.14 (<http://www.financial-reporting.gov.uk>).

# Chapter 4

## REPORTING ISSUES CONSIDERED BY THE BOARD

### Introduction

- 4.1 This chapter considers the reporting issues discussed by the Board during the year. The Board has considered many of these in previous reports. The new topics this year are the Operating and Financial Review and the agreement to include in departmental resource accounts a reconciliation of Estimates, Budgets and Accounts. The chapter starts with an overview of the latest developments in whole of government accounts.

### Departmental Boundary

- 4.2 The Board is very disappointed that it is unable to report any real progress since last year on the question of the extension of the departmental boundary to include non-departmental public bodies. The Board was pleased to note that the formal consultation has shown that most departments understand the aim of the proposals: to remove discrepancies between budgetary and accounting treatments and to bring resource accounts more into line with GAAP.
- 4.3 The Treasury reported to the Board, however, that the consultation with departments confirmed the main concerns to be the accountability arrangements and the independence of non-departmental public bodies. These concerns have been raised with the Board before (see paragraphs 1.21 and 1.22). The Board considers that the Treasury could have done more this year to resolve the issues.
- 4.4 The relationship between departmental Accounting Officers and the Accounting Officers of non-departmental public bodies appears to the Board to be similar to the relationship between the chief executives of a major company and its subsidiaries. The Board is of the view, therefore, that some of the concerns raised might be over-stated and expects the Treasury to resolve this issue as a matter of urgency.

### Management Commentary

- 4.5 Resource accounts have, since their introduction, followed best practice as issued by the ASB and incorporated into the various sets of accounting guidance (now the FReM) the requirement to prepare an Operating and Financial Review. In its eighth report, the Board noted that new regulations<sup>1</sup> required companies to prepare an operating and financial review (OFR) for financial years ending on or after 1 April 2005. The ASB developed a Reporting Standard, based on the requirements in the regulations and on the previous statement of best practice, and published it in May 2005.

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<sup>1</sup> The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (SI (2005) 1011).

- 4.6 The Treasury proposed, and the Board agreed, to adopt Reporting Standard 1, adapted in two ways. First, entities covered by the FReM report performance against key performance indicators that are interpreted for departments as the Public Service Agreement targets agreed with Ministers and, for other entities, the targets agreed with the relevant Department and normally promulgated by means of a Parliamentary question. Secondly, there is already a requirement for central government entities to prepare Sustainability Reports, and the FReM allows entities to cross-refer to these separate reports rather than reproduce the information.
- 4.7 Since adopting Reporting Standard 1 into the FReM, the Government has amended the regulations to repeal the mandatory requirement for an OFR. Quoted companies are now required to prepare a Business Review in line with section 234ZZB of the Companies Act (which reflects the requirements of the EU Accounts Modernisation Directive). The ASB has, as a consequence, withdrawn the Reporting Standard and replaced it with a Reporting Statement, which represents best practice if a quoted company decides to prepare an OFR.
- 4.8 In the light of these developments, the Treasury proposed retaining the requirements for compliance with best practice in an Annual Review, which would form part of the Annual Report. The Board agreed, subject to calling the section in the Annual Report 'Management Commentary'. (Entities not directly covered by the requirements of the FReM, such as NHS or NHS Foundation Trusts, might continue to call their management commentary an Operating and Financial Review.)

#### Whole of government accounts

- 4.9 The Board was pleased to receive a presentation about progress in developing whole of government accounts, and to learn of the benefits that the programme is bringing in terms of improved accounts quality and timeliness and better information for the National Accounts prepared by the Office for National Statistics.
- 4.10 In December 2005, the Treasury published *Delivering the benefits of accruals accounting for the whole public sector* with the Pre-Budget Report. The Board notes that this publication, together with the Long-Term Public Finance Report published with the 2003 Pre-Budget Report, sets the whole of government accounts balance sheet in the context of different measures of debt, including those in the National Accounts and those provided in comprehensive projections (sometimes referred to as generational accounts) that incorporate all future revenue and spending based on current policies.
- 4.11 Whole of government accounts will be an important tool in helping to demonstrate the Government's stewardship of the public finances. The Board welcomes the Treasury's published explanations of how an accruals based balance sheet interacts with other forms of reporting, but considers that these publications have limited audiences. The Board urges the Treasury, therefore, to consider carefully how it will explain in plain English to the general users the meaning of the stewardship information in whole of government accounts.

## Other reporting issues

### *Salary and pension disclosures*

- 4.12 The Board was encouraged by further progress this year. It notes that no civil servants in departments will withhold consent for disclosure of details of their remuneration packages. It also notes that all contracts of employment for senior civil and public servants include a clause that requires such disclosure. The Board acknowledges that, over time, the issue of non-disclosure will fade away, but is concerned about the length of time it might take.
- 4.13 The Board's preferred option has always been to make disclosure a statutory duty for civil and public servants in the same way that it is for company directors. Given the limited scope for specific legislation, the Board considers that other means need to be tried and has suggested that the Treasury look now at administrative mechanisms – such as non-departmental public body Framework Documents – to ensure that all public servants have to disclose information about their salaries, fees, bonuses, and changes in accrued pension benefits.

### *Sustainability Reporting*

- 4.14 The Board noted in its eighth report that the concept of sustainability reporting is one of the more recent developments in reporting. During the year, the Board considered whether the FReM should be expanded to include more rigorous requirements on sustainability reporting, recognising the increasing importance of this area of corporate reporting.
- 4.15 The Board agreed strongly that it should encourage development in this area, but that it should be outside the formal accounting guidance in the FReM. The Board requested the Treasury to provide guidance on the FReM website; the sustainability reporting page<sup>2</sup> has largely been prepared from contributions from Board members. The Board encourages preparers of accounts to use the webpage to obtain information about sustainability reporting generally and, in particular, examples of best practice.

### *Reconciliation of Estimates, Budgets and Accounts*

- 4.16 The Board approved the final proposed changes to the format and content of resource accounts in 2005, following the 2004 consultation carried out by the Treasury. The revised format is applicable from 2005-06<sup>3</sup>. During the consultation period, the Scrutiny Unit, representing parliamentary users and in particular Select Committees, commented that resource accounts would be further enhanced if information about the Departmental Expenditure Limit, Annually Managed Expenditure and budgets were included.
- 4.17 The Scrutiny Unit consulted the Committee of Public Accounts, the Treasury Select Committee and the Comptroller and Auditor General on possible options for reporting a reconciliation of Estimates, budgets and accounts in resource accounts. The Committees and the Comptroller and Auditor General recognised the importance of the information in terms of

<sup>2</sup> See <http://www.financial-reporting.gov.uk/Sustainability%20Reporting.htm>.

<sup>3</sup> Pro-forma for departmental resource accounts and for the main pension scheme accounts can be found at <http://www.financial-reporting.gov.uk>.

improving the level of scrutiny that Select Committees can bring to their evaluation of departments' financial management and achievement of targets. The Scrutiny Unit recommended that the reconciliation, based on that given in the Notes to the Main Estimates<sup>4</sup>, be included in the Management Commentary from 2006-07, and that due consideration be given to moving the reconciliation into the notes to resource accounts at a future date.

- 4.18 The Board also recognises the importance of this information to Select Committees and notes that it will allow effective scrutiny of performance against control totals; provide an overview of all expenditure for which departments are responsible, including that of non-departmental public bodies, which are consolidated into budgets but not into Estimates or accounts; and allow an assessment of departments' progress in achieving efficiency savings. The Board agreed to the proposal.

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<sup>4</sup> Main Estimates are posted on the Treasury's public website at [http://www.hm-treasury.gov.uk/Documents/Public\\_Spending\\_and\\_Services/Parliamentary\\_Supply\\_Estimates/pss\\_pse\\_mainest.cfm](http://www.hm-treasury.gov.uk/Documents/Public_Spending_and_Services/Parliamentary_Supply_Estimates/pss_pse_mainest.cfm).

# Chapter 5

## LOOKING AHEAD

### Introduction

- 5.1 The final chapter of this report looks ahead to the coming year. Some of the topics that the Board anticipates considering have been on the Board's agenda during the year, and are discussed in earlier chapters; other topics have been discussed in earlier reports, and are only now coming to fruition.

### Convergence

- 5.2 Earlier in this report, the Board states that it expects the government to be ready to adopt IFRS no later than the ASB's proposed date for a 'big bang' convergence – January 2009. In order to be ready for this, the Treasury will need to consult the Board about a new *Government Financial Reporting Manual* based on IFRS. The Board expects to spend a large part of the next reporting period in considering the application of IFRS to the entities to which the FReM applies, and to the health sector where accounting guidance is based on the FReM.
- 5.3 The structure of IFRS is different from that of FRS, and it is unlikely that IFRS can be written into the existing FReM. The Board will be pleased to advise the Treasury on the format of a new FReM. The Board understands that, while not directly linked to convergence, the Treasury will also consult it about the coverage of the FReM. Currently, it excludes guidance for the central funds and the taxation revenues, the accounts for which are now prepared on an accruals basis.
- 5.4 The Board expects much of its next report to focus on the preparations for the move to IFRS.

### Developments in international public sector accounting standards

- 5.5 The Board was pleased to welcome the Deputy Chair of IPSASB to its February 2006 meeting and to receive an update on IPSASB's work in developing IPSASs for two areas: accounting for revenue from non-exchange transactions (including taxes and transfers) and accounting for the social policies of government. IPSASB issued Invitations to Comment on both these issues in January 2004. The Board submitted a brief response in May 2004, noting that IPSASB had reached similar conclusions to the Board in relation to accounting for taxation revenues and that its initial views on accounting for social benefits mirrored those of the Board.

### **Revenue from non-exchange transactions (including taxes and transfers)**

- 5.6 In January 2006, IPSASB published an Exposure Draft<sup>1</sup> on accounting for revenue from non-exchange transactions. Comments are due by 30 June 2006, and it is anticipated that an IPSAS should be published in early 2007. In responding to the Invitation to Comment, the Board noted that experience in the UK had shown that significant issues could arise in applying the principles in practice. The Exposure Draft proposes a transitional period of no more than five years, and the Board considers that this is reasonable in the light of UK experience.
- 5.7 The Board noted that there are two main differences between the proposals in the Exposure Draft and existing accounting practice in the UK. First, IPSASB proposes that tax expenses (amounts available to beneficiaries regardless of whether or not they pay taxes) should be accounted for gross. HM Revenue and Customs reports tax credits, which are a tax expense within the meaning of the IPSASB proposals, as negative income tax to the extent that the tax credits offset a taxpayer's liability and as expenditure to the extent that they exceed the offset. This approach is in accordance with OECD recommendations.
- 5.8 However, the work being carried out by the OECD, IPSASB, the International Monetary Fund and others to amend the rules for preparing National Accounts and to align more closely statistical and accounting bases might also adopt the approach proposed by IPSASB. The Board looks forward to discussing with the Treasury any implications that an IPSAS on accounting for revenues from non-exchange revenues might have on how the UK accounts for tax revenues.
- 5.9 Secondly, the proposals in the Exposure Draft mirror the proposals in the ASB's proposed *Interpretation of the Statement of Principles*, which would change the way in which entities account for capital grants and for the implied funding of donated assets. The existing treatment set out in the FReM is for grants or the implied funding to be taken to a deferred government grant reserve or a donated asset reserve and for the reserves to be released to match depreciation. Both IPSASB and the ASB propose that the grants or the implied funding should be reported as revenue. For so long as the FReM follows UK GAAP, the Board notes that these proposals will not necessitate a change in accounting practice, since Statement of Standard Accounting Practice 4 (*Accounting for government grants*) will still apply until superseded by another standard.

### **Accounting for the social policies of government**

- 5.10 The Treasury first consulted the Board about accounting for social security benefit expenditure in May 2000 when, as part of the whole of government accounts programme, the Treasury was considering whether or how all types of social security benefit expenditure might be accounted for under FRS 12 *Provisions, contingent liabilities and contingent assets*. IPSASB started to explore this topic in early 2002, and the Board agreed to defer its discussions in the light of this development. The focus of the

<sup>1</sup> The Exposure Draft can be found on the IFAC public sector website at <http://www.ifac.org/PublicSector/#ExposureDrafts>.

Board's work was not as wide as that of IPSASB, in that IPSASB is looking at expenditure not only on social security benefits but also on government activities such as defence, education, health and law and order.

- 5.11 The focus to date has been on social expenditures, including 'distress pensions', and accounting for the state pension generally has also been discussed. The Deputy Chair of IPSASB reminded the Board that, while changes in demographics might make the old-age pension a pre-occupation in the West, other countries had different priorities – such as, in South Africa, social policies relating to children. The difficulties in obtaining a consensus of views about accounting for pensions has led IPSASB to conclude that the next stage in the project is to work on three Exposure Drafts: one on accounting for employee benefits (based on IAS 19 *Employee benefits*); a second on non-age related benefits; and the third on old age pensions.
- 5.12 The Board looks forward to considering the Exposure Drafts on these topics in due course and to discussing with the Treasury the possible implications for accounting by the central government sector.



# Annex 1

## THE TERMS OF REFERENCE OF THE FINANCIAL REPORTING ADVISORY BOARD

### 1 Context

- 1.1 The primary aims of financial reporting by central government bodies are to demonstrate to the public and their representatives in the UK and Scottish Parliaments, the Northern Ireland Assembly and the National Assembly for Wales:
  - the financial performance of the bodies;
  - their stewardship of public funds and assets; and
  - that, where appropriate, public monies and other resources have been used for the purposes intended by the Parliaments or the Assemblies;and to provide the Parliaments and the Assemblies with information which is reliable and sufficient as a basis for:
  - their consideration and approval of the levels of resources and cash voted to services; and
  - their examination of performance in carrying out policies, functions, programmes and projects.
- 1.2 Financial reporting is also intended to underpin the UK Government's planning, monitoring and management of public expenditure.
- 1.3 The authority to develop financial reporting requirements rests with HM Treasury, the National Assembly for Wales, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland in respect of accounts meeting the criteria set out in paragraph 2.1.b. below.
- 1.4 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. For Resource Accounts prepared by government departments for which an Estimate is laid before the House of Commons and for Whole of Government Accounts (UK) this requirement is set out in sections 5 and 9 of the Government Resources and Accounts Act 2000. A similar requirement is included in sections 9 and 14 of the Government Resources and Accounts Act (Northern Ireland) 2001.
- 1.5 Under section 24 of the Government Resources and Accounts Act 2000 the Treasury is required to consult an advisory group on financial reporting principles and standards for resource accounts and Whole of Government Accounts. Under section 20 of the Government Resources and Accounts Act (Northern Ireland) 2001, the Department of Finance and Personnel, Northern Ireland is also required to consult with and take account of the recommendations made by this advisory group before issuing directions on

resource accounts or determining the form and content of Whole of Government Accounts (Northern Ireland). The Scottish Ministers, with the agreement of the Audit Committee of the Scottish Parliament, have determined that they should be similarly advised on such matters. The Financial Reporting Advisory Board will be the advisory group, and thus will provide an independent element into the process of setting financial reporting standards for the UK Government, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland.

## 2 Terms of reference

### 2.1 Responsibilities of the Board:

- (a) The Board will provide independent advice to HM Treasury, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland.
- (b) The Board will advise HM Treasury, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland on the application of financial reporting standards and principles:
  - (i) where HM Treasury, the National Assembly for Wales and the Department of Finance and Personnel, Northern Ireland are responsible for issuing reporting requirements, in respect of:
    - Departmental resource accounts
    - Supply financed executive agencies
    - Non-departmental public bodies
    - Trading funds
    - Whole of Government Accounts
    - NHS trusts in England and Wales, and HSS trusts in Northern Ireland
    - NHS Foundation Trusts in England
  - (ii) Where the Scottish Ministers are responsible for issuing reporting requirements, in respect of:
    - accounts falling under sections 19 and 20 of the Public Finance and Accountability (Scotland) Act 2000<sup>1</sup>.
    - accounts of executive non departmental public bodies where the Scottish Ministers have the power of direction
- (c) The Board will decide how it reaches its conclusions.
- (d) The Board's advice to the Scottish Ministers will be restricted to the technical rules of accounting and to minimum disclosure requirements. It will not extend to the format of accounts or to disclosures beyond the minimum requirements.
- (e) The Board's advice to the Department of Finance and Personnel, Northern Ireland will incorporate accounting, formatting and minimum disclosure requirements.

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<sup>1</sup> Public Finance and Accountability (Scotland) Act 2000 is available from the Stationery Office or can be located on the web at: [www.legislation.hmsso.gov.uk](http://www.legislation.hmsso.gov.uk).

- (f) The Board will examine all amendments to the guidance in respect of the bodies listed in b above, with the aim of ensuring that they comply with GAAP, and that departures or modifications from GAAP, due to public sector and spending control contexts, are fully explained and justified. The Board will also examine, with the same aim, amendments to accounts directions referred to the Board, issued by HM Treasury, the National Assembly for Wales, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland.
  - (g) The Board will prepare an annual report of its activities, including its views on the changes made during the period to the accounting guidance, or, as appropriate, accounts directions, issued by HM Treasury, the National Assembly for Wales, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland in respect of bodies listed in 2.1 b. above, and will send a copy of its report direct to the Committee of Public Accounts and Treasury Select Committee of the UK Parliament, the National Assembly of Wales, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland.
- 2.2 HM Treasury (in conjunction with the Department of Health in respect of NHS trusts in England and the Independent Regulator of NHS Foundation Trusts in respect of NHS Foundation Trusts in England), the National Assembly for Wales, the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland:
- (a) Will ensure that all relevant matters, including proposed changes to the guidance, or, as appropriate, accounts directions, in respect of accounts meeting the criteria in 2.1.b above, are brought to the Board's attention within a reasonable time. In particular, changes to Financial Reporting Standards and other elements of GAAP that affect such guidance or accounts directions will, as far as possible, be brought to attention in sufficient time to enable their implementation, as appropriate, within the same timescale as changes are to be made generally.
  - (b) Will examine all issues raised by the Board within its terms of reference.
  - (c) Will consider all advice received from the Board.
- 2.3 HM Treasury, the Scottish Ministers, the Department of Finance and Personnel, Northern Ireland, and the Finance Division of the National Assembly for Wales will formally lay the Board's report before the House of Commons, the Scottish Parliament, the Northern Ireland Assembly, and the National Assembly for Wales respectively.
- 2.4 HM Treasury will provide the secretariat to the Board.

### 3 Membership

#### 3.1 The Board will comprise:

An independent Chairman, nominated by the Chief Accountancy Adviser to the Treasury, and in respect of future appointments, in agreement with the Scottish Ministers and the Department of Finance and Personnel, Northern Ireland.

1 member nominated by the Treasury (a Treasury Official)

1 member nominated by the Scottish Ministers

1 member nominated by the Department of Finance and Personnel, Northern Ireland

1 member nominated by the Comptroller and Auditor General

1 member nominated by the Auditor General for Scotland

1 member nominated by the Audit Commission

3 members nominated by the Finance Directors of UK government departments to represent respectively departments, trading funds, and non-departmental public bodies.

1 member nominated by the Department of Health

1 member nominated by the Executive Chair of Monitor, the Independent Regulator of NHS Foundation Trusts

1 member nominated by the National Statistician

1 member nominated by the Accounting Standards Board

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

1 independent member nominated by the Chief Accountancy Advisor to the Treasury and approved by the Chairman.

3.2 Members will normally be appointed for five year, renewable, terms.

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

# Annex 2

## MEMBERSHIP OF THE BOARD

- 1.1 The membership of the Board reflects the relevant spread of interests, as well as ensuring its independence and accounting expertise. The Board members during this reporting period were:

**Chairman:**

Elwyn Eilledge, CBE. Former positions include Director of BG Group plc, Chairman of BTR plc, Senior Partner of Ernst and Young and Member of the Accounting Standards Board and Financial Reporting Council.

**Members:**

John Aldridge. Finance Director, Scottish Executive (until May 2005).

Mike Ashley. Partner, KPMG, Member of the Accounting Standards Board and Member of the European Financial Reporting Advisory Group Technical Expert Group.

Miranda Carter. Assessment Director, Monitor (from June 2005)

Beverley Evans. Assessment Director, Monitor (until May 2005).

Martin Evans. Managing Director, Audit, Audit Commission.

Heather Foster. Finance Director, HM Land Registry (until July 2005).

Russell Frith. Director of Audit Strategy, Audit Scotland.

Professor David Heald. Professor of Financial Management, The University of Sheffield Management School.

Robin Lynch. Director of National Accounts Group, Office for National Statistics.

Alastair Matthews. Finance Director, Ordnance Survey (from August 2005).

Nigel Reader, CBE. Director of Finance, Environment Agency.

Michael Romberg. Senior Specialist, Budgeting and Statistics, HM Treasury.

Martin Sinclair. Assistant Auditor General, National Audit Office.

Alyson Stafford. Finance Director, Scottish Executive (from June 2005)

David Thomson. Treasury Officer of Accounts, Northern Ireland (Department of Finance and Personnel).

Jeff Tomlinson. Head of Accounting, Department of Health, England.

Ken Wild. Partner, Deloitte & Touche LLP, and Member of the International Financial Reporting Interpretations Committee and former Member of the Accounting Standards Board.

Trevor Woolley. Finance Director, Ministry of Defence.

***Parliamentary observer:***

Ross Cranston, QC, MP (until May 2005).

***CIPFA/LASAAC Joint Committee Observer:***

Maureen Wellen (from November 2005)

***Alternates:***

During the reporting period, the following have served as alternates to Members:

Kirstin Baker for Michael Romberg

Gillian Fawcett for a Parliamentary Observer

Graham Jenkinson for Robin Lynch

Andrea Keenoy for a Parliamentary Observer

Peter Morgan for Martin Sinclair

Anne Rylatt for Jeff Tomlinson

John Thornton for Trevor Woolley

Kerry Twyman for John Aldridge and Alyson Stafford

Steve Warren for Martin Evans

John Williams for Alyson Stafford

***Secretariat:******Secretary:***

David Watkins

***Secretariat support:***

Christine Ruston

Sarah Solomon

- 1.2 Ian Mackintosh, Chairman of the Accounting Standards Board, attended the Board's February 2006 meeting.
- 1.3 Mike Hathorn, Deputy Chair of the International Public Sector Accounting Standards Board, gave an update to the Board on Non-exchange revenues at the February meeting.
- 1.4 Andrew Lennard, Chairman of the Accounting Standards Board's Committee on Accounting for Public-benefit Entities, gave a presentation on Heritage Assets at the Board's March meeting.

# Annex 3

## ABOUT THE BOARD

### 1 Independence of the Board

- 1.1 The Board was established by the Treasury to provide independent advice on financial reporting principles and standards. The Treasury hosts the Board's meetings, provides a small Secretariat and bears the minimal costs of the Board. Such arrangements do not compromise the Board's independence and, indeed, are common to nearly all such groups and to advisory non-departmental public bodies across Government.
- 1.2 As an independent body (recognised as such by the Office for National Statistics), the Board has been added to the list of bodies in Schedule 1 of the Freedom of Information Act 2000<sup>1</sup>.

### 2 Publication Scheme

- 2.1 Under its Publication Scheme, which has been agreed by the Information Commissioner under the terms of the Act, the Board publishes its reports and makes them available on a website together with its terms of reference, membership details, publication scheme and its press notices.
- 2.2 More recently, the Board has extended its Publication Scheme to include Board minutes and associated papers. These are posted on the website once the Board has approved the minutes of the meeting.

### 3 Evolution of the Board's coverage

- 3.1 The table below shows how the Board's remit has extended in the years following its establishment.

<b>AREA</b>	<b>YEAR REMIT EXTENDED</b>
Established	1996
NDPBs and Trading Funds	1999-2000
Scottish Executive	2001-02
Northern Ireland Executive	2001-02
NHS Trusts in England	2001-02
NHS Trusts in Wales	2003-04
NHS Trusts in Northern Ireland	2003-04
NHS Foundation Trusts	2004-05

<sup>1</sup> The Freedom of Information Act 2000 is available from the Stationery Office or can be located on the web at: [www.opsi.gov.uk/legislation](http://www.opsi.gov.uk/legislation).



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