



House of Commons
Treasury Committee

The 2008 Budget

Ninth Report of Session 2007–08

Report, together with formal minutes, oral and written evidence

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implementation of the principles-based approach is being deferred to 2009 is welcome and allows more time for the issues to be debated and any changes to be aligned with the introduction of legislation on the taxation of foreign profits.

Overall, the concern is that these proposals will have an adverse effect on the competitiveness of doing business in the UK. In this regard, the commitment “. . . to maintain the most competitive corporation tax rate of any major economy . . .” is welcome but the commitment needs to be in terms of the whole business tax system, not just the rate of corporation tax.

HMRC POWERS

As noted above, the proposals on HMRC powers are the result of a good consultative process. The latest round of consultations, relating to the measures in BNs96-98, has only just closed and so it remains to be seen whether and how the various areas of concern that respondents raised have been answered. The concerns include areas such as HMRC’s access to premises; ability to assess and take away records; debt offset powers; and the operation of penalties for late notification.

The development of proper, modernised powers is, of course, very necessary to enable HMRC to police effectively the tax system. But this process also highlights the need for proper safeguards for the taxpayer. To that end, the commitment by the Government to start discussions on a Taxpayer’s Charter/Bill of Rights is especially welcome and it is to be hoped that this can be brought to fruition in parallel with the general powers review.

TAX AND THE ENVIRONMENT

The various changes under this heading are all valid, but what business (and, one suspects, individuals) would welcome is a clear framework that will be used to develop the UK’s “green” tax agenda. In simple terms, will the tax system be used to raise money or change behaviour? If the latter, will there be a solid and consistent system to allow businesses to plan, long-term, accordingly?

OTHER MATTERS: COMMUNICATION

There are a number of other matters that deserve to be noted. These include welcome measures such as:

- The transitional Gift Aid rules.
- The tax credit on overseas dividends.

As a final point, it has to be noted that many of the changes to income tax and NICs that are about to affect taxpayers were announced a year ago. Some aspects, especially relating to the 10% tax band and the savings rate, remain a source of considerable confusion. It does demonstrate the need for an effective communication strategy over tax changes, so as to ensure as far as possible that taxpayers understand what is happening and that the risk of surprises in the pay packet are minimised.

March 2008

Memorandum by Professor David Heald,² specialist adviser to the Committee

THE IMPLICATIONS OF THE DELAYED SWITCH TO IFRS

INTRODUCTION

1. The Budget Report (Treasury 2008, para C.103) made the following announcement under the heading “Public Sector Financial Reporting”:

As announced in Budget 2007, in order to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice, the annual financial statements of government departments and other public sector bodies will in future be prepared using International Financial Reporting Standards (IFRS) adapted as necessary for the public sector. Following consultation with departments and the Financial Reporting Advisory Board on the technical work needed to implement this change, the Government now intends to move to IFRS from 2009–10 to minimise burdens and to ensure a smooth transition. Whole of

² Declaration of interest: the author is a member of the Financial Reporting Advisory Board, nominated as an independent economist by the Head of the Government Economic Service.

Government Accounts (WGA) will now be published for the first time for 2009–10 to allow time to complete the alignment of local government and central government accounting policies and to enable WGA to be published on an IFRS basis.

2. The oral evidence given to the Committee on 4 March 2008 on behalf of the Financial Reporting Advisory Board (FRAB) demonstrated that this rescheduling from 2008–09 to 2009–10 was the only practical decision that could be made (Treasury Committee 2008). Two key departments (Defence and Health) had indicated that they could not meet this timetable, albeit for somewhat different reasons.³

3. Although this rescheduling is widely recognised as having been inevitable, it raises a number of important issues:

- Unsatisfactory accounting for Private Finance Initiative (PFI) assets.
- Delays to the publication of Whole of Government Accounts (WGA).
- The International Financial Reporting Standards (IFRS) implementation timetable.
- The relationship between IFRS accounts and the national accounts on which the fiscal rules are calibrated.

These issues are briefly considered in this memorandum.

UNSATISFACTORY ACCOUNTING FOR PFI ASSETS

4. The FRAB witnesses explained on 4 March that the Board's recommendation to the Treasury on PFI accounting is that the public sector client should account for concession assets according to IFRIC 12, an Interpretation issued by the International Accounting Standards Board (IASB). However, IFRIC 12 is directed to the private sector operator, not to the public sector client. Applying what has become known as the "mirror-image treatment" led FRAB to the view that IFRIC 12 can be applied in government and that the likely effect is that most PFI concession assets would be recorded on the balance sheet of the public sector entity. The International Public Sector Standards Board (IPSASB) is developing its own standard for concession accounting by public sector entities, and it seems likely that a forthcoming statement will reach a broadly similar conclusion to that of the Treasury and FRAB. There are unresolved issues about the authority attached to IPSASB standards, and this may become an issue in future.

5. The late decision-making with regard to how PFI assets would be accounted for under IFRS as modified for UK public sector entities contributed to the Ministry of Defence and the Department of Health indicating that they could not implement in 2008–09. However, it would be wrong to conclude that the underlying issue is moving from UK GAAP (as modified in the Financial Reporting Manual (FRM)) to IFRS (as modified in the IFRS-based FRM known as I-FRM). The underlying issue is the pre-existing unsatisfactory accounting for PFI assets, an issue that FRAB has raised with the Treasury in successive annual reports since its establishment in 1996. If PFI accounting had been done properly under FRS 5A (ASB 1998; Heald 2003), it is unlikely that the switch to IFRS would have seen large changes to public sector balance sheets. Under such circumstances, the numerical effects of the switch from FRS 5A (where the criterion is "risks and rewards") to IFRIC 12 (where the criterion is "control") are likely to have been manageable.⁴

6. Table 1 has been calculated from the October 2007 PFI data published on the Treasury website. Overall, this shows 43% on the public sector balance sheet and 57% off.⁵ What is most striking is the variation in the On/Off proportions between departments. These differences are heavily driven by the identity of the auditor (the National Audit Office has been stricter about FRS 5A balance sheet treatment than the appointed auditors of the Audit Commission)⁶ and the control framework (local authorities and NHS bodies have known that on-balance sheet PFI would not normally be approved). This situation persisted because it suited the Government's policy of promoting the PFI as a procurement route. This inconsistency was facilitated by the scope for arbitrage⁷ between FRS 5A (published by the Accounting Standards Board) and Treasury Technical Note 1 (Revised) (published by the Treasury as an interpretation but which effectively became treated as a competitor standard) (Treasury Taskforce 1999).

³ The difficulties facing both departments relate primarily to accounting for Private Finance Initiative assets. In the case of Defence, the main issue is the sheer number of PFI contracts and assets that would have to be reviewed. In the case of Health, the main issue is that funding allocations for 2008–09 have already been issued; changes to PFI accounting in 2008–09 would therefore lead to many NHS bodies breaching their statutory financial obligations.

⁴ Although one would expect that bearing the majority of risks and rewards would normally align with control, it is possible to think of specialised cases where this might not be the case. For example, a PFI-financed toll road *might be* controlled by the public sector client (IFRIC 12 criterion) whereas the majority of risks and rewards *might have been* passed to the private sector (FRS 5A criterion).

⁵ An earlier version of this table was supplied by the Treasury to the Treasury Committee (2007, page 25).

⁶ Paradoxically, the Treasury Technical Note 1 (Revised) related to central government (but where the National Audit Office has insisted on FRS 5A) but not to local government and the NHS (but where it was used to validate off-balance sheet treatment).

⁷ In the sense of choosing the competitor "standard" that gives the desired result.

Table 1**BALANCE SHEET TREATMENT OF SIGNED PFI DEALS (OCTOBER 2007)**

	<i>Is capital value scored on or off the Departmental Balance Sheet (on/off)?</i>					
	<i>No. of schemes</i>		<i>Total capital value (£millions)</i>		<i>Percentage of capital value</i>	
	<i>On</i>	<i>Off</i>	<i>On</i>	<i>Off</i>	<i>On</i>	<i>Off</i>
Cabinet Office	1	1	£330	£18	95%	5%
Crown Prosecution Service	1	0	£0	£22	0%	100%
Department for Business, Enterprise and Regulatory Reform	1	2	£22	£41	35%	65%
Department for Children, Schools and Families	1	114	£21	£4,762	0%	100%
Department for Communities and Local Government	0	48	£0	£1,333	0%	100%
Department for Culture, Media and Sport	0	14	£0	£236	0%	100%
Department for Environment, Food and Rural Affairs	0	17	£0	£1,508	0%	100%
Department for Transport	21	30	£19,938	£2,771	88%	12%
Department for Work and Pensions	0	1	£0	£990	0%	100%
Foreign and Commonwealth Office	1	1	£17	£74	19%	81%
Health	5	88	£243	£9,769	2%	98%
Home Office	0	26	£0	£849	0%	100%
Inland Revenue	1	7	£182	£658	22%	78%
Ministry of Defence	12	39	£2,267	£3,495	39%	61%
Ministry of Justice	26	2	£725	£51	93%	7%
Northern Ireland Executive	7	26	£327	£737	31%	69%
Scottish Government	3	98	£32	£4,647	1%	99%
Welsh Assembly Government	1	23	£7	£515	1%	99%
TOTALS	81	537	£24,110	£32,475	43%	57%

Source: http://www.hm-treasury.gov.uk/media/B/E/pfi_signeddeals_231007.xls (last accessed 22 February 2008); calculation by author.

Note: no balance sheet information was available for two Scottish Government schemes, so they have been excluded from these figures.

7. In early 2007 FRAB appeared to have brokered an agreement on PFI accounting under the existing modified UK GAAP basis. This would have involved the withdrawal by the Treasury of Technical Note 1 (Revised) and sole reliance on FRS 5A, with effect from 2008–09 because it was judged to be too late to implement for 2007–08. Before a formal recommendation was made to the Treasury by FRAB, the 2007 Budget Report (Treasury 2007a, bold emphasis in original) announced the switch to IFRS from 2008–09:

6.59. . . . In order to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice, this Budget announces that from the first year of the CSR period these accounts will be prepared using International Financial Reporting Standards (IFRS) adapted as necessary for the public sector.

6.60. This Budget also announces the Government’s intention that Whole of Government Accounts will now be published for the first time for the 2008–09 financial year. This revised timetable is to allow time to complete the alignment of local and central government accounting policies and to enable WGA to be prepared on the new IFRS basis.

8. The subsequent FRAB meeting on 19 March 2007 welcomed the announcement of the switch to IFRS, in anticipation of which much work had been done on the draft I-FReM. However, the Minutes (FRAB, 2007, paras 10–12) record discussion of the implications for PFI accounting. One practical consequence was that neither FRS 5A nor the Treasury Technical Note 1 (Revised) would apply beyond 2007–08 because these both relate to UK GAAP; therefore the latter was not withdrawn. One year later the chosen basis for PFI accounting under IFRS appears to have been settled as IFRIC 12, but implementation will now not be until 2009–10.

THE IFRS IMPLEMENTATION TIMETABLE

9. Given the five-year timetable available to the private sector for IFRS conversion, together with the linkage in the public sector between accounting and the budgetary funding of organisations such as NHS bodies, the one-year timetable announced in Budget 2007 was over-ambitious. Even though departments and other bodies have known for a long time that conversion to IFRS was coming, the revised official timetable only gives two years from the official announcement.

10. It is therefore imperative that all departments and other bodies produce shadow 2008–09 IFRS resource accounts, with the exception of those granted an explicit exemption by the Treasury. These shadow accounts should be thoroughly reviewed by the National Audit Office, if not formally audited. In the run-up to the conversion from cash to resource in 2001–02, the Treasury operated a trigger-point strategy, with clear milestones, and regularly report progress to Parliament. The same approach is now required for the IFRS conversion in 2009–10, otherwise there is a severe risk of further delays.

11. If there had been a trigger-point strategy put in place immediately after the March 2007 announcement of IFRS conversion for 2008–09, it would have quickly become apparent that the timetable was at risk. Because of the need for comparative figures for the prior year, entities reporting for the first time under IFRS for 2008–09 must be able to restate their 1 April 2007 balance sheets on an IFRS basis. Moreover, the links between accounting and budgeting, particularly in the case of the NHS, meant that the accounting regime had to be finalised—at the latest—before funding allocations for 2008–09 were issued by the Department of Health in late Autumn 2007.

DELAYS TO THE PUBLICATION OF WHOLE OF GOVERNMENT ACCOUNTS

12. The Treasury committed itself to the production of Whole of Government Accounts (WGA) in the 1998 Scoping Study (Treasury 1998b; Chow et al 2007). An already delayed timetable slipped again at Budget 2007 (the switch to IFRS for 2008–09) and another year at Budget 2008 (the rescheduling of IFRS to 2009–10). The original timetable was that a fully audited 2005–06 WGA would be published in 2006, having been preceded by published dry run Whole of Central Government Accounts (WCGA), possibly as early as 2002. The Government has subsequently decided against publication of WCGA, apparently on the basis that these would not be “useful”.⁸

13. It is difficult to be sure about the reasons for these delays, which contrast markedly with the Treasury’s success in holding to the original schedule for Resource Accounts to replace cash-based Appropriation Accounts in 2001–02. Contributory factors may include:

- (a) There might have been a loss of belief at high levels in the Treasury as to the potential benefits.
- (b) The numbers emerging from the WGA project may not have been welcome, in particular those relating to the WCGA, publication of which is no longer planned.

⁸ The present author does not accept this view, but this matter does not receive consideration here.

- (c) There may have been a lack of staffing resources and skills in the Treasury and in departments and other entities within the area of the WGA consolidation.
- (d) The WGA may have lacked political and bureaucratic clout within the Treasury, with the result that Treasury enforcement powers over departments have not been used.
- (e) The credibility of the WGA project with departments may have been sapped by delays, with the result that insufficient priority has been given to the consolidation returns.

Complex consolidations are a central feature of the accounting process in listed companies. The WGA consolidation is certainly a formidable exercise, but genuinely technical problems seem unlikely to explain the actual delays.

14. These circumstances mean that it is imperative that Parliament does not allow the commitment to slip out of sight. Such matters may seem boringly technical, but the production of audited WGA is of major political importance:

- (a) The sustainability of UK public finances is an important matter of public debate and the Government's decision not to publish the dry-run WCGA and WGA deprives that debate of relevant information held by Government but not by Parliament and the public, for example, in debates about the possible reformulation of the fiscal rules and about the affordability of current policies.
- (b) One of the five principles of fiscal management in *The Code for Fiscal Stability* (Treasury 1998a) is "fiscal transparency". The Treasury's WGA website claims transparency benefits: "producing Whole of Government Accounts (WGA) . . . will assist in ensuring that best practice accounting methods are used to construct accounts *covering the public sector as a whole, and that fiscal reporting is as transparent as possible*" (<http://www.wga.gov.uk/pages/introduction.html>, last accessed 19 March 2008, italics added)
- (c) *The Governance of Britain* White Paper (Secretary of State for Justice and Lord Chancellor 2007) contains a section on "Transparency of government expenditure", though the content is narrowly focused on the objective of "a clearer line of sight". In terms of making the Executive more accountable to Parliament—a central theme of this White Paper—published WGA can make an important contribution towards reviving Parliamentary fiscal scrutiny.

15. The final sentence of the Budget 2008 announcement (see the quotation in para 1 above) connects the 2009–10 timetable for the IFRS-based WGA to the alignment of local government and central government accounting policies. However, the local government timetable for conversion to IFRS is for implementation in 2010–11 (<http://www.cipfa.org.uk/pt/consultations.cfm#future>, last accessed 19 March 2008), not in 2009–10.⁹ This means that considerable adjustments will have to be made to the local government figures in the 2009–10 WGA consolidation process.

16. At the rhetorical level there is Government commitment to WGA as an additional tool of fiscal analysis. However, implementation is a different matter. The WGA programme is now four years behind the schedule of publishing an audited WGA for 2005–06, with the timetable now being for 2009–10. Consistent pressure upon the Treasury, particularly at each Pre-Budget and Budget, is an essential role for the Treasury Committee to play. The WGA might well bring unwelcome news about UK public finances, and so there may be an incentive for ministers and officials to delay publication. However, there might be circumstances in which the Treasury wished to emphasise past failings; one is reminded of *Fiscal Policy: Lessons from the Last Economic Cycle* published as part of the 1997 Pre-Budget documentation (Treasury 1997).

IFRS ACCOUNTS AND NATIONAL ACCOUNTS

17. The turmoil about PFI accounting has focused attention on two issues regarding the authority and legitimacy of accounting regulation:

- (a) The regulation of financial reporting is moving to a global level, as evidenced by the spread of IFRS in the private sector. However it should be noted that what UK listed companies follow is not "pure" IFRS as promulgated by the IASB but EU-adopted IFRS.
- (b) The approach of the Treasury has been to align government accounting directly with EU-adopted IFRS, albeit with some modifications to suit the circumstances of the public sector, in the same way as it did with UK GAAP from 2001–02. Over the intervening period the influence of IPSASB, a body under the umbrella of the International Federation of Accountants (IFAC), has greatly increased. It is possible to envisage circumstances where there may be disagreement between direct adaptation from IFRS and adaptation mediated by IPSASB.

⁹ In January 2008, the CIPFA/LASAAC Local Authority SORP Board published a consultation on whether to recommend to ministers that governance of the Local Authority Accounting Standard of Recommended Practice (SORP) should move from the aegis of the Accounting Standards Board to that of FRAB (CIPFA 2008).

18. Whereas the above are medium-term issues, there is an immediate issue regarding the relationship between financial reporting regulation and the national accounts, currently prepared under the European System of Accounts 1995 (ESA 95). This issue is of profound significance because the Government's fiscal policy objectives and fiscal rules are formulated on a national accounts basis. Moreover, the United Kingdom's conformity with its international obligations (eg Maastricht Treaty) is assessed on a national accounts basis. This means that the tensions between regulatory systems have to be managed because their sources cannot be eliminated.

19. Two difficulties arise. First, different conceptual frameworks govern the work of the accountants who produce the accounting standards that regulate the preparation of IFRS-based financial reports and of the statisticians who produce the ESA methodology that regulates the preparation of national accounts. Second, the periodicity of revision is completely different: IFRS evolves rapidly, often in a piecemeal fashion in response to new issues, whereas ESA is subject to revision at long intervals, lagging the revision of the System of National Accounts (SNA). This means that alignment issues are inevitable, and will have to be dealt with by accounting adjustments. Readers of the annual *Public Expenditure: Statistical Analyses* are familiar with such adjustments but their existence and, in some cases, changing character, complicate exposition to non-specialists.¹⁰

20. Given these circumstances and the fact that, for practical and resource reasons, the Office for National Statistics (ONS) is heavily reliant on the judgements made by accountants, there are important issues to address. First, complexity creates opportunities for avoiding substantive fiscal transparency. However, the ONS has worked to establish the economy-wide position about PFI, as neither On-On treatment nor Off-Off treatment is acceptable in the national accounts.¹¹ The ONS work on PFI liabilities (Chesson and Maitland-Smith 2006) contributed to the pressures for the regularisation of the financial reporting treatment. Second, there is the danger of arbitrage between financial reporting treatments and national accounts treatments. In the context of PFI accounting, the question has been raised as to whether the "risks and rewards" approach embedded in ESA and in the *ESA 95 Manual on Government Deficit and Debt* (Eurostat 2002) would require public sector reporting entities to make an assessment of their PFI schemes for national accounts purposes in addition to that made for IFRS. The ONS does not have the resources to review all PFI schemes so that, if "risks and rewards" were thought likely to lead to different On/Off decisions to "control", then the approach might have to be one of dual reporting by entities and/or sampling by ONS.¹²

21. Just as in the case of developments with IPSASB in terms of financial reporting, developments in national accounts regulation are likely to be of major significance. Many other countries have PFI schemes and may wish to keep them off-balance sheet and out of deficit and debt figures. There will be a new System of National Accounts 2008, to be followed after a lag by a new ESA. An important issue will be how the IFRS-based WGA relates to national accounts measures of government size, deficit and debt.

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¹⁰ Treasury (2007b, pages 191–201) provides an exposition of the accounting adjustments between budgeting aggregates (Departmental Expenditure Limits and Annually Managed Expenditure) measured on a resource basis (ie modified UK GAAP) and the national accounts aggregate Total Managed Expenditure.

¹¹ In financial reporting, it is possible that the accountants and auditors of the two sides of a PFI will make independent judgements that lead to On/On or Off/Off. However, this should only happen in genuinely marginal cases whereas analysis of the UK experience has shown that Off/Off treatment is currently extensive.

¹² Although UK GAAP and ESA 95 both use the risks and rewards criterion, the national accounts measures have been distorted by the way in which financial reporting treatment of PFI has been distorted. This point should be remembered when considering the possible divergence between the IFRIC 12 control criterion and ESA 95's risk and rewards criterion.

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19 March 2008

Memorandum from Professor Colin Talbot

BUDGET 08—EFFICIENCY AND PERFORMANCE ISSUES

This memo covers four areas:

- Efficiency in Government—Impact of Gershon
- Efficiency in Government—CSR07 and Budget 08
- Performance in Government—CSR07 and Budget 08
- Public Value Programme—Budget 08

EFFICIENCY IN GOVERNMENT—IMPACT OF GERSHON

The government continues to make claims about achievement of the Gershon efficiency targets set out in SR2004 and the Gershon Report which are not substantiated by independent verification. Given the doubts the NAO has expressed previously and the fact that some of the issues they have identified are probably irresolvable (due to absence of historical data and baselines) there will continue to be substantial doubt as to whether “Gershon” really met the targets.

I continue to have further doubts. Firstly, it is difficult to reconcile the outcomes of the ONS’s work on productivity of the health service with the reported efficiency gains from the “more productive working” stream of the Gershon programme. ONS reports a fall in NHS productivity whether measured purely quantitatively or even if quality improvements are included.

One possible, generous, explanation for this is that whilst ONS is trying to measure the productivity of the whole system, the Gershon reported savings are based on a “project” basis. It is quite possible for “local” efficiency to improve within a particular “project” or area whilst overall efficiency or productivity of the system is declining. The worst-case is that local savings actually produce systemic reductions in productivity/efficiency. A private sector example might be where purchase of an inferior part produces local savings but causes consequential production or quality failures which cost more than the local saving.

The irony of this situation is that, as I have pointed out several times, the Gershon programme probably has produced substantial savings and these are probably bigger than any similar programme in the past 20–30 years but the combination of questionable reporting and over-ambition has undermined the public credibility of the effort.

There is now evidence to support this assertion. A recent IPSOS-Mori survey (March 2008) asked the following question:

“Do you think a Labour or Conservative Government would be most effective in getting good value for the public money it spends?”

In 2005 (shortly after Gershon started) the responses to the same question were:

Labour 41% Conservative 30% Other 4% None 13% Don’t Know 12%

By 2008 these figures had changed to:

Labour 27% Conservative 29% Other 3% None 22% Don’t Know 19%