REPORT OF THE COMPTROLLER AND AUDITOR GENERAL ON THE 2014-15 ACCOUNTS OF THE MINISTRY OF DEFENCE

Introduction

1. The Ministry of Defence's (the Department) principal activity is to provide security for the people of the United Kingdom and the Overseas Territories by defending them, including against terrorism, and to act as a force for good by strengthening international peace and stability. In 2014-15 the Departmental Group incurred £ 36.8 billion of net operating costs and held assets of £ 133.7 billion and gross liabilities of £ 22.4 billion.

2. The Department is required to prepare its financial statements in accordance with the Government Financial Reporting Manual (FReM) issued by HM Treasury. Under the FReM, the Department is required to apply International Financial Reporting Standards (IFRS) as adapted or interpreted for the public sector.

The purpose of my report

3. This report explains the basis for the qualification of my audit opinion on the Department's 2014-15 financial statements.

Accounting for lease type arrangements

Basis of my qualification

4. I have qualified my opinion for a sixth year because the Department is likely to have omitted a material value of leased assets and associated liabilities from its Statement of Financial Position. I cannot quantify the impact of these omissions on the accounts with certainty because, as a result of its accounting policies, the Department has not maintained the records, or obtained the information required to do so.

Accounting requirements

5. The FReM requires those preparing accounts to establish whether contracts contain lease-type arrangements and whether those are, in substance, either a finance or operating lease and account for these leases under International Accounting Standard (IAS) 17, *Leases*. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. An operating lease is any other type of lease. The classification made by those preparing accounts could have a significant impact on the financial statements.

6. If the contract is classified as a finance lease then the value of assets used to deliver the service would be recognised in the Statement of Financial Position at the lower of fair value and the present value of the minimum lease payments due under the contract. A corresponding liability of the same value would also be recognised. If it is classified as an operating lease, no assets would be recognised and the payments made under the lease would be reflected in the Statement of Comprehensive Net Expenditure as spend is incurred.

7. I regard the accounting requirements for lease type arrangements as particularly relevant to the Department. The Department must enter into strategic arrangements with certain contractors to procure specialist defence platforms on a non-competitive basis. These arrangements may provide for the exclusive, or near exclusive, use of industrial assets and capability that have only limited use for other customers. Consequently, the contractual terms, which are covered by the government profit formula and its associated arrangements (GPFAA),[1] may result in the Department controlling a significant majority of the outputs of a supplier's assets. An example is where shipyards are used exclusively on defence contracts and the pricing of the contract recognises this by allowing the contractor to recover fixed costs other than through market rate or unit cost pricing. These arrangements may be considered to contain the characteristics of a finance lease as defined by IAS 17, Leases.

Action by the Department

8. The Department assessed a number of contracts when IAS 17, Leases, was first adopted by the FReM in 2009-10. Based on the results, the Department believed that there may be a number of contracts that it would need to account for and disclose as leases. This review has continued and, to date, the Department has identified 25 contracts that demonstrate characteristics of a lease under IAS 17, Leases. Eight of these contracts were then assessed as being finance leases. If recognised, these would lead to assets with an estimated initial net book value (for seven of the eight contracts) of some £860 million being recognised in the Department's Statement of Financial Position. The exercise also identified a number of sites where multiple MoD platforms or contracts were being supplied. The Department's analysis confirms the material impact of not recognising leases although the quality of evidence is still insufficient for the purposes of my opinion.

[1]The GPFAA, also commonly referred to as the Yellow Book, is agreed by government and industry, as represented by the CBI, and is reviewed periodically by an independent review board.

9. In 2013-14, the Department concluded that it needed further management information and supplier engagement to complete its review and conclude on whether its current contracts meet the criteria of a lease under IAS 17, Leases. As disclosed in its Annual Report and Accounts, the Department has, in agreement with HM Treasury, decided not to obtain more detailed information on the grounds that doing so would not represent value for money. In 2014-15, the Department confirmed that it is possible to account for existing contracts in compliance with IAS 17, but this would create significant challenges for the Department. It would need to change its business systems and processes as well as wider interaction with its supplier base to obtain the necessary asset and liability information. Consequently, no conclusion can be drawn as to whether the existing contracts held represent leases and the financial impact of the omission of potential assets and liabilities cannot be determined with sufficient accuracy. This decision will have an ongoing impact on the audit opinion I am able to provide on the financial statements for the foreseeable future.

10. The Department is considering further work on applying IAS 17, Leases, to new contracts although it has not yet taken a formal decision on this matter. The International Accounting Standards Board (IASB) is responsible for setting IFRS, of which IAS 17, *Leases*, is a part. The IASB is currently undertaking a project to revise leasing accounting standards and it is expected that a new standard will be issued in late 2015. It is likely that this will see the accounting treatment of finance and operating leases aligned, so that all leases are recognised in the Statement of Financial Position and not just finance leases. This new standard may be adopted by the Financial Reporting Advisory Board (FRAB) which has responsibility for the FReM. If this standard is adopted then, in the future, the Department will have to adhere to these new requirements. The Department should therefore consider these developments in determining the further work required in respect of lease accounting.

Qualifications arising in 2014-15 relating to prior year comparative figures

11. In 2013-14 I qualified my opinion in respect of the inventory impairments of £860 million charged to the Statement of Comprehensive Net Expenditure. This was because I was unable to obtain the necessary evidence to support the point at which impairments had occurred and the validity of the charge made to the 2013-14 Statement of Comprehensive Net Expenditure. My opinion on the financial statements is also qualified in respect of the corresponding figures for the impairment charge in the 2013-14 Statement of

Comprehensive Net Expenditure comparative figures. This qualification has no impact on the opinion given in respect of the charges made to the 2014-15 Statement of Comprehensive Net Expenditure.

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