Delivering the benefits of accruals accounting for the whole public sector

December 2005

HM TREASURY

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1 OVERVIEW

1.1 The Code for Fiscal Stability[1] sets out the basis for the Government's fiscal framework. In the Code, the Government committed to ensuring that best practice accounting methods are used to construct the public accounts, and to introducing a Resource Accounting and Budgeting approach to the resources consumed by Government. The Government's aims in making this commitment were to provide improved data for fiscal planning, to increase transparency and to improve accountability to Parliament. The Whole of Government Accounts (WGA) programme is a central part of meeting this commitment.

Purpose of this report

1.2 A 1998 scoping study[2] concluded that it would be possible, beneficial and cost-effective to produce audited WGA as consolidated accounts based on Generally Accepted Accounting Practice (GAAP). This report describes how the WGA programme is completing the introduction of accruals accounting across all public sector bodies. It also explains how this programme supports delivery of the Government's priorities for improving financial management across the public sector and managing the public finances within the fiscal framework.

Structure of this report

1.3 Chapter 2 looks at the composition of the public sector and the way in which 'based on GAAP' accruals accounting has been implemented in the various types of bodies it includes. Chapter 3 then considers the Government's objectives in introducing an accruals-based budgeting framework and how these objectives have been realised. Chapter 4 reviews how these improvements have been reflected in higher quality and more timely financial reporting in key areas of the public sector and how this has contributed to improved financial management.

1.4 Chapter 5 considers how WGA data are being used in support of the Office for National Statistics' (ONS) ongoing work to improve the quality of the national accounts, the economic statistics which are used to control delivery of the fiscal rules. It also explains where differences in the underlying frameworks cause timing differences in the recognition of costs in the two sets of accounts. Chapter 6 then summarises how the WGA programme builds on the developments in public sector accounting and outlines the benefits that are already being realised. It also outlines the Government's strategy for publication of GAAP-based information in future years.

1.5 Chapter 7 provides a summary of the key challenges for the WGA programme going forward.

[1] *Code for Fiscal Stability*, HM Treasury, 1998.

[2] *Whole of Government Accounts* (scoping study), HM Treasury, 1998.

2 ACCRUALS ACCOUNTING IN PUBLIC SECTOR BODIES

2.1 This chapter describes the main types of bodies that make up the UK public sector. It then provides some background on accruals accounting, and how this has been gradually implemented across the various areas of the public sector. Finally, it discusses challenges posed by plans to converge UK accounting guidance with international accounting standards over the next few years.

COMPOSITION OF THE PUBLIC SECTOR

2.2 Government in its broadest sense encompasses the whole of the public sector. The bodies within government are very diverse, ranging from multi-billion pound departments to parish councils with budgets of only a few hundred pounds, and from bodies that are fully funded to those that operate effectively on a commercial basis.

2.3 There is a range of ways of organising and differentiating between the individual bodies in this spectrum. One of the most established methods is that used in national accounts. This splits the overall public sector into three sectors – central government, local government (which together are general government) and public corporations. Examples of the bodies in each sector are given in table 2.1 below:

Table 2.1: Types of public sector body by sub-sector

Central government	Local government	Public corporations
Ministerial and non-ministerial departments (45) Executive agencies – consolidated into parent department's resource accounts Non-departmental public bodies (including some NHS bodies) (157) NHS Trusts (297) NHS Foundation Trusts (25) Devolved administrations (3, made up of 142 bodies) Central funds and accounts (31) Pension schemes (14)	County councils (34) London boroughs, metropolitan and unitary authorities (171) District councils (264) Police authorities (47) Fire authorities (39) Greater London Assembly & functional bodies (5) National parks & other authorities (27)	Commercial enterprises controlled by government including most trading funds (70, including 5 Scottish and 3 Northern Ireland public corporations)

Figures exclude certain smaller bodies such as parish councils and minor public corporations

2.4 Central government bodies fall into four main categories in terms of legal status and governance arrangements:

- Departments: Although operationally independent, departments are all legally part of the Crown. They are funded through Parliamentary vote and are responsible to Ministers for the development and delivery of policy within a defined area. There is a huge range in size, with expenditure varying from £109 billion (in 2003-04) for the Department for Work and Pensions to £3.5 million for the Privy Council Office.

- Executive agencies: These operate under powers that are delegated from Ministers and their parent departments, and have a chief executive who reports to the Minister against specific targets. Most agencies receive their funding from their parent department (such as the Benefits Agency within the Department for Work and Pensions), are also part of the Crown, and do not usually have their own legal identity.

- Non-departmental public bodies (NDPBs): These have a role in the processes of national government, but are not legally part of a government department. They are responsible for a range of services (such as the British Museum or the Housing Corporation). They are principally funded through grants from departments, have their own boards, and are accountable to Parliament and, to varying degrees, individual Ministers.

- NHS Trusts and Foundation Trusts: These are legally separate bodies that contract with other parts of the NHS to provide particular types of health care services in a particular area.

2.5 'Central government' also includes the Scottish Executive, Northern Ireland Executive and the National Assembly for Wales. Although their precise legal structures differ, the three devolved administrations consist of bodies that are very similar to those in the rest of central government – departments, executive agencies, NDPBs and NHS bodies.

2.6 All the types of local government body listed in the table above are statutorily separate bodies, which are responsible for the provision of specific types of services in a defined geographical area and are accountable to elected members. They are funded through a combination of local taxes, government grants and charges for services.

2.7 Some public corporations are separate legal entities, such as the Royal Mail, that are wholly or mainly funded through charging for the services they provide. In addition, various revenue generating activities within government have been established as trading funds, which are also classified as public corporations under the national accounts definition. A trading fund, while generally remaining part of a government department, is a means of financing activities which takes them outside the normal Parliamentary supply-financing arrangements. Trading funds, such as Companies House and the Meteorological Office, may retain the income they generate to meet their expenditure, but are required to pay a dividend on their capital and reserves, as well as interest on their loan capital and must meet agreed financial targets.

BACKGROUND TO ACCRUALS ACCOUNTING

2.8 The purpose of accruals accounting is to report the economic substance of the transactions a body has entered into during a period of time and their impact on its financial position, which is often different to their cash flow impact. For example, if a body buys a service in one period, it would reflect the cost of the service in its accounts for that period, even if it only paid for the service in the next period. Similarly, it would account for income it has earned during the period, even if it does not receive the cash until a subsequent period. Also where a body has incurred expenditure on an item that can be used in future periods, then an appropriate proportion of the original expenditure is carried forward, or capitalised.

2.9 The principal advantages of accruals accounting are that it allows better financial management and, indeed, external accountability by:

- presenting expenditure in any period, matched with revenues earned and also on the basis of obligations incurred in that period; and

- separately recording – as capital assets – expenditure incurred for longer term benefit. This expenditure is then recorded as a cost in each of these future periods by a charge for depreciation or amortisation or, if the value of the asset has declined, via an impairment charge.

The maintenance of overall cash recording alongside accruals accounting allows for the forecasting and management of cash flow and debt. Thus cash records and accruals accounting complement, rather than substitute for, each other.

2.10 The framework within which accruals accounts are prepared for the private sector is known as Generally Accepted Accounting Practice (GAAP). There is no wholly definitive catalogue of what constitutes GAAP. In the UK, the main sources of GAAP are the accounting standards issued by the Accounting Standards Board (ASB), as well as the Companies Act 1985. Specialist sectors may also have other sources of GAAP such as specific legislation or accounting frameworks that interpret GAAP in their sector – known as Statements of Recommended Practice (SORPs).

ACCRUALS ACCOUNTING IN CENTRAL GOVERNMENT

2.11 Accruals accounting has been introduced in the various types of central government bodies at different times. This section describes how the accruals accounting frameworks were developed for each type of body, and how they have been brought together over a period of time.

Central government departments and agencies

2.12 There have been a number of reforms designed to move government's financial management into line with 'modern' practice. From the Fulton Report in 1968 to the Financial Management Initiative of the early 1980s much was spoken of improving financial management in government.

2.13 Until the 1990s, however, central government departments planned and reported their expenditure on a cash basis, despite the adoption of accruals accounting and related financial management processes accross the rest of the public sector. It was not until the end of the 1990s that the Resource Accounting and Budgeting (RAB) initiative modernised the basis for planning, managing and recording government expenditure by moving all these onto an accruals basis.

2.14 Accruals accounting was introduced 'piecemeal' in the parts of departments run separately as executive agencies as these were created. In each case, to allow time for the systems and processes required to support accruals accounts to be introduced, 'dry-run' (unpublished) accounts were prepared. The dry-run accounts were reviewed by the National Audit Office (NAO), and when it was satisfied that accounts of auditable quality could be prepared, the Treasury issued the agency with an 'accounts direction'. The accounts direction required the agency to produce GAAP-compliant accruals accounts, as well as dealing with any specific GAAP interpretation or regulatory disclosure issues.

2.15 A similar approach was adopted for the introduction of departmental accounts on a GAAP basis. All departments were required to prepare dry run accounts for 1998-99. The first audited GAAP-compliant (resource) accounts to be laid before Parliament were in respect of 1999-2000, in each case incorporating the accounts of the department's executive agencies. The scale of the changes required to introduce accruals accounts in what are in many cases large and complex organisations meant that there were a number of problems with the first sets of resource accounts. However the quality of the accounts has significantly improved in subsequent years as described in Chapter 4.

2.16 The GAAP standards, published by the ASB and in companies legislation, are designed for application in the private sector. The ASB has a current project to consider the way in which its guidance might need to be interpreted by the not-for-profit (public benefit) sector; government has however had a need for 'public sector GAAP standards' for some time. It was the Resource Accounting Manual (RAM), first published in 1997, which brought together and codified GAAP for departments and their agencies and set the firm basis for accruals accounting in central government.

2.17 While there are many similarities in the reporting needs of government and corporate entities, there are several reasons why the accounting guidance for entities in government needs, in some circumstances, to be different from company accounts. For example:

- the strategic objectives of Government are different from those of most companies, that seek to make a return for investors. For example government aims to make society and the economy better off. So government needs to understand and account for its interactions with the rest of the economy as well as its own financial position;
- the government's overall financial objectives are expressed in terms of national accounts and articulated for government departments through the budgeting system, which determines their spending power and which is used to establish the Public Service Agreement targets they are set; there is no equivalent for companies. This affects both the budgetary framework and the way financial results are reported in respect of objectives;
- government invests to acquire assets for service provision, rather than for direct financial return, which affects the way some assets are valued; and
- technical reasons, such as the absence of share capital.

2.18 The way in which GAAP is to be applied in the accounts of all central government bodies is now set out in the Government's Financial Reporting Manual (FReM), the successor to the RAM. The FReM is first mandatory for departments and their executive agencies, NDPBs and trading funds for 2005-06. It is published jointly by HM Treasury and the devolved administrations under the oversight of the independent Financial Reporting Advisory Board as described in Box 2.1.

Box 2.1: The Financial Reporting Advisory Board

Credibility and transparency are of crucial importance in any system of standard setting for accounting for public expenditure. The Financial Reporting Advisory Board (FRAB) provides an independent element in that system.

The Government Resources and Accounts Act, passed in 2000, requires resource accounts to be prepared in accordance with GAAP 'subject to such adaptations as are necessary in the context' and with particular regard to the standards issued by the ASB. The FRAB's statutory function is to advise HM Treasury on how this should be done. It therefore reviews changes proposed to the government's Financial Reporting Manual (FReM), which all central government bodies are required to follow in preparing their resource accounts. The FRAB reports to Parliament annually on its activities and highlights any departure from UK Generally Accepted Accounting Practice in the FReM, together with its views on any such departures.

The FRAB has an independent chairman and includes representatives from the Accounting Standards Board, the National Audit Office (NAO), the Audit Commission, government departments, devolved administrations and other public bodies, the Office for National Statistics and the academic sector. HM Treasury is also represented.

The FRAB was first established in 1996 when its focus was limited to the resource accounts prepared by departments and their executive agencies. Its remit has since expanded to encompass the accounting guidance for all central government bodies and trading funds.

2.19 The Government will continue to review where GAAP accounting standards may need to be adapted if the content and the format of the accounts are to be most useful to readers, in particular Parliament and also the ONS for the use of data in the national accounts. Adaptations will continue to be discussed with the FRAB before implementation.

Non-departmental public bodies

2.20 The accounting requirements for NDPBs are generally implemented through an accounts direction issued under the legislation establishing the NDPB. Most NDPBs have prepared accruals accounts since they were established although, historically, the exact application of GAAP to each body was negotiated between the sponsoring department and the individual body, often with Treasury input. Although general accruals accounting guidance had been available since the early 1980s, in order to standardise practices, HM Treasury issued the first over-arching accruals accounting guidance specifically for NDPBs in 1996. Following minor updates in the intervening period, a full scale revision of the guidance was undertaken during 2000 to bring it into line with the RAM, when it came under the FRAB's remit.

NHS Trusts & Foundation Trusts

2.21 NHS Trusts were created on a phased basis as part of the establishment of the 'internal market' in the NHS in the early 1990s. Although the exact details of the performance regime were different in England, Wales, Scotland and Northern Ireland, every NHS Trust was required to prepare full GAAP-compliant accruals accounts from the point at which it was established. In order to achieve consistency in each country, detailed accounting guidance was issued in the form of a Trusts Manual for Accounts, which was the responsibility of the department responsible for managing the health service in that country. Therefore, although the overall approaches were similar, the exact requirements differed across the four countries until the various manuals came within the FRAB's remit as discussed below.

2.22 The regulatory framework for Foundation Trusts is set by an independent body (Monitor), which has adapted the existing Department of Health guidance to meet the requirements of its new regulatory regime. However, procedures are in place to ensure that the guidance remains consistent with the FReM.

Convergence of accruals accounting guidance for central government bodies

2.23 In order to provide consistent accruals-based information to support the introduction of resource budgeting and consolidated accruals accounts for central government, there has been a gradual extension of the FRAB's remit. In each case, the underlying guidance was reviewed and brought into line with the over-arching principles set out in the RAM. This process has also had to take account of the fact that responsibility for setting accounting guidance was transferred to the new devolved administrations in Scotland and Northern Ireland (although not to the National Assembly for Wales) in 1999. Table 2.2 below summarises the convergence process.

Table 2.2: Extension of the FRAB's original remit

Area of central government	Year remit extended
NDPBs	1999-00
Scottish Executive[1]	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
Foundation Trusts	2004-05

[1] NHS Trusts in Scotland became part of Health Boards with effect from 2004-05 and separate accounting guidance was not required after that date.

2.24 During 2004-05, a fundamental review was undertaken in order to allow the various existing sources of accounting guidance to be brought together with the rest of the accounting guidance within the FRAB's remit. This consisted of Executive Non-Departmental Public Bodies: Annual Reports and Accounts Guidance, Trading Funds Accounts Guidance, the Scottish Accounting Guidance, and the Northern Ireland RAM. The resulting FReM replaces these five existing sources of guidance with effect from the start of the 2005-06 financial year, bringing together the top-level accruals accounting guidance for all central government bodies into one place for the first time.

2.25 Despite this significant consolidation of central government accounting guidance, there remains room for further development in terms of increasing alignment between the reporting and public spending control frameworks. In particular, HM Treasury has recently consulted departments on consolidating NDPBs into resource accounts, in order to align with the way in which they are treated in budgets.

ACCRUALS ACCOUNTING IN LOCAL GOVERNMENT

2.26 Local authority financial regulation is the responsibility of the Office of the Deputy Prime Minister (ODPM) in England and the devolved administrations elsewhere. It is based on the highly specialised requirements relating to the calculation of council tax and local authority rents contained in both primary and secondary legislation. Below the level of the specific legislation, local authorities across the UK share a common accounting code of practice that seeks to implement GAAP subject to the specific requirements.

2.27 In contrast to central government, the Government does not set the Code of Practice on Local Authority Accounting. Instead, this is done by a joint committee of the Chartered Institute of Public Finance & Accountancy (CIPFA) and the Local Authority (Scotland) Accounts Advisory Committee (LASAAC). The CIPFA/LASAAC joint committee consists of senior local government accountants, auditors and independent members with an interest in local government accounting.

2.28 The Accounting Standards Board endorses the CIPFA/LASAAC code of practice as a Statement of Recommended Practice (SORP). This provides reassurance that adaptations of GAAP are included only where required by the statutory regime, and gives the code substantive professional status for accountants. Considerable improvements over recent years have brought the code more into line with GAAP; many differences between local government and the rest of the public sector have also been eliminated. However, differences resulting from the specific regulatory regime remain; in addition the CIPFA/LASAAC Joint Committee has yet to adopt an approach to accounting for the local roads network that is in line with the rest of the public sector.

2.29 In order to expedite the convergence of the CIPFA/LASAAC SORP with the accrual accounting standards for central government, HM Treasury and the Audit Commission are represented at both the CIPFA/LASAAC Committee and the ASB's Committee on Accounting for Public-benefit Entities. In addition the FRAB includes a representative of the ASB.

PUBLIC CORPORATIONS & TRADING FUNDS

2.30 Public corporations are very diverse and many have their own specific legal requirements that determine the detail of their accounting frameworks. In some cases the founding legislation may permit HM Treasury or the Secretary of State to prescribe the accounting requirements through an accounts direction. In other cases no specific powers exist. Trading funds are all established under the Government Trading Funds Act 1973 (as amended), which requires HM Treasury to issue an accounts direction to each trading fund (although more recently, a generic accounts direction has been issued, listing the trading funds to which it applies). The trading fund accounting guidance also falls within the FRAB's remit as discussed above.

2.31 All public corporations and trading funds follow GAAP, although in some cases (for example, where there is no share capital) adaptations of GAAP may be required. Generally, however, these government business enterprises follow standard commercial accounting practices for companies. In particular, many public corporations adopt the historical cost convention to account for their fixed assets, whereas central government and trading funds use current asset values.

FUTURE DEVELOPMENTS

International convergence

2.32 From 2005, all listed groups in EU member states have been required to adopt International Financial Reporting Standards (IFRSs) as adopted by the EU for their consolidated accounts. This reflects the wider move in world accounting to converge all accounting standards on a common set of principles. UK accounting standards have historically been generally well aligned with IFRSs. Nevertheless the ASB has started a convergence project better to align UK GAAP with IFRSs. The Government is committed to the eventual application of IFRS requirements in its accounts, but as a result of uncertainties in the final requirements of IFRSs and the current absence of international standards in key areas such as accounting for Private Finance Initiative/Public Private Partnership (PFI/PPP) schemes, has decided to follow the ASB's phased approach to convergence with IFRS.

2.33 The convergence process in the UK has already meant that changes are planned to the FReM to reflect new standards in areas such as accounting for events after the balance sheet date. Work has also started to address the impact of major changes, consequent on the international convergence process, that will occur over the next few years in the areas of accounting for:

- financial instruments;
- valuation of non-financial assets;
- recognition of non-financial liabilities; and
- Private Finance Initiative (PFI) schemes and leases more generally.

2.34 A continuing challenge remains, however, that the IASB's standards do not address the specific requirements of accounting for the public sector. Thus, at the same time as the ASB's standards are re-issued to mirror those of the IASB, HM Treasury, the FRAB and the CIPFA/LASAAC committee must consider the additional guidance needed to apply the private sector rules across the broad range of government bodies.

Public sector standards

2.35 In addition to convergence in commercial accounting standards, a process has begun to develop a common set of International Public Sector Accounting Standards (IPSASs). The IPSASs are being developed by the International Public Sector Accounting Standards Board (IPSASB), which was, until recently, the Public Sector Committee of the International Federation of Accountants. The initial phase of work comprised a review of the application to the public sector of the international accounting standards issued as at December 1997. IPSASB began the second phase of its work in 2002. This involves developing IPSASs for key areas in public sector finance that are not directly covered by IFRS. In particular, IPSASB is now in the process of producing Exposure Drafts of Standards on:

- Non-exchange revenue (of which taxation is the major component); and
- Social policy obligations.

2.36 Both of these are significant areas in the Government's finances which are not covered by either UK or international accounting standards. Accordingly, the accruals accounting policies that it has adopted for these areas will be kept under review as the new IPSASs are finalised. The UK government plays an active role in supporting IPSASB's work, because of its relevance as a benchmark in the development of guidance for central government in areas not covered by UK GAAP. In addition to commenting on the development of the IPSASs, Treasury officials were members of the steering committees that undertook the initial development work on non-exchange revenue and social policy obligations.

Aligning budgets and accounts

2.37 The introduction of accruals accounting has improved the information available to government and to readers of accounts. Information on the use of capital and on commitments that was previously largely unavailable at departmental level is now presented in a form that can be read by managers and external users of the accounts. However the clarity of the accounts in other areas could be improved.

2.38 In particular, it is important to make clear the links between key budget and spending decisions and what is reported in departmental accounts. There should be a clear line of sight from the fiscal rules through budgets to resource accounts. Further, the need to keep down compliance costs requires close alignment between the budgeting system that controls public spending and the accounting system.

2.39 The Government continues to develop the format and content of accounts to make them more useful to managers and readers. In some cases that may mean making further adaptations from GAAP to reflect the special circumstances of the public sector and to ensure control of public spending. However any further adaptations will be discussed with the FRAB before implementation.

CONCLUSIONS

2.40 All major public sector bodies in the UK now prepare accruals accounts. Although these have been implemented to different timetables for the various types of entities, considerable convergence in the application of UK GAAP to the UK public sector has been achieved. As explained in paragraphs 2.28 and 2.31, however, particular efforts are still needed to align the accounting treatments of public sector capital assets. In addition, there are now further challenges to face as GAAP in the UK converges with international accounting standards. The Government will also continue to review the need to adapt the content and format of accounts where appropriate to meet the needs of users better. However, the progress made to date has allowed the Government to move the budgeting framework for central government to an accruals basis as described in Chapter 3.

3 ACCRUALS-BASED BUDGETING

3.1 This chapter discusses the accruals-based budgeting regime that the Government has implemented to ensure that the finances of individual public sector bodies are controlled in such a way that the fiscal rules can be delivered.

THE BUDGETING FRAMEWORK

3.2 The fiscal framework is expressed in terms of national accounts concepts, as set out in Chapter 2 of the Pre-Budget Report (HM Treasury 2005). Most transactions are measured in the same way under national accounts and UK GAAP. However, there are a number of differences in the way in which certain transactions are treated (see Chapter 5).

3.3 In addition to supporting the fiscal framework, the budgeting system is designed to provide good incentives for departments to manage spending well by efficiently providing high quality public services that offer value for money to the taxpayer. Since taking office in 1997, the Government has introduced a number of major reforms of the public spending control framework to foster improvements in service delivery through increased investment, underpinned by a sustainable fiscal position. In particular, the framework was moved onto an accruals basis in two stages as part of the introduction of resource accounting and budgeting (RAB), as described in the next section.

3.4 The main features of the budgetary control framework for departments now include:

- three-year budgeting – so that departments can plan with certainty over a reasonable time period, spending plans are now set on a three year basis. Firm departmental budgets are set for three years. These are called Departmental Expenditure Limits (DELs). Other expenditure, which cannot be managed on a three year basis, is treated as Annually Managed Expenditure (AME). Examples of AME include social security, debt interest and Common Agricultural Policy payments;

- focus on outcomes – departments, through their Public Service Agreements (PSAs), agree to deliver specified outcomes and outputs in return for allocation of resources; and

- separate capital budgets – there is a separate Departmental Expenditure Limit for capital, which protects long-term investment plans from current pressures.

Managing capital

3.5 Capital spending by departments scores in the capital budget at the same value and with the same timing as the accounts. It includes expenditure on tangible and intangible fixed assets, however they are financed. When budgeting for capital expenditure, departments follow agreed accounting policies when deciding which costs of a project should be capitalised.

3.6 Departments' agreed capital spending plans are set out in published Departmental Investment Strategy (DIS) documents, which include asset management plans. The DIS is a way of ensuring that service delivery plans, asset management and departmental budgets are brought together and the capital budget effects of spending and the consequences for the resource budget (such as depreciation) are considered together.

THE STAGED MOVE FROM CASH TO ACCRUALS BUDGETS FOR DEPARTMENTS

3.7 Resource Accounting and Budgeting (RAB) is based on the concept of accruals, i.e. that the full consequences of economic activity should be accounted for – not just the flows of cash – and in particular that the treatment of capital spending should reflect its longer-term economic value. This approach removes some of the weaknesses and distortions of the previous cash-based public spending framework through:

- fully recognising the importance of the existing capital stock, not just new investment, supporting the Government's aim to improve the quality of public capital;
- better incentives for managers of public services, particularly in the area of asset management, thus encouraging more efficient use and allocation of resources to priority areas; and
- better information for managers on which to base their decisions, and for Parliament and the taxpayer to scrutinise them – thus improving accountability and transparency.

3.8 RAB became fully operational in 2001-02 with the laying of resource based departmental Estimates. The first stage of the implementation of resource budgeting also began in that year. Stage 1 spanned the years covered by the 2000 Spending Review (2001-02 to 2003-04). In this first stage, the principal new costs introduced by RAB were treated as part of AME, and were therefore not controlled by departments alongside their other expenditure in the DEL.

3.9 In order to realise the benefits of RAB as soon as possible, the Government proceeded as planned with the full implementation of resource budgeting in the 2002 Spending Review. As a result, from 2003-04 departments' main budgets have included charges for:

- depreciation – the cost of using assets;
- a cost of capital charge to reflect the cost of holding assets; and
- provisions for costs already incurred that will commit future cash flows.

3.10 Parliament endorsed this change. The Committee of Public Accounts (PAC), giving agreement to the implementation of RAB in 2000, commented that 'unless resource Estimates and resource accounts form the bedrock of financial management in departments, much of their benefit will be lost. Sound financial management should be part and parcel of departmental systems' (PAC, 2000).

3.11 The Government will continue to develop the budgeting system further to improve its role in controlling public spending and to incentivise departments to pursue value for money.

ACCRUALS BUDGETING OUTSIDE DEPARTMENTS

Other central government bodies

3.12 NDPBs are treated as part of their parent departments for budgeting purposes. Their income, revenue and capital expenditure, measured on an accruals basis, therefore all have a direct impact on the department's resource and capital DELs in the same way as for an executive agency or part of the core department.

3.13 The performance of both NHS Trusts and Foundation Trusts impacts directly on the Department of Health's revenue and capital budgets. However, in contrast to NDPBs, Trusts are not fully consolidated into budgets and their net surpluses and capital expenditure score, rather than their income and expenditure.

Local government

3.14 Local authorities are responsible for setting their own budgets, although there must be a strict distinction between revenue and capital. Detailed statutory requirements also exist to ensure authorities' revenue budgets are prepared on a break-even basis. Local authorities are free to determine the levels of their capital budgets, including how the expenditure will be financed (i.e. whether to use borrowing or reserves) provided this is affordable against certain 'prudential' indicators. Strict controls ensure local authority borrowing is for capital purposes. In addition, Ministers throughout the UK retain reserve powers to limit council tax increases or borrowing budgets to protect local taxpayers, when necessary.

3.15 Both capital and revenue support from departments to local authorities score in the relevant departmental DEL. In addition, funding raised locally through council tax, charges, etc, known as Local Authority Self-Financed Expenditure, is included in AME.

Public corporations & trading funds

3.16 Public corporations are set financial targets by the Government as the shareholder. These targets are normally based on a target return on capital employed. The sponsoring department for every public corporation and trading fund is expected to set clear objectives and challenging targets covering return on capital employed, dividend levels, efficiency, and quality of goods and services. How the public corporation or trading fund meets these targets is delegated to the management of the entity.

3.17 Each department bears a cost of capital charge, which scores against its resource budget, for the value of its investments in public corporations and trading funds. This charge should be met from the public corporation's dividend to the department, therefore incentivising it to ensure its public corporations meet their performance targets.

CONCLUSIONS

3.18 The Government has used the accruals accounts prepared by all public sector bodies as the basis for implementing a comprehensive accruals-based budgeting framework. The new framework has been implemented on a staged basis in order to allow departments the time to implement the necessary systems and processes. Further development will proceed as the accounting basis changes, as introduced in Chapter 2, and in order to improve its effectiveness in supporting the fiscal framework and promoting value for money. The next chapter describes the improvements in financial information that have already been achieved and gives further detail of the prospective changes now in hand.

4 IMPROVING FINANCIAL REPORTING

4.1 Introducing Resource Accounting and Budgeting (RAB) has represented a challenging change process. It has not only required departments to develop new accounting systems to capture and process the necessary data, but has also brought the need for new skills and attitudes from staff in order to understand and use the information that RAB provides. Although it is difficult to measure fully the scale of the changes delivered in these areas, improvements in quality and timeliness of annual accounts provide an indication. This chapter describes the range of audit arrangements in the public sector, and then considers the improvements that have occurred in key areas over the last few years.

AUDIT IN THE PUBLIC SECTOR

4.2 In England, government departments, their agencies and NDPBs are audited by the Comptroller and Auditor General (C&AG) and his staff in the National Audit Office (NAO). The C&AG is an officer of Parliament, and is wholly independent of government. The NAO is funded directly by Parliament, although departments also show the cost of their audit in their resource accounts and budgets. The Audit Commission (AC), which is a public corporation funded from audit fees, is responsible for the audit of all local government and most NHS bodies. Both the NAO and AC contract out about a quarter of their audits to private audit firms.

4.3 There are separate audit arrangements in Scotland, Wales and Northern Ireland. In each case, there is a national audit body which is responsible for the audit of both central and local government bodies.

4.4 Despite the differences in audit regime, there are three common elements of the audit of central government bodies across the UK:

- an audit of the accounts to determine whether they give a 'true and fair view' of the financial performance and position of the body;
- ensuring that the body has used the resources provided for the purposes Parliament or the devolved legislation intended and has not exceeded its Estimate; and
- conducting value for money audits to ensure bodies are using the resources provided efficiently and effectively.

4.5 The first two aspects of these common elements are discharged through the audit of the annual accounts; value for money reports may or may not be independent of the annual accounting cycle. Where, in the auditor's opinion, the accounts do not give a true and fair view he will issue a 'qualified' opinion on the accounts. 'Disclaimed' or 'adverse' opinions imply major disagreement between the auditor and the body over the content of the accounts or an inability to substantiate significant areas of the accounts. 'Disagreement' over an item in the accounts, or stating that the auditor was unable to form a view on an item ('limitation of scope'), may imply that a serious issue remains unresolved, but generally implies the issues are not pervasive throughout the accounts. The auditor will also issue a qualified report if the expenditure was in excess of Estimates (an 'excess vote') or not for the purposes intended (a 'regularity qualification').

4.6 Public corporations that are not trading funds are subject to audit arrangements similar to the normal private sector model. A private sector auditor is appointed to give an opinion on whether the accounts provide a 'true and fair view'.

CENTRAL GOVERNMENT DEPARTMENTS

4.7 As discussed in Chapter 2, central government departments are the public sector bodies that have most recently moved to the presentation of accruals accounts. This section considers the significant improvements in both the quality and timeliness of their accounts in recent years.

Improvements in the quality of resource accounts

4.8 The audit opinion is a key measure of the improving quality of departments' resource accounts. Qualifications can be an indication not just that the statement of accounts is inadequate, but that improvements to a department's financial management are also required. The number of qualified accounts is thus a key quality measure for both accounting and financial management. Table 4.1 summarises the significant progress that has been made in reducing both the number and severity of qualifications in resource accounts for central government departments.

Table 4.1: Progressive improvements in resource accounts

Financial Year	Qualified Accounts (a)	Type of Qualification (b)				
		Disclaimed opinion/nil opinion (c)	Adverse opinion	Disagreement/ limitation of scope	Regularity	Excess vote
1998-99(d)	30	7	5	18		
1999-00	12	3		9		
2000-01	9	2		7	2	
2001-02	16			6	3	10
2002-03	8	1		2	1	6
2003-04	4			2	2	2

(a) The number of accounts qualified does not equal the total of all types of qualification because some accounts had multiple qualifications of different types.

(b) See paragraph 4.5 above.

(c) Nil opinions were given in the first year of resource accounting where the accounts were insufficiently developed to receive an audit opinion.

(d) The 1998-99 accounts were dry run accounts.

4.9 The number and level of qualifications in the early years was higher than was desirable, but departments moved quickly to address the issues highlighted. The increase in the number of qualifications in 2001-02 reflects the introduction of resource budgeting as most qualifications were for excess vote or regularity issues rather than the content of the accounts. Again, most departments were able to respond rapidly to the issues raised.

4.10 The reduction in the number of qualifications should not be seen as a technical accounting matter. Rather it highlights the significant improvements in financial management that resource accounting has already delivered. Although the remaining qualifications indicate that further improvement is desirable, the qualifications on the 2003-04 resource accounts illustrate the significant improvements in the quality of financial information that have been achieved during the last few years.

4.11 Of the remaining qualifications on the 2003-04 resource accounts, two relate to the Department for Work and Pensions and reflect the level of fraudulent claims for, and errors in calculating, benefits. Although this is an on-going issue, the Department has taken significant steps to address the level of fraud and error. This includes both preventative measures (such as improving IT to ensure more accurate processing of claims and more secure payment systems) and better targeted fraud investigation and corrective action to identify and recover sums that have been incorrectly paid.

4.12 The 2003-04 resource accounts for the NHS Pension Scheme for England and Wales received a 'limitation of scope' qualification because work remained to be done to ensure the NHS Pension Scheme had sufficiently current data on the employees of all 10,650 employing bodies. The C&AG highlighted the significant uncertainty this caused. He also acknowledged that arrangements were in place for a full valuation in 2004-05 and to ensure robust data in place going forward. The accounts of the Teachers Pension Scheme for England and Wales were also qualified for an 'excess vote', which arose due to technical factors in the calculation of the estimated change in the pension liability during the year. The necessary controls have now been put in place.

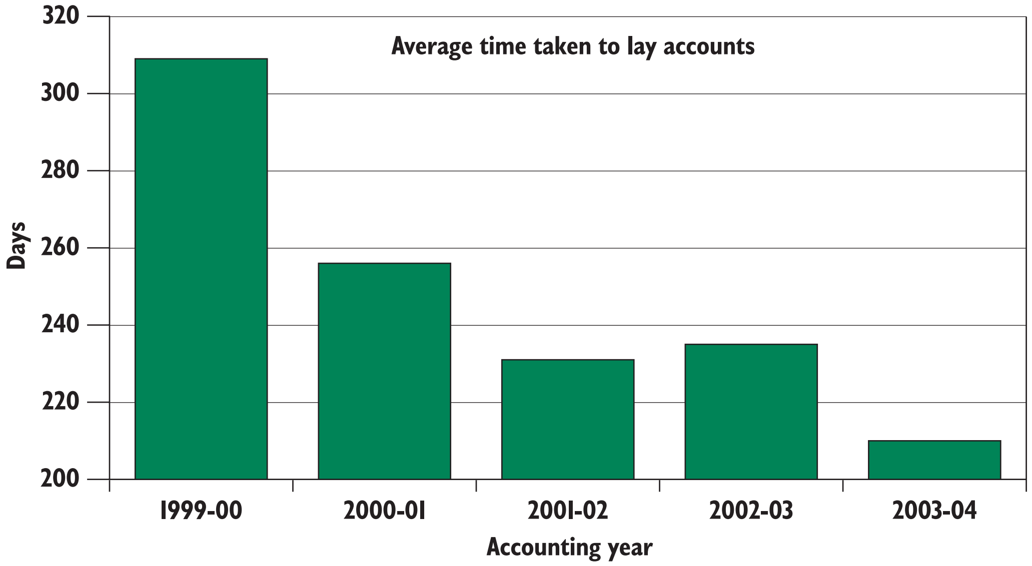
4.13 The other qualification in 2003-04 related to a less complex issue. Although the C&AG concluded that the accounts of HM Customs and Excise gave a true and fair view, his opinion was qualified in respect of payments totalling £167,140 not covered by the Parliamentary authorisation for expenditure (the 'ambit'). The ambit has since been amended to allow for future such payments, if necessary, and this qualification is not expected to reoccur.

More rapid accounts publication

4.14 A second key measure of the quality of financial reporting is the timeliness of accounts. Prompt production, audit and publication of accounts maximises the usefulness of the information to Parliament and other stakeholders. It also helps departments and HM Treasury in planning and controlling public spending. Faster production of accounts also relies upon improved in-year financial control systems and processes, and thus helps support improvements in departments' financial management that contribute to driving the Government's efficiency agenda. Therefore HM Treasury instigated a process from 2003-04, involving departments and the NAO, to drive faster closing of accounts.

4.15 Once the audit of the accounts is complete, central government bodies are required to 'lay' their accounts before Parliament. This formal process of submitting the accounts for scrutiny can be seen as broadly similar to a company sending the accounts to shareholders. Once the accounts have been laid, the relevant House of Commons Select Committee may choose to hold hearings into any issues raised by the C&AG.

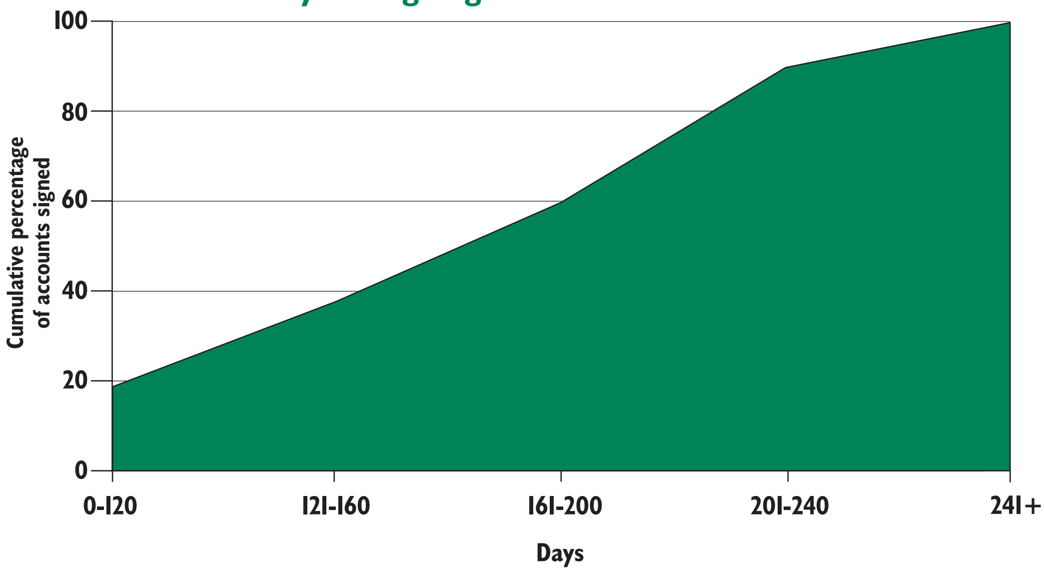
Chart 4.1: Improvements in the timeliness of resource accounts



4.16 Chart 4.1 shows the progress that has already been made in moving forward the laying of departmental resource accounts. Because the laying of accounts is a formal Parliamentary process, however, it can only occur when the House of Commons is sitting. In 2005, for example, no accounts could be laid between 21 July (112 days after the year end) and 10 October (193 days after the year end). This helps explain why the time periods for laying resource accounts remain higher than in the private sector, despite the progress already made, and the further improvements expected in coming years.

4.17 The average time taken to prepare the accounts is significantly less than the time taken to lay them. For 2003-4 the average time taken by a department to finalise its accounts was 177 days. Chart 4.2 shows the time taken by departments to sign their accounts for 2003-04.

Chart 4.2: Days to signing resource accounts 2003-04



4.18 The degree of difficulty in preparing annual accounts more quickly is also heavily dependent on the size and complexity of the department. It is much easier for a small single-site department such as the Privy Council Office than for a large department spread across many sites with a number of executive agencies to consolidate. Box 4.1 summarises how the Ministry of Defence has made significant progress in both the timeliness and quality of its resource accounts. HM Treasury has provided written guidance for departments on faster closure of accounts and is supporting departments through this process.

Box 4.1 Improvements in resource accounts at the MoD

The Ministry of Defence has perhaps the most diverse and complex range of activities of all government departments, and a large fixed asset base (£87 billion at 31 March 2004). For it, therefore, the transition from cash to accruals based accounting was a major undertaking, presenting considerable implementation challenges.

The most significant of these was that in the late 1990s its many information systems were designed for purposes other than the production of accurate and timely accruals-based information. In particular, it had little information on the value or extent of its asset base. It therefore had to invest considerably in IT and in staff and much work was necessary to identify and value its land, buildings, military and other equipment. These changes have contributed to improved management information as well as better financial reporting for the department.

The significant progress the department has made in meeting the challenges is shown by the changes in its audit opinion and in the timeliness of accounts presentation. Its first accruals accounts, for 1999-2000, were laid before Parliament on 31 January 2001 and received the heaviest possible audit qualification. The Comptroller & Auditor General disclaimed his opinion, being unable even to form an opinion overall on the accounts. The quality of the next year's accounts was better, with an audit qualification restricted to deficiencies in a number of specific areas. The Ministry of Defence worked further on these over the next few years with the result that its accounts for 2003-04 were completely unqualified and were laid before Parliament on 12 October 2004.

NHS BODIES

4.19 NHS bodies are amongst the quickest bodies in the public sector at producing and finalising their accounts. As part of its drive to close its accounts earlier, the Department of Health has brought forward accounts timetables in recent years so that NHS Trusts are now required to formally approve their accounts by 15 July, and Primary Care Trusts are required to do so by 22 July. The audited accounts must be presented to the body's annual general meeting by the end of September.

4.20 Each year the Audit Commission publishes a Stewardship and Governance Report for the NHS bodies in England audited by the Commission and its appointed auditors. The 2004 report highlights that significant improvements were made in both the timeliness and quality of accounts and the progress still to be made. These improvements are summarised in Charts 4.3a and 4.3b below.

Chart 4.3a: Quality improvements in NHS bodies' financial reporting

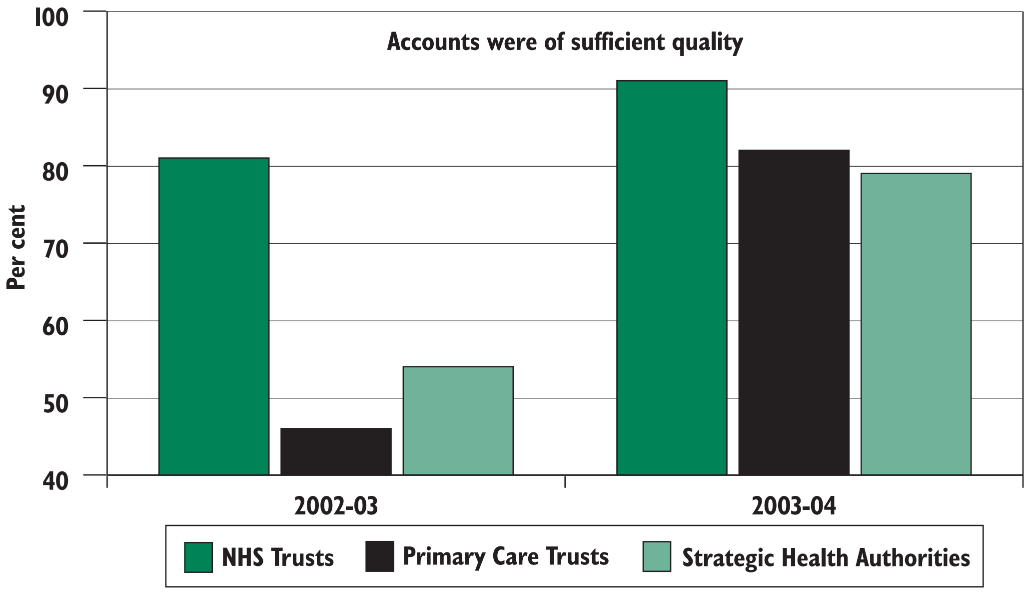
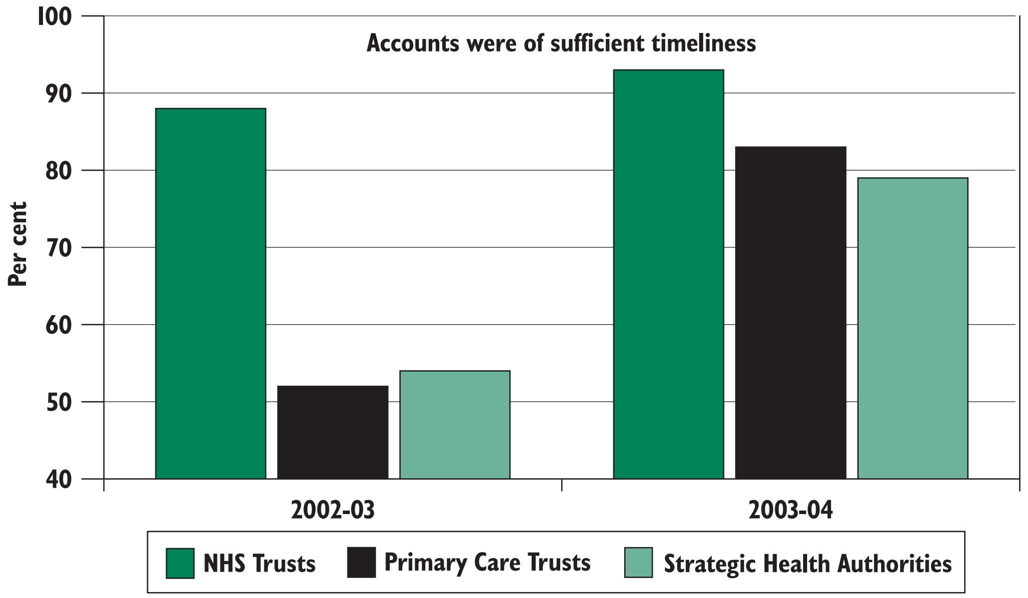


Chart 4.3b: Timeliness improvements in NHS bodies' financial reporting



LOCAL GOVERNMENT

4.21 In England, the local government audit regime applies to local authorities, police authorities, fire authorities and some bodies that are classified to central government – such as local probation boards. Bodies covered by the regime are audited by private sector auditors appointed by the Audit Commission or the Audit Commission itself.

4.22 Statutory regulations specify the date by which the accounts must be approved and the date for publication. Local authorities are required to approve formally their accounts before submitting them for audit; the audit then includes opportunities for local taxpayers to raise concerns about the accounts with the auditor. Three months are required between approval and publication to allow for the public's rights to inspect the accounts and question the auditor. If the auditor finds that changes to the accounts are needed, the authority may be required to change the accounts and resubmit them for audit. Similar arrangements apply in Scotland, Wales and Northern Ireland.

4.23 The regulations specifying the deadlines for local authority accounting include provision for speeding up the timetable. For 2002-03 English and Welsh authorities were required to submit their accounts for audit by 30 September and publish them by 31 December. These deadlines have been brought forward by one month each year so that the deadlines for 2005-06 are 30 June and 30 September. This brings these authorities into line with the long-standing practice of Scottish Authorities.

4.24 The Audit Commission's Stewardship and Governance Report 2004 shows that 95 per cent of English local authorities achieved the 31 August deadline for approving their 2003-04 accounts. The 30 November publication deadline for 2003-04 accounts was met by 89 per cent of authorities.

4.25 Timely high-quality financial information is as essential in local government as elsewhere. Because the audit process allows for resubmission of accounts, it is possible to track the quality of local authority accounts prior to audit and the issues resolved during the audit process. The Audit Commission's Stewardship and Governance Report 2004 shows that 24 per cent of English authorities were required to resubmit their accounts for 2003-04, compared to 19 per cent for 2002-03. However, many of the problems identified were resolved during the audit process; overall, 97 per cent of local authority accounts were unqualified. Nevertheless, the number of 2003-04 accounts qualified (11) was almost double that in 2002-03 (6). The Audit Commission, supported by the Government, has taken significant action to ensure authorities prioritise the quality and timeliness of their accounts. The Comprehensive Performance Assessment framework has been revised to reinforce the incentives on authorities to produce reliable financial information to the statutory deadlines. CIPFA has also supported these efforts by producing guidance on improving financial management and on faster closing of accounts.

CONCLUSIONS

4.26 Even by the standards of major commercial organisations, government is large and complex. Introducing accruals accounting and budgeting represented a challenging change process which required a staged approach. The improvements in departments' accounting processes are reflected in the significant reductions in audit qualifications and improved timeliness of accounts production in recent years. There have also been improvements in these areas in both the NHS and local government. The challenge is now to extend these improvements over the whole of each part of the public sector and to harness the resulting benefits in financial management for each individual body to the overall management of the public finances. Chapter 5 discusses the ways in which the accruals data for individual bodies is increasingly being used to improve the quality of data in the national accounts.

5 The national accounts framework

5.1 Previous chapters have considered the progress that government has made in introducing accruals-based accounting for public sector bodies, the improvements in financial information this has delivered, and how that supports the government's aim of improving financial management in public sector bodies. This chapter considers the public sector data in national accounts, how GAAP data are increasingly being used in national accounts and where the different frameworks for preparing the accounts cause differences in the timing of cost recognition.

National accounts public sector data

5.2 National accounts are the primary means by which economic activity in countries and the financial activities of governments are measured. The national accounts for the UK are published by the Office for National Statistics (ONS). As a European Union (EU) membership condition, they are prepared using the rules in the European System of National and Regional Accounts 1995 (ESA 95), produced by Eurostat (the EU's statistical office). ESA 95 is itself based on the over-arching System of National Accounts (SNA), which is under the control of a committee comprising a range of international bodies including the United Nations, the International Monetary Fund and the World Bank.

5.3 Because the principles of SNA and ESA 95 are adopted across the world, the UK national accounts are widely comparable with European and other comparator nations. This international comparability is one of the reasons why national accounts are fundamental to the assessment of fiscal performance. A further advantage of national accounts is that they are integrated accounts for the whole economy; government is presented as a sector in the economy. National accounts thus reflect government's role in the economy and society.

Sectoral analysis

5.4 The flows and balances within the UK public sector reflect past decisions about both how services should be delivered and how they should be financed. As a consequence of those decisions it is not necessarily the case that assets, and the associated financing, are held in the same sector. In order to ensure the totality of such decisions is taken into account, the fiscal framework encompasses the whole public sector.

5.5 The net worth of the UK public sector (i.e. assets net of liabilities) is not distributed evenly among the sub-sectors. In particular, within general government, the central government sub-sector tends to hold liabilities while local government holds assets. Highways are a good example of the reasons for this. Historically, roads were a local matter. As a national network of 'A-roads' and motorways developed, some roads were brought into national control; others have remained in, or been returned to, local authority management. This aligns accountability with the relevant interest – local or national. Local authorities pay for local roads, and some borrowing for investment in local roads rests with local government.

5.6 Nevertheless, central government recognises a national interest in having a network of well-maintained local roads across the whole country. It therefore provides additional funding to equalise resources for investment between local areas. Capital expenditure financed by borrowing is reflected in central government debt. As a result, local government holds all the local road assets, but only part of the related debt, while central government holds part of the related debt only.

5.7 Accounts for sub-sectors within government therefore reflect not simply the financial performance of that sub-sector but also decisions about the structure, accountability and financing of the public sector as a whole. However, although they reflect only part of the picture, accounts for the individual sub-sectors are not without value. As the introduction to the European System of Accounts manual states, 'the accounts and tables showing creditor/debtor relationships provide a detailed picture of financing of the economy and are considered very useful for understanding the channels through which the financing surpluses move from final lenders to final borrowers.'[1] There is also considerable Parliamentary and public interest in the financial relationships between the various parts of the public sector.

USING GAAP DATA IN NATIONAL ACCOUNTS

5.8 In many respects, the conventions of national accounts are similar to GAAP. Both record most transactions on an accruals basis, i.e. when transactions or events occur, rather than on a cash basis. National accounts are also based on a system of double entry that ensures the accounts of each sector fully reflect the impact of transactions. As a result, the GAAP accruals data from individual public sector bodies are increasingly being used to address a number of the challenges in national accounts preparation:

- elimination of public sector flows and balances;
- provision of timely data;
- consistency of data; and
- limitations of estimation and modelling.

Elimination of public sector flows and balances

5.9 Fiscal policy centres on the government's impact on the economy. Thus to be useful for an assessment of fiscal policy, financial information must concentrate on the overall consolidated financial performance of the whole public sector. Flows or balances between different parts of the public sector are important in assessing how the finances of each sub-sector are organised but, in measuring the fiscal stance, they need to be removed, or eliminated, in order to avoid double-counting.

5.10 GAAP consolidation operates on a 'bottom-up' basis. Public sector bodies will identify all material flows and balances with other public bodies. These will then be eliminated through a series of 'sub-consolidations.' This process will improve the quality of information available for national accounts on eliminations.

[1] *European System of National and Regional Accounts 1995*, Eurostat, paragraph 1.58.

Provision of timely data

5.11 HM Treasury provides the ONS with much of the detailed data it uses to compile the statistics on public sector finances. Until March 2005, the Treasury used three different systems for collecting financial data from departments, which operated at different levels and used different data structures. Through the Combined On-line Information System (COINS) Project, it is now in the process of combining these three legacy systems, so that one system is used for collection of all budgetary, in-year monitoring and outturn information. The integrated data structure that the new system will use is intended to improve the quality and consistency of the data provided to ONS.

Consistency of data

5.12 The increased application of more consistent accounting policies discussed in Chapter 2 will facilitate use of the data in national accounts and other publications. For example, as part of the work on converging accounting policies and disclosures across central government, fixed asset disclosure categories needed to be standardised across the sector in order to permit consolidation. The new categories implemented for the 2002-03 accounts onwards were chosen in order to maximise compatibility with those used in national accounts, within the formats prescribed for the private sector by the Companies Act. This change has led the UK national accounts to use the capital asset data from GAAP accounts for central government departments from 2004 onwards.

Limitations of estimation and modelling

5.13 National accounts are prepared for the economy as a whole; however, the difficulty of assembling reliable audited data for the whole economy means that the ONS is generally reliant on 'top-down' statistical modelling and estimation techniques to generate much of the necessary detail. This can bring advantages, for example that there is no risk of using data that have been modified by reporting entities (such as companies seeking tax advantages). However there are also advantages in using GAAP data built from the bottom up. Individual bodies retain records of their assets and liabilities, which are based on the detailed knowledge of their activities of their own in-house experts or professional advisors. Thus their accounts provide a detailed, accurate and up to date summary of their activities and financial position, even though in certain circumstances they may need to rely on estimation and modelling. Also by implementing a system of consolidating bodies' GAAP data, this will allow audited data to be transmitted to the ONS, thus further enhancing data quality in national accounts.

5.14 In the case of capital asset depreciation, the ONS has already begun using department data consolidated by the Treasury to inform estimates of capital stock for the central government sector. This has, however, yet to replace the output of the Perpetual Inventory Model (PIM)[1] as the main source of capital consumption estimates for the central government sector. As the recent Atkinson Report on methods of preparing national accounts public sector data acknowledges, 'the very substantial potential improvements in quality [depend on] several data classification issues.'[2] These include timing differences and differences in coverage between GAAP accounts and the national accounts central

[1] The Perpetual Inventory Model (PIM) is the recommended model for the production of capital consumption data in national accounts. It uses capital expenditure data and assumed asset lives to generate estimates of capital consumption for each sector of the economy.

[2] *Atkinson Review Final Report: Measurement of Government Output and Productivity for the National Accounts*, ONS, 2005 paragraph 5.54

government sub-sector. HM Treasury and the ONS are working together to address these issues. In particular ONS will have to address issues of consistency, as PIM data will continue to be used to estimate depreciation in other sectors of the economy.

DIFFERENCES BETWEEN NATIONAL ACCOUNTS AND GAAP

5.15 Despite the fundamental similarities between national accounts and GAAP discussed above, differences in the concepts underlying the two frameworks remain, reflecting the different purposes for which the frameworks were developed. National accounts are designed primarily for economic analysis, showing economic activity by sector of the economy. The main focus of national accounts is therefore on the income and consumption in each of the various sectors (and sub-sectors) of the economy rather than on individual entities' financial performance. GAAP, on the other hand, has been developed to reflect the financial performance and position of individual organisations.

5.16 Using GAAP for the accounts of individual public bodies enhances accountability as it ensures that the financial performance of the entity is reported on a recognised basis. It also provides comparability with possibly similar bodies outside the public sector (for example between a local housing authority and a housing association). The GAAP framework also enhances accountability for the financial performance of individual entities by ensuring that all costs (including provisions) are recognised as they are incurred. This ensures the management and stakeholders of individual bodies are fully informed about the true long-term cost of their activities.

5.17 However, as national accounts have been developed for the purposes of economic analysis, they remain the appropriate basis for reporting fiscal performance. They measure the government's activity in terms of economic concepts, such as final consumption, that GAAP does not support. As noted above, they are also widely internationally comparable, while only a few countries produce GAAP-based data.

5.18 The conceptual differences between today's national accounts and GAAP frameworks referred to above result in costs being recognised at different times under the two frameworks. These timing differences encompass both costs that are recognised earlier in GAAP and costs that are recognised earlier in national accounts.

Earlier cost recognition under GAAP

5.19 There are two types of expenditures that are recognised earlier under GAAP:

- provisions; and
- public service pensions.

Provisions **5.20** A GAAP balance sheet includes two types of liability: creditors, which also appear in national accounts, and provisions, which do not. A liability is a present, unavoidable, obligation to pay a third party as the result of a past event. Generally it is clear when a liability arises. A supplier delivers goods (the past event), with the buyer having a contractual obligation to pay for them (the present obligation).

5.21 In more complicated cases, however, it can be less clear that there is a liability. There may be uncertainty regarding whether an obligation exists, or about the amount required to settle the liability or the timing of payments. Where it is considered probable that a transfer will be required to settle the obligation, a provision is recognised in GAAP. For example:

- where the government is defending a legal case, its legal advisors may advise that it is probable that a known amount of damages will be awarded, or that government will settle the case; or
- a nuclear generator will not have to pay decommissioning costs until electricity generation stops and decommissioning work starts. Statutory obligations to pay for clean up costs arise as soon as nuclear energy starts to be generated but the cost of decommissioning remains uncertain.

5.22 Table 5.1 summarises the differences between creditors and provisions.

Table 5.1: Defining creditors and provisions

Concept	Level of certainty	Example
Creditor	Certain	Government debt
Provision	Certain obligation but uncertainty over amount or timing	Nuclear decommissioning costs
	Probable obligation	Undecided legal case

5.23 A provision is recognised in GAAP-based accounts when the transaction or event that creates the obligation occurs. When the provision is created or increased, the amount is charged as an expense. Amounts paid then reduce the provision. The value of the provision at the balance sheet date is the best estimate of the amount required to settle the obligation at that date. The amount recorded in national accounts as an expense is the amount paid for the year.

Public service pensions

5.24 Most public sector employers offer pensions schemes that provide a level of benefits based on length of service and final salary (known as 'defined benefit' or 'final salary' schemes). GAAP requires that the benefits accruing to employees be recorded as a liability for future pensions. However the exact value of this liability depends on uncertain future events such as the time a pension is in payment. The cost of the benefits accruing each year, plus the salary and other costs, shows the full cost in the year of employing staff, even though parts of the cost may not be paid for many years.

5.25 The public service pensions liability in GAAP accounts is essentially a provision for future amounts payable. National accounts include actual and imputed pension contributions in government expenditure as part of pay, while contributions which are deemed to be paid by employees are netted off expenditure. So it is essentially pensions in payment that determines expenditure in national accounts. This means public sector pension costs are recognised much earlier in GAAP accounts than in national accounts.

Earlier cost recognition in national accounts

Single Use Military Equipment

5.26 The Ministry of Defence holds many types of assets as part of the nation's defences. These are accounted for in one of two ways. Where the asset could be used for military or non-military purposes it is treated as 'dual-use' and accounted for in whichever asset class is most appropriate. For example a military truck is classified as 'transport equipment.' However, where the asset is only suitable for military purposes (such as a warship) it is classified as Single Use Military Equipment (SUME). Most SUME assets are tangible fixed assets, but intangible assets of solely military value, and significant stocks, are also included.

5.27 SUME is treated differently in national accounts and GAAP. In national accounts purchases of SUME are treated as consumed in the year of purchase; in effect as current expenditure. In contrast, GAAP treats the purchase as capital expenditure in the year it is spent, meaning that it is added to the capital stock in the balance sheet and depreciation is charged. These differences combine to mean that national accounts will recognise expenditure on such military equipment earlier than GAAP accounts. The stocks of SUME are considerable and this difference represents one of the larger reconciling items between assets in national accounts and GAAP.

National accounts developments

5.28 An updated version of the overarching SNA framework that governs the preparation of national accounts is due to be issued in 2008. The changes in SNA will then in due course need to be reflected in the subsidiary ESA framework used to prepare national accounts in European Union countries. One of the aims of the revision process is to bring national accounts and GAAP accounting policies closer together, whenever the two frameworks permit, in order to allow GAAP data to be used directly in the preparation of national accounts.

5.29 It is planned, for example, that SUME will be capitalised in national accounts in future, thus removing one of the differences in timing of cost recognition between the two frameworks. However, the timeframes for issue of the new SNA manual and the subsequent revision of ESA guidance mean that changes in the process of preparing national accounts will take place on a longer timetable than convergence between UK and international GAAP.

CONCLUSIONS

5.30 The national accounts are prepared under an internationally set framework and use accruals data whenever possible. The differences between the GAAP and national accounts balance sheets are largely due to differences between when costs are recognised under the two frameworks. The accruals-based data being produced by individual bodies are increasingly being used as part of ongoing national accounts data quality improvement work. This process will be reinforced by the introduction of consolidated accounts for the whole public sector as described in Chapter 6.

6 DELIVERING WHOLE OF GOVERNMENT ACCOUNTS

6.1 In 1998, in the Code for Fiscal Stability, the Government committed to produce full accruals based accounts for the whole public sector. This was reaffirmed in the 2003 Pre-Budget Report, which indicated the Government's intention to publish Whole of Government Accounts (WGA) information for the 2006-07 financial year onwards, once the methodological issues raised by the development work have been addressed through dry-run processes. This chapter explains what WGA are, why they are being introduced, and what is involved.

WGA: ACCOUNTS FOR THE WHOLE PUBLIC SECTOR

6.2 WGA will use commercial accounting methods to produce a single set of consolidated financial statements based on Generally Accepted Accounting Practice (GAAP) for the whole public sector. As described in Chapter 2 in the context of individual body resource accounts, WGA will be prepared under GAAP, as adapted for the context. The Government Resources and Accounts Act 2000, which provides the legislative framework for WGA, requires the Treasury to prepare a set of consolidated accounts for bodies that appear to it:

- to exercise functions of a public nature; or
- to be entirely or substantially funded from public money.

6.3 Full WGA will therefore include all the different types of public sector bodies shown in Box 2.1. WGA will treat these bodies as a single entity, so all material transactions and balances between the constituent entities must be eliminated. Consistent accruals accounting policies must be applied across the group for all material transactions and balances. The programme of work required in order to achieve this is described in the subsequent sections of this chapter.

Benefits of WGA

6.4 WGA will provide additional and complementary data to that in national accounts for government, Parliament and the taxpayer. Through the approach being adopted to producing WGA, some of these benefits are already being realised. Amongst the benefits from the WGA programme are:

- greater comparability of financial information across the public sector as discussed in Chapter 2;
- additional impetus to improvements in the quality and timeliness of individual body accounts and to financial management systems as discussed in Chapter 4;
- new information on the public sector finances at an aggregate level;
- accruals-based data to support the ONS' continuing efforts to improve the quality of the national accounts; and
- improved accountability.

CENTRAL GOVERNMENT – PROGRESS AND WAY FORWARD

6.5 Achieving a full consolidation of the GAAP accounts for the whole of the public sector is a significant challenge. Implementation of full GAAP-based WGA requires the timely collection of audited data from around 1,300 bodies across the public sector. In contrast to the situation in a commercial group of companies, for many this will be the first time that they have had to comply with such a requirement. In view of the extent of the new systems and processes that implementing full WGA immediately would require, combined with the significant development and implementation of the necessary new accounting policies, it was decided to focus first on central government.

6.6 This section looks at progress in central government and the remaining challenges in the process. The following section then considers the greater challenges posed by the scale and complexity of preparing full WGA.

Further moves from cash to accruals accounting

6.7 Implementing Resource Accounting and Budgeting (RAB) required the introduction of accruals accounts in departments, as discussed in Chapters 2 and 4. Although together these bodies cover a large proportion of the Government's central expenditure, the following significant areas of activity were still accounted for on a cash basis in bodies' accounts:

- debt management, gold and foreign currency reserves; and
- taxation income.

6.8 Accounts for all these areas needed to be moved onto a consistent accruals basis in order to implement WGA. In addition, the Financial Reporting Standard on Retirement Benefits (FRS 17) required the valuation of the Government's liabilities in respect of the various unfunded pension schemes for its employees.

6.9 There have been both different and complex challenges to face in each of the areas. Therefore, as with resource accounts, the processes below were followed in order to allow the technical and practical problems to be properly addressed before the first audited accounts were published:

- development of accounting policies and the necessary implementation guidance; and
- dry run accounts for several years in order to ensure the systems and processes were sufficiently well implemented to allow accounts of auditable quality to be produced.

Debt and reserves

6.10 Considerable progress has been made in modernising the accounting for government's debt and reserves and central funds. The National Loans Fund is the body through which the government's borrowing activities are co-ordinated. HM Treasury is responsible for preparing these accounts, which were brought onto a GAAP basis for the first time for the 2003-04 financial year. This was a complex process, involving establishing the exact nature of the relationships with a number of other central accounts, as well as gathering a significant amount of historic data on debt issuance. The Comptroller and Auditor General's opinion on the first GAAP accounts was unqualified.

6.11 The accounts of the other main debt and reserves accounts, the Debt Management Account (DMA) and the Exchange Equalisation Account (EEA), were both brought onto a GAAP basis for the first time for the 2001-02 financial year. The DMA is the primary vehicle for government's market activities in relation to its borrowing. The EEA was originally founded to manage undue fluctuations in sterling; its functions have since been extended to include certain transactions associated with the IMF and making payments abroad. The only remaining development work in the debt and reserves area relates to some residual issues on producing consolidated risk disclosure information.

6.12 The accounts of the Consolidated Fund, the central account into which most tax revenue and other forms of income are ultimately received, and from which funding for departments is paid out, continue to be prepared on a cash basis. It will only be possible to introduce full accruals accounting for the Consolidated Fund once the remainder of the WGA processes have been completed, because of the interaction of the Consolidated Fund with the accounts of other public entities.

Taxation income

6.13 Moving taxation income recorded in the relevant tax income trust statements onto an accruals basis has proved particularly challenging for two reasons. First, there are currently no relevant UK or international accounting standards. HM Treasury worked closely with the former Inland Revenue and HM Customs and Excise to develop suitable accounting policies for each tax and duty head, based on the underlying principles for financial reporting. Revenues are deemed to accrue evenly over the (tax return) period for which they are due and are recognised in the period in which the event that generates the revenue occurs.

6.14 Secondly, the long assessment and collection periods for some taxes (particularly direct taxes) have required the use of complex estimation procedures. In preparing estimates, HM Revenue and Customs (HMRC) takes account of areas of uncertainty and makes complex judgements around those factors that determine future revenue flows. In deriving the estimates, HMRC uses statistical models, based on a combination of projections based on the most recent revenue flows and forecasts of economic variables on which future flows depend. Because of the areas of uncertainty involved, there will inevitably be differences between the forecasts and future outturn, but HMRC believes that the levels of variation are acceptable and that the maximum likely overall uncertainty will not significantly affect the reported position. These initial estimates will be kept under review as actual outturn data become available.

6.15 The move to accounting for taxation revenue on an accruals basis means that the UK retains its position among world leaders in accounting for government's income and expenditure. Recognising revenues in the period in which the taxable event occurs will provide better information for decision making, and will facilitate a more accurate assessment of the impact of tax policy changes on revenue flows.

6.16 The extent of the challenges faced has meant that accruals accounts for the taxes administered by HMRC were only published for the first time for the 2004-05 financial year. (Separate accounts were published by the former Inland Revenue and by HM Customs and Excise.) In addition, the particular problems faced in devising and implementing auditable accruals accounting policies for taxes with long collection periods, such as Self-Assessed Income Tax and Corporation Tax, have meant that accruals information on taxation income for 2003-04 was not available. However, the successful preparation and audit of the 2004-05 accounts for these taxes has now allowed estimates of tax receivable at both 31 March 2004 and 31 March 2005 to be published.

Public service pensions

6.17 For public service pension schemes, the move to GAAP-based accounts required significantly improved data collection from hundreds of public sector bodies, notably across the entire NHS and for all schools, as well as considerably accelerated actuarial valuation processes. Despite the scale of the changes involved, they were largely implemented in sufficient time to allow publication of full accruals-based data for 2003-04.

6.18 The main area where some work still remained to be done was ensuring that the NHS Pension Scheme for England and Wales had sufficiently current data on the employees of all 10,650 employing bodies. As discussed in Chapter 4, the Comptroller and Auditor General highlighted the significant uncertainty this caused and qualified his audit report on the scheme's 2003-04 accounts as a result. He also acknowledged that arrangements were in place for a full valuation in 2004-05 and to ensure robust data in place going forward. The accounts of the two other NHS pension schemes (for Scotland and Northern Ireland) were also qualified because, even though interim valuations were provided, it was more than four years since the last full valuation. These issues are being addressed.

Coverage

6.19 The central government work has taken an incremental approach to bringing bodies into the programme. Although NHS Trusts, and the recently created Foundation Trusts, are currently classified to the central government sector by the ONS, they have not to date been included in the work. This is because when the WGA programme was launched, NHS Trusts were classified as public corporations. When they were reclassified to the central government sector by the ONS in 2001, the decision was taken to continue with the incorporation of NHS Trusts into WGA, to the original timetable. This has allowed both the individual Trusts and the Department of Health more time to prepare, thus avoiding the additional burdens on these front-line bodies that would have been caused by an unnecessarily fast changeover.

Systems and processes

6.20 Excluding NHS Trusts, therefore, the focus of the central government work is on central government departments and their agencies, non-departmental public bodies and Government's central funds (Consolidated Fund, National Loans Fund, etc). This is already one of the larger sub-consolidations in the world, including over 300 bodies and assets worth over £400 billion. It was therefore decided to work through a series of dry-runs, using the approach adopted with individual resource accounts and the new accruals accounts discussed above.

6.21 Early in the preparations a decision was taken to work through a series of sub-consolidations. Under this approach, the devolved administrations, and departments that sponsor other public bodies, are responsible for collecting the information required from their related public bodies and eliminating transaction streams and balances within the sub-consolidation group. In all the central government process includes 20 sub-consolidations, which are aligned with the relevant departmental budgeting boundaries. These range from the relatively simple (a department and a single public body) to the relatively complex (such as the Department for Culture, Media and Sport with over 40 public bodies and funds).

6.22 Public sector bodies are free to establish the accounting systems, and in particular the data structures, or 'charts of accounts', that suit their particular businesses. However, to undertake a large consolidation it is necessary to have a central consolidation system based on a standardised chart of accounts. By implementing a relatively simple and 'high-level' Standard Chart of Accounts (SCoA), together with a web-based consolidation system, HM Treasury has ensured there is the necessary consistency without requiring individual bodies to make significant systems changes.

6.23 The SCoA and the consolidation system, first introduced in 2002, have already brought benefits to government. By providing a standard data structure for GAAP-based accounts, it has been possible to map these to the national accounts data structures (the economic statistics produced by the ONS as explained in Chapter 5). This has allowed HM Treasury to bring together its in-year and outturn monitoring onto a single software platform that can provide data to both national accounts and GAAP specifications. This single data system (known as COINS) is, this year, going live on a phased basis, and will provide a more integrated platform for collecting the data to control public spending.

6.24 There have been a number of dry run processes, using a series of 'milestones' to project manage development of the systems required. Early milestones concentrated on introducing agreement of transactions streams and balances within central government for the first time. More recently the focus of development has been on improving timeliness. The dry run processes, by introducing the submission of audited data by departments to HM Treasury, have progressively improved the quality of data available for policy purposes and national accounts.

6.25 The NAO and other auditors have been involved throughout the dry run processes. As well as contributing to the development of guidance, the NAO has used the dry run processes to develop the necessary working relationships with other public sector audit bodies in devolved administrations and commercial audit firms as well as reviewing the main consolidation process.

Way forward

6.26 As the process of consolidation requires consistent high quality audited data, it has been a key driver of, and beneficiary from, the process of improving the quality and timeliness of resource accounts. However, the consolidation process needs to be accelerated if public sector consolidated data are to be as timely, and thus useful, as possible. HM Treasury is therefore continuing to work with departments and other central government bodies to ensure the impetus to improve timeliness and quality is continued.

6.27 Having now completed a successful 'third dry-run' consolidation of the central government balance sheet at 31 March 2004, HM Treasury has already embarked on the consolidation processes for the income and expenditure and balance sheets for the year ended 31 March 2005, to form part of the 'first dry-run' WGA process. It intends to continue to accelerate these processes (because departmental data will be available earlier), thus making better, faster aggregate data available to the ONS for its work on national accounts.

IMPLEMENTING WGA

6.28 The process of achieving full WGA will increase the size of the consolidation task very significantly. It also increases the complexity of the process as different legal and accounting regimes in other parts of the public sector have to be accommodated. This section looks at both the technical and practical challenges involved in the move to WGA, and the progress already made.

Convergence of public sector accounting policies

6.29 As discussed above, it is a fundamental principle that a consolidation must be based on consistent accounting policies – i.e. that material transactions of the same type are accounted for in the same way across the group. Unlike most commercial groups, however, responsibility for setting accounting policies is statutorily devolved for a number of key areas of the public sector. The devolved administrations have varying responsibilities for the public bodies in their areas, while, in England, NHS accounting is the direct responsibility of the Secretary of State for Health and local government finance is the responsibility of the Deputy Prime Minister.

6.30 As discussed in Chapter 2, HM Treasury has been leading a general programme of convergence of accounting policies across the public sector. Bringing responsibility for the review of accounting guidance for all parts of central government under the remit of the FRAB has been a key part of this process. For the various types of bodies within the FRAB's remit, the minor differences that remain are attributable to the different regulatory regimes that apply.

Local government accounting

6.31 Local government is the most significant area of the public sector to retain its own accounting regime. This is largely because its finances are defined by highly specialised statutory requirements. Below the level of the specific legislation, a joint committee of the Chartered Institute of Public Finance & Accountancy and the Local Authority (Scotland) Accounts Advisory Committee (CIPFA/LASAAC) publishes a Code of Practice that establishes UK-wide accounting standards for local government.

6.32 Considerable changes over recent years have brought the Code of Practice more into line with GAAP, with the result that many differences between local government and the rest of the public sector have been eliminated. Three particular challenges, however, remain:

- the use of group accounts within the local authority sector has been limited until recently (i.e. local authorities have not necessarily consolidated into their accounts the other operating bodies which they control). CIPFA/LASAAC published new guidance for 2005-06 designed to clarify the requirements for group accounts and to improve the frequency with which these accounts are prepared;
- certain differences from GAAP accounting, resulting from the specific local government regulatory regime currently remain, primarily affecting the accounting reserves included in local authorities' balance sheets. CIPFA/LASAAC is now consulting on ways of addressing these issues. It is hoped that amended guidance will be in place for the 2006-07 financial year; and
- local government has yet to adopt an approach to accounting for the local roads network that is in line with the rest of the public sector. Although proposals to address this issue, based on using current values and renewals accounting, are under consideration, the eventual resolution remains uncertain.

Public corporations

6.33 The exact accounting framework for public corporations depends on their status and nature. As discussed in Chapter 2, those public corporations established as trading funds must already prepare their accounts in accordance with the FReM. Others – although not under the FRAB's remit – are subject to Treasury accounts directions, while some are free to determine their own accounting policies. In practice, however, most public corporations adopt GAAP in a way that closely mirrors normal commercial practice. While this means that in most areas there are no significant differences of accounting policy compared with the FReM, many public corporations account for their fixed assets at historic cost. HM Treasury is now looking at ways in which public corporations might deliver the necessary current value information on assets as efficiently as possible.

WGA Systems and Processes

6.34 As regards the consolidation, WGA will use essentially the same systems and processes as developed for central government. However, the expansion to include almost another 1,000 bodies, of a number of different types and across four territories, introduces considerable complexity.

WGA sub-consolidations

6.35 Extension of the sub-consolidation approach already being used will be a key part of the WGA implementation process. This will mean that the devolved administrations, and the relevant UK departments, will become responsible for collecting consolidation information for WGA from their sponsored bodies, as well as for preparing sub-consolidations for each sector as set out in Table 6.1.

Table 6.1: WGA sub-consolidations

Type of body	Geographical sub-consolidations				
	England	Wales	Scotland[1]	N. Ireland[2]	UK
Local Authorities	481	32	48	26	**587**
NHS Trusts	264	14	–	19	**297**
NHS Foundation Trusts	25	–	–	–	**25**

[1] *NHS Trusts in Scotland became part of Health Boards with effect from 2004-05.*

[2] *Based on current structures included in the 2004-05 dry run. On 22 November 2005 the Secretary of State announced plans to restructure the Northern Ireland public sector including moving to seven councils and six health and personal social services trusts.*

6.36 The Office of the Deputy Prime Minister will undertake the sub-consolidation of English local authorities; the Department of Health and Monitor will sub-consolidate English NHS Trusts and NHS Foundation Trusts respectively. The devolved administrations will each undertake the sub-consolidations of local government and NHS bodies in their area. These eight sub-consolidations will then be consolidated by HM Treasury, together with the central government data and information on public corporations, to produce consolidated information on each sector for the UK as a whole.

6.37 This planned WGA sub-consolidation structure reflects the complexity of the UK public sector. However, it brings considerable advantages in that it will allow the sponsoring departments and devolved administrations to improve the quality of their existing information; in many cases this will be the first time that audited outturn information for these bodies has been gathered by central government. For example, it will allow the Department of Health to move from preparing summarised accounts for the NHS (which did not involve full elimination of transaction streams) to producing fully consolidated accounts, thus providing Parliament with better information. It will also allow the Office of the Deputy Prime Minister and HM Treasury to develop jointly an integrated data set for local authorities, thereby allowing data to be collected once and used for several purposes – ensuring burdens on front-line bodies are minimised, while providing more reliable data to the centre.

WGA dry-runs

6.38 WGA, like the central government work, are being implemented through dry-run processes over several years. The first dry-run for 2004-05 is already under way, and is concentrating on establishing the systems and processes necessary to prepare WGA. The first dry-run will not be audited, although the NAO will, throughout 2006, review the process of preparing the new sub-consolidations, as well as the overall WGA consolidation itself.

6.39 The second dry-run, for 2005-06, will focus on improving the timeliness of the consolidation process and, in conjunction with the accounting policy developments described above, the quality of the accounts. The second dry-run will also involve bodies providing audited consolidation data for the first time.

CONCLUSIONS

6.40 Implementing GAAP-based WGA is a major technical and logistical undertaking that will place the UK at the forefront of accruals reporting by governments across the world. The significant progress already made has allowed us to have considerable confidence in the information for central government. However, there are still significant accounting policy issues and systems changes that need to be addressed in the WGA process.

6.41 If the first two WGA dry-runs are progressively successfully achieved, and if local authority and public corporation accounting practices are – over the same time frame – brought into line with those in central government, it is then hoped that the first WGA balance sheet information can be made available for the year ending 31 March 2007.

7 Way forward

7.1 This report has described the significant improvements in financial data across the public sector as result of the successful introduction of accruals accounting and budgeting in all major bodies. However, further major challenges to the WGA programme remain over the next few years in terms of:

- implementation of eight major new sub-consolidations covering health and local government bodies in England, Scotland, Wales and Northern Ireland;
- completion of the convergence process to bring the accounting policies applied in local government in line with those in central government - in respect of group accounts, GAAP–compatible reserves and the local roads network;
- obtaining current value asset data from public corporations; and
- the timing and impact of the ASB's plans to converge UK financial reporting standards with international standards – and of the public sector specific guidance being produced by IPSASB.

7.2 In addition, right across the public sector – including in central government – there is a need to continue improving the quality and timeliness of financial reporting, and to develop the in-year systems and processes required to support both these changes and improvements in financial management more generally.

7.3 Meanwhile, the accruals-based data prepared by individual bodies are increasingly being used in support of the ONS' continuing efforts to improve the quality of the national accounts that are used to manage the finances of the public sector as a whole. The Government will continue to develop the format and content of public bodies' accounts to clarify the line of sight from the fiscal rules through the budgeting system to resource accounts. Addressing the challenges above, and other incremental improvements, will further improve the quality of accruals data provided to the ONS.

7.4 HM Treasury is in the final stages of implementing a new collection system for data on the public finances (COINS) that will be a key enabler in these developments. COINS will provide better quality financial information by eliminating inconsistencies in the data HM Treasury uses and streamlining the processes for collecting and processing the information. Nevertheless it is important that HM Treasury, and departments supplying the data, rise to the challenge posed in the Atkinson Report to build on the implementation of COINS by working with the ONS to drive further improvements in the national accounts process.

7.5 The development of the GAAP processes for central government represents a major achievement for the WGA programme. Much remains to be done if the Government is to publish the first WGA balance sheet information for the year ending 31 March 2007. However, the more consistent and timely top-level data that are already being provided as part of the process of moving towards production of auditable WGA represent an increasingly significant contribution towards delivering the full benefits of accruals accounting for the whole public sector.

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