

APPLYING ACCRUALS-BASED ACCOUNTING AND BUDGETING TO UK CENTRAL GOVERNMENT

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ABSTRACT

A current UK initiative will mean major changes to government planning, control and reporting through the application of resource accounting and budgeting – a term which covers the introduction of accruals-based concepts. The changes and the reasons for their introduction are first set out. A number of issues arising from the application to government of GAAP designed primarily for trading organisations are then illustrated. The changes are set in the context of similar Irish and international changes being implemented or discussed.

INTRODUCTION

Before outlining developments in the UK, it is worth noting that the Irish government has also been considering the adoption of accruals-based accounting. It has conducted a pilot scheme in one department (Department of Transport, Energy and Communications, 1997) and an Annual Report and Financial Statements were produced for 1995 (Department of Transport, Energy and Communications, 1996). This involved (p.4):

... the production of financial statements with accompanying notes and conforming as closely as possible to Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs) ... Fundamentally the accounting policies which were adopted were no different in most respects to those adopted by public limited companies ...

However, some differences (e.g., fixed assets, depreciation, pensions and notional charges) were identified.

Meanwhile the Northern Ireland Civil Service is scheduled to introduce resource accounting and budgeting as described below on the same basis as other UK government departments over the period 1997 to 2000. The rest of this article outlines the nature of the UK changes and identifies a number of accounting issues which pose particular challenges in applying to government activities a framework designed primarily for trading organisations.

WHAT IS RESOURCE ACCOUNTING AND BUDGETING?

The terms “resource accounting” and “resource budgeting” to describe the changes is a signal that the UK government’s proposals include accruals principles, but also go wider. The two terms are defined respectively as (HM Government, 1995, p. 49):

... a set of accruals accounting techniques for reporting on the expenditure of central government and a framework for analysing expenditure by departmental aims and objectives, relating those to outputs wherever possible

and

... planning and controlling public expenditure on a resource accounting basis.

Thus it is not only the incorporation of an accruals basis but the link between inputs and departmental aims, objectives and outputs that are key dimensions of the proposals. Included in the changes to the inputs is the recognition of the cost of capital. The new basis applies both to the conduct of government business as well as to the way the government reports to Parliament.

To give the background to the UK changes, a White Paper announced in 1995 (HM Government, 1995) that resource accounting would be introduced by 1998 and resource budgeting from the year 2000. It was also announced that Parliament would be asked to make a similar change to the basis on which approval is given for government expenditure and on which the government reports. In setting out the details of reporting, the White Paper established that there would be five audited statements:

1. A summary of resource outturn (information for Parliamentary control purposes)
2. Operating cost statement (this, and the next two statements, correspond to those used in private sector reporting)
3. Balance sheet
4. Cash flow statement
5. Statement of resources (identifying the resource costs of the department's aims and objectives).

A sixth statement – an output and performance analysis – would follow the notes to the accounts, but would not be part of the accounts and would not be audited.

The White Paper also announced a review of the financial documents presented to Parliament, the creation of a Financial Reporting Advisory Board (FRAB) to advise on the application of accounting principles and standards, and confirmation that departments would be charged for cost of capital employed.

For reporting to Parliament, the White Paper's proposals were to replace the existing (Appropriation) accounts by a Resource Account for each department. There were also proposals for changes in the way Parliament approves expenditure. Instead of providing all information in cash, the Supply Estimates – documents providing the information for Parliament to authorise expenditure – would present detailed information in resource terms, with an associated cash requirement.

The new basis for resource budgeting – including planning, monitoring and control – was defined in less detail, not because budgeting was seen as any less important than reporting, but because such arrangements are only decided in detail nearer to the public expenditure Survey to which they apply. In outline, the new Survey will include both cash and accruals figures. It will involve, as now, top-down procedures within a framework for decision making by the Cabinet to help achieve macroeconomic, and support microeconomic, objectives. The new dimensions will be introduced without the danger of losing control of cash, which remains a key measure of macroeconomic management for the Treasury and for Parliament.

THE REASONS FOR THE CHANGES

A commentator on the White Paper, Wright (1995, p. 580) noted that 'Not since the ... 1960s ... has a change of such magnitude been introduced unprovoked by either a financial or an economic crisis'. The reasons why the change is taking place include a combination of dissatisfaction with the current system of Vote accounting for Parliament (which had its origins in Gladstone's public finance reforms of 1866) and cash budgeting and reporting, the enhanced possibilities of what the new information can offer departmental management, demands for greater accountability, developments on similar lines in other countries and the reduction in cost of application through technology.

More specifically, the initiative provides benefits for departments, for central government as a whole, for the economy and for Parliament. For each department, it offers improved management information, especially on costs and assets, including working capital. It provides the opportunity for better informed decisions on, for example, the allocation of resources, especially on capital, and on comparisons over time and between internal and external providers. It also gives the opportunity for a greater focus on outputs. For central government as a whole, it offers improvements in several aspects of the planning and control of public expenditure, the possibility of cash control at a higher level than in the past, consistent with a more strategic approach to Civil Service management, and the opportunity to bring closer together the systems used for Parliament and those used within the government.

For the economy, there is the opportunity for improved information on the holdings and use of central government assets, again including working capital. This will give better quality data for the National Accounts as well as for the better use of national resources. Capital charging provides the means to promote the improved use of resources through a recognition of the opportunity cost of capital employed in central government. For Parliament, there will be information not only on how much is being spent but on how departmental objectives are being achieved and what is being obtained for the money which is spent.

Many of these benefits do not have to await the completion of the implementation process. Additional information will be available to departments over an extended period before full implementation of the new framework is in place. To take some examples:

- Asset registers, and associated valuations, will provide details of what a department owns with a view to seeing whether all are essential for delivering outputs
- More comprehensive information on the cost of outputs will be available
- Departmental aims may be appraised in new ways, once costs are put against them
- The financial knowledge of many Civil Servants will improve as a result of training associated with the initiative
- Performance measures will be reviewed and will become more systematic
- Stock control systems will be tested for their robustness.

Some of these benefits, such as output-related information, will be the direct result of this initiative, while some will reinforce existing pressures for managerial improvement, for example stock control systems.

ACCOUNTING ISSUES

The White Paper set out that resource accounts would be based on Generally Accepted Accounting Practice (GAAP). The use of GAAP will give a read-across to other organisations in both private and public sectors, help in an understanding for those outside government familiar with accrual-based accounts and provide an existing framework, adapted as necessary, for the particular circumstances of central government, rather than having to devise a new one. Both the Treasury Select Committee (TSC, 1996a) and Public Accounts Committee (PAC, 1997) welcomed the use of GAAP and urged the Treasury to stick as closely as possible to it.

However, the application of the new framework gives rise to a number of general issues which need to be resolved. Many of these stem from the need to apply to government departments a set of accounting rules which, when devised, had trading organisations as their primary focus. Application to departments also needs to take account of the differences in the nature of accountability between public and private sectors since the constitutional basis for the relationship between government and Parliament has no private sector parallel. The following are a number of examples:

Accounting Policy-making

A major question in this aspect of accounting is 'Who should set reporting standards?' Some, including the National Audit Office (NAO, 1995) and the Treasury and Civil Service Select Committee (TCSC, 1995a – see Note at end), felt that it would be inappropriate for those responsible for preparing financial statements to have the sole responsibility for deciding on the standards that such statements should follow. It was felt that Parliament (and others, including other users of the accounts) should have a say in the development of reporting requirements specific to central government. An extension of this view was that there should be an independent body to oversee and approve reporting standards (PAC, 1995), not only because preparers should not set their own rules for reporting, but as a means of commanding public confidence. There was some caution in the Treasury's initial response (TCSC, 1995b), and it was later explained (TSC, 1996a) that complete independence was not possible where the Treasury had responsibility to Parliament for financial reporting and when the use of the information in planning meant that presentation of information for reporting could not be taken in isolation. The White Paper nevertheless accepted that there should be external involvement in standard-setting and an advisory body – hence the setting-up of the FRAB to (HM Government, 1995, p. 17) 'advise HM Treasury on the application of accounting principles and standards to resource accounting financial reporting requirements'. This was welcomed by the National Audit Office (NAO, 1996), by the Treasury Select Committee (1996a) which also put down a marker about its ability to question the FRAB, and by the Public Accounts Committee (1997) which emphasised the need for the Board's independence.

The Nature of the Audit Opinion

The White Paper proposed a 'presents fairly' opinion on the grounds that some of the functions of central government have no counterpart in the private sector and accounting for them may not be covered by GAAP. This view was opposed by the National Audit Office (NAO, 1996) which argued that a 'true and fair' opinion already covered a wide range of bodies in public and private sectors, that 'presents fairly' was confined to a few particular cases, that the reader would be aware of the way in which 'true and fair' was being used, so there would be no confusion, and that 'presents fairly' could be interpreted as a second-rate audit opinion. The Treasury and Civil Service Select Committee (TCSC, 1995a) supported the National Audit Office, but the Treasury Select Committee later refined its support to suggest (TSC, 1996b) that the audit opinion should refer to

compliance with the resource accounting reference manual. The Public Accounts Committee (PAC, 1997) recommended that the wording should be decided by the head of the National Audit Office, the Comptroller and Auditor General. In replies to the two Committees, the Treasury (HM Government, 1997; TSC, 1997a) accepted the recommendation of the 1996 Treasury Committee report.

The Boundary

The boundary between central government and the rest of the public sector is different in nature to the boundary between a private sector organisation and other organisations. For public expenditure control, this is not a trivial matter since where the boundary is drawn has considerable implications, for example, arising from the results of differences in accounting for grants made by central government to other public bodies. Parliament was particularly interested in the implications for reporting, following the proposal in the Green Paper (HM Government, 1994) that Non-Departmental Public Bodies (NDPBs – commonly known as Quangos) should be outside the departmental boundary. The National Audit Office (NAO, 1995) sought additional information in the notes to the accounts on NDPBs sponsored by the department, while the Treasury and Civil Service Select Committee preferred that they should be consolidated (TCSC, 1995a). However, the Public Accounts Committee (PAC, 1995) thought that a final view on the boundary issue should await the introduction of resource accounting. Following the White Paper's modification of the boundary to reflect control, some NDPBs were inside, some outside. The National Audit Office (NAO, 1996) continued to be concerned about transparency and the Treasury Select Committee (TSC, 1996b) about where the boundary was drawn. The Public Accounts Committee (PAC, 1997), while continuing to suggest that the boundary issue should wait, supported the National Audit Office in its concern about transparency, a concern which the Treasury met in its reply to the Committee (HM Government, 1997, p. 2) in promising a list, in the notes to the account, of 'the names, and extent of financial support for NDPBs and sufficient information to enable users to locate the bodies' accounts'.

The Role of Parliament in Voting Supply

Parliament votes the government the means to carry out its business as well as being the recipient of the accounts. This role is very different to the framework of stakeholder accountability in the private sector and much attention has been devoted to how a new system of voting Supply will

work in practice and whether there should be a change from voting cash to voting resources. The Green Paper (HM Government, 1994) raised the possibility of Parliament voting resources, to which the National Audit Office (NAO, 1995) responded with a cautious welcome, echoed by the Public Accounts Committee (PAC, 1995), though in both cases further details were sought. The White Paper (HM Government, 1995) provided such details by proposing that resources should be voted in detail, with overall cash consequences for each department. The National Audit Office (NAO, 1996), Treasury Select Committee (TSC, 1996b) and Public Accounts Committee (PAC, 1997) continued to be cautious, but not to rule out the possibility of change, the PAC suggesting that the Procedure Committee be brought into the discussions.

Audit of Schedule 5 (the costing of departmental aims)

The private sector has no equivalent statement to Schedule 5 and the issue here is whether an audit opinion should cover them, and if so, what it might be. The National Audit Office (1995), and the Treasury and Civil Service Select Committee (TCSC, 1995a) were concerned that Schedule 5 should be audited, bearing in mind its importance in showing the purposes of expenditure. The Treasury accepted this in the White Paper (HM Government, 1995).

Audit of the Output and Performance Analysis (OPA)

Here again there is a statement without a private sector equivalent. There was recognition by the National Audit Office that it would take time for the information to be of a quality to allow for audit, though it hoped that audit would be possible as the information improved. The Public Accounts Committee (PAC, 1995, p. vii), while suggesting that ground rules should be established, was more cautious, commenting that audit 'should be achievable as the quality of departments' performance information continues to improve'. The Treasury and Civil Service Select Committee (TCSC, 1995a, p. xii) was also sceptical, describing the information as 'interesting reading' while indicating that it would be 'impossible' to provide a formal audit opinion without clarification to ensure consistency. In the White Paper, the Government (1995) indicated its willingness to work with departments to develop good practice. Following a further report by the National Audit Office (NAO, 1996, p. 12) stating that 'validation of performance data is ... becoming increasingly important to the effective Parliamentary scrutiny of the Executive' and that 'there is an opportunity for trial and experimentation so that a robust system of performance

reporting, with validation, can be ready for the new century', there was greater enthusiasm for audit, or at least a validation of the OPA. The Treasury Select Committee (TSC, 1996b) suggested that further consideration should be given to including the OPA in the notes to the accounts and to being subject to audit. The Public Accounts Committee (PAC, 1997, p. vii) recommended that the Treasury should aim to achieve 'independent validation' and that meanwhile the Comptroller and Auditor General should review the data 'to ensure that it is not inconsistent with the resource accounts themselves, or is otherwise misleading'.

While many accounting issues may seem to be unique to central government, they can be set within a well-established framework, even though there may be complexities in their application. Some examples of such complexities are:

- The degree of consistency in the application of general principles to accounting practice in different departments.
- Price-level adjustments. How to account for changing price-levels. The issue has been on the agenda in various UK (private sector) professional proposals for over 50 years. The additional dimension for central government is the difference in the balance of argument about the choice between operating capital maintenance and financial capital maintenance. It is not possible to summarise the complex arguments here, but anyone interested should at least read the Byatt Report which appeared over ten years ago (HM Treasury, 1985) and which discussed these issues in considerable detail.
- Treatment of less conventional assets including military equipment, the heritage, the road network and assets donated to the public sector. The sums involved are very large and even the boundaries of the categories are not straightforward, as for example whether a value should be attributed to the operational elements of a heritage asset.

More generally, concerns have also been expressed about the dangers of the 'creative accounting' which has been a problem for the UK private sector in the past. It is worth remembering that there are a number of constraints on central government which are not present in the private sector (TSC, 1996b). These include a highly public form of accountability to Parliament, having the Comptroller and Auditor General as a single auditor and the absence of some of the major problem-areas which have bedevilled the private sector (such as the results of trading, mergers and

acquisitions and many foreign currency transactions). The development of expertise in central government provides a further safeguard (TSC, 1997b)

The reporting requirements set out above relate to departmental accounts. On the question of whether these should be aggregated to produce whole-of-government accounts, it has been argued that the government is like a holding company, with departments as subsidiaries. According to this argument, whole-of-government accounts would be both appropriate and necessary to gain a picture of government as a whole for such matters as whether public sector capital is being renewed, the results of the sale of public assets and the accumulation of public liabilities. A number of commentators and the National Audit Office (1995) have indicated that such accounts would be of interest to Parliament and the public and both the PAC (1995) and the Treasury and Civil Select Committee (TCSC, 1995a) suggested that the feasibility of producing them should be explored.

The Treasury has been cautious about doing so (HM Government 1994; 1995), given the same kind of constitutional and definitional issues that are relevant to consideration of the departmental borderline, including the status of NDPBs, public corporations and local authorities. They also argued that there are considerable technical difficulties of aggregating the information and that there is a question-mark over the value of the resulting information, bearing in mind that the definition (and non-professional expectations of the definition) of assets and liabilities are not the same as for the private sector. Nevertheless, the Government agreed (HM Government, 1995) to the proposal of the PAC to participate in joint National Audit Office/Treasury research on how this might be done.

THE INTERNATIONAL CONTEXT

The international interest in such developments is considerable. Although the relative emphasis may be different from one country to another, the main reasons for the interest in accruals-based information are very similar between countries. As an OECD booklet on accrual accounting in the public sector set out:

While the advantages of cash are acknowledged in terms of assessing short term economic impact and compliance with spending limits, the ability of cash information to enable in-

formed decisions on the stewardship and financial position is constrained because it excludes physical and financial assets and liabilities. Alone it provides no basis for judgements on performance in terms of economy and efficiency. (OECD, 1993)

Other international studies at the same time (Premchand, 1993; IFAC, 1993) noted other aspects of the limitations of cash for governments and the possibilities offered by accruals accounting.

At a national level, the pioneer is undoubtedly New Zealand which has already implemented a similar system covering many of the areas envisaged for the UK. The reasons that the UK could not simply use the New Zealand experience was that while New Zealand, in response to a budgetary crisis, had introduced a comprehensive package of changes of which their equivalent of resource accounting and budgeting was one part, the UK is modifying an existing system. The UK also has a more complex set of public sector relationships and is seeking in parallel to improve the integration of Parliamentary reporting with the government's own planning, control and reporting.

Sub-nationally, there are already many countries where parts of the public sector report on an accruals basis. Several other countries have introduced national accruals-based reporting, often with modifications.

A number of countries are currently developing some or all of the elements of resource accounting and budgeting. Australia and France are two of the countries which are seeking to cover similar aspects. Canada, Iceland, the Netherlands and Sweden are among the countries which have developed, or are developing, some of them. The analysis of costs by objective and/or output and performance measures is the subject of work in many other countries including Austria, Denmark, Finland, Germany, Italy, Mexico and the United States. Not all of these developments are discretionary. In the US, for example, the Government Performance and Results Act 1993 requires budgets from 1999 to have a government-wide performance plan using specific measurable goals for all major programs and operations.

Finally, it is interesting to note that the approach to the use of accounting standards for government reporting varies considerably. At one 'extreme' New Zealand has adopted the private sector model, at the other the US is

developing a special government financial reporting model and set of reporting standards. In between come most other countries, such as French work on standards 'inspired' by commercial standards.

IRISH DEVELOPMENTS

For Ireland, the Project Report of the Department of Transport, Energy and Communications (1997, p. 7) set out the lessons from the pilot project and concluded:

The benefits of accrual accounting will be maximised if the accruals system is expanded further and utilised as a framework for analysing expenditure by Departmental aims and objectives and relating these to outputs. The introduction of a system which matches outputs to inputs i.e. resource accounting, involves all Cost Centre managers, and makes accrual accounting relevant to their work. Resource accounting will produce financial information on the costs incurred in implementing Cost Centre objectives and will provide performance indicators, both financial and non-financial, relating to these objectives.

The most important benefit of resource accounting will be the improvement in planning by Cost Centre managers, because the process will involve a commitment to achieve stated objectives with specific resources. By the same token, the system will also highlight the effectiveness of cash and asset management by Cost Centres and, as a consequence, by the Department as a whole.

The requirements in Ireland for departmental asset registers and for some accruals-based information (on accrued expenses and income, prepayments and deferred liabilities, current assets and liabilities, a statement of capital assets, commitments and matured liabilities) in the Appropriation Accounts has laid the groundwork for further developments. These, together with the above quotations, appear to indicate that the UK and Ireland may well have similar systems in due course.

CONCLUSION

For the UK, there is still much to do. The period up to full implementation will continue to offer many challenges in translating principles into workable systems. If Parliament approves the proposals for changes in reporting to them, the completion of the full cycle of Estimates for 2001–2 and reporting in 2002 will have provided a comprehensive programme of reform with new information for better management in government and improved Parliamentary accountability.

NOTE

The Treasury and Civil Service Select Committee was split into the Treasury Select Committee and the Public Service Select Committee in 1995.

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