Inquiry into government accounts

1. Introduction

The Committee’s inquiry is concerned with two main themes:

- The Departmental Accounts published for Parliament and the public, and their relevance in holding Government to account.
- The format and utility of monthly management accounts used by Ministers, Permanent Secretaries and Departmental Boards.

The authors are both professionally qualified accountants with extensive experience of accounting and financial management in the public sector including central government. Both authors are active researchers and have, in the past few years, written academic papers and published reports on aspects of financial and management accounting in the public sector.

2. Financial accounting and Management accounting

It is not easy to provide a concise definition of accounting since the word has a broad application within businesses and other organisations. The American Accounting Association defines accounting as follows:

"The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information! (Valix et al 2009)

The following words in this definition should be highlighted:

- **Information** - accounting is about providing information to others. Accounting information is economic information - it relates to the financial or economic activities of the business or organisation.
• **Identification and measurement** - Accounting information needs to be identified and also measured.

• **Communication** – there is a need for accounting information to be communicated. The communication need is about understanding who needs the accounting information, and what they need to know.

In relation to business and other organisations, accounting practice is usually considered as being of two types – financial accounting and management accounting (Prowle 2010). Both types of accounting utilise the same raw financial data but the distinction between management accounting and financial accounting is exemplified below.

<table>
<thead>
<tr>
<th>Theme</th>
<th>Financial Accounting</th>
<th>Management Accounting</th>
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<tbody>
<tr>
<td><strong>Focus</strong></td>
<td>External to the organisation</td>
<td>Internal to the organisation</td>
</tr>
<tr>
<td><strong>Users</strong></td>
<td>A variety of external stakeholders</td>
<td>Managers at various levels in the organisation</td>
</tr>
<tr>
<td><strong>Purpose</strong></td>
<td>Accountability</td>
<td>Inform management decisions at strategic and operational levels</td>
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<td></td>
<td>Inform external stakeholder decisions</td>
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<tr>
<td><strong>Period</strong></td>
<td>Annual</td>
<td>Any period but typically much more frequently than annually</td>
</tr>
<tr>
<td><strong>Framework for production</strong></td>
<td>Legislative/professional framework</td>
<td>Organisationally determined</td>
</tr>
<tr>
<td><strong>Orientation</strong></td>
<td>Historically oriented</td>
<td>Historical and future oriented</td>
</tr>
<tr>
<td><strong>Disclosure of information</strong></td>
<td>Limited disclosure of information into the public domain</td>
<td>Wide and detailed range of information made available internally</td>
</tr>
<tr>
<td><strong>Independently Audited</strong></td>
<td>Yes</td>
<td>No</td>
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3. Financial Accounting

Overview

Virtually all organisations in the public, private and third sector are required, by law, to produce annual financial accounts that provide certain information about the organisations for the previous twelve months. The primary reasons for this requirement can be summarised as being:

- **Accountability** – to discharge accountability, to owners and/or other stakeholders, for the resources used by the organisation over the previous twelve months. In the Government sector, holding governments to account has been a key task for over 800 years. The Magna Carta introduced the first standards of accountability in government by forcing King John to accept the basic principle that taxes should not be raised without first consulting his wealthy subjects and that the expenditure of the monarch should be examined. This has evolved over centuries with on key element of accountability being the production of annual accounts by Government departments (Prowle 2012)

- **Decision making** – to inform decisions made by external stakeholders concerning the organisation itself. In a limited company, this can involve shareholders making decisions about their shareholdings or banks making lending decisions. In the public sector this can inform decisions about the choice of public services, the competence of Governments etc.

UK Central Government Departments follow this model and their accounts are referred to as resource accounts emphasising the approach if accruals accounting which replace cash based accounting in 1993.

Finally, it should be noted that these statements are independently audited by the National Audit Office to confirm their veracity. The provision of this independent review enhances the reliability of the information contained in the accounts to users. Other financial information may also be disclosed in annual reports of Government Departments but this is voluntary disclosure and will not be subject to audit and hence has a lower level of reliability attached to it.
Research into usefulness of financial accounts in central government

Based on research undertaken by the authors (Prowle et al 2012), the following points should be noted concerning the annual accounts of public sector organisations including Government Departments

Identification of user needs for information

If we consider what are seen as the information needs of users of Government accounts, then various professional and academic sources point to the following as being important:

- The legality with which public funds have been used.
- The on-going financial and operational viability of the organisation.
- That public funds have been used according to plan.
- That public funds have been used effectively and efficiently.

It might also be thought, that taken together, these four needs also constitute the requirements for accountability and stewardship.

Potential for meeting user needs for information

If we now turn to the issue of whether the published (and audited) financial statements produced by Government Departments are actually likely to meet the needs of users then the following conclusions can be drawn

<table>
<thead>
<tr>
<th>User Need</th>
<th>Extent to which need is met</th>
</tr>
</thead>
<tbody>
<tr>
<td>The legality with which public funds have been used</td>
<td>Yes. However, the provision of an audit certificate is paramount</td>
</tr>
<tr>
<td>The ongoing financial and operational viability of the PSO</td>
<td>Possibly. The balance sheet may indicate this to some extent</td>
</tr>
<tr>
<td>That public funds have been used according to plan</td>
<td>No. There is no attempt made in statutory financial accounts to indicate this</td>
</tr>
<tr>
<td>That public funds have been used effectively and efficiently and give VFM</td>
<td>No. It is extremely difficult to see how this can be the case given the nature of the information disclosed and the lack of comparisons with others</td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Accountability and stewardship</td>
<td>In the light of the above, the answer must be that this is only achieved in part.</td>
</tr>
</tbody>
</table>

Thus, overall, the extent to which existing financial accounts are likely to meet the needs of users is extremely limited

**Use made of accounting statements by users**

In the light of the above, another relevant question concerns the extent to which stakeholders might actually read and make use of statutory accounts of government departments. In this case, we are looking for empirical evidence as to the extent to which users look at statutory financial accounts and what value they gain from them. There appears a general dearth of empirical evidence in this area and especially in the UK. There seem to be few if any studies about who actually looks at statutory financial accounts of public bodies and the modern practice of placing of such accounts on the web, as part of a larger annual report, means that no record can be derived from that source. If we consider the usefulness of such accounts then there also seems to be limited numbers of studies and very limited evidence about their usefulness to users. Having undertaken an exhaustive review of research literature, it appears to us that, internationally, there is little evidence about the utility of statutory financial accounts any part of the public sector including central government. Most studies seem to be incomplete, inconsistent or lacking in robust evidence.
Furthermore, anecdotally one of the authors has, on many occasions, asked individual or groups of senior public service managers whether they look at the accounts of their organisation and whether they understand the content. More often than not, the answer to these questions is in the negative. The author has also asked qualified accountants if they have ever looked and/or analysed the accounts of their own local authority or NHS Trust of residence on a personal basis as a citizen or taxpayer (as opposed to a professional basis). He has hardly ever found anyone who has done this. What then is the non-accountant who has no accountancy training, supposed to do?

When these facts are presented to professional accounting bodies and representative organisations, more often than not their response is to say something like “we must work harder to get people to look at and use the information” rather than being prepared to look at the nature and format of the accounts themselves.

**Costs of production and audit**

Although there is no hard data available, the costs of producing the financial accounts of central government departments, must be substantial. For each government, department, there are significant staff time costs associated with the planning, preparation, production, review and publication of these accounts and also the costs associated with the audit of a complex set of statements.

**Conclusions on financial accounting**

The authors believe a number of important conclusions can be drawn:-

- Firstly, it seems likely that there are substantial costs associated with the preparation and audit of Government financial accounts and there is hardly any evidence that current financial accounts meet user needs or are relevant to users.
• Secondly, while some form of financial accounting is clearly necessary for stewardship and accountability, the current accounting arrangements seem over-elaborate (and have become even more elaborate over time). If there is no real evidence that the current complex sets of accounts are meeting users’ needs there seems a strong case for having statutory financial accounts that are either more relevant to user needs and/or simpler, easier and cheaper to produce.

• Thirdly, as already mentioned, the current financial accounting approaches in Government seem over-elaborate given the lack of evidence about meeting user’s needs. Thus, it is a very interesting question to ask why we have got to this situation and what the causal factors were. It is difficult to be definitive about this but based on wide ranging discussion, we suggest the over-elaboration has come about as a consequence of two main factors:-

  ➢ **Blindly copying accounting practices from the private sector** - Given the difference in user needs for information there seems no logic that private and public sector accounts should have the large degree of similarity that they do have. It seems to us that statutory accounting frameworks in the public sector have developed by blindly copying private sector practices with limited thought about the relevance of what was being done. As one example, consider the implementation of International Financial Reporting Standards (IFRS) in the public sector. In what way does this help meet user information needs or improve accountability for public resources, while the costs of IFRS implementation were substantial?

  ➢ **Professional self-aggrandisement** – It almost seems to us that there is a view that the importance of the accounting profession is being enhanced by having more and more complex sets of accounts (which only trained
accountants can understand) irrespective of the relevance to users. Examination of the membership of the UK Accounting Standards Board shows that it is dominated by the accounting profession with little or no involvement of users of accounts. Furthermore, more complex sets of accounts probably mean a larger audit burden and larger audit fees for professional firms of auditors.

- Fourthly, however pessimistic we might be about the current state of UK Government accounting, we recognise that there is potentially considerable public benefit from having some relevant form of accounts. All organisations have two critical financial statements: the budget that sets out what the organisation plans to do, and the statutory financial accounts which sets out what it has done. Within the private sector, the statutory financial accounts are important because ultimately they show the sustainability of the enterprise. As private sector organisations can easily go out of business if they fail to act in a sustainable way, the statutory financial accounts are always the most critical document. Because PSOs hardly ever go out of business, it is the budget with its taxation implications that is the critical document. However, if the concept of sustainability of a public sector organisation was developed more thoroughly and was incorporated in a completely revised set of financial accounts then it would give the public important information about the long-term consequences of organisational, managerial, and political decisions being taken on their behalf. At a time when the long-term debt of the public sector is a critical issue, and questions are being raised about the intergenerational equity of public finance decisions, a set of financial accounts produced on a sustainability basis would be invaluable. Such statutory financial accounts would have to address the question of the realistic
impact of long-term liabilities, the use of capital, and the replacement of assets within its format, and indicate the cost in terms of future taxation of current policies as well as all long-term liabilities and the use and replacement of capital. This would be a considerable undertaking, but well worth doing in our view, and would render a set of accounts that are currently "the great unread" into a useful document. We recognise that this would be politically very sensitive, and practically difficult, but it would be worth doing.

- Fifthly, and finally there seems to us to be an urgent need to undertake research concerning:
  - The magnitude of the costs of preparing and publishing the current form of statutory financial accounts in Government organisations.
  - The extent to which information contained in UK Government accounts is read and used by various individuals and groups and the benefits derived from this.
  - What alternative approaches to statutory accounting in the UK Government sector might be of more relevance. We reject the obsession with international approaches to this.

4. Management accounting

Overview

Management accounting has a wide-ranging set of roles in all type of organisations. It is defined by the Chartered Institute of Management Accountants (CIMA 2009) as being:

“the practical science of value creation within organisations in both the private and public sectors. It combines accounting, finance and management with the leading edge techniques needed to drive successful businesses. Management accountants operate in financial and non-financial roles throughout organisations and carry out all
their training and experience requirements within business itself, providing them with a unique insight into how their organisations operate”.

Thus, management accounting can be seen as the interaction between three elements

- **People** – they key people are the management accountants themselves and the skills and knowledge they possess.
- **Roles and methods** – management accounting has many roles in an organisation at the strategic, managerial and operational level. It undertakes these roles through the use of a variety of methods such as: costing, budgeting, investment appraisal, value analysis etc.
- **Management information** – the provision of information (financial and non-financial) within the organisation that is used in various ways by managers at various levels in the organisation. This information may be relevant at strategic, managerial and operational levels.

Thus while management accounting information is an important issue, effective management accounting practices must involve more than that. Consideration must be given to the skills of management accountants and the roles they perform in government as well as issues of information.

**Criticisms of central government practices**

In recent years, there has been a lot of criticism of financial management and management accounting in central government starting in 2008, with the Public Accounts Committee (PAC) in its report Managing Financial Resources to Deliver Better Public Services (2008) which stated that:
there was a lack of financial management skills in government
only 41% of departments’ policy proposals included full financial appraisal
only 20% of departments’ policy decisions were based on a thorough financial assessment
there was no significant improvement in forecasting and in-year monitoring of expenditure (PAC 2008)

Subsequently the PAC stated that ‘Government organisations have been successful in improving their resource management, but a lack of financial management skills amongst non-finance staff is a barrier to further progress’.

Early in 2013, the Institute for Government published a report entitled Financial Leadership for Government (IfG 2013). The report compared and contrasted financial leadership in UK government with that in the private sector and made a number of important points.

- Strategic roles are often weaker at the centre of government than in large private businesses.
- In some areas, such as supporting performance management, central leadership roles are relatively underdeveloped.
- The structure of financial leadership in government, at a cross-departmental level, is more fragmented than that typically found in a private sector environment.
- The UK’s Treasury does not take a leading responsibility for supporting performance management. The Cabinet Office takes on this responsibility.
- The position of the leading finance professional in government is relatively weak, being a part-time post, acting as a first among equals but with no formal input into key decision-making processes.
- These weaknesses appear to be specific to the UK and it seems clear that the UK government needs to strengthen its performance management and financial leadership.

In June 2013, the National Audit Office (NAO 2013) published a report entitled Financial Management in Government. Initially, the report outlines the challenges faced by government and the potential roles to be played by financial management
and financial managers in this situation. The report then notes that there have been signs of improvement in financial management in government, as well as greater recognition of the strategic importance of the finance profession. It states that there was positive progress in relation to leadership, financial management processes and management information. Even so, while noting this progress the NAO report also comments that none of the improvement processes had been completed. It states that on management information, government remains a long way from ensuring that decision-making is routinely based on appropriate and robust information. Unit cost data are not systematically collected across government, and when efforts have been made to gather such data (for example in the 2010 Spending Review), the data were limited and inconsistent. The NAO report says that the progress so far does not mean that government is well placed to meet the forthcoming challenge of continued fiscal consolidation alongside substantial demand pressures.

While most people said (as did the Public Accounts Committee) that some progress has been made it was emphasised that the rate of progress was far too slow and nowhere near fast enough to meet the financial challenges of the day. Some have argued that there was (through the media) too much in the way of public relations initiatives about the development of financial management, and not enough emphasis on the substance of any improvements.

In 2013, the authors published a report entitled “The importance of strategic financial leadership, in the UK public sector, in a time of financial austerity” (Prowle et al 2013). The project aimed to cover many parts of the UK public sector but, at the outset and during the course of this project, the researchers were unable to get any direct engagement from central government departments despite strenuous efforts to obtain this. Consequently, the central government sections of the report relies on published studies and information, and on opinions provided by informed commentators (e.g. retired civil servants, former civil servants, think tanks, auditors). Some of the findings of this research were as follows:

• While there are many hundreds of accountants now employed in central government, it is not always clear what roles they fulfil or what
It does seem to be the case that finance professionals are just not sufficiently engaged in the financial evaluation of public policy or the financial planning of expenditure reductions consequent on the policies of austerity.

- There appears to be a significant emphasis on the process of financial reporting and the production of statutory financial accounts (including compliance with domestic and international standards). While such an emphasis is laudable and understandable, we do question whether there is a sufficient and/or equal emphasis placed on modern and sophisticated approaches to financial management and management accounting practices in central government. We are aware, for example, of strong criticisms being made about the inadequacy of financial forecasting methods in central government.

- Significant improvements are needed in the skills base of central government accountants in areas such as; costing, financial forecasting, performance management, financial strategy etc. However, investment in such skills development would be a waste of resources if those skills were not subsequently utilised.

- There is no strong coordination of attempts to improve the standards of financial management across central government.

Our interviewees also reinforced a strongly held view that improvements in financial management and management accounting practices in government are inhibited by huge cultural barriers. The attitudes of professional economists and generalist civil servants was seen to be one of ignoring the potential contribution that management accounting can make to government decision making, especially in a time of austerity. Such attitudes are almost unique and would not be found in other parts of the UK public or private sector or in advanced Western economies overseas. Finally, the culture of secrecy in central government inhibits any real consideration of progress being made by external parties, apart from access given to organisations such as the NAO.
Developmental themes

In any organisation, the management accounting arrangements need to be developed to fit with the organisations and to meet the needs of managers, at all levels, in that organisation. However, organisations differ in terms of structure, cultures and the types of activities undertaken. If we consider just three central government departments (Department of Defence, Department of Work and Pensions and Department of Justice) while there may be similar cultures there are huge differences in the activities undertaken and the types of managerial tasks involved.

Consequently, we are extremely sceptical about the idea of developing a single overarching model of management accounting information that would fit all central government departments. While such a model may be developed at a high level of aggregation to meet the requirements for centralised reporting to HM Treasury, we cannot see how such a model could be developed that would meet all the information needs of a wide range of users in disparate central government departments.

What is more important is to design management accounting systems that meet the needs of managers at all levels in the Department and for Ministers. To do this means being clear about matters such as clarity of responsibilities, rationale for activities and identification of costs.

There is, however, a prototype for such a development namely the MINIS model developed, over thirty years ago, by the then Secretary of State for Environment, Michael Heseltine. Mr Heseltine was a successful businessman and had a keen eye for weaknesses in management practices. MINIS came into being because of the view that that Ministers could not get a clear picture of what was going on in their Departments. Lines of responsibility were confused and there was inadequate information for assessing costs and making decisions. MINIS aimed to clarify this by improving clarity over responsibilities, providing an understanding of why activities were undertaken and identifying the costs involved.

MINIS basically was very simple. First, it required an organogram of every part of the Department in order to see who was accountable to who. Then managers were given information on their cost base and told to analyse those costs against exactly
what they did. In this way, knowledge was gained about exactly what function each of the officials was doing and what it cost. Then one could go through the information and make changes as deemed appropriate. It should be noted that MINIS was developed before the IT revolution and such a system today could be far more sophisticated than in could in the 1980s.

Conclusions
In conclusion, we would emphasise the following

- The need to examine the format and content of Government Department accounts and consider whether there is any point in producing such time consuming and elaborate sets of accounts when there is no evidence that any use is made of them by users.
- The urgent need to strengthen the management accounting function in Central Government Departments. It is commonly said that “improvements are being made but there is still some way to go”. In the light of austerity and the pressures on Government resources, there is a need to update the pace of reform substantially.
- A need to recognise that there would be substantial resistance to the above changes from the civil service and the accounting profession which will be difficult to overcome

May 2016

Key References
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- Malcolm Prowle, Don Harradine, Roger Latham, Glynn Lowth, Peter Murphy, Kevin Orford - *The importance of strategic financial leadership in the UK public sector in a time of financial austerity*, published by ACCA 2013
• Malcolm Prowle, Managing and Reforming Modern Public Services: The Financial Management Dimension, Pearsons 2010
• NAO (2013), Financial Management in Government (National Audit Office)
• PAC (Public Accounts Committee) (2008), Managing Financial Resources to Deliver Better Public Services, 43rd Report of Session 2007/08
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