1.1 I welcome the opportunity to submit evidence to the Inquiry into Government Accounts. My submission relates to the format and utility of departmental accounts and the standardisation of government accounts. I am particularly concerned about the accountability of public service entities at local level that are consolidated into Departmental Accounts and subsequently Whole of Government Accounts (WGA). The first part of my submission draws heavily on a recent themed issue of Public Money & Management (April 2016) on public sector accounting internationally. In addressing the specific points in the Terms of Reference I draw out reservations about the increasing adherence to IFRS and the move towards reduced disclosure. I would like to see a theoretical underpinning for government accounting and more innovation in integrating financial information with service performance. I also consider the propensity for governments to manipulate reported figures, accounting audit and governance.

Reforms to the format of government accounts

What is best practice in public sector accounts across the world and why is it best practice?

1. Review of public sector accounting internationally:

2.1 European Union. Within the EU there is evidence of increased use of IFRS or IPSAS based government financial reporting (Rossi et al 2016), but several countries (e.g. Germany, the Netherlands, Italy, Denmark, Finland) have no intention to introduce IFRS or IPSAS in government accounting (Brusca et al 2015; Ernst & Young 2012). The financial crisis was a stimulus for proposals to harmonize government financial reporting within the EU through the introduction of EPSAS (and the possible use of financial reporting under EPSAS for macroeconomic surveillance). Pontoppidan and Brusca (2016) examine the first steps to harmonization through the development of EPSAS. They find limited stakeholder participation in the decision. The development of EPSAS has many obstacles including the lack of perceived value of more commercial style accounting for decision-making by governments; the protectionism of member states for their own national approach and the substantial costs of implementing a new, comprehensive system of accounting.

2.2 USA. Over 25 years ago the US federal government founded the Federal Accounting Standards Advisory Board (FASAB). Since 1999, under the oversight of the American

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Institute of Certified Public Accountants (AICPA), the FASAB has produced generally accepted accounting principles (GAAP) for the federal government. The US approach is not for the FASAB to adopt or adapt standards established for the private sector (or the state and local government sector), but for each standard-setter to serve a unique domain (Payne, 2016). However, consistent concepts are generally applied to analogous circumstances. Thus the standards are not common across the public and private sectors, but there is a level of consistency, the differences reflect underlying arrangements and user needs. FASAB’s view of user needs has changed over the 25 years: initially serving the needs of managers to, more recently, the information needs of the public. Recent initiatives have sought to help people assess budgetary integrity and operating performance. Currently, the focus is on developing an open system where costs can be aggregated by programme and related to programme outcomes.

2.3 New Zealand. New Zealand, previously a world leader in moving central government to ‘full accruals’ accounting, has rethought its approach. From 1992, standard-setting for both the public and private sectors was carried out by one standards board which developed standards to be applied in both sectors, i.e. ‘sector-neutral’ standards. In 2002, New Zealand moved to require public sector organizations to adopt (modified) IFRS, but 10 years later the decision was taken for these entities to report according to (adapted) IPSAS. Cordery and Simpkins (2016) explain the influences that operated between 2002 and 2012 to change New Zealand to a process similar to Australia whereby sector-neutrality became transaction-neutrality. New Zealand found it impossible to retain pure IFRS and meet the needs of preparers and users of public sector bodies. The International Accounting Standards Board (IASB) was seen to be only interested in profit-orientated entities operating in international markets. Neutrality is still prized, but it is now considered within a framework of users’ needs.

2.4 China. Chan (2016) explains the Chinese government’s decision to adopt accrual accounting by referring to an ancient Chinese strategy of governing. He argues that it is necessary to craft a system of government accounting and reporting with Chinese characteristics. The characteristics include serving the governing party’s agenda, balancing macroeconomic policy with organizational objectives and making small innovations while moving from the status quo to international norms.

2.5 Overview. The Financial Crisis led to initiatives, for example, IMF (2012) and the promotion of European Public Sector Accounting Standards (EPSAS), to improve and align all government accounting systems. However, there remains considerable variation in approach between accounting and budgeting systems and across countries. Despite a definite and continuing trend to use the accrual basis of accounting there is no consensus regarding the accounting regime. (Most writers mistakenly seem to assume that the only form of accruals accounting is business accounting and that accruals-based information was not used in the UK public sector prior to the 1990s). However, there is some evidence of a move away from pure commercial approaches such as IFRS and developments to link accounting information with policy outcomes. Commercial accounting such as UK GAAP and IFRS is designed to serve the needs of investors in capital markets; the needs of users of public sector accounting are quite different (Ellwood 2003 and 2009; Ellwood and Newberry 2006 and 2016; GASB 2013). Users of public sector accounts are not focused on profit or wealth creation but the provision of services that achieve public policy objectives. These differing objectives have implications for reporting formats and accounting recognition and measurement.
In the UK, the Treasury publishes the standard format for government accounts. It published new guidance in 2014 which will be implemented in 2015–16 accounting year. The guidance seeks to make accounts clearer for the user and connect performance and financial data.

How could information be improved to meet the needs of Parliament and the public?

3.1. Non financial performance information. I support the move to connect wider (non-financial) performance data with the information in the financial statements (HM Treasury 2014). Ironically on the move to introduce commercial style accounting in the 1990s to the NHS some of the information by services and subjective analysis was lost. (Ellwood 2003). The formats of the financial statements should be useful to the users of public sector financial statements and not driven by IFRS which primarily serves investors (IASB, 2010). Unfortunately it appears from the new 2014 guidance (p34 S 6.7) that greater adherence to private sector formats will apply from 2015/16 onwards. This will align the reporting more closely with Whole of Government Accounts and ignores the problems experienced when applying IFRS in WGA. Conceptual problems lead to WGA receiving a qualified audit report each year, but there are also the accountability problems that permeate down from an inappropriate reporting mechanism.

3.2. The format and presentation of government accounts. Recent guidance has concentrated on streamlining and simplifying rather than considering whether the basic format and content is appropriate for government. The new approach relegates the simplified (private sector format) statements to the third and final part of the new annual report. The first part will ‘tell the story’ and will be more accessible to readers. This will be much more attractive for users but how will the ‘commentary against trends and performance against policy’ be verified and linked to financial information that is not classified by programme and policy? Can such information be linked to financial information and be relied upon? The second section ‘accountability’ again follows that of a large listed company apart from information on Parliamentary accountability –including the Statement of Parliamentary Supply. The third section presents the annual financial statements and disclosures.

3.3 The needs of the users of government accounts. Arguably, government accounting should use an accounting regime tailored to the needs of the public and parliamentarians and adopt (or design) an appropriate system. I would expect both the public and Parliament to be interested in whether spending is allocated and spent according to policy objectives: how much is spent on various forms of service provision, where more resources are being expended and what is achieved. This is not the same as the users of listed companies’ financial reports –IFRS serves these users by concentrating on the needs of investors and financiers making investment decisions in the capital markets (IASB 2010). Thus the new formats (Treasury 2014), appear to have the wrong focus, achieving financial balance is a constraint to be met in achieving government policy objectives whereas for listed companies, achieving profits and shareholder value is the prime objective. Table 6B page 36 is therefore not very informative for the public or Parliamentarians. This problem is compounded as the standard formats are required for local bodies such as hospitals. The public are interested in spending on different health care services and are likely to be less interested in a breakdown by staff costs; pension costs, depreciation and impairment, provisions; with separate classification of financing costs etc. The functional and subjective analysis of expenditure provided before the implementation of UK GAAP in the 1990s into the NHS was arguably more useful in this respect. There are some studies that draw out deficiencies of commercial approaches (e.g. Mack and Ryan 2006). Very little consideration appears to have been given
to accounting approaches in other countries that are not using IFRS (or IPSAS which is IFRS-based). Some countries e.g. Finland, operate accruals-based accounting that is not business accounting (Oulasvirta 2014). Interpreting government accounts meaningfully is very different to interpreting the accounts of a limited liability company (for example, the balance sheet shows ‘taxpayers equity’ but the taxpayer, unlike the shareholder, does not have limited liability).

3.4 Lack of horizontal accountability at local level. There is a lack of understanding of IFRS style accounts within the public sector. IFRS statements are complex and lack relevance to public sector preparers and users (Mack and Ryan, 2006). Ironically, the move to reduce the length of disclosures (FRAB 2015 p.17) may exacerbate the accountability deficit problem. Reducing the length of disclosures does not give rise to more appropriate information. Newberry (2015) comments on the Australian reduced disclosure requirements: ‘reducing disclosures from full IFRS, while protecting recognition and measurement requirements will not make the accounting any less complex and neither will it make the financial statements any less opaque’. The IFRS for SMEs that sets out the reduced disclosure requirements is not aimed at small or medium sized companies – ‘any company of any size is eligible to use the IFRS for SMEs’ (IASB 2016:3) provided that it does not have public accountability. According to the IASB ‘an entity has public accountability if its securities are publicly traded’ thus subsidiaries of parent companies using full IFRS standards are eligible in their own financial statements to use the reduced disclosure of IFRS for SMEs. FRS 101 Reduced Disclosure Framework in UK GAAP is similar to IFRS for SMEs. To follow such a reduced disclosure route seems to compromise the understanding of public interest and jeopardise public sector accountability.

3.6 Improving links with Whole of Government Accounts (WGA). The changes to the financial statements are intended to facilitate Whole of Government Accounts. WGA while applauded as an attempt to provide a comprehensive picture of government finances, has already required a level of standardisation of accounting that hampers appropriate accountability at local level. Applying IFRS for WGA has given rise to several conceptual financial reporting problems: the accounting boundary for the consolidated WGA is not according to the definition of control in IFRS; there are inconsistent policies and difficulties in removing within-government transactions (see Reports of Comptroller and Auditor General). Furthermore definitions of assets and liabilities; recognition criteria and measurement are all designed for profit-making entities and do not necessarily fit well with public service provision. Reinterpretation is therefore required for a public sector context and this modification may enable manipulation. See for example the difficulty in applying fair value measurement (Hodges 2016) and the huge changes in asset values in NHS financial statements in recent years (Ellwood and Garcia-Lacalle 2012).

3.7 Accounting Manipulation. The introduction of more principles-based, full-accruals accounting derived from a commercial setting has enabled more accounting manipulation (Ellwood 2006). The change to IFRS was perhaps thought to reduce the potential for manipulation (particularly as relating to PFI schemes and off-balance sheet finance) but such manipulation continued to some extent elsewhere under ESA95 and we now see large adjustments of figures condoned by regulatory agencies such as Monitor and sometimes instigated by Government Departments. For example, I expect the recent initiative by the Department of Health in contracting PwC to review accounting treatments at a sample of NHS organisations ‘focussing on areas that have the greatest impact on DEL and CDEL in FY15/16 and where there is judgement around the application of accounting policies’ to lead to significant changes to figures produced by local NHS organisations when they are
consolidated in Department of Health Accounts. Some of these adjustments are contested by
the NHS organisations concerned. The adjustments will be merely ‘shifting the deckchairs on
the Titanic’ – they will have cost sizeable consultancy fees and resulted in no efficiency
savings for the NHS (merely shifted the impression of spending between years). This action
also confuses accountability relationships and who is responsible for the accounting
statements of ‘independent’ foundation trusts: finance directors, chief executives, their board
and the auditors or the Department of Health and their consultants. Problems of accounts
manipulation instigated at Departmental level but relating to local public bodies are
exacerbated by the removal of the Audit Commission which reduced independent oversight
of accounting by local public bodies. (Ellwood and Garcia-Lacalle 2014 and 2015).

3.8. Accounting and governance. There is a mismatch in the principal- agent governance
regime set out for local public bodies such as Foundation Trusts and the realities under which
they operate which impacts on the integrity of financial reporting. A private sector model of
corporate governance relies on shareholders protecting the integrity of financial reporting
through auditors and audit committees. But members/ governors of FTs do not have the same
personal financial relationship to FT reporting as shareholders have to company reporting:
shareholders may lose substantial share value if the financial accounts are found to be
manipulated and require directors to resign (e.g. Tesco’s revenue recognition issues in 2014)
or if the assets have to be substantially impaired (Rio Tinto in 2013). Members of FTs and the
general public have no personal financial relationship dependent on the integrity of the
financial reporting. A local FT impaired its new £500m hospital by 240 million in its annual
financial statements when it opened in 2010, but the impairment was not queried by any
members, governors or the public and it was not reported in the local press. IFRS style
reports seem to largely be ignored as irrelevant to the public and local press which
concentrate on service standards and lack of resources.

What if anything is missing from the Treasury 2014 Command Paper (PDF 1.52MB)
which laid out the new accounting procedures for 2015–16?

4.1. Omissions and theoretical underpinnings. It is too early to know whether there is more
interest in the 2015-16 financial statements and disclosures, but it seems the recent exercise
did not delve into what was missing (even though it is unlikely that the formats used for
reporting, and the recognition and measurement procedures of IFRS which was designed for
a completely different purpose could achieve the objectives of government financial
reporting). Useful reference points could be the work undertaken in other countries on service
efforts and accomplishments and earlier work on programme reporting and programme
outputs. There has also been useful work undertaken on conceptual frameworks for public
sector/ government reporting (GASB 2013, IPSASB 2014) that could be developed to form a
useful frame for future modification of IFRS or where there is no accounting standard.
Ellwood and Newberry (2016) emphasise the importance of adherence to conceptual
frameworks when introducing accounting standards. At present, it seems to be assumed that
adherence with minimum modification to IFRS is ‘best’. Modification with reference to the
needs of government accountability seems more suitable, perhaps through an accounting
conceptual framework for government accounting. All the well-known commercial
accounting approaches (IFRS, US GAAP, UK GAAP) set out the balance sheet as the
primary document in their conceptual frameworks (assets and liabilities are defined and then
all other elements of financial statements are defined accordingly). But what is a government
asset or liability (and their value) is far from clear. Measurement problems are extensive,
particularly when based on a private sector model of fair value and can cause huge
movements in value in both the operating statement and the balance sheet.

4.2. Innovation. Government should perhaps be far more innovative in its approach to
accounting and consider more dynamic accounting using the income (or more usually, net
expenditure) statement as the primary document with the residual being the increase in net
assets/liabilities in the balance sheet. Designing a system with this focus would fit more
easily and appropriately with government financial management and government finance
statistics. It would also serve accountability to taxpayer’s by focussing on how public
resources are used and the effect on net liabilities. More innovative approaches have rarely
been considered perhaps because of the mind-set of those who set or advise on the format of
consultants had ‘a zealous belief that bringing public sector accounting into line with private
sector accounting was an inherently righteous objective.’

Currently the Treasury sets the framework for the format of government accounts.
They are advised by the Financial Reporting Advisory Board (FRAB) which includes
representatives from the House of Commons, the National Audit Office, professional
associations and the government.

1. Who should have control over the format of Departmental Accounts and Whole
   of Government Accounts?
2. What independent body should advise on the format of Departmental accounts
   in the future?

5.1 FRAB. Sovereign governments have control over their accounting systems. As legislative
bodies they can determine where authority for accounting for public bodies lies. In the UK,
FRAB advises on public sector accounting. International monetary bodies may require
reporting along specific lines if loans are requested (similar to commercial companies
complying with debt covenants), but even if other requirements are imposed, governments
may still choose the regime under which public spending is reported (Rossi et al 2016,
Ellwood 2016). Who advises governments on accounting is important and the effect can be
pervasive, accounting is not a neutral technology, it has consequences which are sometimes
unintended (Hopwood 1992; Ellwood and Newberry 2007; Ellwood and Garcia-Lacalle
2012). Mussari (2014) argues that accounting unification such as mooted by EPSAS is based
on a misunderstanding of public sector accounting as a neutral tool. The FRAB has
endeavoured to improve the financial reporting of government and the wider public sector. It
has had considerable success in developing accrual-based reporting. FRAB’s primary
objective is to ‘promote the highest standards of financial reporting by government’ and it
addresses this by applying IFRS with minimum adaptation (FRAB 2015). This reflects its
statutory role and the background of influential members.

3. How can we judge the success of Departmental Accounts as disclosures of
   information to the public?

5.2. Further scrutiny and research. The simplified financial statements and disclosures to
be produced for 2015/16 require further scrutiny and research before a full assessment can be
made of the changes. There is a danger that the simplified accounts provide unsuitable
classifications that leave the statements irrelevant in terms of accountability to those citizens
with an interest in financial accountability of public services.
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