

# The V Conference EUROSAI/OLACEFS – Lisbon May 2007

## Theme 1 - Presentation of accounts and accountability

### UK Country Paper – Resource Accounting and Budgeting in the United Kingdom’s central government

#### Summary

1. This paper discusses the introduction and operation of ‘Resource Accounting’ and ‘Resource Budgeting’ in the UK central government sector. Resource accounting is commercial style ‘accrual accounting’ adapted for the non-profit nature of government activity. It replaced ‘cash based accounting’ which had previously been the mainstay of public sector accounts.
2. Cash based accounting, at its most basic, had simply involved the recording of cash receipts and payments when made and the consequent cash balance. The purpose of accruals based resource accounts, on the other hand, is to report the economic substance of the transactions a body has entered into during a period of time, 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 did not hand over the cash for the service until 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.
3. Accrual based resource accounts were introduced by the political decision of ministers and were first prepared by UK Government departments as the main means of reporting their expenditure to Parliament in 2002. This followed a period of discussion, consultation and preparatory work lasting over 5 years from the time of the decision as well as a period of “parallel running” with the cash-based accounts they replaced. A major aim of this modernisation of government accounting methods was to promote accountability and efficiency in the management of public spending. Accruals based resource accounts help to achieve this aim by, for example,

recognising that cash expenditure leads to the creation of assets which then need to be properly managed to ensure value for money is achieved.

4. Accruals based accounting requires judgements and estimates that are not required in cash based accounting and the determination of appropriate accounting policies. An example is the depreciation policy for a class of machinery which will be influenced by estimates of its useful life, the likely residual value of the machinery and whether its wear and tear is even over its life.
5. New accounting systems, staff training and a general increase in the 'professionalisation' of the finance function are also needed if the full benefits of accruals based accounting are to materialise. These have been major challenges and are being achieved in a gradual and incremental process that is still continuing.
6. But, while the process has not always been trouble-free, and some departments have experienced significant shortcomings, it is evident that many of the predicted benefits of resource accounting and budgeting are now beginning to materialise with more timely and comprehensive financial reporting information assisting both the internal management of departments and accountability to Parliament. For example a greater focus on its asset base has led the Ministry of Defence to rationalise and reduce a large volume of its stocks which were no longer required.
7. More pro-active management of assets and liabilities reflects a progression from the compilation of balance sheets and accruals based income and expenditure accounts as one-off year-end manual exercises based on the old cash accounting systems, to the use of fully integrated and embedded management accounting systems that can produce accurate and comprehensive figures at monthly or even more frequent intervals.
8. But such benefits are not entirely cost-free. Accruals accounts are more complex and more expensive to prepare than cash based accounts, and further complexities have been introduced into departments' resource accounts through the introduction of additional statements to support scrutiny and control of departmental spending by the finance ministry (the Treasury).
9. The UK government's recent decision that government accounts should be based upon International Financial Reporting Standards, rather than domestic UK accounting standards, with effect from 2008/09 may bring better consistency and

comparability between financial reports in the global economy, following the example of the European Union's move to require the use of IFRS for all its listed groups from 2005, but is also likely to add to the complexity. It will be major challenge for the future that such complexity is not allowed to detract from easily understandable clear and transparent accountability in published financial statements. But there is no denying that accrual accounts, whether in the public or private sector, require careful study if the advantages they offer are to be fully grasped by politicians, public servants and the public at large.

# Resource Accounting and Budgeting in the United Kingdom's central government

## The purpose and content of Resource Accounting and Budgeting

1. Resource accounting is commercial style accrual accounting adapted for the non-profit nature of government activity and to serve parliamentary and government scrutiny and control. It provides a framework for reporting on the expenditure of central government and for analysing expenditure by departmental aims and objectives, relating these to outputs where possible. Resource budgeting involves using resource accounting information as the basis for planning and controlling public expenditure.
2. A major aim of this modernisation of government accounting methods was to promote the accountability and efficiency of the management of public spending and assets. This paper discusses the theoretical benefits and justifications of resource accounting and budgeting and some preliminary views on the extent to which these benefits are occurring in practice at paragraphs 17 to 19.
3. While resource accounts are essentially based on commercial-style accruals accounting concepts, the accounts have been tailored and provide additional information for the UK Parliament and Government. Together with the introduction of resource accounting, Parliament now provides resources to departments on an accruals basis, and the Treasury has also introduced an accruals based budgeting framework.

## *The Contents of Departmental Accounts*

4. Departmental accounts include the following statements:
  - **Statement of Parliamentary Supply** - a Parliamentary control schedule comparing outturn with estimate for both resource expenditure and the overall cash requirement. Notes explaining significant variations from estimates are also included.

- **Operating Cost Statement** - showing resources consumed during the year in support of both the department's own administration expenditure and its programme expenditure, net of departmental income.
  - **Balance Sheet** - showing the assets and liabilities at the yearend which are represented by 'taxpayers equity'.
  - **Cash Flow Statement** - analysing the net cash flow by headings including operating activities, capital expenditure and financing.
  - **Statement of Operating Costs by Departmental Aim and Objectives** - an analysis of the uses of resources, as represented by the net operating cost as shown in the operating cost statement, between departmental objectives.
  - **Notes to the accounts** - explaining and amplifying the information in the previous schedules.
5. These prime statements are accompanied by various other statements and background contextual material including:
- **a Management Commentary** – a balanced and comprehensive analysis of the development, performance and position of the department, including disclosure of performance against departmental budgets;
  - **a Remuneration Report** detailing the department's remuneration policy and the salaries, pension arrangements and other benefits of the departments senior management, including ministers;
  - **a Statement on Internal Control** detailing the department's risk and control framework and its Internal Audit unit's assessment of the effectiveness of the internal control system.
6. Departments are also required to separately report on a number of other corporate governance requirements set out in a Treasury published 'Code of Good Practice on Corporate Governance in Central Government Departments'.

## *Resource Budgeting*

7. Resource budgeting involves using resource accounting information as the basis for planning and controlling public expenditure. This is split between
  - expenditure that is subject to three-year Departmental Expenditure Limits (DEL) – mainly expenditure over which the department can exercise direct or indirect control, and
  - Annually Managed Expenditure (AME) – mainly large volatile expenditure in demand-led areas such as social security payments.
8. For central government expenditure, the planning figures agreed as part of DEL or as AME for the year ahead provide a basis for annual expenditure estimates presented to Parliament.

## **Statutory and Regulatory Framework**

10. New legislation - the Government Resources and Accounts Act 2000 - was needed to ensure a proper statutory basis for the preparation of accruals accounts. The Act provides for Parliament to vote 'resources' (which includes 'cash') rather than just 'cash'. It requires a department to send its resource accounts for the year ended 31 March to the Comptroller and Auditor General for audit not later than the following 30 November and for the accounts to be laid before Parliament by the following 31 January. However in practice the Treasury has set increasingly tighter deadlines for departments to present audited accounts to Parliament. The current timetable is for departments to lay audited accounts before Parliament's summer recess begins (around the third week of July) following the end of the financial year. For the financial year ended 31 March 2006, 47 out of 54 departments managed to achieve this deadline.
11. The Act also provided for "Whole of Government Accounts" to be prepared. These will eventually bring together departments' resource accounts with accounts of other central government bodies and the National Health Service, local authorities and public corporations to provide commercial-style group accounts for the whole of the public sector.

12. The accounting practice and standards adopted for resource accounts has been firmly based on the Generally Accepted Accounting Practice (GAAP) used in the listed company sector in the United Kingdom. To guide departments on the application of GAAP in a public sector context, and to provide requirements for further accounting statements to support accountability to Parliament, the Treasury has prepared a Government Financial Reporting Manual (FReM). This is currently based on the accounting standards promulgated by the UK Accounting Standards Board, adapted where appropriate to take account of the public sector context. However, following the adoption of International Financial Reporting Standards (IFRS) by listed companies throughout Europe, the government has now decided to apply IFRS in the public sector and is developing an IFRS based FReM. IFRS based accounting will apply for 2008-09 accounts.
13. The adoption of IFRS based accounting by the government reflects that this is now seen as best practice for the listed company sector and that IFRS provides a comprehensive and mature source of developed accounting standards. But in considering the adaptation or interpretation of IFRS for the FReM, the Treasury also acknowledges the role of the International Public Sector Accounting Standards Board's increasing number of standards as another influential source of guidance.
14. The process of incorporating and as necessary adapting accounting standards into the Government Financial Reporting Manual is overseen by the 'Financial Reporting Advisory Board' (FRAB), an independent board set up to advise the Treasury. Its purpose is to ensure that there is a justifiable rationale for any modifications or adaptations that may be required - to act as an independent 'check' on the government. The National Audit Office is represented on the Board.

### **The Challenges in introducing Resource Accounts**

15. The implementation of resource accounting and budgeting was not an overnight process. Accrual based resource accounts were first prepared by UK Government departments as the main means of reporting their expenditure to Parliament in 2002. But this followed a period of discussion, consultation and preparatory work lasting over 5 years as well as a period of "parallel running" with the cash-based accounts they replaced. During this period, the Treasury, in consultation with the UK National Audit Office and others developed the framework for preparing accruals accounts

which included statutory changes, and developing accounting policies and practice. Government departments also undertook a significant amount of preparatory work including the implementation of new accounting systems and training.

16. The main stages in the implementation of accruals accounting in central Government were:

- 1994 - the Government issued a discussion document on Resource Accounting.
- 1995 - the Government published its proposals and made the decision to implement.
- 1996 and 1997 - preparations by departments and the Treasury. This involved the introduction of new accounting systems, determination of accounting policies, development of an accounting manual, and preparation of a model account format.
- 1997-98 and 1998-99 - departments prepared unpublished “dry run” resource accounts. It was accepted that departments would not be able to present auditable accounts straight away and these accounts were to help departments test their systems. These accounts were audited on an informal basis but no audit opinion was given. However, the UK National Audit Office discussed the results of its audit with departments with the aim of helping them make further improvements.
- 1999-2000 - the first published and audited resource accounts. However, at this stage resource accounts were not the main means of reporting to Parliament on the financial results of departments; and cash-based accounts were also prepared. The period of “parallel running” continued for a second year and in 2000-01, accounts were prepared on a cash basis for the last time.
- 2001-02 - for the first time accruals based resource accounts were the principal means by which departments reported on their expenditure. This was also the first year in which Parliament provided resources to departments on an accruals basis.



17. Some particular aspects of the implementation of accruals accounting required detailed consideration. These included:

- Which bodies to **consolidate** into departmental accounts - the UK Government undertakes its activities through a number of different types of bodies such as departments, agencies and public corporations. Where a department has detailed policy control over other bodies, the financial results of such bodies are consolidated into the departmental accounts. Policies had to be devised to determine which bodies should be consolidated.
- **Opening balances** for assets and liabilities needed to be recognised and valued according to the appropriate accounting policies. This information was not always readily available and reliable evidence had to be obtained and verified.
- **Fixed assets** - a complete record of the assets held was not always available or if such records did exist, they did not always include a record of the cost of the assets. Where asset values were not available, it was necessary to determine an appropriate basis for valuation. Furthermore, in some cases, assets were used by departments but legally owned by other Government bodies; and in such cases it was necessary to consider whether in substance the asset was that of the department and thus whether the asset should appear on the department's balance sheet.
- **Debtors and creditors** - sales ledgers and purchase ledgers had to be introduced. This required new accounting and record keeping systems.
- **Stocks** - records needed to be maintained including records of receipts and issues, the balances of stocks held and their value. Stocktakes had to be undertaken.

### The Benefits of Resource Accounting and Budgeting

18. The expected benefits of resource accounting include

- Better information for Parliament on how resources are used to meet objectives and whether taxpayers are receiving value for money;

- More and better focussed-information to assist with setting strategic priorities;
- Better information on assets and their utilisation;
- Better use of resources, directly and through 'capital charging' (a notional interest charge on a department's net asset balance)
- Resource allocation and the capital spending is linked to the delivery of services;
- Better information to inform decisions on how to allocate resources;
- Incentives to improve management of debtors, creditors and stock (working capital) and fixed assets.

19. The majority of departments and their agencies are now able to prepare good quality year end accruals based accounts on an accurate and timely basis. However it is important that if many of these benefits described above are to fully materialise that departments should recognise that the accounts production process should not merely be a year end activity and that the principles, disciplines and systems underlying accruals accounting should be embedded in their day to day financial management processes. Robust, accurate and timely financial information is pivotal to improved resource planning decision making and should be something that departments produce and utilise throughout the financial year. In 2003, the National Audit Office undertook a study of how departments were managing resources in light of the changes to the public spending and control regime associated with the introduction of Public Service Agreements and Resource Accounting and Budgeting (*'Managing resources to deliver better public services'*). A key finding was that the complexity of the changes, particularly the introduction of accruals accounting, meant that the full benefits of the new approaches to improve resource management will take some time to be realised. The report concluded that departments need to focus more on:

- Adopting a strategic approach to resource management, including downgrading peripheral activities and achieving greater consistency in investment strategies;
- Having a well developed capability to convert resources into services and particularly, identifying the weakest links in the service delivery chain;
- Allowing appropriate flexibility to encourage innovation;

- Using management information to make better use of resources and improve efficiency.

19. Thus the government's focus in the last three years or so has turned towards the improvement of financial management. In 2004 and 2005 the Treasury conducted a department by department review of financial management addressing issues such as accountability structures, planning and budgeting, production and use of financial information and the effectiveness and efficiency of the finance function and an 'Action Plan' was derived for each department. The government is committed to improving the professionalism of the finance function throughout central government departments and to increase the efficiency of the management of public spending and assets.

## Conclusions

20. The introduction of Resource Accounting and Budgeting by the UK Government represented a step change in the formulation and presentation of accounting information and how departments are accountable to Parliament. Implementing the changes in a way that allows the benefits of an accruals approach to be realised involved a considerable amount of preparation and planning, and has required the introduction of new accounting systems and training. Nevertheless some departments still have some way to go in changing behaviours and systems if the full potential benefits of resource accounting and budgeting in the efficient management of the departments are to be realised. Whilst traditional accruals based prime financial statements are key in promoting accountability, further statements, such as the Statement of Parliamentary Supply and performance against budget reporting in the Management Commentary, are also important in a public sector context.