



Inquiry into Government accounts

ICAEW welcomes the opportunity to comment on the *Inquiry into Government accounts* instigated by the Public Administration and Constitutional Affairs Committee (PACAC) in February 2016. Details are available from this [link](#).

This response of 6 May 2016 has been prepared on behalf of ICAEW by its Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. Comments on public sector financial reporting are prepared with the assistance of the Faculty's Public Sector Development Committee. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 145,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained. Under the Local Audit and Accountability Act 2014, ICAEW is a Recognised Supervisory Body in England, appointed by the FRC, to regulate firms that will carry out audits of principal local public bodies.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

Copyright © ICAEW 2016
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

For more information, please contact representations@icaew.com

icaew.com

MAJOR POINTS

Support for the inquiry

1. ICAEW strongly supports the use of accruals accounting based on internationally-recognised GAAP to facilitate and support management decision-making, as well as transparent reporting to external stakeholders.
2. We fully support PACAC's inquiry into Government accounts and whilst acknowledging that important updates to financial reporting are due to take effect in the 2015-16 reporting cycles – such as the streamlining and simplification project – we believe that further improvements are possible. We hope that our response contributes to the debate on the format and utility of monthly management and departmental accounts.

The role and importance of monthly management accounts

3. We welcome the focus of this inquiry on the quality of monthly management accounts as they provide decision-makers with essential information to discharge their stewardship obligations effectively. Board decisions are based on a number of inputs, with both management and annual accounts playing a key role. Best practice in the private sector is to use monthly management accounts to provide timely information that reflects how the entity is managed, aligned with the accounting policies adopted in quarterly, six monthly and annual company reports.
4. Organisations with subsidiaries are obliged to consolidate the year-end accounts of those entities to produce one final set of accounts that represents the entity as a whole. Good financial reporting allows management to drill down from consolidated accounts to more granular levels of detail to support and validate their decision-making process. The alignment of management accounts up through every stage of reporting to the final consolidated annual accounts promotes transparency and accountability since the financial impact of day to day departmental decisions will ultimately be reflected in the final numbers reported in those annual accounts.

The role and importance of WGA

5. In the context of the UK public sector, the ultimate accounting report is the Whole of Government Accounts (WGA), which consolidates all public sector entities, bar just a few exceptions. We have been active supporters of WGA since their inception, but much remains to be done before their full potential as a basis for management decision-making is realised. Firstly, WGA must be published sooner after the year end for the information to be used effectively for decision making. Secondly, and more fundamentally, there needs to be a clear commitment for WGA to be used consistently by management - from the top down - to inform their operational decision-making. We are disappointed that this is not the case. If Treasury officials were to use WGA as a key tool to influence fiscal policy, alongside other sources of information such as ONS statistics, we expect that the outcome would be a tendency for increased scrutiny of departmental accounts to ripple down from the top.
6. The UK government have all the foundations in place to be world leaders in government financial reporting: accruals budgeting; alignment of estimates, budgets and resource accounts; the use of IFRS-based accounting; the recent focus on sustainability; and the production of WGA are all noteworthy. The effective and consistent use of accounts as a tool for decision-making is now necessary to cement the major steps taken in recent years to improve government accountability and financial management. We do not underestimate the significant challenges involved in making this transition, but believe that clear and steady movement in this direction to be strongly in the public interest.

Other developments

7. We applaud the government's single departmental plan (SDP) initiative, which sets out individual department's objectives and how these will be delivered. We recommend that the objectives be linked to relevant key performance indicators (KPI) that are in turn linked to the financial statements in the accounts. This would not only increase accountability and transparency, but it would also improve the usefulness of accounts as a tool for scrutinising departments if this information forms part of the performance report. This is something we strongly recommend.
8. We also view the imbedding of sustainability reporting using integrated reporting <IR> techniques as a step forward, both in terms of increasing the appeal of the annual report and in terms of accountability. IR is a relatively new approach to corporate reporting and has the potential to provide a platform for departments to demonstrate how their resources are creating value in an environment where value is broadly defined. We look forward with interest to seeing the first departmental reports applying these techniques for the 2015-16 year end.

RESPONSES TO PACAC'S QUESTIONS TO CONSIDER

We have re-numbered the questions to run in sequential order. We have included the sub-headings used within the 'Questions to consider' section of the inquiry.

The format of monthly management accounts

Question 1:

What is the purpose of monthly management accounts?

Question 2:

How far do monthly management accounts currently meet this objective? Is their quality consistent?

Question 3:

How can the monthly management accounts be improved to ensure they are more useful to decision makers, particularly Permanent Secretaries, Departmental Boards and Ministers?

Question 4:

How could outcomes be integrated into the monthly management accounts, such as proposed by the MINIS system promoted by Lord Heseltine?

Question 5:

How far can the monthly management accounts be made public?

9. The first part of the inquiry focuses on monthly management accounts. ICAEW members are deeply involved in the production and use of monthly accounts across the economy. However, as our familiarity with current practice in government is limited, we have not at this stage provided detailed answers to the above questions on the format of the monthly management accounts. We would however like to share a number of general observations.
10. We welcome the focus on the quality of monthly management accounts. They provide decision-makers with essential information to discharge their stewardship obligations effectively. On the one hand, they provide summarised financial data taken from the underlying accounting system, on the other they typically provide additional analysis – such as non-financial information on the economy, competitors, regulation etc – and forecasts. The forward looking nature of management accounts is an important attribute to enable effective management of the business. Yet equally important is the alignment between management accounts and resource accounts, which in both cases should reflect the way the entity is managed.

11. The existence of rigorous monthly management accounts is likely to form a key part of a strong internal control environment, for example. This should enable the auditors to place more reliance on systems and controls, potentially reducing the length of audit required (for example due to reduced substantive testing).

The current utility of departmental accounts

Question 6:

How useful are the accounts as a tool to scrutinise the Government?

Question 7:

Which parts of the accounts are used by those scrutinising the Government? Which parts are not?

12. ICAEW believe that departmental accounts are a useful tool to allow scrutiny of the reporting department. The accounts are based on IFRS standards, which promote transparency and accountability by providing a truthful representation of the financial position and performance for the reporting period. The Public Accounts Committee (PAC) has been using accounts to scrutinise departments for many years, with some success. There are a number of planned improvements that are due to take effect in the 2015-16 departmental accounts that will further enhance their usefulness. Paragraphs 16 and 26 of this submission provide more detail.
13. Accounts play an important role in the scrutiny of individual departments, but questions remain about whether that translates into effective scrutiny of government. ICAEW has been a strong supporter of HM Treasury's WGA since its first publication, which was the 2009-10 year-end. WGA consolidate all departmental accounts and should naturally play a central role in the scrutiny of government as a whole. Unfortunately, the usefulness of WGA in holding government to account is affected by timeliness of publication. Meeting the PAC's recommendation of publishing WGA within nine months of year-end seems a long way off; the 2014-15 account has not been laid before Parliament at the time of writing this submission. This represents a deterioration compared to the year before, and is unwelcome.
14. The utility of departmental accounts and WGA are, moreover, in effect dependent on those they are directed towards taking full advantage of the information they provide in order to increase scrutiny. The focus on fiscal debt figures and resistance to using different and, in some ways, more sophisticated and wider-ranging figures and performance measures may do a disservice to the taxpayer.
15. Departmental accounts are based on IFRS, amended where appropriate for the UK public sector, and the disclosures made within them are comprehensive. However, to scrutinise any accounts, one needs to have a benchmark against which outcomes can be measured. Government departments do not make their objectives and the relating KPIs transparent enough, leading some to question the extent to which they have been properly formulated. A recent ICAEW paper *A Modern Finance Ministry* draws attention to a lack of accountability resulting from the lack of clearly defined KPIs and clearly defined responsibilities for them.
16. We note that the Government has started from February this year to address this shortcoming with the introduction of SDP, the aim of which is "to describe the government's objectives over the Parliament and how departments are fulfilling their commitments. The plans will improve the way in which the government monitors its performance and will allow the public to track progress against key outcomes." SDPs are a welcome initiative, and we will be interested to see how they will be interwoven with departmental resource accounts. It is imperative in our view that the individual departments have plans that are specific, measurable and time-bound. Broad-brush political statements would not be particularly helpful in this context.

17. We appreciate that the public sector business model is based on the provision of goods and services often for nil consideration or at below market rates. The objectives of government are very different from the private sector, where profit maximisation is mostly at the core. This makes the identification of KPIs more difficult, but this is nevertheless crucial in ensuring that accounts facilitate meaningful scrutiny. In particular, KPIs are important in establishing a trend of performance data over several periods, and it is this that may make them so challenging for the public sector. In the public sector, changes in boundary happen frequently and past results are not restated, so trend information is either impossible to produce or, where it is produced, muddled and hard to understand.
18. A good set of accounts will be well laid out and easy to navigate. The front half of the accounts will be more narrative based and less technical by nature compared to the back half, which contains the financial statements and related notes. The accounts should clearly evaluate the entity's performance against its objectives/KPI's with clear referencing back to the financial statements, and efforts should continue to exclude extraneous information that obscures key messages for users of government accounts.

Reforms to the format of departmental accounts

Question 8:

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

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

b) What is best practice in the private sector and why?

19. The UK Government has a strong, accruals-based financial reporting framework based on internationally-recognised accounting standards, IFRS. Compared with many other countries, the UK public sector is a leading force in accountability and transparency in financial reporting.
20. In 2007, the Clear Line of Sight (CLOS) initiative included a commitment to simplify financial reporting to Parliament by aligning budgets, estimates and accounts. This was a large, complex exercise which had a transformative effect on many departments; the first set of accounts produced with this alignment was for the 2011-12 year end. Parliament is now able to see a clear link between the estimates they voted on, the budgets used to manage control totals and the accounts which report the outcome. This represents a major improvement in the information supplied to meet the needs of Parliament. However, tensions remain due to the different systems of reporting across government and how the measures they produce are used.
21. Key policy decisions are made using the national accounts as a benchmark. The fiscal mandate for example makes reference to Public Sector Net Debt (PSND), which is the national accounts equivalent to net liabilities (or taxpayers' equity). Currently there are differences between WGA and the national accounts. These relate primarily to differing boundaries and policy frameworks (WGA use IFRS and national accounts ESA10). An area of further improvement would therefore be to align WGA with the general government sector (GGS) within the national accounts. It would not be an easy task to ensure that WGA and the national accounts show the same deficit and debt figures, but it can be done – it has, for example, in Australia. If WGA and national accounts were aligned, understanding of how WGA fits into the bigger picture would improve greatly and so would its use within government as a tool on which fiscal policies are based and measured against. The national accounts would also gain credibility if they agreed to audited numbers.

22. Departmental accounts currently focus their analysis and commentary on the current and preceding accounting period. We would like to see more trend data and how the performance of the department compares to its objectives; however, this is often difficult when trend data is obscured by the inability (or lack of requirement) to apply retrospectively changes to structure or accounting standards in departmental and WGA accounts. While this is understandable from a cost-benefit perspective, it means that useful trend and stewardship information is obscured. The information given should in any case be underpinned by effective use of graphics and colour to make the accounts more engaging and easy to navigate. The publication of the accounts could also be supplemented by a summary of key financial indicators.
23. In the private sector, a good annual report has clearly set out messages in the front half of the annual report. In many cases, the front-end narrative reports will show the entity's mission statement, objectives, KPI's and the outcomes against individual KPI's, with cross-reference back to the financial statements in the back half of the accounts. We think this approach is just as relevant for the public sector.

Question 9:

What if anything is missing from the Treasury 2014 Command Paper which laid out the new accounting procedures for 2015-16?

24. The Simplifying and Streamlining project was approved in 2014, which means that the first opportunity to reflect the changes was in the Financial Reporting Manual (FReM) issued in December 2014 for the 2015-16 year of account. Under the rules set out by Parliament, all changes to the format of accounts or estimates have to be made in advance of the year in which they take effect.
25. Departments are currently preparing accounts using the new format as described in the Command Paper for the 2015-16 year end, largely in response to and shaped by Parliament's wishes. We feel that departments should produce at least one set of accounts under this new format to allow all stakeholders to take stock of its effect before deciding what works and what does not. We feel that the questions in relation to the Simplifying and Streamlining project in this inquiry are a little premature and that informed answers cannot yet be given.
26. Furthermore, government departments are also being asked to show "how sustainability is embedded within corporate decision making and performance. In particular, how economic, social and environmental impacts that are most material to the organisation relate to policy, procurement and operations." The new guidance does not prescribe a specific proforma but it does strongly encourage the use of Integrated Reporting <IR> techniques and will require entities to show how "sustainability is an essential characteristic within the strategic objectives, operations and policy making, the risks to these and how the risks are being managed."
27. We applaud HM Treasury in asking departments to embed sustainability reporting into the annual reports. This is an inherently difficult task to do well and it is important for the accounts to demonstrate that sustainability is a factor in management's key decision making by ensuring that the sustainability report is completely embedded within the accounts with clear cross-referencing to the financial statements. This new requirement will no doubt add to the reporting challenge faced by departments, underlining the need to review the overall impact of changes in reporting requirements.

Question 10:

How far should other government accounts (for NDPBs and Agencies) reflect the format of Departmental Accounts?

How much more should government accounts be standardised?

28. Unlike some other accounting standards, the FReM does not have a 'light' version for non-departmental bodies, which tend to be smaller in size. Materiality is an important concept that should dictate the disclosures made by individual bodies. The application of materiality within government has not always been as effective as it could be. Our view is that the format is not the issue, rather it is the amount of disclosure being made by NDPBs and Agencies which detract from and obscure key messages in the accounts.
29. One of the effects of CLOS has been that most NDPBs and Agencies are consolidated into departmental accounts. Consolidated entities must provide the parent entity with the relevant information to facilitate consolidation. In many instances this involves the completion of a standard template that is often in the same format as that of the parent entity's accounts, which in turn can lead to identical disclosures being made by smaller entities compared to the department, irrespective of materiality.
30. Given that all central departmental accounts follow the FReM, there will be a broadly standardised approach to accounts production. This is desirable in our view, as it ensures comparability. Comparability is not so important across government as a whole, but it is important within sectors. It should be possible for example to compare one hospital's accounts to another's to allow the analysis of comparative performance and to better hold management to account.
31. Improving financial management within government will become more challenging as further devolution increases the complexity of the public sector in the UK. As we noted in the 2016 IFS Green Budget, the government should introduce a modern standardised financial consolidation system for all public sector entities, which should enable the government to obtain and utilise accurate comprehensive financial performance data from across the public sector within days rather than months. Standardised accounts are imperative for this to happen.

Future improvements to accounts

Question 11:

Who should have control over the format of Departmental Accounts and Whole of Government Accounts?

32. Currently HM Treasury sets the framework for the format of government accounts, along with the other "relevant authorities", including the devolved governments, the NHS and local authorities. They are advised by the Financial Reporting Advisory Board (FRAB), which includes representatives from all the relevant authorities, the National Audit Office, and various government entities. Importantly there is an independent chairman and other members independent of the public sector, as well as an observer who is a Member of Parliament, and the FRAB reports to Parliament each year on its activities.
33. HM Treasury is the natural place in which to govern the format of the accounts since the department is also responsible for parliamentary estimates and PESA – Public Expenditure Statistical Analysis. Estimates and PESA are linked to underlying resource accounts and the accountability, expertise and oversight is best kept within one department.

Question 12:

What independent body should advise on the format of Departmental accounts in the future?

34. The FRAB is doing a good job and we do not see the need for a change. The FRAB has good representation from inside and outside government, including a parliamentary observer, and its activities have ensured that government reporting has followed best practice while allowing pragmatic and practical adaptations to private sector rules where these are demonstrably not appropriate to the public sector.

Question 13:

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

35. The UK Government is committed to being open, transparent and accountable to its citizens and the provision of information is one way of achieving this. The fact that citizens have the option of reviewing the information is of importance in a democratic system; whether they chose to do so is a secondary issue. To some extent, press scrutiny should also be seen as a proxy for the involvement of the public.

Improving scrutiny of financial information from the Government

Question 14:

How can financial scrutiny of Departments in both Parliament and outside be improved?

36. Improving the financial literacy of users of the accounts and their understanding of the financial reporting process and key principles would naturally lead to improved scrutiny. ICAEW stand ready to offer support in this matter.
37. Rather than issuing the full annual report, which can easily run to 300 pages, government departments could also issue a smaller, leaflet-style key facts and figures version of the accounts to make them easier to digest. These could also include trend data and more imaginative visuals, as these are outside the confines of the official reporting requirements. Government departments could also do more to embrace other media formats and social media to increase publicity. The annual reports could be optimised for viewing on mobiles and iPads, and social media could be used better to promote financial output of departments and the government.
38. The Government's current fiscal mandate is based on national account measures such as public sector net debt, and the Office of Budget Responsibility (OBR) focuses more on macro-economic indicators for the economy as a whole. The fiscal mandate and OBR have received and continue to receive the most media attention and we think that Parliament and the public sometimes find it difficult to see how departmental accounts ultimately feed into public sector net debt and OBR's data. If WGA were reconciled and was equal in status to the national accounts, and if HM Treasury's fiscal policy were based in part on WGA, then understanding would most likely increase, leading to increased use of departmental accounts and thus scrutiny.
39. Finally, we think that there could be more publicity regarding PAC hearings and the outcomes. We would also welcome more discussion of departmental accounts at board meetings of the relevant departments and in the relevant select committees.