

# **Public Audit Forum**

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working together to develop public sector audit

## **The Whole Truth: Or Why Accruals Accounting Means Better Management**

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Public sector audit has a key part to play in safeguarding public money, ensuring proper accountability, upholding proper standards of conduct in public services and helping public services achieve value for money.

The Public Audit Forum was established in 1998. It brings together the national audit agencies on a purely advisory basis to provide a focus for developmental thinking about public audit. It has a remit to build on the existing co-operation between the national audit agencies: to enhance the efficiency and effectiveness of public audit, to provide a strategic focus on issues cutting across their work and to help develop broadly consistent approaches to public audit.

# The Whole Truth: Or Why Accruals Accounting Means Better Management

## 1 Introduction

With the introduction of Resource Accounting and Budgeting (RAB) in central government, accruals accounting is now the norm across the public services. This form of accounting has a number of significant benefits over cash accounting.

While excellent progress is being made in many public bodies, not all of the benefits of accruals accounting have so far been realised and a number of the barriers still have to be overcome, both by new and by more established users.

In particular, some of the techniques that accruals accounting makes possible could be applied more widely. For example, many of the benefits in the area of better planning, management and decision-making have still to be realised. This is linked to the increased emphasis in modern public management on the effective delivery of better quality services. Better use of the information available as a result of accruals accounting can contribute to better management of services and, as a result, to better service delivery.

Auditors have a role in helping bodies to realise the benefits of accruals information.

This pamphlet is a summary of a fuller paper issued by the Public Audit Forum.

The purpose of the full paper is to:

- ◆ review the benefits of accruals accounting in the private sector and their application to the public sector;
- ◆ consider the benefits available for the public sector, illustrated by a number of case studies demonstrating the progress made to date in achieving them;
- ◆ identify the barriers that exist both within the system as a whole and within individual organisations, and how they can be overcome; and
- ◆ consider the role of the auditor.

This summary concentrates on the lessons for public service managers and auditors.

## 2 The benefits of accruals accounting in the private sector. Do they apply in the public sector?

The accrual basis of accounting requires the non-cash effects of transactions and other events to be reflected, as far as is possible, in the financial statements for the accounting period in which they occur, and not, for example, in the period in which any cash involved is received or paid. (FRS 18, para. 27)

RAB adapts commercial practice to the needs of government. With the introduction of Central Government Accounts for 2003/4, scheduled to be followed by Whole of Government Accounts for 2005/6, the principles of resource accounting will spread out across the public sector, reducing the extent of the variation between parts of the public sector seen currently.

The benefits of accruals accounting for the purposes of financial reporting by businesses to the *outside* users of financial statements are that performance is measured in terms of revenues earned and resources consumed in a period, rather than cash received and paid; it provides a fuller picture of an entity's position than a simple cash statement; assets and liabilities have to be accounted for; and the owners' interest (and changes in it) becomes clear.

Further benefits become evident when managers begin to use the accruals basis for their internal management information: costing can be based on resources consumed rather than those purchased; assets may be better managed because they are recorded; and better investment decisions may be made because the present period can be seen more easily in the context of the past and the future.

These benefits are very similar to those enjoyed by the public sector, which are summarised below. However, whilst there are considerable benefits in accruals accounting, it is important to recognise that there are also some complications. For example, accruals accounting is more complex and requires more resources, both financial and people, to achieve. Accruals accounting skills were not previously required in government and in most departments they are still being developed.

The benefits of accruals accounting for public services can be summarised as:

- ◆ **Completeness** - accruals-based accounts are more complete than cash accounts. The need to include transactions in the period in which they occur reduces the potential for manipulation of accounts and improves comparability between periods and organisations.
- ◆ **Better planning, management and decision-making** - accurate and objective financial and management information is essential for good management, decision-making and better resource planning and allocation.
- ◆ **Ability to change behaviours** - better management is possible with accruals accounting, but it is not automatic. Achieving some changes may also require policy changes or financial incentives.
- ◆ **Performance management** - good performance management needs effective performance measures. Performance measures, or indicators, have to be calculated on the basis of comprehensive and consistent financial and operational data. Accruals accounting is therefore an essential component of better performance management.
- ◆ **Assessing financial resilience** - one of the purposes of published financial statements is to enable the user to predict future cash flows and assess resilience or risk. Financial statements cannot foretell the future with complete accuracy but the aim can at least be to give a fair and balanced picture of the past and some signposts to future performance.

### 3 Progress in achieving the benefits in the public sector

In this chapter the benefits are explained in more detail and a number of case studies demonstrate the benefits that organisations have already realised from accruals accounting or, in some cases, show the difficulties they have experienced because accruals accounting was not in place.

### 3.1 Completeness

In the NHS in England and Wales, the introduction of a new financial reporting standard (FRS 12) has been a catalyst in ensuring that liabilities in respect of clinical negligence are brought to account completely and accurately. Senior NHS managers hope that greater visibility and more integrated management of these liabilities will lead to better control of a major cost.

The government has identified a number of benefits from the creation of the National Asset Register, which enables more informed decisions to be made about the holding, acquisition and disposal of assets, including the opportunity to identify surplus assets. In 1999-2000 alone, assets to the value of £1.3bn were disposed of. RAB underpins the Register because it requires departments to manage and account for the costs incurred in holding assets.

### 3.2 Better planning, management and decision-making

The design of Croydon Primary Care Trust's accommodation option appraisal demonstrates how a combination of accrual-based financial information and a number of non-financial factors can be combined within a single decision process.

When the market reforms were introduced into the health sector in the early 1990s, a behavioural study took place in East Anglia to explore what might happen in practice when the structures changed. This study did not rely only on accrual-based information, but the financial perspective was nevertheless important in the exercise and the full range of lessons would not have been available without it. The Regional Health Authority found the experience very beneficial in guiding its planning. Despite the benefits of this exercise, this form of simulation prior to the introduction of major structural change, remains the exception rather than the rule.

### 3.3 Ability to change behaviours

Asset management plans in local government have had similar impacts to the National Asset Register. They are of particular interest because of the relationship between the accrual-based data that is the cornerstone of the asset information, the government initiatives that have provided the requirement and the incentives for action, and the performance information that is being produced.

The British Waterways case study demonstrates how its asset information, based on its accruals accounting data, has enabled it both to generate income, from telecommunications networks, and to help other public bodies to respond effectively to the Foot and Mouth outbreak in 2001/2.

### **3.4 Performance management**

The Environment Agency established environmental performance indicators, and a monitoring and measurement system, based on financial accrual-based data. Not only did it achieve better environmental outcomes, but also significant cost savings as compared with previous levels of usage.

In the case of East Cambridgeshire District Council, the introduction of performance indicators, and a relatively poor result, spurred the council to introduce new performance management processes. The new processes are helping it to improve performance and provide a link with the accruals-based revenue budget.

### **3.5 Assessing financial resilience**

In the Metropolitan Police Service, accounts were cash-based and moved to accruals only in 2000. Therefore the Service did not account in full for its assets or liabilities and had no reserves. This has caused the new Metropolitan Police Authority great difficulty in its early years and it has had to work with the Service to start to overcome the problems.

The London Borough of Brent, and its auditors, worked together over a number of years to resolve an extremely difficult situation where there was such uncertainty over the key financial data, and such a problem with its timeliness, that managers and members were no longer in a position to monitor the financial resilience of their organisation.

The final example is one in which the organisation, Kent County Council, was not in immediate difficulty but wished to avoid a situation in which a problem could arise in the future. A consensus was established between members and officers to provide for an increase in balances over several years.

## 4 The barriers to progress, and how to overcome them

### 4.1 Cultural and historical

Cash-based records and reports require only a basic knowledge of accountancy, with the result that there has been little need for technical accountancy training or qualified accountants, even at the higher levels. Policy-making was achieved without technical accounting skills and hence they have not always been regarded as important.

Responses to the cultural problem are:

- ◆ political commitment and strong and frequent support from senior management and the board;
- ◆ leadership of the change process by senior managers and politicians with a vision of what needs to be achieved and how to do it; and
- ◆ training and recruitment - there must be sufficient staff, trained to a sufficient level, with technical training only being the start, as demonstrated by the scale of the successful training programme within the Ministry of Defence. Policy and operational managers need to understand what information is available, how to interpret it and how to use it for analysis, performance management, activity costing and investment appraisal.

Implementation of change needs to focus on:

- ◆ the strategic priorities: why are we doing this and what will the end result look like?
- ◆ planning: how will we get there? What do we have to do along the way? This involves analysing the organisation's ability to change, thinking through the issues and potential problems, and the steps necessary to deal with them.
- ◆ the people issues: how will people become involved and motivated to contribute to or embrace the change process? What are likely to be the difficult cultural and people issues?

- ◆ resources: picking the right team to lead and manage, motivating them to take responsibility for success. Deciding who needs to be involved in implementation and what tools they will need.
- ◆ capabilities: what skills do we need to have to make the change successful? What skills will be needed in the "new world"?
- ◆ communication: what do people need to know? How and when will they be told? Do stakeholders understand and embrace the need for change? Prepare a communications plan.

## 4.2 Disjunction between funding control mechanisms and financial accounts

In the transition from cash to accruals, traditional ways of controlling spending have needed to change, for example, through the introduction of break-even requirements. This has sometimes resulted in departures from standard accounting practice or the creation of artificial mechanisms for dealing with the different demands of the financial reporting and the cash funding-based positions.

Responses to these issues include:

- ◆ greater end-year flexibility in funding mechanisms - some additional flexibilities are now available and managers need to understand them and use them to meet targets and to avoid last minute spending surges; and
- ◆ changes to funding mechanisms - a new approach to capital control has been proposed for local government.

## 4.3 Lack of appropriate incentives

Recognising assets is generally seen as a positive result of accruals accounting; recognising liabilities for the first time may be less welcome. The identification and valuation of commitments, liabilities and contingent liabilities is important to prudent longer-term financial management.

Historically, within the public sector, there has been little understanding of the cost of capital and little opportunity to compare capital and revenue options. There therefore needed to be incentives for public bodies to identify surplus assets and a number have now been introduced. However in some cases

government departments and Parliaments have yet to shift their perspective fully towards accruals. When this happens there will be a greater incentive for the whole of the public sector to operate fully on an accruals basis.

#### 4.4 Internal structures, management information and communication


RAB means that the Estimates process, financial policy, budgeting and the preparation of year-end accounts need to be closely linked. However, this is taking time to implement. It is also difficult for any organisation to arrive at an appropriate balance of management information for users at all levels of an organisation.

Communication is also often a major problem in an organisation that has recently gone through a major change, and any failures in communication can make people feel worse about change, and as a result more negative than the situation warrants.

Some solutions to these problems include:

- ◆ Internal structures - internal communication barriers need to be broken down and financial policy, accounting and budgetary functions need to come together;
- ◆ Management information - at the top of an organisation, Boards need to have and use relevant management information to manage; audit, finance and scrutiny committees need it to monitor and challenge. Without appropriate information at budget manager level, costs cannot be properly controlled. A model for assessing progress appears in **table 1**. The characteristics of good management information are set out in **table 2**.
- ◆ Improved communication - it is frequently said that the first rule of change management is "communicate, communicate, communicate". Managers involved in RAB implementation need to also be aware of developments outside their own organisation and network with others to share concerns and good ideas.

**Table 1:** A model to assess progress in realising the benefits of accruals accounting

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- 5 Balance sheet and cash flow information included within monthly pack. Information on activity data, linked to future financial implications also likely to be included, to give an indication of future trends. Reporting within 2-3 weeks of month-end and a good set of draft financial statements within 2 months of year-end, audited within 3 months of year-end. Internal and external performance data produced regularly and based on the most recent financial data, drawn automatically from ledgers. Full range of planning and appraisal techniques used, also based on the most recent financial data.
  - 4 Monthly accrual-based management information produced by the same process as that used to produce the annual financial statements. Focus of control shifts to accrual-based targets. Good use of financial and performance data in decision-making. Reporting of balance sheet data at least quarterly.
  - 3 Accrual-based ledgers but full accrual-based management information produced only periodically (say, quarterly) and not monthly. Information limited to income and expenditure. Budgetary control based on a hybrid of cash and accruals. Traditional option appraisal techniques used.
  - 2 Cash-based budgets and management information; separate process to create accrual-based financial statements.
  - 1 Cash-based systems, budgets and management information.

**Table 2:** Management Information

Good management information should be:

- timely;
- accurate and reliable;
- produced only once;
- relevant to users' responsibilities, generally more summarised at the higher levels and less at the lower;
- clear: jargon-free, legible, appropriately totalled, consistent from period to period;
- well laid-out; and
- visual: using charts and tables, colours, clear brackets or italics to differentiate positive from negative variances.

## 4.5 Systems

The complexity and time lag between the investment in new systems and reaping the benefits of accruals means that it is difficult for finance managers to justify to senior management why scarce resources need to be diverted from service delivery areas and invested in costly management information systems.

Procuring and implementing a system to produce the accrual-based information is not the whole challenge but it is nevertheless an important part of the process, and there is a great deal of good advice available on how to achieve this effectively. This is summarised in **table 3**.

**Table 3:** Implementing new systems

Implementing new systems requires:

- good leadership;
- placing the project in the context of the whole-business changes of which it is only one part, and using appropriate change management methodologies alongside the system development methodology;
- clear allocation of responsibilities;
- strong project management and monitoring of progress;
- introducing risk management into the project;
- considering whether the IT change can be effected through a modular or incremental approach, rather than big bang, and with off the shelf systems rather than bespoke;
- ensuring that the systems architecture is appropriate, which includes decisions about how distributed the systems need to be, levels of user access and the security levels required;
- setting standards for systems performance (number of concurrent users; transaction volumes; back-up facilities; processing speed required);
- systems implementation controls including user involvement, end-to-end testing;
- measurement of desired benefits and monitoring of their achievement;
- constructive relationships with and between suppliers based on clear responsibilities and appropriate risk-sharing; and
- providing for learning and sharing experience.

## 5 The role of the auditor

If an organisation is not realising the full benefits of accruals accounting, the auditor is well placed to recognise where more can be done and assist management by helping them to plot an achievable course. The auditor will know the extent of an organisation's progress because it is part of the audit to understand how the financial statements are produced.

The auditor is financially skilled and has a good overview of the audited body and of its position relative to others. By providing this information, the auditor can be a trigger to improve the rate of change.

In certain public bodies, it is also a part of the auditor's role to consider the overall arrangements for performance management and, in local government, the best value arrangements. In some circumstances the auditor may also report publicly.

The auditor can help the audited body to implement new requirements effectively. When reporting deadlines are brought forward, it is particularly important for the two to work closely together and for auditors to develop new techniques where necessary.

The audited body needs to provide the three 'A's:

- ◆ availability of promised items as scheduled;
- ◆ access to relevant staff to answer audit queries throughout an agreed period; and
- ◆ accuracy of information produced.

The auditor will need to focus on the three 'B's':

- ◆ briefing the team thoroughly. An un-briefed team-member wastes management time and patience, as well as audit time and budget;
- ◆ budgeting in detail for staff time - by hours and days rather than weeks; and
- ◆ bringing in extra resources if needed.

Both external and internal auditors provide information for audit committees. It is valued as objective and independent evidence and complements the deep knowledge of the organisation that its senior managers bring to the committee. To maximise the value it gets from auditors, the audit committee's relationship with auditors should be open and positive, rather than confrontational or defensive.

Quality of the audit service is important, but audit is not a service industry. Audit committees should respect and value this distinction because, ultimately, auditors' professionalism, independence and objectivity give tone and substance to the assurance provided.

As the role of audit committees continues to develop, public auditors will continue to be challenged to provide them with insight into the comparative position of the organisation relative to others, and to be objective and clear about how it can improve its financial reporting and its internal controls.

**The full paper offers ideas for auditors, managers and audit committees in the areas discussed in this summary.**

**It can be obtained from [lisa.bowie@nao.gsi.gov.uk](mailto:lisa.bowie@nao.gsi.gov.uk) or downloaded from the Public Audit Forum website [www.public-audit-forum.gov.uk](http://www.public-audit-forum.gov.uk).**

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