

Spectrum

November 2003 Issue number 3
Policy & technical perspectives for CIPFA members and students



Contents:
Front Page
Introduction

Page 2
'Environmental' and 'Sustainability' Accounting and Reporting in the Public Sector
By Amanda Ball

Page 4
Foundation Hospitals: Back to the Future
By David Hunter

Page 5
Risk Management and the Statement on Internal Control in Central Government
By Gordon Adam

Page 7
The Proceeds of Crime Act in the Public Sector
By Graham Miller

Page 8
Impairment in the Public Benefit Sector
By John Stanford

Page 10
Capital Investment by Local Government - Brave New World?
By Maureen Wellen

This edition of CIPFA Spectrum covers a wide range of issues, topics and sectors. On the policy front, Amanda Ball critiques the public sector's relative lack of progress on environmental and sustainability accounting and reporting. With over 50% of the FTSE 250 companies producing such reports, the public sector's record looks patchy by comparison. In the health sector, David Hunter questions whether the foundation hospitals policy represents progress and asks why the lessons of recent NHS history are apparently being ignored.

Risk management is an issue never far from the top of the public services management agenda. Gordon Adam takes a view of developments in the central government sector, focusing on the use of statements on internal control as part of the sector's evolving risk management framework. The risk theme is continued in Graham Miller's review of the application of the Proceeds of Crime Act 2002 in the public sector. The potential impact of the Act is highly personal, since it places responsibility for compliance on individuals rather than organisations, with sanctions for non-compliance including fines and imprisonment.

Reporting the value of public sector assets and financing the investment in such assets are the subjects of the final two articles. In introducing a new International Federation of Accountants Exposure Draft, John Stanford examines the difficulties of applying FRS 11 and IAS 36 on impairment to the public sector, both of which take as their starting points the assumption that assets will be used for income generation rather than service delivery. Maureen Wellen concludes by reviewing the potential benefits for capital investment in local government stemming from the inclusion of the prudential framework in the Local Government Act 2003 and asks whether, combined with HM Treasury's recent report on the PFI, it signals the start of a new era of genuinely alternative procurement routes across the public services.

The recent CIPFA membership survey produced positive feedback on the 2003 launch of Spectrum and as a result we plan to increase to four editions during 2004. Spectrum is also available on the CIPFA website at www.cipfa.org.uk/pt/spectrum.cfm and we would be pleased if you felt able to recommend it in this format to interested colleagues who may not be CPFAs or students.

If you have any comments or feedback on Spectrum, please email me at vernon.soare@cipfa.org.

Vernon Soare, Policy and Technical Director, CIPFA

'Environmental' and 'Sustainability' Accounting and Reporting in the Public Sector

Amanda Ball

The term 'sustainability' may not yet be part of the vocabulary of most public sector accountants, but it may rapidly become so. More and more business leaders are choosing to think about the links between corporate activity and the environment, both in terms of the risks this gives rise to, and potential opportunities. New ways of accounting and reporting for environmental performance or the sustainability of business activity are emerging as central tools in moving us towards what will hopefully be a new business paradigm. Focussing on the case of local government, this article asks why, when over 50% of the FTSE 250 leading companies are now reporting on their environmental performance (Financial Times, 9 September 2003), there isn't yet comparable systematic progress in the public sector.

'Environmental' or sustainability performance management and reporting are finding their way onto the business agenda because business leaders and political decision-makers are increasingly recognising the link between the way in which we pursue economic development and its effects on the environment. Even for the most ecologically illiterate, the looming prospect of global climate change is beginning to symbolise the ecological thresholds we have reached and the limits of natural systems. There is no longer any serious scientific dispute that our survival prospects as a species is in serious doubt. For practical and ethical reasons, 'business as usual' can simply no longer be sustained.

Yet, conventional financial reporting practice allows us to go on behaving as though stocks of natural capital (as well as social and cultural systems) and the services which the Earth provides such as the air we breathe, the climates in which we live, fresh water, waste disposal, provision of food and so on are free and unlimited. The result has been that we have liquidated this 'capital' and called it 'profit' (Gray, 1992; Hawken et al., 2002).

Having some kind of enhanced management system for performance reporting and accountability in place is increasingly recognised as a prerequisite to being able to see where the organisation is in terms of its making a start with

the sustainability agenda. The point is not to carry on with 'business as usual', making incremental improvements in materials and resource use, but paradoxically increasing 'throughput' of precious natural material, whilst attending to the financial bottom line (Milne, 1996). Rather, the end game is a fundamental shift in the way we organise our economic activity. And although the effectiveness of environmental or sustainability accounting and reporting as an agent in moving organisations nearer to a different end game consistent with ecological (and social) sustainability has not been proven, it is arguably one of the best management tools we have.

So, using local government as an example, where is the public sector in all this?

At a first level, there are successes in the development of environmental or sustainability accounting and reporting in local government which deserve acknowledgement. 'Sustainable development' moved to the mainstream of the international public policy agenda in 1987 with publication of the United Nations World Commission on Environment and Development 'Our Common Future' (the 'Brundtland Report'), which defined 'Sustainable Development' as "Meeting the needs of the current generation without compromising the ability of future generations to meet their own needs". Arguably, business has been

rather slower than local government in taking up the sustainability agenda. Between the late 1980s and the mid 1990s local authorities were involved in using environmental audit to assess the state of the local environment and the environmental impact of local authority policies. Through the mid 1990s the focus shifted to the development of environmental management systems. More recently, authorities have been developing and using 'quality of life' indicators to measure the economic, social and environmental sustainability of communities.

These developments, however, do not attract the same attention as the business community's decision to take up the sustainability agenda. In part this may be because local government services and issues are the stuff of everyday life and seemingly parochial – measuring air quality around motorways; traffic congestion; waste incinerators that no-one wants on their doorsteps; and so on. At the same time, local government is still struggling to re-define its services in the context of sustainability. In comparison, companies' interests (such as oil companies' interests in precious natural ecosystems) are 'big ticket'. More fundamentally, whilst sustainability may present a way forward to guide public governance and business strategy, it remains at the margins of public debate and mainstream politics (Christie and

'Environmental' and 'Sustainability' Accounting and Reporting in the Public Sector

Amanda Ball

Warburton, 2001). UK Central Government is only just recognizing the need for economic regime and institutional change. (Frustratingly, reporting on corporate performance remains a voluntary and therefore patchy activity).

Yet, local government remains a key agent in delivering a sustainable future. According to Christie (2000), an examination of Agenda 21 (the global strategy adopted by 178 countries at the landmark UN Conference on Environment and Development held in Rio de Janeiro in 1992) suggests that around half the things we will need to change if we are to put ourselves on a path towards sustainability imply action within the sphere of local government. Increasingly, the well-intentioned efforts of companies to report on damage done will need to be linked to locally or regionally-based initiatives which look to the cumulative impacts of economic activity (Milne, 1996). Most of us (80% of us in Europe) live in urban settlements. Many of us enjoy a high standard of living, linked to the role of these settlements as the engine of economic growth. This growth, however, has depended on the throughput of an ever-increasing level of materials and resources (particularly fossil-fuel). If we are to change the nature of economic activity, then a useful way forward is a new level of analysis (and an accounting focus) around the idea of sustainable communities.

In local government, a useful focus for these new approaches is via the letting of PFI contracts, particularly in environmentally sensitive areas like waste management (Ball, 2002; Howes, 2002). In waste management, sustainability accounting and reporting may be linked to strategies focussed on resource productivity and risk reduction through the design of products and processes, and recycling. Local government accountants may increasingly find themselves drawn into processes of understanding 'cost' in the context of

pressures to re-define services.

At a different level, the continuing development of sustainability indicators for whole communities (via initiatives like the quality of life indicators) is providing the basis for new accounts, helping to form ideas about, for example, the idea of 'too much' or the 'wrong sort' of economic activity, and where our communities might be headed. A key question, however, is whether it is feasible or sensible to suggest that these developments could take on greater importance given the wider policy context and external performance monitoring arrangements in the local government sector. For example, could the Audit Commission's Comprehensive Performance Assessment and Best Value approaches be adapted to anything that leads to a more systematic focus on 'quality of life', the sustainability of communities, or the re-thinking of local services in terms of their contribution and promotion of a socially and ecologically sustainable society (Ball, 2002; Bovaird, 2003)? An underlying set of questions relates to how sustainability fits into policy developments like Community Strategy and Well-Being, as well as Government's wider modernization agenda.

Although 'environmental' and 'sustainability' accounting and reporting developments in local government currently operate largely in parallel with conventional (economic) accounts, these competing 'accounts' are increasingly likely to come up against each other as we begin (or are forced) to develop different ideas about how we are to live in relation to our environment. Accountants in all types of organisations will inevitably be drawn into this learning process. It would be depressing to think that public sector accountants in organisations with such a potentially central role in advancing the sustainability agenda are clinging to increasingly outmoded approaches,

whilst the corporates appear to be making systematic progress. The agenda must now be one of how to advance practice for the public (and planetary) interest.

References:

- Ball, A. (2002) *Sustainability accounting in UK local government: An agenda for research*. ACCA Research Report No. 78. Association of Chartered Certified Accountants, London.
- Bovaird, T., Loeffler, E. and Martin, J. (2003) 'From corporate governance to local governance: Stakeholder-driven community score-cards for UK local agencies?' *International Journal of Public Administration*, Vol. 26, Nos. 8&9, pp.1037-1060.
- Christie, I. (2000). 'Sustainability and modernisation: resolving tensions by providing complementarity'. In WWF-UK (2000) *Leadership for Wellbeing. Democracy, Sustainability and Civil Society. Proceedings of a Conference held on 15 February 2000 at the RSA London*. Godalming, Surrey: WWF-UK, pp. 18-22.
- Christie and Warburton/The Real World Coalition (2001) *From Here to Sustainability: Politics in the Real World*. Earthscan, London/VA.
- Gray, R. (1992) 'Accounting and Environmentalism: An exploration of the challenge of gently accounting for accountability, transparency and sustainability'. *Accounting, Organisations and Society*, Vol. 17, No. 5: pp. 399-425.
- Hawken, P., Lovins, A. B. and Lovins, L. H. (2002) *Natural Capitalism: the next industrial revolution*. Earthscan, London.
- Howes, R. (2002) *Environmental Cost Accounting: An Introduction and Practical Guide*, CIMA, London.
- Milne, M. J. (1996). 'On sustainability; the environment and management accounting'. *Management Accounting Research*, Vol. 7: 135-161. ●

Amanda Ball
Royal Holloway
University of London

The first point to make about foundation hospitals is that it remains unclear exactly what kind of organisational entities they will turn out to be. As ever, the 'devil is in the detail'. What finally emerges from the legislative process may be so emasculated as virtually to nullify the original intention. Moreover, there are indications that the timetable for the introduction of foundation hospitals could slip from their intended start date of 1 April 2004.

The Government's original conception of foundation trusts arose from its conversion to 'real localism', whereby local communities would own public assets and be given the means to exercise choice and attend to local priorities. Foundation hospitals are therefore not the radical new departure that the Government would have us believe. Indeed, the structure of hospitals and their ownership prior to the introduction of the National Health Service in 1948 bear a remarkable similarity to foundation hospitals. Nor should we forget that it was mounting concern about the dysfunctional features of such a system that in large part led to the introduction of the NHS. So, some 55 years later, we have come full circle.

From historical studies of the pre-NHS period in health policy, it seems reasonable to conclude that what could happen as foundation hospitals become established and gain in confidence is a return to fragmentation, competition and hospitals isolated from their communities. But such lessons from history are lost on a government for whom history ended in 1997.

A particularly curious aspect of foundation hospitals is that they appear to run counter to the Government's own policy which has been driven by three things:

- To develop primary care and give it a more central role in the planning and delivery of health and health care.

- To promote a 'whole systems' perspective around the patient, so that the boundaries between primary, secondary, tertiary and social care do not serve as obstacles to integrated care.
- To improve health and arrest (and hopefully narrow) the widening health gap between rich and poor which requires action that is not solely centred on the NHS, and hospitals in particular.

From its inception, the NHS has been driven by a capital-led view of planning. A 'bricks and mortar' mind set has prevailed and the NHS has become synonymous with hospitals and beds. This is despite the fact that only 10% of the population who come into contact with the NHS receive hospital treatment. A substantial, and welcome, part of the Government's early modernization project has been to see the NHS as being about the health of communities, rather than simply as an ill-health service treating disease.

Of course, there are many other aspects of foundation hospitals which appeal to reformers, especially those aimed at reducing the micro-management of health care from the centre and at creating new forms of local governance centred on mutualism that hark back to the co-operative movement and friendly societies which flourished in the early part of the last century. These ideas also resonate with advocates of participatory democracy. But such developments are engulfed by muddle and confusion. For example, the proposed governing boards of foundation hospitals will bring together public and staff representatives. Is there anyone who thinks this will be anything other than a recipe for confusion and conflict? It mixes two quite distinct sets of interests which generally are not aligned. Moreover, if the experience of having non-executive directors (NEDs) on various types of NHS boards is anything to go by, it is that the role suffers from a lack of

clarity and adds little value. Most NEDs lack confidence and an ability to assert themselves in the face of powerful and experienced managerial and professional vested interests. Is it really going to be significantly different under foundation hospitals?

Hospitals are among the most complex organizations in existence. Does it really make sense to engage the public in their running, even assuming it will be possible to attract sufficient numbers of motivated citizens with the time to spare to get to grips with difficult issues and 'wicked problems'? Will it do anything other than reinforce an emotional, or worse still, romantic attachment to a local institution that probably makes no sense in terms of modern, safe health care?

A Better Way

A more appropriate strategy would be to engage the community in the planning and commissioning of health care to achieve agreed health outcomes, rather than become embroiled in the mechanics of its provision. Such a course of action would mean giving primary care trusts, and perhaps even strategic health authorities, overdue democratic legitimacy.

If a desire to address the 'democratic deficit' in the NHS truly exists, then why not put responsibility for health care under local government control with, perhaps, a regional role for specialized services? Experience with the new local government overview and scrutiny committees suggests that they are proving surprisingly effective and are succeeding in holding the NHS to account locally in ways that have not previously been possible.

Those who believe that foundation hospitals will enjoy untold freedoms from central control surely betray a breathtaking naivety. Again, wilfully or otherwise, they have ignored the lessons from history. The NHS is centrally funded—there are limits

to how far central government can, or will be allowed by Parliament to, let go. Health is a life-and-death affair for which the public will expect their elected representatives to remain accountable. And, finally, for a government and prime minister that have staked their electoral fortunes on having successfully rescued the NHS, it seems unlikely in the extreme that letting go (even if they were allowed to by the public and media) is a serious proposition.

A final central objection to foundation hospitals is that the policy is curiously old-fashioned. Modern health care is intent on reducing the role and place of the hospital. It is regarded as merely one part of a health system and not by any means the central part or the point of first contact. Foundation hospitals seem to run counter to this policy thrust and play to the Government's unhealthy preoccupation with acute health care and its somewhat simplistic notion of consumer choice. ●

*David Hunter
School for Health,
University of Durham*

*First published in
Public Money &
Management, Vol. 23,
No. 4 (October 2003).
For more information
about subscribing to,
or writing for Public
Money & Management,
contact Sandra
Harper at CIPFA on
0207 543 5600 or see
<http://www.cipfa.org.uk/pt/pmm.cfm>*

Risk Management and the Statement on Internal Control in Central Government

Gordon Adam

Governance is a fast moving hot topic, and this is as true in central government as in any other part of the economy. Most central government organisations have now completed, or are completing, two rounds of publishing a "Statement on Internal Control" (SIC) alongside their accounts, the requirement having been promulgated in December 2000 in advance of the 2001/02 financial year in which it was first effective. The expectation was that all organisations should have "all relevant processes" in place by March 2003 to facilitate this and some 86% of organisations achieved this. Those who did not achieve this have reported their circumstances to the Treasury, and will be monitored to help ensure progress is made towards completion by March 2004.

The SIC requirement for central government has now been further developed. There are a number of reasons for these developments.

Not least is that in November 2002 the Strategy Unit's report "Risk: Improving government's capability to handle risk and uncertainty" was published. This provided renewed impetus to the development of risk management and instigated the "Risk Improvement Programme", led by the Risk Support team based in Treasury, which aims to "enable confident decision taking on risk and innovation, reduce waste and inefficiency, and initiate processes based on continuous improvement that will lead to fewer unanticipated problems and crises that may undermine confidence and trust". This drive towards improving risk management meant that we could reasonably expect that central government would have an improving "story to tell" about how it managed risk and consequently we could use the SIC to provide more meaningful disclosures about how risk is controlled.

In May 2003 a revised SIC requirement was promulgated which will be embedded into central government accountability structures

in the December 2003 revisions to "Government Accounting" which will include a new Chapter 21 on risk management and the Statement on Internal Control.

The structure of the proforma SIC has been changed. Rather than providing a "model" as the previous proforma SIC had done, the revised requirement sets out a number of headings under which organisations are required to provide text describing how they handle particular aspects of risk and control. This has been done to try to overcome the problem of "boiler plate" or minimalist SICs, which simply replicated the wording of the model and disclosed nothing which described the particular risk and control processes of the organisation concerned. There seemed to be an element of "the less we say, the less we can be hit with", particularly with regard to the external auditor's review of the SIC; the Treasury view was that this was not an appropriate spirit of openness and did not provide the sort of transparency which we want to see in accountability and governance structures in central government.

The other major development is that the previous proforma SIC delivered ▶

Risk Management and the Statement on Internal Control in Central Government

► an assurance that a review of effectiveness had been carried out – but said nothing about what had been done with the results of that review. The revised proforma requires assurance to be given that the "Accounting Officer" (who, in central government is normally the permanent head of the organisation) has discussed the results of the effectiveness review with the Board, the Audit Committee (and the Risk Committee if there is one). In this respect the central government requirement goes further than the Turnbull requirements applicable to listed companies – but we believe that this requirement gives additional, meaningful assurance to the reader of the SIC.

We have also developed guidance on what constitutes the essential elements of the risk management process which have to be in place to allow the organisation to make a SIC which states that "the system of internal control has been in place...for the year ended 31st March ... and up to the date of approval of the annual report and accounts, and accords with Treasury guidance". These elements are:

- Leadership and strategy : Every government body should have a strategy for risk management which sets out the overall approach and establishes senior level leadership for the risk management process.
- Context for risk management: The context in which risk has to be managed should be identified. (The scope of this may include consideration of stakeholder interests and the body's relationships with other bodies both inside and outside of government).
- Risk identification and evaluation: Risks should be identified and evaluated in structured way. (The documentation for this process may be in a discrete "Risk register" or may be embedded in the strategic and business planning documentation)

- Criteria for evaluation of risk: There should be specific criteria, encompassing a range of factors, for evaluating risk.
- Risk control mechanisms: Appropriate controls should be in place in relation to each risk (Controls should be proportionate to the risk and should normally be designed to constrain risk to an acceptable residual exposure rather than to obviate the risk. Controls can include mechanisms designed to encourage and exploit opportunity as well as those to prevent, detect, and correct realisation of threats)
- Review and assurance mechanisms: Review and assurance mechanisms should be in place. (It is generally beneficial if the ways in which these mechanisms contribute to the SIC are documented as part of the risk management strategy)

The Risk Support Team has recently published an evaluation tool, the "Risk Assessment Framework" which, whilst not primarily developed for SIC purposes, provides a valuable tool in assessing the adequacy of these elements of the risk management process.

I began by saying that governance is a fast moving hot topic. Further, wider based, governance work is afoot in the central government sector. By the time you read this article the final version of the "Audit Committee Handbook" for central government will have been published, and early work is being developed on a plan to take a wider based view of the whole governance structure, and the formal guidance and requirements which support it, in the central government sector with the aim of ensuring that it is cohesive, comprehensive, and fit for purpose. ●

Gordon Adam
Assurance, Control
and Risk Team
HM Treasury

The Proceeds of Crime Act in the Public Sector

Graham Miller

Accounting and audit practitioners in the public sector may view the risk or incidence of money laundering as being a lot less relevant for them than for their private sector colleagues. However the Proceeds of Crime Act 2002 (POCA), brought into force this year, combined with the Money Laundering Regulations 2003, brings the issues of money laundering and due diligence right in front of the individual accounting or audit professional, whether or not they are working within the private and regulated financial services sectors.

Practitioners looking for a frisson of excitement to spice their conventional daily activities now have it in POCA. This is especially true for auditors, who may instinctively regard themselves as one step removed from any direct financial transactions carried out between principals and counter-parties.

The POCA requires the reporting of all suspicions of money laundering which arise during the provision of accountancy services; and represents a clear wake up call for professionals whose clients - individual or corporate - might be involved in possessing, or in any way dealing with, or concealing, the proceeds of any crime. The POCA has introduced an "all crimes" reporting regime, covering the proceeds of any criminal activity, with currently no de minimis limit.

This effectively means that reports will need to be made to the National Criminal Intelligence Service, NCIS, when there is suspicion or reasonable grounds to know or suspect that a criminal offence, which gives rise to criminal proceeds, has been committed, regardless of whether that offence has been committed for instance by an audited body or by a third party. If you know or suspect that another person is engaged in laundering proceeds of crime, you must report it either via your organisation's Money

Laundering Reporting Officer (where applicable) or directly. You are personally liable and could go to jail if you fail to do this. Significant criminal penalties apply where the requirements of the new legislation are breached. Penalties for failing to report suspicious activity can be an unlimited fine or up to five years imprisonment, or both.

We no longer have the luxury of assuming that money laundering is solely a private sector issue; or a concern only for firms with paying clients. Received wisdom may have it that the exposures to money laundering are much less in the public than the private sector. True so far as it goes, since the opportunities for the placement of dirty money in public sector enterprises are more restricted, in the relatively more "closed" systems of Parliamentary and public funding, and expenditure by public bodies.

However, the tightening of regulations and controls in the private sector (from improved reporting, due diligence and Know Your Customer arrangements) drives the criminal towards other avenues for recycling the proceeds of crime. It is food for thought that thousands of small firms contract with and provide services to the public sector. If any such firm benefits from the proceeds of crime to fund its activities and subsequently obtains legitimate profits from public sector contracts, it has transformed dirty money into clean. Paying a Council Tax bill with undeclared earnings (the proceeds of tax evasion) may be money laundering. Paying income tax arrears or buying National Savings with proceeds of crime would constitute money laundering.

The requirement to report knowledge or suspicion is particularly relevant to the professionally sceptical auditor. Especially since 'knowledge' is likely to include actual knowledge; shutting one's mind to the obvious; deliberately refraining from making

enquiries for fear of the results; knowledge of circumstances which would indicate the facts to an honest and reasonable person; and knowledge of circumstances which would put an honest and reasonable person on inquiry, but failing to make reasonable inquiries which such a person would have made. And suspicion (not defined in existing legislation) is likely to be more than speculation but falls short of proof or knowledge.

At the National Audit Office, we have acknowledged that the Proceeds of Crime Act affects us as public sector external auditors; and that our approach to anti-money laundering arrangements - as with other aspects of our work - must continue to reflect best professional practice as auditors, even though we are not directly part of the regulated sector. This means ensuring that our auditors are informed and aware of money laundering risk as distinct from fraud risk; that our audit procedures specifically address money laundering risk at the individual entity level; and that we have appropriate procedures to report money laundering or the suspicion of money laundering if (when?) we come across it. ●

Graham Miller is a Certified Fraud Examiner and the National Audit Office's Money Laundering Reporting Officer.

*Note:
The Proceeds of Crime Act 2002 and the Money Laundering Regulations 2003 are available to view at www.hmso.gov.uk*

Impairment in the Public Benefit Sector John Stanford

The trend towards the adoption of accounting approaches congruent with UK Generally Accepted Accounting Practice (GAAP) has been the main feature of financial reporting in what has been known as the UK public and not-for-profit sector over the last decade (and we shall all learn to call the public benefit sector in the future!).

Whilst the development of accounting policies consistent with GAAP has been challenging to say the least- we only have to think of the travails of the local government sector with tangible fixed assets and the health sector with provisions and contingent liabilities relating to negligence claims- impairment stands out for providing a particularly complex set of issues for public sector standard-setters to grapple with.

You don't have to spend long seeking out the reason why impairment has proved so difficult. Both the UK Standard, FRS 11, Impairment of Fixed Assets and Goodwill and its international counterpart IAS 36, Impairment of Assets share as primary objectives that assets are not carried at more than their recoverable amount. Recoverable amount is the higher of net realisable value and value-in-use (IAS 36 uses the term net selling price rather than net realisable value). Apart from the fact that active and liquid markets are not always easy to find for many assets, net realisable value does not present particular problems in a public benefit context. However, it is not straightforward to interpret value-in-use in such an environment. Value-in-use is a concept related to the identification of cash-generating units and the projection and discounting of future cash flows. Such a concept does not fit easily into the public benefit world where the majority of assets are held primarily for the purposes of service delivery rather than income generation. The recent UK Accounting Standards Board's Discussion Paper on a Proposed Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting acknowledges this key point.

Some current UK requirements

Both the central government Resource Accounting Manual (RAM) and the Local Government SORP attempt with different degrees of

emphasis to supply a public sector interpretation of the requirements of FRS 11. The RAM asserts that "an impairment occurs where the recoverable amount is lower than its carrying amount" and goes on to acknowledge that "the not-for-profit nature of the vast majority of central government activities means that value-in-use is not measurable in terms of income". Value-in-use is assumed to be at least equal to the cost of replacing the service potential provided by the asset. This may not necessarily equate to the replacement cost of the asset, particularly if the asset has been over-specified, is obsolete or has been used for a purpose different to that originally intended.

The LG SORP, very understandably, eschews discussion of service potential and requires the "value at which each category of assets is included in the balance sheet to be reviewed at the end of each reporting period." It goes on to give some examples of events and changes in circumstances that indicate a reduction in value may have incurred. These include significant declines in market value, obsolescence, physical damage and a commitment to a reorganisation by the entity deploying the asset.

Whilst, to my knowledge, there has been no extensive research carried out, impressionistic evidence suggests that some of these requirements have not proved particularly easy for accounts-preparers to apply. When

international counterparts challenge us to provide the beef on where these approaches have actually been used it has not been easy to provide convincing examples, other than relatively straightforward ones. In local government most impairments appear to have arisen from incidences of fire or other physical damage or, more simply, at five yearly revaluations

The Challenges: Measuring Service Potential and a Public Benefit Set of Indicators

The main difficulty is the measurement of service potential. Service potential is fine as an abstract concept, but practical application is highly challenging. It is only recently that the United States Governmental Accounting Standards Board (GASB), the standard-setter for the state, local and municipal levels of the US polity has produced some detailed examples of how it proposes to determine service potential in an historical cost context (Statement 42, Accounting and Financial Reporting for Impairment of Capital Assets and Insurance Recoveries.)

The main international standards on impairment have adopted what is known as a two-step approach. This approach firstly requires an assessment of whether impairment is likely to have occurred –an indicator or trigger- followed by an impairment review. Both FRS 11 and IAS 36 provide a minimum set of indicators. These are not exhaustive, but are important because

identification of one of these indicators will normally lead to a review and reviews can be costly. IAS 36 and FRS 11 both include a decline in market value as triggers. In a public benefit context, it is a least debatable whether such declines should always trigger reviews. For a building that is used specifically for service delivery, are declines in market value necessarily relevant to the building's capacity to deliver a public service?

An even more complex and interesting debate is over declines in the demand for an asset's outputs. In its Discussion Paper, the ASB puts forward the view that assets that are not expected to be fully utilized may have suffered an impairment. Conceptually this is highly convincing, although again it gives rise to practical measurement difficulties. GASB has interestingly not included reductions in demand for the goods and services provided by an asset in its set of impairment indicators automatically triggering a review, unless such reductions amount to a complete cessation of demand. GASB notes that, where there has been a reduction in demand, another trigger may be activated, such as a management decision to change the use of the asset. The GASB approach raises some issues of its own. Is it equitable that where management reacts to problems by changing the use of an asset a review should be required, but not where management has been inactive? Nevertheless GASB deserves praise for acknowledging some practical difficulties over measuring the impact of reductions in demand and a keen awareness of the cost of carrying out impairment reviews.

The IFAC PSC Exposure Draft

The IFAC Public Sector Committee has just issued Exposure Draft 23 (ED), Impairment of Assets. Whilst its impact on the UK may be quite limited-tangible fixed assets on a valuation model, including current value, are outside its scope- it does raise a number of key public sector issues, including many of those

raised in this short article. Encouragingly from a UK perspective, it retains the concept of value-in-use, which the UK has championed in wider standard-setting circles over the last few years. The ED will therefore be important in raising the level of debate about approaches to impairment in the public benefit sector and deserves both a wide readership and a strong response. It can be accessed free of charge from the IFAC website at www.ifac.org. The consultation response closes on 31 January 2004 ●



*John Stanford
Assistant Director
Technical &
International, CIPFA*

Capital Investment by Local Government – Brave New World?

Maureen Wellen

In the Government's view, the present capital control system blurs accountability, limits local financial freedom and has become an obstacle to effective capital investment. We need a new regime....."

These words are a quotation from the then Department for the Environment, Transport and the Regions (DETR) green paper on modernising local government finance back in 2000. They heralded a long process that has led to recent firmly expressed intentions to introduce from 1 April 2004 a new system for local authority capital investment – the prudential framework – in England, Wales and Scotland. This means that it will affect budgets for next year, which local authorities will be already considering.

The key feature of the new prudential framework is that local authorities will determine their own programmes for capital investment. In welcoming the new system, Steve Freer, CIPFA's Chief executive said:

"The current legislation that controls capital investment by local government has long been recognised as getting in the way of good asset management. The new framework will have a real and beneficial impact on service delivery by supporting strategic planning for capital investment at the local level. We are proud that CIPFA has been able to play an important part in the introduction of the new framework through the development of the Prudential Code."¹

How important is capital investment by local government? In my view, local authorities have a very significant role to play in the provision of public service capital infrastructure, which is vital to quality public services. Their balance sheets include schools, libraries, cemeteries, sports centres, town halls, car parks, commercial starter units, local roads and sea defences. Local authorities are also, together with housing associations, major providers of social housing. In terms

of quantum, the latest available figures² show in-year capital investment by local government in Great Britain running at £11.5 billion, a total asset value of £196.8 billion, debt of £51.7 billion and investments of £17.5 billion. By anybody's terms, these are significant figures.

So what practical difference will the new prudential framework make to the capital investment decisions being made on the ground by individual local authorities as they enter into budget setting for 2004? There will – or should be – greater integration between revenue and capital decisions. The absence of pre-set government limits will mean that real choices can be made between revenue intensive and capital intensive schemes. Spend to save projects will be more achievable. Typical examples are where 'patch and mend' repair activities are currently undertaken on a regular basis and where a major overhaul would be cheaper over a period of time. Potholes in roads and leaky school roofs spring to mind.

There will be more genuine choice between procurement options – leases, traditional borrowing, PFI, partnerships. All can be appropriate in different circumstances. CIPFA has long argued that the choice of procurement option should be based on sound value for money and service criteria. The prudential framework will assist with this by allowing genuine choice between capital and revenue. However, decisions will be skewed if central government / devolved administration support for capital investment is tied to particular financing options. The recent HM Treasury report on PFI³ took a stance on this:

"[The report] explains the Government's approach to PFI based on clear limits on its appropriate use and a rigorous assessment of value for money with no bias in favour of any particular procurement route."

It will be interesting to see how this is tackled by individual government

departments in practice. Perhaps significantly in this context, the Department of Health's plans for Foundation Hospitals include the concept of a Prudential Code for capital investment by such hospitals⁴.

Local authorities will be able to undertake self financing capital schemes, where the income raised from charges will pay for the investment – care will however be needed to ensure income estimates are realistic. Local authorities will be able to undertake additional capital investment over and above that which receives central financial support, where they can afford to do so. The Prudential Code provides a framework for this decision making. It will, for example, require local authorities to record the impact of their plans on borrowing and on the council tax.

The prudential framework introduces significant new freedoms. Provided only that the Government does not step in and use its longstop powers to control future capital investment, local government has the best opportunity for decades to make radical improvements to infrastructure and services. ●

¹ The CIPFA Prudential Code for Capital Finance in Local Authorities was published in October 2003 and is available from CIPFA Publications. See www.cipfa.org.uk/pt/prudential_framework.cfm for more information on the Prudential Code, and further guidance and training available from CIPFA and IPF.

² Sources CIPFA Local Authority Assets Statistics at 31 March 2002 and CIPFA Capital Expenditure and Treasury Management Statistics 2001/02.

³ HM Treasury, PFI: Meeting the investment challenge, July 2003.

⁴ The Guide to NHS Foundation Trusts, Department of Health, 2002.

Maureen Wellen
Assistant Director
Local Government
Finance and Policy
CIPFA

THE PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES

CIPFA has played a key role in the development of the prudential framework for capital investment by local government. This will replace the present complex regulatory frameworks in England, Wales and Scotland.

The new system will be one based largely on self-regulation by local authorities. At its heart will be the CIPFA Prudential Code for Capital Finance in Local Authorities. This is potentially the most significant and positive change in local authority finance for decades and will enable authorities to take greater control of their investment in the fixed assets that are central to the delivery of quality local public services.

It is expected that local authorities throughout Great Britain will, from 1 April 2004, be required by Regulation to have regard to The Prudential Code when carrying out their duties in England and Wales under Part 1 of the Local Government Act 2003, and in Scotland under Part 7 of the Local Government in Scotland Act 2003.

To support implementation of The Prudential Code, CIPFA has developed Guidance Notes for Practitioners on its technical implications.

Also, to help pave the way to understanding the real-life impact of the new regime, CIPFA is publishing a Road Testing Manual that carefully charts the experiences of more than 30 authorities from throughout Great Britain that undertook extensive road testing of The Prudential Code. The road testing manual is packed with solid examples of how The Prudential Code can operate in practice in each type of authority to which it has to be applied.

The Code was published on 9 October 2003, and the interim Guidance Notes for Practitioners and the Road Testing Manual will be available this month.

To find out more about these publications and how to obtain your copies, please go to the CIPFA website at www.cipfa.org.uk/shop or telephone the publications department on 020 7543 5605.

To complement the guidance available to practitioners on implementing the Code, CIPFA is planning a technical update day for late January/early February 2004. Full details will be placed on the CIPFA website at www.cipfa.org.uk/shop shortly. Alternatively if you prefer to be sent a printed copy of the programme when available please email courses@cipfa.org or telephone 020 7543 5746.

GROUP ACCOUNTS IN LOCAL GOVERNMENT

"How many separate entities provide the services of your authority? The answer is almost certainly more than one. An increasing diversity of service delivery vehicles are being used by local authorities. There are many sound reasons why authorities do this but the use of such vehicles does mean that there is an increasing risk that authorities that do not produce consolidated group accounts will not be 'presenting fairly' the activities of the authority. Where different entities are used to deliver some of the activities of the authority then single entity financial statements will not show a full picture of the activities of the authority. This is one of the key reasons for revising the SORP requirements in relation to group accounts. It is important that readers of local government financial statements are provided with information about the financial risks and benefits of entities and arrangements over which the authority exercises control, significant influence or joint control. The preparation of high quality group accounts should have governance and accountability benefits and implications as well as technical benefits."

The consultation on the 2004 SORP contains new proposals for a revised approach to group accounts for local authorities. The above is the introductory paragraph of an article written by Catherine Park of CIPFA, which summarises the importance of the proposals. The full text of the article and the SORP consultation can both be found on the Policy and Technical pages of the CIPFA website and are being sent to the Chief Finance Officers of local authorities.

www.cipfa.org.uk/pt

CIPFA stands out as an authoritative, independent commentator on policies which have implications for the way in which public services are organised and delivered. It understands the pressures and challenges and is quick to identify the needs and often develop solutions for members and their employing organisations.

The CIPFA Policy and Technical website provides a key resource in support of this work and has much to offer:

Online Policy and Technical Resources

- Detailed information on CIPFA's Prudential Code
- An area dedicated to the Best Value Accounting Code of Practice 2003 and the opportunity to contribute to its continuing development. This section also provides answers to frequently asked questions
- Download issues of *Spectrum* magazine, providing information and analysis on topical and emerging issues
- All of CIPFA's responses to discussion papers and consultation documents issued by government, regulatory and other bodies are provided in full, arranged by category
- CIPFA has a number of functional and sectoral panels which are responsible for the Institute's policy and technical work. Each panel has a dedicated website providing a range of resources including bulletins, newsletters and responses. www.cipfa.org.uk/panels

Not just another accountancy body

www.cipfa.org.uk

No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the authors or the publisher.

While every care has been taken in the preparation of this publication it may contain errors for which the publishers and authors can not be held responsible.

Apart from any fair dealing for the purposes of research or private study, or criticism, or review, as permitted under the Copyright, Designs and Patents Act 1988, this publication may be reproduced, stored or transmitted, in any form or by any means, only with the prior permission in writing of the publishers, or in the case of reprographic reproduction in accordance with the terms of licences issued by the Copyright Licensing Agency. Enquiries concerning reproduction outside those terms should be sent to the publishers at CIPFA, 3 Robert Street, London WC2N 6RL

'The opinions expressed in *Spectrum* are not those of CIPFA or of contributors' employing organisations, unless expressly stated.'