

The second 2004 edition of CIPFA Spectrum opens with an article of relevance across the public services, a review of changing approaches used in the assessment of value for money delivered by the private finance initiative. The second article on financial forecasting will be of particular interest to National Health Service finance practitioners, but again has wider relevance to the achievement of value for money by all public service organisations.

The central/local government balance of funding review currently in progress with the Office of the Deputy Prime Minister is set in recent historical context by an article on the relevance today of the 1976 report of the Layfield Committee. Moving a little further back on the time line, the next contribution examines the issues involved in the public and charities sectors' balance sheet treatments of such items as historic buildings and museum collections.

Effective internal control is an important part of corporate governance. The following article examines recent developments in statements on internal control in English local authorities and, drawing on experience from the United States, questions the adequacy of the new reporting requirements. The final article examines the accountability of the 'regulatory state', highlighting the recent report of the House of Lords' Constitution Committee on this subject.

CIPFA Spectrum is also available at www.cipfa.org.uk/pt/spectrum.cfm. If you have any feedback, please email me at vernon.soare@cipfa.org.

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The times they are a-changing: assessing value for money in the private finance initiative

*Jane Broadbent and
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The Private Finance Initiative (PFI), launched in Autumn 1992 by the Conservative Government, was driven by a belief in the importance of private sector involvement in public services. The Labour Government has both expanded the public sector areas in which PFI is operationalised and increased the level of PFI investment. In this article we look at how value for money (VFM) is assessed and the way this has changed over time.

From 1992 to April 2003, 563 PFI projects reached financial close with a capital value of £35.5bn. Four hundred and fifty one PFI projects are now operational delivering over 600 new public facilities. In every area of local and central Government in the UK PFI projects have been, are and will be developed.

PFI involves the private sector supplying property-related services to the public sector over a period of initially 30 years, with possibility for extension to 60 years. A PFI project is, in most cases, a Design Build Finance and Operate (DBFO) model which involves the public sector

specifying what it wants by way of outputs from specified services. In prisons this might include the entire service whereas in hospitals and education it might exclude devoted professional services such as clinical care or education provision. Whatever is requested is expected to be expressed in output terms. The private sector partner designs and constructs the required buildings and supplies soft services to satisfy this output requirement. It then finances these plans and charges the public sector procurer a monthly fee for the provision of these property-based services over the period of the contract. ►

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► The terms of this ongoing relationship, related to ensuring the provision of output-defined services at the standard specified, are defined by a long-term contract (cf. Broadbent, Gill and Laughlin, 2003).

VFM came to the fore after certain more macro fiscal arguments, which drove the early development of PFI, were discarded. Initially a macro fiscal objective of reducing borrowing, led to a focus on the balance sheet treatment. For complex reasons it was perceived that if the PFI deals appeared on the balance sheet of the public sector it would count against public borrowing and thus undermine the value of PFI. This led to a well-documented disagreement between HM Treasury and the Accounting Standards Board (cf. Broadbent and Laughlin, 2002), which was eventually solved by mutual agreement on a particular interpretation of the ASB guidance. Possibly more importantly, changes in the fiscal rules in relation to borrowing led to the final demise of any lingering macro fiscal argument for the rationale for pursuing PFI.

VFM has always been a criterion cited in the argument for PFI. Competition between private sector suppliers was initially seen as the best way to make the VFM judgement and, because of a genuine faith in market mechanisms, such competition was seen as demonstration enough that VFM had been achieved. However, changes in policy by the Private Finance Treasury Taskforce (PFTT) in 1998 (PFTT, 1998), which was developed more forcefully in 1999 (PFTT, 1999), downplayed competition. The new VFM emphasis stressed the importance of comparing the costs of a 'Public Sector Comparator' (PSC) with the cost profile of the PFI alternative.

The PSC '...describes the option of what it would cost the public sector to provide the outputs it is requesting from the private sector by a non-PFI route' (PFTT (1998a) p.9). The PSC does not require the same design of building via the different funding routes, but a different means of procuring the outcomes desired that is possible under public procurement. Thus the achievement of a common set of output specifications is the only

point of common reference.

There are a number of key elements in the comparison of the PSC and the PFI. All estimated costs are time-valued for the duration of the contract period. Net Present Cost was calculated, originally using a 6% discount rate. Now under the new 'Green Book' (HM Treasury, 2002) rules, 3.5% is used. The change was a reaction to the accusation of 'double counting' of risk – 3.5% being seen as the risk free rate. The adoption of the new lower rate has been accompanied by a greater concern with the estimation of the risks to be transferred, in order to avoid what is referred to as 'optimism bias' in the calculation. 'Optimism bias' is the possible understatement of the costs to be incurred; the concern about this element is explained by cost over-runs associated with some public procurements.

The PFI alternative used in the comparison has two cost elements. The first is referred to as 'retained risk' and is replicated in the PSC alternative; it involves the downside risks that come from major new developments in service provision. These remain the sole responsibility of the public sector to incur and manage. The second element is the discounted ongoing costs of the contracted service payments.

The PSC alternative, in contrast, has three elements. First, the retained risk, is exactly the same as in the PFI alternative. Second, the 'base cost', which is the best estimate of the net discounted costs, a cost estimate of downside risks related to ongoing variability in costs of service provision, of the PSC alternative. Finally, the 'risk adjustment' is the estimate of the possible additional costs (notably in relation to construction and operational costs) that could be incurred as downside risks if the project is undertaken by the public sector. The assumption is that these downside risks would be transferred to the private sector if the PFI alternative were pursued. Without this 'risk adjustment', the PSC is invariably cheaper than the PFI alternative.

Led by recent criticisms from the

National Audit Office (NAO) the PSC/PFI VFM comparison has been under considerable pressure. In 1999 the NAO issued an unprecedented report about how they judged VFM (NAO, 1999). This concentrated on a qualitative assessment using 'four pillars' related to 'getting a good PFI deal'. There was still residual support for the PSC. Being quantitative and relatively objective, as well as a known method of capital investment appraisal, the PSC/PFI comparison weighed heavily in practice. This logic was finally blown away when Jeremy Colman, an NAO Assistant Auditor General, in charge of PFI/VFM studies, '....described some of the comparators as prone to error, irrelevant, unrealistic and based on 'pseudo-scientific mumbo jumbo'' (The PFI Report, July 2002, Issue 65, p.36). The NAO have, more recently, become concerned that their 'four pillars' report (NAO, 1999) needs to be developed and are consulting widely on new ways to judge VFM.

Treasury officials are also concerned. They remain supportive of the use of the PSC but now argue that issues related to 'deliverability' and other qualitative matters should also be taken into account. Their view seems to be that the delivery of new hospitals, new schools etc. to time and to contract price, is an important indicator of VFM – even if the PSC calculation and comparison is open to question.

This new 'softer' emphasis is reflected in two recent reports (HM Treasury, 2003, 2004). Current thinking is to have '....three stages of assessment: investment test, project test and final procurement test' (HM Treasury (2003) Paragraph 7.16, p.83). The PSC is still important (at the second stage) but, at all stages, the consideration of more qualitative factors is being encouraged. As yet there is little clarity as to how the qualitative and the quantitative can be meaningfully brought together to guide decisions.

In conclusion, VFM assessment seems indeed to constantly be 'a-changing'. The final configuration remains to be seen. However, the importance of VFM and the distraction of the macro justification for PFI is now recognised

as such. This has to be welcomed as the best use of scarce resources for public service provision is surely imperative. ●

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Introduction

Health Service forecasts in 2002/03 swung from a deficit of £500 million half way through the year, to a surplus of £300 million, before a finally reported surplus of just less than £100 million. An £800 million movement in forecasting is not credible, especially as it is a movement around zero, the break-even duty.

Although the movements in forecasts were exceptionally large in 2002/03 they have followed a familiar pattern for the past five years.

I believe there are three main elements that assist accurate financial forecasts – the right mind-set, sound professional techniques, and strong performance management .

Mind-set issues

Too much gaming – Historically there has been far too much gaming across the NHS. There are several reasons why deficits are forecast:-

- to justify seeking financial support
- to play safe in months five to eleven
- to stop managers spending money
- so that the Finance Director (FD) cannot be accused of failing to identify financial problems (even if they are only risks)

Usually if a plc FD declares a deficit, the share price drops, stock market confidence in the company falls and the FD is seen to be weak on financial control. Accepting that plc FDs usually do not have to achieve precise financial balance, or operate in the public service political arena, they do not routinely resort to declaring deficits to meet internal goals. Finance professionals in the NHS should adopt their mind-set.

Potential penalties – One approach might be to reduce Revenue Resource Limits in the year following a forecast deficit by an equal amount to the deficit which did not transpire. Whilst not being able to enforce this, I have asked FDs to have this as their mind-set when considering their financial forecasts each month.

Financial forecast or revised plan? – Financial forecasts should be viewed as the organisation's revised financial plan. FDs should forecast the planned year-end position after management actions to bring the position back into balance.

Professional techniques

Good quality service level agreements / monthly budget plans – Good forecasting is based on sound budgetary systems and sound and timely agreements between commissioners and providers. Sound service level agreements agreed at the outset are fundamental to credible monthly budgets against which FDs can monitor, identify the reasons for variances and determine corrective action.

Risk management – FDs are usually quite good at identifying risks but often translate them 100% to the bottom line. They need to quantify risks using sensitivity analysis, and remember that not all risk affects the bottom line directly.

Having identified the risks FDs need to determine management action. Only when both proper sensitivity analysis and a management action plan are in place can an organisation determine the financial implications some months hence.

Locally I have encouraged FDs to highlight risks in their monthly commentaries. This helps to assess the situation and advise the Department of Health of the challenges while avoiding crying wolf! Equally FDs do not want anyone to hide a real financial problem – as big a sin as exaggerating an unreal deficit!

Challenging operational and commissioning managers – How strong is the challenge by your finance department? The importance of challenge has grown in recent years, with many publications and tools now available including CIPFA's *Throwing Down the Gauntlet – A Practitioner's Guide to Challenging Effectively*. FDs must also remember that the finance department does not have a monopoly on gaming. How well do finance teams know what is ►

► happening in each department? Can they mount a serious challenge to the monthly information used to formulate the FDs forecast.

Challenging accruals – Often, many more employees may approve accruals than are authorised to incur expenditure. By using accruals, line managers may try to retain money they may never be able to spend for fear of having their budgets cut, leading to money suddenly being available in March when managers finally admit they cannot spend it. Strong management of accruals is needed throughout the year.

One tactic is for FDs personally to approve every accrual for just one month of the year. It may seem a lot of work but FDs will be surprised by how many accruals they do *not* approve.

Cash / I&E / balance sheet and capital positions – How well does your organisation compare the amount of cash required to the current I&E and balance sheet?

How well is it compared to the progress on capital schemes and the overall capital programme? If organisations managed cash drawing better throughout the year the unseemly scramble at year-end would not be as bad. A detailed comparison of cash drawing with progress on capital schemes often leads to uncomfortable questions, but usually leads to better overall financial control – and therefore better forecasting.

Recurrent and non-recurrent items – It may sound obvious but are all non-recurrent items excluded before trends are extrapolated to the year-end? Even if they are, how good is the phasing of the recurrent items? This links back to quality service level agreements being available early enough to determine credible monthly budget plans.

Prescribing – Simply taking the Prescription Pricing Authority (PPA) forecast is not good enough. How early do Primary Care Trust (PCT) FDs review prescribing data? Do they review the data available through GP practices so that they can spot

trends, check the level of generics, see if high cost drugs are being prescribed instead of cheaper and equally effective alternatives and calculate whether they are on track to manage within the annual budget well before the PPA data is available. Corrective action can be taken at a much earlier stage.

This problem is not confined to primary care. How pro-active are Trust FDs? What input do they have to Drugs and Therapeutics Committees? How do they measure the effect of National Institute for Clinical Excellence (NICE) recommendations? Are they sure that drugs which should no longer be prescribed are still not being accrued to maintain an expenditure level in directorates?

Performance management

In Shropshire and Staffordshire Strategic Health Authority (SHA) we put much emphasis on performance managing the position throughout 2003/04.

Chair and Chief Executive sign-up – While the financial forecast is the FD's professional responsibility, the Chief Executive is the Accountable Officer. Chairs and Chief Executives should also own financial forecasts before they are submitted to the SHA and need to make a robust challenge to the FD on the assumptions. At Shropshire & Staffordshire, the SHA Chair has agreed to include this aspect of the role in future performance appraisals of all Trust and PCT Chairs.

Patch finance managers' input – SHAs continually need to develop the role of patch finance and performance managers. If these managers are fully aware of all the issues relating to each organisation, they will be in a better position to review forecasts and offer help and advice both to the organisations and the SHA FDs.

SHA FD reviews – It is not usually possible for the SHA FD to personally review all financial forecasts in detail. They could, however, undertake more detailed reviews on a rotational basis each month. Clearly if there are outliers the SHA

FD needs to get involved immediately.

Longer term forecasting – NHS FDs should use these techniques (and mindset) to improve longer term planning, particularly now there is more certainty over funding streams with three year allocations under the revised Comprehensive Spending Review procedure.

Results after one year

Having discussed all of the above with NHS Chairs, Chief Executives and FDs across Shropshire and Staffordshire, I believe we achieved real ownership. The movement in forecast outturn throughout the year reduced from £15 million in 2002/03 to £5 million in 2003/04. Given how difficult 2004/05 is already looking, high quality financial forecasting that enhances the credibility of the finance function is vital. ●

Tom Taylor, Chair of CIPFA's Financial Management Panel and (from May 2004) Deputy Chief Executive & Director of Delivery for Birmingham & The Black Country SHA. The work outlined in this article was undertaken when he was Director of Performance & Finance for Shropshire & Staffordshire SHA.

Layfield's relevance today George Jones

The report (Cmnd.6453) of the Layfield Committee in 1976, reviewing 'the whole system of local government finance in England', is still relevant today. The Committee realised that to focus on large local tax increases was to tackle only the symptoms not the main problem. It examined the system as a whole from first principles.

The report remains an authoritative survey of the various options for financing local government.

It posed a question to the Government that only elected politicians could answer: 'what was its desired relationship between central and local government?' To answer this constitutional and political question the Government had to decide who was to be responsible and therefore accountable for local government expenditure and taxation, central government or local government. Having made this decision, the Government had then to select arrangements for financing local government that sustained its preferred relationship. If the choice were for central government, then it should provide the lion's share of the funds for local authorities from national taxation. But if the choice were for local government, then it was necessary for local authorities to be responsible and accountable to their electorates for local taxation to fund the greater part of local government expenditure. The majority on Layfield supported local responsibility.

It is important to grasp this central point of the Layfield Report that first there had to be a Government commitment to either central or local responsibility and accountability, since some later misrepresented the report as arguing that greater local taxation caused greater local accountability and autonomy.

The report's emphasis on the need to clarify where responsibility and accountability lay came from its frustration with the evidence from central and local government. Central government said local authorities were wasteful and extravagant, and were to blame for increased local taxation, while local government said central government determined its spending and allocated authorities too little grant. Some even justified this confusion by arguing it was joint or shared responsibility, which meant no one could be held accountable for billions of pounds of taxpayers' money.

This ambiguity about responsibility and accountability is the cause of the annual wrangling between central and local government over the grant settlement. The centre proclaims its sophisticated arrangements have allocated grant to meet the needs of local authorities, while local government argues it has not received adequate funding to meet even the mandatory spending priorities of central government. Recently central and local government disclaimed responsibility for council tax increases. But the Audit Commission's report of December 2003 vindicated Layfield's allegation of confusion and put most blame on central government. Yet ministers persist in

blaming local authorities and threaten to cap local authorities that exceed central government's assessments.

Layfield proposed a package of measures to tackle the defects of the system, based on its support for local responsibility and accountability. It liked a property tax for local government. If it were abolished as a local tax, it would not be long before the Treasury would introduce it as a national tax. It was ideal as a local tax, which is why it is so common throughout the world. It is easy and cheap to administer, hard to avoid and evade, and it assists local accountability by being based on where citizens live and vote. But it should not be overloaded. A system of local responsibility requires the property tax to be supplemented with another tax. Layfield's solution was local income tax, now administratively even more viable than when Layfield reported.

Local income tax exists now but in a hidden form. It is that part of national income tax that feeds into grant to finance 75% of local government expenditure. Layfield's proposal was to make explicit a part of income tax as a local tax. It never recommended the abolition of central grant, which was needed for equalisation for local authorities with different resources and needs. Adoption of the local responsibility model required a reduction in grant, to wean local authorities away from their dependency on grant, and to stop their annual whingeing, like drug addicts, that they had not been given their fix. ►

► Central government and the Treasury should have welcomed the Layfield Report. It would have relieved them of the impossible burden of trying to estimate what each local authority should spend on each service, determining an accurate allocation of grant, and facing accusations of not providing enough from the shrill lobby of local authorities always wanting more. Central and local government could have worked together as partners, each seeking the wise use of resources by taking decisions about spending and taxing in their respective areas of responsibility and being held accountable to their own voters for those decisions. Praise and blame could have been more clearly apportioned.

Alas the then Labour Government shelved the Layfield Report. The confusion condemned by Layfield continued. The Conservatives under Mrs Thatcher focussed on a replacement for the property tax and rushed into the fiasco of the poll tax, which the Layfield Committee had considered so outlandish as not to be worth mentioning. John Major restored what was essentially a property tax, and centralisation has continued with local government still dependent on central grant for the bulk of its income.

Layfield's choice has to be faced. The only way to solve the problem of financing local government is to take either the centralising or the localising route. Those who see the dangers of centralisation should champion the recommendations of the Layfield Report. It provides a route map for a system of local government finance that sustains local responsibility and accountability. ●

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Editor's note

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Valuing our heritage

The British are renowned for preserving and celebrating their past. How many other nations would, for nigh on 300 years, celebrate a failed attempt to blow up their Parliament? For that matter, who else would continue to use a building that was constructed some 150 years ago, and parts of which are much older, as their Parliament?

Despite this fondness for things past, until relatively recently in the UK there has been no great wish to account for the value of items that have been passed down by former generations. Until the mid-1990s, at least, there was a general consensus that the value of 'collection assets' held by museums and galleries, and other (frequently unique) artefacts such as Stonehenge, Nelson's Column and the Albert Memorial could not be valued on any reliable basis. The items had physical existence, but they did not appear on the balance sheets of the bodies responsible for maintaining them.

Then, in 1994, came Financial Reporting Standard (FRS) 5. This defined an asset not in terms of an item with physical existence, but as 'rights to future economic benefits controlled by an entity as a result of past transactions or events.' This pointed towards the need for valuation of items which were held for their heritage value. However, the 1995 Charities Statement of Recommended Practice (SORP), in clarifying this definition, permitted the non-capitalisation of assets which were deemed 'inalienable' or 'historic'.

FRS 15 was published in 1999, and was closely followed by the 2000 Charities SORP. The effect of FRS 15 was in principle to require that all fixed assets, including heritage assets, be capitalised. The SORP, however, allowed charities to exclude historic and inalienable assets if reliable cost information was unavailable and conventional valuation approaches would lack reliability, or the costs of obtaining valuations would be onerous compared with the likely benefits of capitalisation.

Although the exclusions permitted by the SORP allowed many charities to continue to exclude their existing collections from the balance sheet, no such exclusions were permitted in respect of newly acquired items, where reliable cost information would be available.

So much for the history. Two years on, the effect of capitalising additions to collections was that the balance sheets of charities and other bodies holding heritage assets frequently showed only the value of acquisitions made since the introduction of the SORP; these commonly represented only a tiny proportion of their total collections.

In early 2003 a working group was formed under the auspices of the UK Accounting Standards Board (ASB) to take forward consideration of the heritage assets issue. Working from

first principles, the group addressed a series of questions, including whether heritage assets are really assets (the group concluded that they are); whether the terms 'historic' and 'inalienable' were useful in the context of the capitalisation debate (not really, since not all heritage assets are old, and inalienability does not affect whether an item falls within the FRS 5 definition of an asset), and why heritage assets are so difficult to value reliably. On the latter, there would seem to be several factors to consider.

Firstly, many artefacts are unique; secondly, their value is frequently enhanced by the event or person they are associated with, rather than the item's intrinsic value (think of the value of the musket ball that killed Nelson compared with the value of any other one ounce lead sphere); thirdly, there is frequently no real market in the items concerned (take, for example, the Egyptian mummies in the British Museum); and fourthly, for many charities, the cost of obtaining reliable valuations would be overwhelming (many of the larger collections number more than a million items).

In the view of the working group, a new approach was needed which gave better information to the user of charities' and other bodies' accounts while keeping within the spirit of accounting standards. After much debate, the following proposals emerged:

- heritage assets should be considered as either 'operational' or 'non-operational'. The former should be capitalised, and would include, for example, the buildings within which museum collections were housed and assets used as part of the day-to-day business of the entity. 'Non-operational' assets (including additions to collections) would include assets that were held purely for their heritage value, and would not be capitalised;

- Charities' financial statements should include a note disclosure giving information on the value of the most important items in the collection, the overall size and scope of the collection, together with a trustees' estimate of its total value. Because of the inherent difficulty of obtaining reliable valuations in this area, it is likely that this figure would be provided as a range.

Resolution of the heritage assets issue remains unfinished business. The working group's conclusions have been discussed by the ASB's Public Sector and Not-for-Profit Committee, and are being further considered as part of the ongoing review of the 2000 Charities SORP. Proposals on whether, and if so, how, the working group's conclusions should be incorporated in the revised SORP, should be considered within the next few months. ●

Martin Daynes,
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The Accounts and Audit Regulations 2003 introduced an explicit requirement on English local authorities to ensure that they have a sound system of internal control, which they review at least annually, and to publish a Statement on Internal Control (SIC) with their annual accounts. The Regulations of course provide no assistance on interpretation of these new requirements and as such a CIPFA working group has recently produced guidance¹ for local authorities on how to meet them. This document will therefore form part of a wider corporate governance framework which includes *Corporate Governance in Local Government (CIPFA/SOLACE)*, *Effective Internal Control (CIPFA)* and the *Local Government SORP*. As usual, CIPFA is to be congratulated on the speed with which it recognises the need for such guidance and produces practical help and assistance. However, the field of corporate governance is a fast-moving one, and in this instance I wonder if CIPFA is doing enough to provide the leadership this important area demands.

Internal control is of course just one aspect of the corporate governance framework which needs to be in place but one with which CIPFA should be particularly concerned given its obvious expertise and professional base. To this end we need to ensure that we are cognisant of best practice developments not only within the UK public sector, but in the private sector and other countries also. Both the CIPFA/SOLACE documents and the recently issued CIPFA guidance make reference to, and draw heavily on, the Turnbull Guidance issued in 1999, which now forms part of the *Combined Code on Corporate Governance* revised and adopted last June as part of the London Stock Exchange Listing Rules. In this respect it could be said that the public sector environment encouraged by CIPFA and Society of Local Authority Chief Executives, (SOLACE) is in step with UK best practice.

However, after several years basking in the self-satisfied glow of the *Combined Code*, the UK and indeed the rest of Europe is facing an upstart challenge to its pre-eminence in standards of corporate governance. High-profile corporate failures in the USA such as WorldCom and Enron have brought a strong, some would say draconian, response in the form of legislation commonly known as the Sarbanes-Oxley Act (SOA), which seeks to regulate every aspect of corporate governance for firms listed on the US stock exchanges, wherever they are headquartered. The 'comply or explain' approach underpinning the *Combined Code* contrasts sharply with the Sarbanes-Oxley 'comply or be sanctioned' principle, a shift in emphasis which has met with a predictably sniffy response from the European corporate sector. Even so it's fair to say that the European Commission is seriously considering a tougher approach following the Parmalat scandal. A consensus appears to be emerging that, while the Sarbanes-Oxley approach may be heavy-handed, a stronger governance environment is inevitable, whether introduced through Europe-wide legislation or through less formal processes such as shareholder/investor pressure.

So what has SOA to say about internal control, and what issues does this new benchmark raise for the UK public sector? Section 404 of the Act, as implemented by United States Securities and Exchange Commission (SEC) rules, requires listed companies to produce an internal control report articulating *management's* responsibilities to establish and maintain adequate internal control over *financial reporting*; management's assessment as at the year-end (i.e. a point-in-time assessment) of the effectiveness, in design and operation, of internal control systems; and the framework used by management for this evaluation. The CEO and CFO have to certify in annual reports that they accept responsibility for and have

supervised the design of internal control systems over financial reporting; report quarterly on any material change in the controls in these systems; and declare any significant deficiencies and material weaknesses in the design and/or operation of those controls. And here's the sting in the tail: management's assessment has to be reviewed by their auditors who provide not one but two opinions – their view of the effectiveness of management's assessment and their own view. So a robust process. But it does not end there; the regulations go further. Section 906 contains provisions for criminal penalties to be applied for deliberate or negligent misrepresentation in the financial statements.

This brief précis of the key internal control requirements of the SOA raises a number of issues for our consideration in the current context, of which I will touch on only the most significant here. Firstly, it is important to note that SOA concerns itself solely with internal controls over *financial reporting* – to ensure that controls over the processes and transactions that produce the 'numbers' contained in the income statement, balance sheet and related disclosures are effective in providing reasonable assurance that the reported financial data is not materially misstated. The wording of the Accounts and Audit Regulations implies a wider interpretation of internal control, and indeed the CIPFA guidance rightly emphasises how effective internal control can be an invaluable tool in helping organisations to achieve their business objectives and comply with applicable laws and regulations. However, as the UK Accounting Standards Board (ASB) recognised body for issuing recommended accounting practices for local authorities, is CIPFA comfortable that existing guidance adequately addresses financial reporting controls in the current environment?

Secondly, the SOA requires identification of a framework used by management to evaluate the effectiveness of internal control in the organisation. CIPFA's new guidance makes reference to its 1994 publication, *Effective Internal Control – A Framework for Public Service Bodies*, as providing advice on how to set up a system of internal control. I would question the adequacy of this document to meet developing standards. The US SEC has specifically acknowledged that the *Internal Control – Integrated Framework* produced by COSO (the Committee of Sponsoring Organisations of the 1985 Treadway Commission on fraudulent financial reporting) is a 'suitable framework' on which to base management's evaluation, while acknowledging others exist. Whereas the CIPFA and Turnbull guidance are more or less a statement of principles, the COSO framework, issued in 1992, is a detailed exposition of the ingredients of sound internal control (taking a broader perspective than just financial reporting) and contains practical suggestions and examples to aid its implementation. Should we be developing a public sector 'COSO' for the UK?

Finally, the onerous certification requirements in the SOA ensure that CEOs and CFOs take a direct interest in the review, development and operation of their internal control frameworks. Their prime source of assurance will be the routine monitoring and attestation of operational controls by management. Internal Audit has a strong role to play, but cannot hope to give the extent of coverage that is implied by signing a SOA certificate, and indeed a SIC. CIPFA needs to play a strong advocacy role to ensure that CEOs and leading members are fully aware of what they are attesting when they sign the SIC; that they understand the detailed implications arising from the new Regulations; and provide detailed guidance to help them implement appropriate frameworks.

Let's hope that the new CIPFA guidance on internal control will be the start of a development process of support and education, and not the final word on the subject. ●

¹ *The Statement on Internal Control in Local Government: Meeting the Requirements of the Accounts and Audit Regulations 2003 (CIPFA, 2004).*

Andy Proudfoot, UK CEO of Axena, a Business Governance Solutions provider.

Editor's Note

This article raises several issues that will be considered when the Statement on Internal Control in Local Government is revised with the benefit of practical experience of its initial application

Regulatory accountability and control Peter Vass

Regulation has increased, is increasing, and should be reduced! It is a deregulatory agenda which finds a ready voice in the business community and amongst Conservative politicians. It has also been the subject of a Parliamentary inquiry by the Constitution Committee of the House of Lords, whose report, *The Regulatory State: Ensuring its Accountability*¹, was published on 6th May 2004 .

Undoubtedly, regulation has increased, particularly since 1979, the start of the Thatcherite programme which saw the water, energy, transport and communications industries privatised, accompanied by new 'independent' regulators, such as Oftel and Ofwat. The growing body of 'economic' regulators has underlined the transfer from the 'providing' to the 'regulatory' state, focusing on the control of monopoly power, particularly through increased competition.

Some expected regulation to 'wither away' as competition became effective. However, market failures remain entrenched, and regulation is also required to address social and environmental issues. The response, particularly since New Labour came to power in 1997, has therefore been to focus on 'better' regulation, rather than simply deregulation. Achieving this has required institutional reform, and new forms of public management.

The Better Regulation Task Force set out in its five principles of good regulation in 1998 – transparent, consistent, proportionate, targeted and accountable – and the Cabinet Office has a Regulatory Impact Unit which oversees the use of Regulatory Impact Assessments (RIAs) – a form of cost-benefit analysis – which are now required throughout government as the foundation for policy and decision-making. The National Audit Office is playing an increasingly important role in assessing their cost-effectiveness, as part of their value for money responsibilities. The Select Committee has recommended that the National Audit Office should have full access to all public bodies, most notably the Financial Services Authority (FSA), which is constituted as a company limited by guarantee.

Better regulation processes may result in less regulation, but they also identify areas where more regulation might be required in the public interest. It therefore accommodates the deregulatory agenda whilst at the same time recognising the legitimate role that regulation must play in achieving economic, social and environmental goals. Broad political consensus has been achieved through this perspective, with the debate now focusing more on the detail of which regulatory practices are most effective, comparing market 'instruments', such as tradeable permits, with traditional 'command and control' techniques.

The Constitution Committee's report has examined how the responsibilities of the regulatory state for better

regulation can be achieved and maintained. The key is regulatory accountability. The Committee see accountability as a control mechanism, and identify three key elements in practice:

- the duty to explain;
- exposure to scrutiny;
- the possibility of independent review.

The regulators have to set out their objectives, and give reasons for their decisions. Regulators have to consult in a meaningful way, providing both sufficient information and the means for interested parties to 'engage' effectively in the debate. Parliamentary scrutiny comes in for particular criticism in being less comprehensive and consistent than it should be. A new Joint Committee of both Houses of Parliament is recommended, and to act as a counterpart to the role of the Cabinet Office in promoting good regulatory governance at the heart of government. Finally, access to judicial review of regulatory decisions has to be complemented by increased appeal rights, built into the enabling legislation for each regulator. New bodies, such as a Regulatory Appeals Tribunal (a RAT!), are mooted.

Individual regulators, known as director generals, have been strongly attacked for 'personalising' regulation, and therefore government has progressively replaced them with regulatory boards. The Committee noted that whilst this policy was intended to improve the quality and consistency of regulatory decisions, there were some dangers to maintaining effective accountability if the regulatory board becomes 'faceless'.

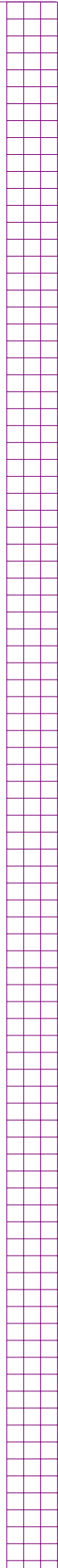
Whilst improving the means to challenge regulators should stop the seemingly inexorable process of regulatory creep, and redress the balance between the regulator and the regulated, it also requires an enhanced political and Parliamentary commitment. The Committee's report is clear that regulation starts and ends with Parliament, set within a regulatory cycle of accountability. It has four stages.

First, Parliament identifies the regulatory objectives, and sets out the regulatory framework in appropriate legislation, whilst at the same time setting out the principles and processes for achieving good regulation through the machinery of government, including codes of practice as appropriate. This is the 'macro' level. Implementation can then be carried out by 'competent' authorities, in the legal sense, but also in the sense of 'technically' competent. This is the 'micro' level. The Committee therefore finds no conflict between regulatory independence and accountability. The third part of the cycle is regulating the regulators through the processes of accountability described above. The final stage is 'learning the lessons', whereby regulators adopt revised practices or Parliament reviews the legislation.

The Committee's report underpins the modern framework for good regulation, consistent with the international best practice as set out by the Organisation for Economic Co-operation and Development (OECD) in its series of reviews of regulatory reform, in particular *'From Interventionism to Regulatory Governance' (2002)*. ●

¹ 6th report – Session 2003-04, HL Paper 68, Vols 1-111

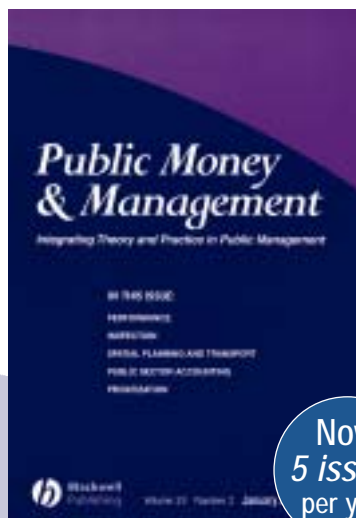
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