

Spectrum

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Policy & technical perspectives for CIPFA members and students

CIPFA

This issue of CIPFA Spectrum starts with two contributions from the United States – one reviewing the US accounting standards setting scene and the other drawing on US local government's experience of encouraging citizen participation in the finance and budgeting process.

Chronic disease management is a significant issue for the National Health Service and the third article looks at ways to better manage the human and financial costs involved.

Efficiency reviews, in particular the Gershon review, are the focus of the fourth article, which reviews the contribution that better management of long term assets might make towards the efficiency targets in both central and local government.

The final two articles examine the impact of legislation on charities and public sector auditors respectively, specifically the Proceeds of Crime Act 2002 and the Freedom of Information Act 2000.

Feedback on these articles is welcome, please send to vernon.soare@cipfa.org

Vernon Soare, Policy and Technical Director

Accounting standards setting in the United States of America

David Bean

Accounting standards setting is performed in the United States of America (United States, U.S., or States) by three organizations—the Federal Accounting Standards Advisory Board (FASAB), the Financial Accounting Standards Board (FASB), and the Governmental Accounting Standards Board (GASB). Some view this arrangement as a triumvirate that appropriately recognizes environmental differences associated with the entities under the standards setters' purview, while others view it as a 'three-headed monster' that adds unnecessary complexities for all involved in financial reporting. No matter what one's views are regarding this arrangement, everyone recognizes that it is unique.

The current standards-setting structure

The FASB and GASB can trace their roots back to the 1930s. Of the current U.S. standards setters, the FASB has the longest tenure. It was established in 1973 under the auspices of the Financial Accounting Foundation (FAF), which was created at the same time. The Board of Trustees of the FAF appoint the members of the FASB, raised money to support the activities of the FASB (which ended with the implementation of the public company accounting support fee in 2004), and provides oversight of the FASB's activities.

The FAF Trustees, however, are prohibited from influencing the technical activities of the FASB.

One standard and one concepts statement issued by the FASB had a direct influence on the establishment of the next standards setter, the GASB. The FASB stated in its Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, issued in 1980, that the provisions apply to '... an ongoing plan that provides pension benefits for the employees of one or more employers, including state and local governments....'

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AT THE HEART OF
PUBLIC SERVICES

► That standard was followed later that year by FASB Concepts Statement No. 4, Objectives of Financial Reporting by Nonbusiness Organizations, which noted, 'the Board is aware of no persuasive evidence that the objectives in this Statement are inappropriate for general purpose external financial reports of governmental units.' However, there were those who believed that there was persuasive evidence that both the pension standard and the objectives were inappropriate for the public sector, and they set out to establish an independent standards-setting body for state and local government.

After several years of negotiations, including reaching a jurisdictional arrangement, the GASB was formed in 1984. Like its sister organization the FASB, the GASB also was established under the auspices of the FAF. The FAF relationship is the same with the FASB and the GASB, with the notable exception that the FAF Trustees still raise moneys for the support of the GASB.

The final U. S. standards setter to join the triumvirate was the FASAB. It was established in 1990 based on a memorandum of understanding between the Comptroller General of the United States (GAO), the Secretary of the U. S. Treasury (Treasury), and the Director of the Office of Management and Budget (OMB) who shared the responsibility for establishing financial reporting standards for the federal government in the past. As the chart in Exhibit A illustrates, each of the standards setters has clearly defined jurisdictional lines of authority, and all three are now recognized by the American Institute of Certified Public Accountants, which sets generally accepted auditing standards in the U.S., as bodies that establish generally accepted accounting principles in the United States.

How Is the triumvirate working?
In a world where convergence is on the minds of accountants around the globe, it (surprisingly, to those outside the States) has not been the primary goal of the three U. S. standards setters. When one looks at the differences that have occurred over the years, those differences arose primarily because of the environments in which the boards operate. None of the boards subscribes to a 'follow who got there first' view when addressing similar issues. However, that should not imply that the boards disregard the work of the other standards setters.

It is easy to identify differences among the standards setters; however, one must not lose sight of the fact that there are more similarities than differences. For example, all three have financial reporting models that are built on the accrual basis of accounting. When differences do occur, the boards naturally believe that there is justification for those differences. The following are two examples that highlight those differences between the FASB and the GASB.

A prime example arose in the area of employee benefits in terms of pension and retiree healthcare benefits (referred to as OPEB), which is not unexpected given the reaction that helped lead to the GASB's establishment. Two almost entirely different Boards adopted the GASB standards, as the pension and OPEB standards were adopted almost 10 years apart; yet they hold similar views.

Those views have been articulated in a forthcoming GASB staff paper, 'The Impact of Unique Features and

Distinguishing Characteristics of Governments on Accounting and Financial Reporting by State and Local Governments.' The following is a modified excerpt from that draft paper:

The GASB believes that the permanent nature of most governments has implications for financial reporting. For private sector entities permanent existence is not guaranteed. Although private sector financial statements are prepared using a 'going concern' assumption, emphasis is still placed on the recoverability of assets, such as through future sales or contributions, and on the fair values of assets and liabilities. In contrast, governments' ability to exist in the future generally is not in doubt, but rather the question is the sustainability of the level of services being provided and the ability to meet future levels of demand for services. As a result, the emphasis that the GASB has placed on financial reporting generally has been on determination of cost of services and taking a longer-term view of operations.

The longer-term view of operations of government arguably is consistent with focusing on trends in operations, rather than on short-term fluctuations, such as in fair values of certain assets and liabilities, in particular the short-term fluctuations that are associated with the fair value or actuarial changes in assets associated with employee benefits. The GASB believes that cost of services is an important element of governmental financial statements because it indicates the level of resources that should have been provided, whether those goods or services have been supported through taxes, user charges, or grants, or accumulated resources. Comparing cost of services with the level of resources provided helps assess interperiod equity, another financial reporting objective identified in GASB Concepts Statement 1. Recognition of certain short-term fluctuations in long-term assets and liabilities would distort cost of services, thereby reducing the usefulness of the financial statements in assessing issues of interperiod equity. Immediate recognition of changes in fair values of assets set aside in employee benefit plans and immediate recognition of changes in accrual actuarial liabilities as a result of a change in benefit plan terms are a prime example of how short-term fluctuations could distort cost of services.

The final example of a FASB/GASB difference also focuses on the environment; in this case, the differences are associated with measuring and reporting the impairment of capital assets. The FASB standard is based on analyzing discounted cash flows related to an asset or group of assets; however, most governmental capital assets do not generate cash flows. The IPSASB was facing the same situation in their effort to develop a standard on asset impairments for non-cash-generating assets. Although the GASB and IPSASB did not form a joint project, the boards did work closely together in developing their government-specific standards.

Those standards were based on the concept of service potential (or service capacity) and the measurement of whether the service potential of an asset had been adversely affected by an event.

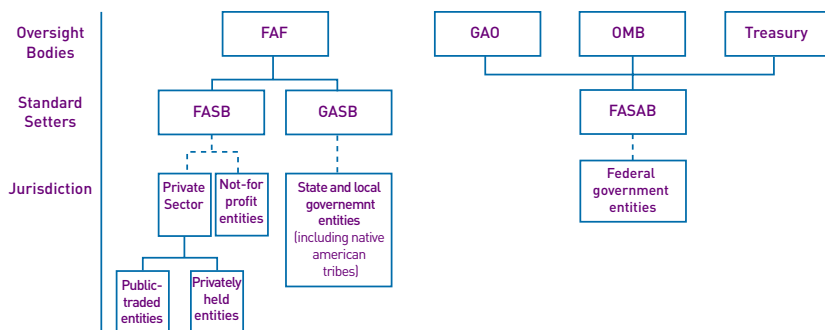
Conclusion
The standards-setting structure in the States is certainly unique. It is based, in part, on the belief that an organization's operating environment necessarily influences its financial reporting objectives, which should be relevant and reflective of the needs of financial report users in that environment.

The intent of this article was not to advocate the adoption of such a model in the United Kingdom or any other country in the world. Instead, it hopefully does provide a better understanding of how the process works in the United States.

The views expressed in this article are those of Mr. Bean. Official positions of the GASB are determined only after extensive due process and deliberation ●

Exhibit A

Standard Setting Structure in the U.S.



*David Bean
Director of Research
Technical Activities
Governmental
Accounting Standards
Board*

Local government finance and budgeting – encouraging meaningful citizen participation through education

Nicole Lun

Most citizens have little knowledge about local government budgeting and its impact on their communities. This may be driven by the fact that over the last few decades, the American public has grown increasingly apathetic to political affairs and civic involvement. A recent Gallup poll showed that public trust in state and local government has declined in the last five years, due largely to the slow economy and its negative effects on budgets.¹ To counter these trends, many local governments are strategically engaging the public in local affairs through citizen education. Governments of all types and sizes are now using a variety of strategies – including newsletters, annual reports, radio programs, call centers, and high school civic classes – to develop an informed citizenry that is both interested in and capable of contributing to local policy making.

Citizen education serves an important function in a democracy, especially in a large and complex society such as ours. Access to information is necessary for citizens to exercise political power and participate in public affairs. Citizen education provides people with the tools to understand and influence the decision-making process. Evidence suggests that when citizens participate in government activities, they are more likely to view the government as trustworthy and responsive to public concerns.² Ultimately, citizen education can strengthen collaboration between citizens and the government by promoting awareness and communication.

This article discusses four ways local governments are educating citizens about budgeting: budgets-in-brief, the internet, public access television, and citizen academies. These methods vary in terms of the time and effort they require from citizens and the types of media or technology employed. While these methods represent just a few effective strategies for educating citizens, they illustrate the range of strategies local governments are using to reach their diverse constituencies.

Budgets-in-brief

For citizen education to be successful, local governments must provide information that is clear and easy to understand. Also known as popular budgets, budgets-in-brief provide a concise overview of the annual budget and its key issues. Many citizens think budgets are too

boring or complex to read and understand. Budgets-in-brief are an attractive alternative, because they are written specifically for a lay audience and focus on the most relevant aspects of the budget.

Hillsborough County, Florida, developed its Taxpayer's Guide to the Hillsborough County Budget to educate its citizens on the basic issues of county budgeting in Florida and to overcome public confusion and distrust over changes in the county's taxes and taxing authorities. First published in 1992, the Taxpayer's Guide is designed as a supplement to conventional budget documents and is intended to provide an objective overview of what drives the annual budget. It allows citizens to gain insight into the budget while the next year's budget is still under preparation. The Taxpayer's Guide is distributed widely to social and civic organizations, homeowners' associations, and civic watchdog groups, as well as to the media, including local newspapers, radio and television stations, and their editorial boards.³

Internet

The internet is a powerful tool for educating citizens about local budgeting. A good example is the Metropolitan Government of Nashville (Metro), which developed what it calls the Citizen's Guide to the Metro Budget to increase budgetary transparency and help stakeholders understand and participate in the budgeting process. The Web site, which is accessible from Metro's home page, provides an overview of the budgeting process,

details of the current year budget (including plans and progress toward achieving Metro's priorities), and information on departmental activities and finances. The Citizen's Guide also provides access to budget presentations and council meetings with streaming video. By presenting information in a condensed format that is easy to understand, Metro hoped to focus budgetary conversations less on accounting details and more on how resource allocations impact the community.⁴

The City of Cedar Rapids, Iowa, has created a comprehensive resource for accessing budgetary information. The City's Web site devotes a section to the Controller-Auditor's Office, which provides a downloadable summary of the city's budget, as well as departmental budgets broken down by funds. Like Metro Nashville, Cedar Rapids provides tools to help citizens understand the budget, including a guide that explains key budgetary concepts and a glossary of terms and acronyms used in the budget.⁵

Public access television

Despite the growing influence of the internet, television remains the most popular and widespread form of mass communications. While little more than half of American households own a computer, nearly all households own at least one television set. The Cable Communications Policy Act of 1984 provided for the establishment of public, educational, and government (PEG) access channels, which serve the public as an open forum.⁶ The Federal Communications

Commission mandates that cable franchises dedicate a prescribed number of hours to free, local public affairs programming.

Local governments commonly use PEG access television to post announcements and to air coverage of council, board, committee, and commission meetings. For example, Portland Community Media – the PEG access station to Portland, Oregon – airs coverage of the city's community budget forums. During these meetings, neighbors participate in round table conversations with the directors of city bureaus and city commissioners. Portland Community Media also airs live coverage of the Portland City Council, the Metro Council and Multnomah Council Commission.⁷

Interactive PEG access programs give citizens the opportunity to express their opinions and access the government at a personal level. Interviews or live call-in shows featuring local officials introduce citizens to the people behind their government. Local governments produce informational programs on a wide variety of topics, including crime prevention strategies, child safety tips, budgetary news and hiring information. PEG access television can also be used to provide live coverage of local emergencies such as storms, floods, fires and earthquakes.⁸

Citizen academies

Citizen academy programs give people the opportunity to learn first-hand about the functions and services of their local governments. Like other forms of citizen education, citizen academies are intended to strengthen communication and cooperation between citizens and their local governments. The programs typically include presentations of the different government departments, tours of local sites and facilities, and opportunities for participants to role play government jobs. Most – though not all – citizen academies include a finance or budgeting component.

Sarasota County, Florida, developed

its citizen academy to provide participants with an informative and engaging opportunity to learn about the operations and services of their county government. The program takes place twice a year and consists of 10 classes held at various county facilities, as well as an additional half-day tour.⁹ The ninth week of the academy, titled 'Behind the Scenes,' introduces participants to the budgeting process, the PEG access television station, and the county's Web site. The budgeting component includes a 20 minute overview of the operating and capital budgets and how they are developed.

In addition, a budget analyst leads a role-play exercise in which participants divide into small groups and act as 'commissioners.' They listen to five or six different appeals for funding, including requests for a skateboard park, a water study, a new fire station, expanded bus routes, a paws park, etc. After the presentations, the participants work in groups to discuss how they will prioritize these requests and allocate their funds. The goal of the exercise is to show that public resources are limited and that elected officials are sometimes forced to make difficult choices when trying to meet a variety of needs. Participants rate this exercise very high as an informative and engaging learning experience.¹⁰

The City of Troy, Michigan, has seen its citizens academy graduates become active in city government. Many have been appointed to city boards of committees, and a few have been hired for city jobs or run for the City Council. A substantial majority of the graduates now volunteer at city facilities such as the museum, nature center, library and election polls, or at local non-profit organizations. Most of them now vote in all city elections and attend city events and activities with their families.¹⁰

Conclusion

Most efforts at citizen education are developed with the expectation that people will do something with the knowledge they acquire. An important function of citizen

education is to facilitate participation in public and civic affairs. Of course, most budgeting professionals readily acknowledge that citizen participation is not without its drawbacks; some even regard it as an unnecessary intrusion. Citizen participation can prolong debate and delay decision making, which makes budget development more difficult and sometimes adds little value to the final product. However, citizen education programs can foster more productive public participation by helping citizens understand government operations, processes, and issues. ●

Acknowledgement

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¹ Jeffrey Jones, 'Issues Facing State, Local Governments Affect Public Trust,' Gallup Poll Tuesday Briefing, 14 October 2003.

² Kathleen M. Halvorsen, 'Assessing the Effects of Public Participation,' Public Administration Review 63, no 5 (September/October): 535-543

³ Eric R. Johnson, 'Taxpayer's Guide to the Hillsborough County Budget: Turning the Tide from Distrust to Understanding,' Government Finance Review 10, no 1 (February 1994): 17-19. The Taxpayer's guide can be viewed online at www.hillsboroughcounty.org

⁴ Robert Boydston and William Aaron, 'The Citizen's Guide to the Nashville Budget: Providing Better Information in Better Ways,' Government Finance Review 20, no 1 (February 2004): 12-16.

⁵ City of Cedar Rapids, Iowa, <http://www.cedar-rapids.org/audit/budget/index.asp> 30 January 2004

⁶ Robert Snyder, 'The Right to Access: Jaquith v. Waterloo Cable Commission,' Communications & the Law 18, no. 3 (1996): 93-101

⁷ Portland Community Media, <http://www.pcmv.org/index.asp> 3 February 2004.

⁸ John Berkich, 'Defusing Those Hot-Button Issues,' Public Management 80, no. 8 (August 1998): 18

⁹ International City/Council Management Association (ICMA), Citizen Academies, IQ Report 33, no 8 (August 2001).

¹⁰ Casey Pilon, Community Involvement Coordinator, Sarasota County, Florida, interview by author, e-mail, 17 November 2003.

¹¹ Cynthia Stewart, interview by author, e-mail, 17 November 2003.

Nicole Lun is a policy intern in GFOA's Research and Consulting Center in Chicago.

Chronic disease management – addressing the long term

Tom Lewis and Noel Plumridge

There can be no doubt that the NHS has made massive strides forward in improving access to acute hospital care in recent years. But while the Government recognises that there is still a way to go – not least as regards the way in which waiting times are actually measured – attention is now also being focussed on chronic illness as a health priority, together with the new emphasis on public health.

John Reid's theme, in his first major speech as Health Secretary, speaking to the NHS Confederation in 2003, was the alleviation of pain and fear. In 2004, seven out of the eight new public service agreements addressed public health and long term disease management issues. And the required 5% reduction in emergency in-patient bed days recognises the importance of long term disease sufferers to the management of bedspace resources. The Department of Health (DH) estimates that just 5% of in patients account for 42% of all in patient bed days. People who are suffering from long term diseases tend to be heavy users of unplanned care, especially in the later stages of those illnesses; if alternative ways of managing long term disease can be found, there is a significant potential for improving access to acute care still further.

Chronic illness is a growing factor in most western economies, and not just because the population is living longer. The statistics are startling:

	Number of people (millions) in the UK
Total Population	c.59
Long term illnesses, affecting day to day life	8.8
Arthritis sufferers	8.5
Asthma sufferers	5.2
Doctor – diagnosed diabetes sufferers	1.5

(Source:Department of Health)

There are also large numbers of people who suffer from heart problems, epilepsy and mental illness

It is thought that about 45% of those with one long term disease will suffer from at least one other long term problem; about 25% of people with long-standing health problems have 3 or more conditions. One condition – asthma – kills 1,400 people a year in the UK; asthma sufferers face a

'seemingly endless round of emergency hospital admissions' (Asthma UK – 'Living on a Knife Edge', 2004), and many live in fear that the next attack will kill them.

The Department of Work and Pensions (DWP) estimates that about 1 million people report sick every week, and around 2,500 people each week are beginning a long term absence from work of at least 5 years. As well as the economic costs of the days lost to employment, there are substantial social costs in the form of isolation and social exclusion, leading to additional economic burdens on the health and social care systems. Successful chronic disease management – even for a small percentage of those claiming incapacity benefit which totals some £125 million per week – has very clear economic benefits. This opportunity is not just the product of blue-sky thinking, but is borne out by actual experience, mainly in the USA, but also with smaller scale initiatives already up and running in the UK.

The two best known examples from the USA are the Kaiser Permanente and Evercare models. Kaiser Permanente – a Californian not for profit health organisation – has achieved a considerable reduction in its use of acute hospital beds, through integrating service delivery between the primary and secondary services, and focussing on ongoing management of people with long term diseases. Evercare is a system designed to improve the care of elderly people, by means of regular care visits, and treating the whole person, rather than acute problems as they occur. There is more detail on these programmes on the Department of Health (DH) website, and the DH has sponsored initiatives in which individual PCTs have introduced working with the 'Kaiser Principles.'

In 2004, the DH published a 'Pyramid of Care,' identifying three principal segments of the chronically-ill population. At the apex of the pyramid are the intensive users of specialist care, but the DH believes that between 70% and 80% of chronically ill people would be suited to a structured programme of supported self-management. This approach involves such techniques as:

- patient and carer education about self-management of their illness, including help in understanding what to do, how to adjust medication dosage, and how and when to use the health care system
- active reminders and prompts when patients should be attending for care or doing something
- support from a knowledgeable patient
- support networks, such as groups of patients with the same condition.

The DH believes that successful self care could result in over a 40% reduction in visits to GPs, and very substantial reductions in both the number and length of hospital admissions. The DH has also made it clear that its support for developing chronic disease management will require NHS organisations to follow a standard approach, and also to prioritise the most complex chronically ill people. More work is needed, however, to deal with the potential risks; in particular, the requirements on the support structures outside the hospitals, and indeed on management time, and information system resources, need to be fully explored. The US experience suggests that success will depend upon a substantial up front investment of time and money.

No review of the subject would be complete without mentioning the King's Fund assessment, published in January 2004. ('Managing Chronic Disease ; What can we learn from the US experience?' (J Dixon et al)). This noted that the progressive measures introduced by US organisations in part reflected the competition that exists between health care providers. The King's Fund suggested that, while this situation is not replicated in the UK, there might be potential to follow one of two routes –

- Stronger financial incentives for PCTs, GPs and acute NHS trusts to manage patients with long term conditions in the community, possibly including competition between PCTs for patients.
- A non-market approach based on a more sophisticated mix of existing incentives, 'aligning them more strongly to the goal of better health and reduced avoidable hospitalisation.'

CIPFA plans to publish a detailed practical study of the financial aspects of chronic disease management. This publication aims to support shared understanding and active co-operation between financial specialists and the broader health community, by offering accountants and finance staff a solid grounding in the importance, concepts and practice of modern chronic disease management. The study also offers the NHS an independent professional commentary on some of the financial and economic issues arising from this major health care initiative, and some practical signposts through some of the potential tensions and conflicts.

CIPFA believes it can offer a valuable contribution in support of improving chronic disease management, by identifying practical solutions to apparent obstacles within the NHS financial regime – in particular, an apparent mismatch with tariff-based funding for acute hospitals – and by helping the NHS make good chronic care a reality in the United Kingdom. ●

Tom Lewis, Assistant Director – Central Government and Health, CIPFA and Noel Plumridge, Independent Consultant

Efficiency, capital assets and depreciation

Maureen Wellen

The pursuit of efficiency has been a mantra in the public sector for as long as

anyone can remember. But it has

come into greater prominence

recently because of the Gershon

review, with its demand for £ 21.5

billion worth of efficiencies in

England's public services by 2007/08.

We are assured that the Gershon

review is about efficiencies, not cuts.

Now we all know that in the past the

word efficiencies has often been

used as Orwellian-speak for cuts.

However, the Gershon rules state

that cuts in services cannot be

counted as efficiencies. Cuts in

services may or may not happen for

other reasons, but if they do, they

won't count towards the £ 21.5 billion

demand by Gershon.

In fact the Gershon report contains quite a sophisticated definition of efficiency. This can be summarised, perhaps rather crudely but hopefully without undue over-simplification, as: more bangs for your bucks (dreadful phrase); the same level of service for less resources; or remodelled service provision leading to better outcomes. And Gershon sees six fruitful sources of greater efficiency in the public sector

- back office functions
- procurement
- transactional services
- policy, funding and regulation for

the public sector

- policy, funding and regulation for the private sector
- increasing the productive time of front line services.

However, there is a very significant omission from this list and one which could be the source of relatively pain free greater efficiency in the public sector – this is the use of long term assets. In this context the term includes land, property, equipment and infrastructure.

The public sector is a heavy user of long term assets. In local government in Great Britain alone the value of fixed assets on their balance sheets is some £ 215 billion and annual capital spending some £14 billion. The public sector also uses assets in the provision of services through the PFI/partnership schemes and leases.

Traditionally, control and accounting systems in the public sector have not facilitated – and indeed have often actively worked against – good strategic planning and management in respect of long term assets. Whilst there has been substantial progress in recent years, more could be done in this regard – in particular in the way that depreciation is taken into consideration.

In central government until relatively recently cash accounting meant, first, that expenditure on long term assets 'scored' in the year in which it was spent. Not unnaturally, this made the initial spend on long term assets difficult to afford. It was akin to an individual having to afford the entire purchase of a house out of annual salary – instead of the mortgage. The initial 'hit' of capital expenditure also skewed decisions on the respective benefits – in terms of both service provision and efficiency – as between revenue intensive and capital intensive options. Second, cash accounting meant that, once purchased, capital

assets were then free to the public service provider. This was hardly conducive to the good management, full utilisation or maintenance of long term assets. Or indeed of even having a comprehensive asset register, which is a basic and fundamental pre-condition for good asset management planning.

Things have changed in recent years in central government with the introduction of resource accounting. Individual government departments have been operating with the government's Resource Accounting Manual (RAM) for several years, although 2004/05 will see the first year of full audited resource accounts for central government as a whole, which will have particular importance in my view through consolidating into one set of accounts government departmental spending and government borrowing and investment activities.

The introduction of resource accounting in government departments has meant that full asset registers have been compiled, assets have been valued for the balance sheet and departmental accounts are charged with amounts for depreciation to reflect the using up of assets and with an appropriate rate of interest to reflect their value in use. The definition of depreciation within this article is the annual depreciation of fixed assets in accordance with proper accounting practice, including any impairment falling to be treated in the same manner as depreciation. Appropriate rate of interest is used in this article to mean the amount required to be charged to departments by the RAM and to local authority services by CIPFA's Best Value Accounting Code of Practice [BVACOP].

In central government departments, the introduction of resource accounting has increased the importance of and facilitated asset management. In particular, the using

up of fixed assets is highlighted and identified within the accounts through the charge made for depreciation, rather than as under cash accounting being hidden (until, that is, the assets noticeably fall apart).

However, the impact of resource accounting on budget setting and forward planning for government departments is still embryonic. In particular capital monies still reach the department as a resource in year one. For planning capital expenditure, it is therefore questionable how much the cost over time rather than the year one cash is the primary focus.

Local government has been using the equivalent of resource accounting – ie full accruals accounting for both capital and revenue expenditure – since 1994/95. One immediate benefit of this, which is often overlooked, was the compilation of asset registers. Comprehensive asset registers had previously been recommended good practice but it was the introduction of capital accounting that converted this into actual practice for many.

In 1994/95, it was hoped that the making of a charge to services for depreciation and interest based on the value of the asset in use would impact directly on financial planning. However, because within the consolidated accounts of a local authority these elements were replaced with the actual interest incurred and the statutory charge for the repayment of debt Minimum Revenue Provision [MRP] in England and Wales, loans fund repayment in Scotland, capital charges to services were not perceived as real and so had little effective impact on financial management in practice. This null impact was re-inforced by the control mechanisms imposed by central government. Under these, capital spending 'hit' in year one, scoring either against useable capital

receipts, revenue, capital grant or a central government determined limit on borrowing (in Scotland, on expenditure).

The prudential framework, introduced in local government throughout Great Britain in 2004/05 and supported by the CIPFA Prudential Code, has improved the situation in local government. Capital expenditure is not now externally rationed by central government in the year that it is incurred. Rather, local authorities decide how much capital expenditure they wish to undertake, providing this is within the limits of affordability and prudence that they set for themselves.

It is evident, after one full year of operation, that many local authorities are already using the new framework to incur capital expenditure to improve public services and also to improve efficiency. A common example of increased efficiency is where authorities are re-examining their use of operating leases. Previously, capital rationing meant that for some expenditure an operating lease was the only realistic option. Now (unless government support is tied to a particular option) authorities can compare different financing options on an even footing and choose the one offering best value. Sometimes an operating lease will be optimum, sometimes a finance lease, and sometimes procurement. A further example from one authority of long term efficiency gains is in the provision of services for adults with severe disabilities, where current provision is bought in from private establishments and where substantial savings without loss of service are projected from the provision of a new self build asset.

A significant limitation on the benefits flowing from the new system is that in local authorities whilst depreciation is charged to services it

does not have to 'hit' the bottom line for taxation purposes. This is because MRP in England and Wales and loans fund repayments in Scotland have survived into the new system. In England, central government has announced its intention to move MRP to a depreciation based system over time, and after due consideration of affordability with local government. And certainly, where matters of taxation are involved, affordability is a key issue.

But there can be no excuse or reason for not including both depreciation and an appropriate rate of interest whenever the cost of services is included in a test for whether an efficiency gain has been made, or a measure of how much. It is only by measuring the true total cost of services, including the use and consumption of capital assets, that real efficiencies can be deduced. Furthermore, the integration of capital and revenue planning can be achieved by concentrating on the real cost of capital over the life of the asset, whilst keeping total borrowing within a prudent limit. This is a key facet in encouraging real, long term efficiencies in the public sector. ●

Maureen Wellen,
Assistant Director,
Local Government
Finance & Policy,
CIPFA^o

A regulatory perspective on money laundering and the POCA

Stephen Gogerty and Nigel Davis

The interest of the regulator

The interest of the Charity Commission lies in the premise that, although the vast majority of charitable activity is undertaken by trustees acting honourably and in the best interests of their beneficiaries, money laundering does exist and it does affect charities. The Financial Action Task Force (FATF)¹ assessment is that, 'the misuse of non-profit organisations for the financing of terrorism is coming to be recognised as a crucial weak point in the global struggle to stop such funding at its source.'

That said, in the absence of reported data by the National Criminal Intelligence Service (NCIS), it is unclear how much money is laundered in the UK, and to what extent charities are involved. The Commission remains concerned that the damage to the public perception of charities from the incidence of significant levels of money laundering in general and links to terrorism in particular justify a close regulatory interest in the areas of risk posed to charities. This article is intended to assist trustees and their advisers in considering and evaluating rationally the risks posed in the particular circumstances of their charity.

When considering these issues, it is important to look at the regulatory framework for charities operating in England and Wales. The public perception is that charities enjoy a privileged status in part due to favourable tax treatment; and as such there is an increasing expectation that charities be transparent and accountable. The regulatory framework set out in the Charities Act 1993 and associated regulations seek to put in place that accountable framework but inevitably there is a high degree of 'self-regulation' by the trustees of charities. Allied to this the Charity Commission is applying risk-based measures in the regulation of charities emphasising the freedom within a framework that charities enjoy and by repositioning the Commission's regulatory approach to one of an enabling regulator. This approach will involve developing further the interaction and partnership with other regulators and law enforcement agencies.

Charity trustees need to be aware of the duty placed on their professional advisers by the Proceeds of Crime Act 2002 (POCA) and Money Laundering Regulations 2003,

which are widely drawn and make certain matters a money laundering offence. Professional advisors can avoid committing an offence by making an authorised disclosure to the National Criminal Intelligence Service (NCIS) where there is knowledge or suspicion, or reasonable grounds for knowing or suspecting that another person is engaged in money laundering. Money laundering includes concealing criminal property, entering into an arrangement to use or control such property or acquiring or using such property. Section 330 of the POCA provides for a separate offence of failing to disclose and consequently imposes a duty to report such knowledge or suspicion. The Regulations place certain businesses and professions under explicit duties in relation to how they deal with clients and other internal matters. The POCA sets out the penalties for non compliance and tipping off offences. When designing internal financial controls and assessing operational risk, trustees should consider those business activities where the risk of a breach of POCA is greatest, ensure appropriate controls are in place and take appropriate professional advice.

The Terrorism Act 2000 requires disclosure as soon as is reasonably practicable and this can be construed as making it an immediately reportable matter to the police, where any person has evidence of or a reasonable suspicion that transactions have taken place or individuals are involved in activities supporting terrorist offences. The Charity Commission's guidance on terrorism is set out in Operational Guidance 96 – Charities and Terrorism..

The role of accountants, auditors and independent examiners

Auditors and independent examiners may come across matters that require a duty to report under POCA, anti terrorist legislation and the Money Laundering Regulations 2003. Accountants should be fully aware of their responsibilities in relation to this legislation and the CCAB² has issued 'Second interim guidance for Accountants' to assist in this matter. Reporting to NCIS does not relieve auditors from other statutory duties, such as reporting to other regulators, auditors are also required to report matters of material significance to the Charity Commission. The Auditing Practices Board (APB). Practice Note 12 'Money Laundering Interim guidance for auditors in the United Kingdom [Revised]'³ explains this further.

Independent examiners have a duty, by virtue of the Charity Commission's publication CC63, Direction 12⁴, to inform the Charity Commissioners in writing if, whilst acting in the capacity of the examiner of a charity, they obtain information or evidence which gives the examiner

reasonable cause to believe that any one or more of the charity trustees has been responsible for deliberate or reckless misconduct in the administration of the charity. Examples of deliberate or reckless misconduct are published in appendix 4 of CC 63. Accountants acting as independent examiners should take a risk based approach when considering whether a charity is likely to be carrying out activities that may warrant a reporting duty under POCA.

Independent Examiners, who do not hold a practicing certificate but who are qualified accountants, must bear in mind the more stringent requirements of POCA where the threshold is one of reasonable knowledge and suspicion when considering whether a reporting duty arises under direction 12, in addition to their reporting requirement to NCIS.

Accountants who are employees of a charity do not have a specific duty with respect to POCA but they are required, in the same manner as any person, to report to the police any suspicion of involvement in terrorist activity in accordance with the Terrorism Act 2002. Accountants as professionals however are governed by the ethical code of their Institute and where any suspicion of a reportable matter under POCA arises accountants are encouraged to contact their professional body to confirm if disclosure is required to NCIS. It is expected that accountants aware of any wrong doing will advise their auditors, provided they are not impeded from doing so by advice from their professional body that they may cause a tipping-off offence under POCA. Accountants as employees should also be aware of the whistleblowing policy of their organisation.

Accountants who are contracted by the charity to undertake accounting work fall within the relevant businesses and should report reasonable suspicions of incidents falling under POCA to NCIS in the normal way.

Risk areas for trustees

Charities are vulnerable to exploitation by money launderers in part because some organisations have a high cash turnover. Certain charities and NGO's work internationally, crossing international boundaries and jurisdictions, making any audit trail difficult to follow. This international dimension, the public perception of charity integrity and the reliance in part on volunteers is attractive to a money launderer because it creates opportunities to conceal funding flows. Charities should be especially vigilant to ensure that their charity is not inadvertently assisting other organisations, by allowing the charity to be used for money laundering purposes. This is one of the more difficult areas for charities to deal

with, as the type of activity listed below may be perfectly legitimate and lawful. Charities should consider that in certain circumstances unsolicited donations could be suspicious, especially if they are unable to satisfy themselves about the credentials of the people involved, or the propriety of the donation or loan.

- If offered large donations from persons unknown to the trustees, the trustees may wish to make further enquiries before accepting the donation, and may refuse a donation if satisfactory replies to enquiries are not received.
- Donations which carry a restriction that particular individuals or organisations are used to do work for the charity.
- Offers of donations in cash, for a certain period of time, the charity to receive the interest, but the principal to be returned to the donor at the end of the specified period.
- Donations in foreign currencies, with the provision as above, but the principal to be returned to the donor in the form of a sterling cheque.

Aside from donations, other areas that charities and their advisor should consider as a risk are:

- Entering partnership arrangements with organisations that may be fronts for criminal activities
- Use of an alternative banking system (Hawala) to move funds to areas of operation
- Use of conduits for funding (money held for the organisation in a conduits name)
- Use of couriers to transport cash or valuables (gold or commodities) into areas of operation
- Payment of facilitation charges in an area of operation where these amount to a private benefit rather than a lawful tax or duty.
- Operating trading outlets with donated goods with insufficient internal controls. (No purchase invoices to match any sudden increase in cash income.)
- Operation of trading subsidiaries with insufficient internal controls (can be used to receive loans and repay loans to confuse the audit trail)

Clearly the level of risk depends upon the context and how well the charity knows its donors and partners. Charities reliant on offshore donations or donations outside of the jurisdiction of the UK tax authorities should be particularly wary that the funds are untainted by money laundering; this is of particular importance if the charity raises its funds and applies those funds wholly outside of the UK. ►

- ▶ Methods of using charities by terrorist or criminal organisations may include:
 - Using money raised by charities to fund terrorist organisations;
 - Using charities to smuggle people into countries illegally;
 - Using residential schools as military recruitment and training centres;
 - Using charities set up for providing facilities for young people for organisation and recruitment;
 - Using charities as a base to spread propaganda; or
 - Using charities for money laundering purposes.

Conclusion

Whilst there is little evidence to suggest that charities have been unwittingly involved in terrorist and money laundering activities or have been used for such purposes by criminals, instances of alleged or proven money laundering, as defined by POCA, have arisen and been investigated by the Charity Commission. Instances have been identified of funds being lost to trustee control overseas or of insufficient checks being made on the final application of those funds, both of which provide reasonable cause for concern that funds may have been lost to criminal activities.

It is important that charity trustees, charity employees and their advisers build into their risk management and internal controls a rational consideration of the potential risk and actively and immediately follow up any suspicious transactions in a robust and transparent manner. When investigating an incident or considering making a report it is essential to act in accordance with any guidance by NCIS⁵ concerning the handling of a Suspicious Activity Report in such a manner as to avoid committing a tipping off offence. ●

Stephen Gogerty, Senior Accountant, and Nigel Davies, Deputy Head of Financial Regulation and member of CIPFA's Charities Panel, Charity Commission

An expanded version of this article, together with case studies can be found on the CIPFA Charities Panel website at www.cipfa.org.uk/panels/charity/index/cfm

1 *Financial Action Task Force on Money Laundering: Combating The Abuse Of Non-Profit Organisations*
 2 www.icaew.co.uk/ccab/documents.html
 3 www.frc.org.uk/apb/publications/practice/cfm
 4 *Direction 12 CC63 – Independent Examination of Charity Accounts*
www.charitycommission.gov.uk/publications/pdfs/cc63text.pdf
 5 www.ncis.co.uk/disclosure.asp

Background

This article sets out some of the issues arising for the audit and value for money (vfm) examination of public authorities from the Freedom of Information Act 2000 (the Act), whether the audit is undertaken by a public audit body or a private firm. The Act applies to England, Northern Ireland and Wales, Scotland being subject to the separate Freedom of Information (Scotland) Act 2002 and the Scottish Information Commissioner.

The Act creates a general right of access to information held by 'public authorities', commencing on 1 January 2005. It is retrospective, giving access to information whenever it was created. It applies to information that is held – ownership of the information is not relevant. The Act is intended to promote a culture of openness and accountability amongst public sector bodies by providing rights of access to the information held by them. It is expected that these rights will facilitate better public understanding of how public authorities carry out their duties, why they make the decisions they do and how they spend public money.

The right to information

The right to information applies to anyone, both individuals and organisations, regardless of citizenship or residence, and regardless of reason or purpose. Public authorities are defined by a list in Schedule 1 of the Act, and this may be extended by order. The Audit Commission, National Audit Office, Northern Ireland Audit Office and the Auditor General for Wales (and so from 1 April 2005, the Wales Audit Office) are all designated. Private firm auditors appointed under the Audit Commission Act 1998 are not currently designated, but may be included in a designation order in 2005. Private firms conducting public audit work in relation to public authorities will in any event be affected insofar as they hold information which may be the subject of an application for access under the Act.

Duties under the Act

The Act places duties on public authorities to facilitate access. A code issued by the Secretary of State under section 45 of the Act sets out the assistance that public authorities should provide. For example, while on the face of the Act requests must be in writing, the s45 Code requires public authorities to record and confirm telephoned requests. Requests must be processed within 20 working days of receipt, except where the public interest is being weighed (see below). Regulations under the Act allow for charging, however public authorities are only able to charge for requests costing £450 (£600 in central government) or more in terms of collating material. Compliance with the full extent of such requests is discretionary, but public authorities have to provide what they can up to the limit.

The Act provides a regulation and enforcement regime under the Information Commissioner. He is to promote and report on good practice, monitor compliance and take

enforcement action. He can demand information to assess whether it should be disclosed, and may order its disclosure. He has powers to search and seize. Ultimately, he can certify to the High Court that a public authority is in breach of the Act, whereupon the public authority is treated as being in contempt of court. The Act also makes it a criminal offence to alter or destroy records with the intent to prevent disclosure. However, controlled destruction of records in accordance with set policies, such as those agreed with the National Archive, is permitted.

Exemptions from the Act

The Act provides 23 exemptions that public authorities may apply where appropriate, and there is one for those public authorities which carry out the audit of accounts and vfm examination of (other) public authorities (the 'public audit' exemption). However, whilst some of these are absolute exemptions (such as that applying to court records (s32)), most are qualified, in that they are subject to tests of prejudice and public interest (and this includes the public audit exemption (s33)). As the Act applies to information rather than documents, and as there are few exemptions of classes of information, in most cases exemptions will need to be applied on a detailed basis. To apply, qualified exemptions will require a public body to detail the prejudice that disclosure will cause and the public interest reasons for and against disclosure. These records may be reviewed by the Information Commissioner.

Application of the public audit exemption is, in effect, subject to guidance issued by the Information Commissioner. His Casework Advice on s33, which is intended to inform his own staff has raised considerable concerns. However, his more general Awareness Guidance No18 gives greater recognition to the nature of

the professional relationship. And the Department for Constitutional Affairs issued guidance (on 26 October 2004), which is closer to Awareness Guidance No18 than the Casework Advice.

The Information Commissioner has indicated his willingness to consider some of these matters further, in the interests of the fair and sensible application and workability of the Act, and it seems likely that he will modify his Casework Advice so that it is more in line with his Awareness Guidance No18. It should, however, be noted that the Information Commissioner cannot go so far as to give a blanket commitment, such as would effectively establish the public audit exemption as a class exemption, because that would contradict the legislation and would therefore be open to legal challenge.

The Act, audit and trust

Effective external audit requires a relationship of trust between the auditor and the audited body. Whilst public sector auditors have various access powers, in practice, most of the time they rely on a relatively free and full exchange of information and views with audited bodies, who provide information to auditors with a reasonable expectation of confidentiality. Third parties, such as the users of public services, also provide information which supports effective audit, and they also have expectations of confidentiality. If this information were disclosable, it may be less forthcoming.

As noted above, the public audit function exemption is a qualified exemption. For it to apply there needs to be prejudice (i.e. harm) or potential prejudice to the public audit function. In addition, application of the exemption requires a public interest test – a weighing of the public interest arguments in favour of disclosure against the public interest in non-disclosure.

► The exemption is limited to use by bodies with audit functions, and this makes it unavailable to most audited bodies themselves. (Although it should be noted that the exemption relating to the conduct of public affairs (s36) may be relied on by audited bodies in a way which would complement the application of the public audit exemption by the auditors themselves).

The Information Commissioner's Awareness Guidance (No 18) recognises that disclosure of information may prejudice the audit function through the erosion of trust:

'Secondly, however, there may be more general prejudice to the function of audit. For instance, if the release of information supplied in confidence or on a voluntary basis to an auditor were to discourage cooperation with the auditor in the future, it may be reasonable to argue prejudice. Similarly, while there would be unlikely to be prejudice in the release of information about standard audit methodologies, the release of information about other techniques might cause prejudice if it were to reduce the likely effectiveness of those techniques in the future.'

This recognition is welcome, and should be reflected in amended Casework Guidance.

Conclusions

It is too early to assess the longer term implications of the Act on the public audit function, however it is clear that it raises fundamental issues for the effective discharge of the public auditor's responsibilities. Over recent years the public audit function has moved further towards taking a citizen's view of the use of public money and the delivery of public services. It would be ironic if one outcome of the Act was to erode the very trust between the public and public auditors that auditors have worked so hard to achieve. ●

The author acknowledges use of materials produced by the Public Audit Forum and the ICAEW's Audit and Assurance Faculty.

For further information on the Information Commissioner visit www.informationcommissioner.gov.uk

For information on the Scottish Information Commissioner visit www.itpublicknowledge.info

*Clive Grace, Director
General, Audit
Commission in Wales*

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