6. The government's financial accounts: an ICAEW perspective

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Summary

- Over the past four years, the UK government has introduced a new method of reporting its financial position, adopting financial accounting similar to that used by businesses around the world in accordance with international generally accepted accounting standards. 'Whole of Government Accounts' prepared on this basis include a balance sheet that reflects not only the inclusion of assets controlled by government bodies, but also the inclusion of liabilities such as those for public sector employee pensions, nuclear decommissioning costs and clinical negligence claims.
- In 2012–13 (the latest year available), the accounting deficit of £179 billion was £94 billion more than the current deficit of £85 billion reported in the National Accounts. The main differences were £49 billion in higher charges for public service pensions, £35 billion from the accounting for assets and £16 billion for nuclear decommissioning, clinical negligence and other obligations.
- Financial statements provide useful information that can be used to support financial decision-making, in addition to measuring progress against previous plans, budgets and market expectations. For example, the reported liabilities of £1.2 trillion for employee pension obligations included in the balance sheet give a measure for monitoring the scale of the government's obligations and offer the potential for improved transparency about how the government intends to fund the payment of these obligations over the coming decades.
- The financial accounts provoke some significant questions. How does the government plan to address an accounting deficit of almost 30% of total revenue? How will long-term public sector pension obligations and nuclear decommissioning costs be funded?
- Financial accounting should also support the government in developing comprehensive financial reviews that use balance-sheet information as an integral part of the analysis used in making financial decisions.
- Financial analysis based on Whole of Government Accounts has the potential to change the public debate on the government's finances from a narrow focus on balancing the public finance deficit in the National Accounts to a more comprehensive discussion around how the government plans to deal with its longer-term financial challenges, using a similar financial language to that used by millions of people outside of government.

6.1 Introduction

> The WGA [Whole of Government Accounts] is a key means by which Parliament holds the Government to account for its management of public finances, including its progress in delivering fiscal consolidation measures.
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> *Public Accounts Committee, January 2015*[1]

Over the past four years, the UK government has introduced a new method of reporting its financial position, differing in many respects from the public finances reported in the National Accounts still used primarily by the government and focused on by the media. Although 'new' to the government itself, this approach is based on financial accounting similar to that it has required businesses in the UK to comply with for many decades.

Financial statements provide useful information that can be used to support financial decision-making, in addition to measuring progress against previous plans, budgets and market expectations. For example, the reported liabilities of £1.2 trillion for employee pension obligations included in the Whole of Government balance sheet give a measure for monitoring the scale of the government's occupational pension obligations and offer the potential for improved transparency about how the government intends to fund the payment of these obligations over the coming decades. Similarly, the scale of obligations to decommission nuclear facilities and to settle clinical negligence claims is brought to prominence by the requirement in accounting standards for estimates to be recorded in the balance sheet and then updated as circumstances develop.

The implementation of Whole of Government Accounts is still in its early stages, and the government took 15 months to produce the latest available Whole of Government Accounts, covering the fiscal year ended 31 March 2013. The government plans to reduce this to 12 months for 2013–14 and to nine months for 2014–15.

As shown in Figure 6.1, the deficits reported under accounting standards over the four years to 2012–13 have generally been substantially higher than the current deficits reported in the National Accounts,[2] as a consequence of the more comprehensive nature of financial accounting. These higher numbers for the deficit provide an indication of how the financial challenges facing the government are much wider than the ongoing debate about the balancing of income and spending as reported in the National Accounts.

Section 6.2 provides an analysis of the government's financial position as set out in the Whole of Government Accounts for 2012–13, including its income, expenditure, assets and liabilities and how they relate to the numbers for the public finances reported within the National Accounts. The section also addresses the accounting treatments adopted for pension obligations, student loans, Private Finance Initiative (PFI) contracts and Network Rail. In Section 6.3, we comment on how financial accounting can be used more effectively by the government in making financial decisions and in improving transparency and accountability for its financial performance. Section 6.4 concludes.

Box 6.1 sets out some distinctions that are important in this chapter.

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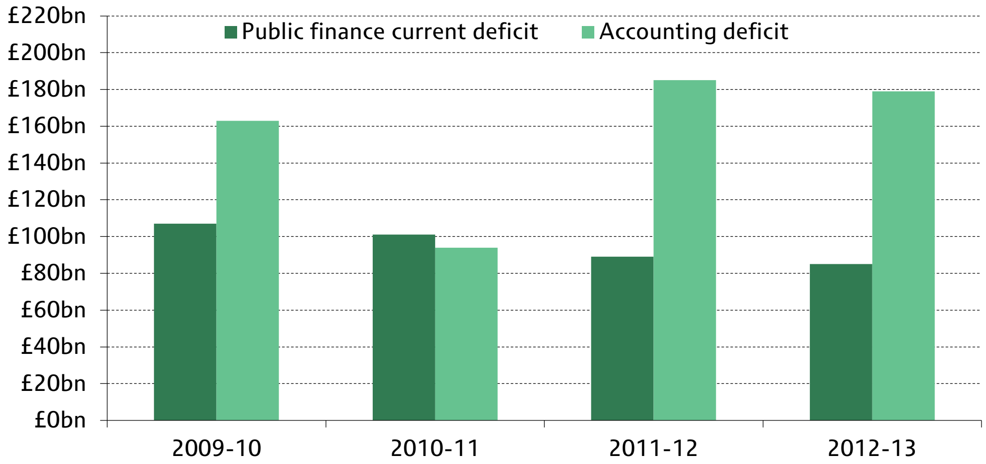
[1] Page 4 of House of Commons Committee of Public Accounts, *Whole of Government Accounts 2012–13*, 26th Report of Session 2014–15, HC 678, http://www.publications.parliament.uk/pa/cm201415/cmselect/cmpubacc/678/678.pdf.

[2] The exception was 2010–11, when there was a substantial one-off gain in the Whole of Government Accounts arising from changes to pension arrangements for government employees.

Figure 6.1. National Accounts versus Whole of Government Accounts



Source: Whole of Government Accounts, 2011–12 and 2012–13.

Box 6.1. Key differences between the National Accounts and financial accounting

National Accounts

The National Accounts is a framework for the presentation and measurement of economic activities in the UK, featuring many key economic statistics. It includes a set of rules for how public sector financial activities should be reported on.

The National Accounts are generally prepared in accordance with the European System of National and Regional Accounts (ESA), which is similar but not identical to the UN System of National Accounts. For the UK, the amounts reported in the National Accounts for 2012–13 and 2013–14 at the time were based on ESA95. In September 2014, a new version – ESA10 – was adopted.

In this chapter, references to the National Accounts are to the public finances as reported within the National Accounts unless the context requires otherwise.

Financial accounting

Financial accounting is a method of accounting in accordance with generally accepted accounting standards. Accounting standards provide a comprehensive set of rules and principles for recording financial transactions and for reporting on the financial performance and position of an organisation in the form of financial statements, which include a balance sheet as well as income and expenditure and cash flow statements.

The Whole of Government Accounts are an example of such financial statements, prepared in this case in accordance with International Financial Reporting Standards (IFRS), with some adaptations for government use under the auspices of the UK government's Financial Reporting Advisory Board.

In the private sector, management teams, boards, audit committees and regulators use external and internal financial reports prepared under IFRS in monitoring the financial performance of businesses and in making financial decisions, while shareholders and debt investors use financial statements and other external financial reports prepared under IFRS in making decisions about the equity or debt finance provided to businesses.

The intention in implementing financial accounting within government is to improve the financial information provided to ministers and their departments, the Cabinet, the Public Accounts Committee, parliament, the public and debt investors and so improve the quality of financial decision-making and the accountability of the government for its financial performance.

Promises, commitments, obligations and liabilities

In this chapter, the term 'obligation' refers to a legal or similar requirement to make a payment in the future, distinct from other types of commitment. If an obligation arises as a consequence of a past event, then accounting rules require it to be recognised in the balance sheet as a liability.

Commitments to spend money in the future, such as on state pensions, future welfare payments or infrastructure spending plans, are not the same, for accounting purposes, as obligations or liabilities. Although similar in terms of outcome, they are treated differently from, for example, payments for clinical negligence claims or contractually committed payments to construct new assets.

To illustrate the differences, consider a plan to build a bridge:

1) Transport Secretary announces plans to build a bridge.

This is a commitment in the form of a political **promise**. But the government could change its mind and so there is no obligation to pay for the bridge.

2) The Chancellor includes funds to build the bridge within the Budget.

This is a **commitment** in the form of planned expenditure. But the government could still change its mind and so there is still no obligation to pay for the bridge.

3) A contract is signed with a construction firm.

This is a commitment in the form of a legally binding contract. The government is not able to change its mind easily because it has signed a contract that is enforceable in the courts by the other party. Hence there is an **obligation** to pay for the bridge. This obligation is required to be reported within the notes to the accounts.

4) The bridge is built.

The government has a current obligation to pay the construction firm as a consequence of a past event (the construction of the bridge). Hence the government has to record a **liability** for the cost of the bridge in its balance sheet.

6.2 The UK government's financial accounts

The Whole of Government Accounts are consolidated financial statements, reflecting the activities of 3,800 different bodies across central government, devolved administrations and local government in the UK. They comprise four primary statements, together with extensive associated notes and accompanying explanatory reports, and in 2012–13 comprised 218 pages of information on the UK government's financial position.

The income statement records income and expenditure incurred during the course of the year, accompanied by a cash flow statement that reconciles from that income statement to the net change in cash balances over the same period. The statement of financial position, commonly known as a balance sheet, summarises the assets and liabilities controlled by the government at the end of that year. Balance sheets do not attempt to record the effect of all future transactions or wider resources that may have value to an organisation. Nor do they record all future commitments to spend money. In the case of the government, the abilities to raise taxes in the future, to print money or to access financial markets to borrow as required all have a value over and above the amounts recorded in the balance sheet, while commitments to pay state pensions, welfare or other payments in subsequent years out of future revenues or borrowing are also not captured.

The accounting deficit for the year in the income statement provides the first line on a statement of comprehensive gains and losses, incorporating other gains or losses made in the year such as asset revaluations, to calculate a comprehensive loss. This feeds into a reconciliation of movements in financial position that shows how the net liabilities reported in the balance sheet have changed from one year to the next.

Whole of Government Accounts 2012–13[3]

Revenue of just over £620 billion in 2012–13 was insufficient to cover operating expenditures of £717 billion, resulting in a net operating loss of £97 billion before net finance costs of £79 billion and losses on asset disposals of £3 billion. As a result, the total deficit for the year on an accounting standards basis was £179 billion, equivalent to 29%

Table 6.1. Summarised Whole of Government Accounts 2012–13

Revenue and expenditure		Balance sheet	
Year ended 31 March 2013	**£bn**	**As at 31 March 2013**	**£bn**
Revenue	620	Property, plant and equipment	747
Operating expenditure	(717)	Other assets and investments	516
Operating loss	(97)	Public sector pensions	(1,172)
Net finance costs	(79)	Debt and bank deposits	(1,330)
Net loss on disposal of assets	(3)	Other liabilities	(391)
Accounting deficit for the year	**(179)**	**Net liabilities**	**(1,630)**
Cash flow statement		**Comprehensive loss / Movements in financial position**	
Operating loss	(97)	**Accounting deficit for the year**	**(179)**
Add back: non-cash transactions	83	Property revaluations	7
Changes in working capital	2	Financial asset revaluations	6
Operating cash outflow	(12)	Actuarial loss	(97)
Capital expenditure and investments	(58)	**Comprehensive loss for the year**	**(263)**
Cash outflow before financing	(70)	Other movements	(20)
Net cash inflow from borrowing	**99**	**Change in financial position**	**(283)**
Net interest and other financing	(30)	Opening net liabilities	(1,347)
Net change in cash in the year	(1)	**Closing net liabilities**	**(1,630)**

Source: Whole of Government Accounts 2012–13.

[3] HM Treasury corporate report, *Whole of Government Accounts 2012 to 2013*, https://www.gov.uk/government/publications/whole-of-government-accounts-2012-to-2013.

of revenue. This is shown in Table 6.1, together with a summary of the balance sheet, cash flow statement and the statement of comprehensive loss and movements in financial position.

Although revenue is similar (but not identical) to the income reported in the National Accounts, operating expenditure is significantly higher. This is because it includes significant expenditures not recorded in the public finances in the National Accounts, such as charges for nuclear decommissioning costs and clinical negligence claims that may not be settled for several years, and the costs of writing off assets no longer in use. This is even after excluding interest charges, which are reported under the separate heading of finance costs.

As well as interest on the government's debts, net finance costs include the unwinding of the discounting of public service pension obligations and of long-term liabilities such as for nuclear decommissioning.

The cash flow statement shows how net borrowing of £99 billion during the year was utilised to finance operating (i.e. non-capital, non-interest) cash outflows of £12 billion, capital expenditure and investments of £58 billion, and net interest and other financing payments of £30 billion.

The balance sheet included assets of £1,263 billion (£747 billion plus £516 billion) and liabilities of £2,893 billion (£1,172 billion plus £1,330 billion plus £391 billion), giving a net liability position of £1,630 billion.

Based on an estimated population of 64 million people living in the UK as of 31 March 2013, this was equivalent to assets and liabilities as measured under accounting standards of approximately £20,000 and £45,000 per person respectively, a net liability position of £25,000 per person. It is very important to appreciate that this does not represent the net liabilities of individuals due to government activity: as the balance sheet treats the government as a distinct entity separate from the rest of the economy, this does not take account of the fact that a proportion of these liabilities are the assets of private individuals, whether in the form of direct or indirect ownership of government debt (e.g. through investment funds, pension funds or insurance policies) or, for current and former government employees, in the form of pension entitlements.

The overall change between the balance sheet at 31 March 2012 and at 31 March 2013 was an increase in net liabilities of £283 billion. The largest contributors to this were the reported loss of £179 billion and actuarial losses of £97 billion, the latter primarily as a consequence of changes in the rates used to discount pension obligations to their net present value. The majority of these movements are not reflected in the public finance numbers reported in the National Accounts, as discussed in more detail below.

The Whole of Government Accounts also reported £88 billion in contingent liabilities outside of the balance sheet. These are obligations that had not turned into liabilities because they are dependent on uncertain future developments. They included financial guarantees provided to the UK banking sector, export credit guarantees provided to businesses, potential clinical negligence claims, taxes subject to challenge, and support and guarantees provided to international organisations. Generally, these are items that may not occur, but for which there is a reasonable possibility[4] that they could happen.

[4] This means a 50% or less likelihood of occurrence; if they were considered more likely than not to occur – i.e. a greater than 50% likelihood – then they would need to be included within liabilities on the balance sheet instead.

Other items reported in the notes to the financial statements were the total of £245 billion of future payments due under PFI contracts and asset leases, comprising £42 billion of principal repayments recorded as liabilities in the balance sheet and £203 billion for future services, assets yet to be constructed and future interest payments.

The financial statements do not reflect implicit commitments that may have been made by the government – for example, to support the wider financial industry in the event of another banking crisis.

Differences between the National Accounts and the Whole of Government Accounts

There are some significant differences between the numbers reported at the time under ESA95 for the public finances within the National Accounts for 2012–13 and the Whole of Government Accounts, as shown in Table 6.2.

The accounting deficit for 2012–13 of £179 billion was significantly higher than the current deficit reported at the time of £85 billion. This was primarily as a consequence of recording changes in the value of assets and liabilities that are on-balance-sheet for financial accounting purposes, but which are not recognised in the public finance numbers within the National Accounts.

The largest difference related to the accounting for public sector pensions, with £1,172 billion in pension obligations recognised, together with an associated £49 billion of increased charges in the year. These are discussed in more detail later in this section.

Turning to the balance sheet, £747 billion was recorded for property, plant and equipment. This brought with it net charges of £35 billion in the financial accounts, comprising asset write-downs of £21 billion, higher depreciation charges of £5 billion,

Table 6.2. National Accounts reconciled to Whole of Government Accounts 2012–13

Income and expenditure		Balance sheet	
Year ended 31 March 2013	**£bn**	**As at 31 March 2013**	**£bn**
Public finances total deficit[a]	(115)		
Add back: net capital investment	23		
Add back: quantitative easing	7		
Public finances current deficit	**(85)**	**Public sector net debt**	**(1,185)**
Asset-related charges	(35)	Property, plant and equipment	747
Public service pensions charges	(49)	Net pension obligations	(1,172)
Provision charges	(16)	Provisions	(131)
		PFI contracts	(32)
		Nationalised banks	74
Other accounting treatment and timing differences	6	Other assets recognised	197
		Other liabilities recognised	(128)
Accounting deficit for the year	**(179)**	**Net liabilities**	**(1,630)**

[a] This measure for the deficit excluded a £28 billion one-off benefit from the transfer of the Royal Mail pension fund to the government.
Source: Whole of Government Accounts 2012–13.

£3 billion for assets disposed of or scrapped and £12 billion for capital grants treated as an expense, partially offset by £6 billion for military equipment expensed on use.

Provisions (the accounting term for general liabilities) of £131 billion were recorded for nuclear decommissioning, clinical negligence and other costs that the government is expected to incur as a consequence of past events, while £32 billion was recorded for obligations under PFI contracts not included within the national debt.

The balance sheet also records £74 billion relating to the government's investment in the banking sector, including its shares in Lloyds Banking Group, the Royal Bank of Scotland, Northern Rock and Bradford & Bingley.

The other differences were principally related to the recording of receivables and payables in the balance sheet.

Revenue and operating expenditure

The majority of income for the government in 2012–13 was derived from taxes, with the largest items within direct taxes being income tax (£151 billion) and National Insurance (£91 billion) and the largest item within indirect taxes being VAT (£99 billion). These are shown in Table 6.3.

Table 6.3. Revenue and operating expenditure 2012–13

Revenue		Operating expenditure	
Year ended 31 March 2013	**£bn**	**Year ended 31 March 2013**	**£bn**
		Social security benefits	(215)
Direct taxes	289	Employment costs	(183)
Indirect taxes	179	Purchase of goods and services	(163)
Local taxes	56	Grants and subsidies	(56)
Total taxation revenue	524	Depreciation and impairments	(51)
Other income	96	Other charges	(49)
Total revenue	**620**	**Total operating expenditure**	**(717)**

Source: Whole of Government Accounts 2012–13.

Operating expenditure, which is also presented in Table 6.3, excludes finance costs and capital investment, but includes depreciation and impairments of assets. The largest cost within expenditure on social security benefits was for state retirement pensions and pension credit, totalling £92 billion. It also included housing support and tax credits, benefits relating to sickness and disability, jobseeker's allowance, income support and child benefit.

Employment costs of £183 billion related to 4.6 million full-time equivalent employees, of whom 1.3 million worked in the health sector, 1.1 million worked in central government, central government agencies and bodies, public corporations and the armed forces, and 2.2 million worked in local authorities, schools, and police and fire services. These are some of the most significant numbers included in the Whole of Government Accounts, particularly in the light of the government's ongoing austerity programme.

Assets

The balance sheet starts with the assets controlled by the government at the end of the fiscal year, as shown in Table 6.4.

Table 6.4. Government assets at 31 March 2013

Property, plant and equipment		Other assets and investments	
As at 31 March 2013	**£bn**	**As at 31 March 2013**	**£bn**
Buildings, dwellings and land	348	Investment properties	13
Motorways and trunk roads	109	Military systems and munitions	29
Local authority highways	56	Unpaid and accrued taxes	99
Other infrastructure assets	108	Other non-financial assets	57
Assets under construction	39	Investment in nationalised banks	92
Military equipment	36	Student loans	36
Other	51	Cash and other financial assets	190
Property, plant and equipment	**747**	**Other assets and investments**	**516**

Source: Whole of Government Accounts 2012–13.

Most businesses preparing financial statements record property, plant and equipment on a depreciated historical cost basis, i.e. at what they paid for an asset less depreciation as it is used or ages. However, the effect of inflation over long periods of time means that old assets will be recorded at a much lower value than similar assets built more recently and so accounting standards provide for an alternative approach using depreciated replacement cost. Under this approach, assets are revalued to the amount it would cost today to construct them, before being reduced by depreciation for their age and usage. This results in assets of different vintages being more comparable with each other within the accounting records, which is why the government has adopted this approach instead of the depreciated historical cost method.

Irrespective of which of these two methods is used for calculating the book value of an asset, this is not the same as calculating the amount that asset could realise from a potential sale, nor is it the same as the future economic activity expected to be generated by that asset. However, implicit in the decision to record assets in the accounting balance sheet is a conclusion that the assets concerned have an economic value equal to or greater than the amount recorded, even if that value is not quantified.

The infrastructure assets in the balance sheet at 31 March 2013 do not include the approximately £46 billion of railway infrastructure assets owned by Network Rail, but the government has confirmed that they will be included within the Whole of Government Accounts from 2014–15 onwards. The accounts also indicate that local authority highway infrastructure is estimated to be understated in the order of £200 billion because of insufficient information about the current replacement cost of these assets, which are currently carried at historical depreciated cost instead. The Treasury plans to obtain depreciated replacement cost numbers to resolve this issue in future accounts.

The other exception to using the depreciated replacement cost basis for accounting for property, plant and equipment was with respect to investment properties. These are assets held for commercial purposes, such as rental to businesses or for potential future sale, and in accordance with accounting standards are recorded at market valuations. This included the Olympic Park, which was carried at a value of £0.3 billion, substantially less than its construction cost of £1.6 billion.

Military assets are a notable element within the balance sheet, with £36 billion of military equipment complemented by £21 billion in military-related intangible assets (including software and weapons development) and £8 billion in munitions and other defence supplies.

Unpaid and accrued taxes amounted to £108 billion, before deducting a provision of £9 billion for anticipated non-collection.

The investment in the nationalised banks comprised £45 billion in equity investments, loans of £30 billion and £17 billion recoverable under the Financial Services Compensation Scheme. This included £26 billion invested in the Royal Bank of Scotland, £14 billion in Lloyds Banking Group and a £5 billion equity investment and £27 billion in loans to the Northern Rock and Bradford & Bingley 'bad' banks, together with a £2 billion bilateral loan to Ireland.

Student loans are accounted for as an asset to the government, with £36 billion recorded after taking account of estimated future non-payment. This comprised gross amounts due from students of £53 billion, less an £8 billion allowance for non-payment and £9 billion in interest subsidies, equivalent to a reduction of 32% against the face value of the loans outstanding.

Cash and other financial assets of £190 billion comprised £84 billion in cash, loans and deposits with banks, £40 billion in debt securities, £10 billion in gold holdings and £56 billion in other investments. These are held for a variety of reasons, from day-to-day operations through to long-term international commitments. Of the debt securities, £37 billion are invested in short-term foreign government treasury bills and similar securities with the US, other European countries and Japan as part of the Exchange Equalisation Account used for foreign currency operations. Other investments included £20 billion in Special Drawing Rights with the International Monetary Fund, £8 billion invested in the European Investment Bank and £3 billion in other international financial institutions.

Pension obligations

The second half of the balance sheet consists of liabilities, with pension entitlements of current and former public sector employees of £1,172 billion (as shown in Table 6.5) amounting to just over 40% of the total liabilities of £2,893 billion reported in the balance sheet at 31 March 2013. These obligations are not reflected within public sector net debt as reported within the National Accounts.

Central government has a policy of not setting aside investments for its future pension obligations and instead pays pensions out of current revenues. This policy applies to the national pension plans established for teachers and police and fire services as well as those for central government civil servants, the NHS and the armed forces.

In line with this policy, the government decided to cash in the £29 billion of investments that it received on the transfer of the old Royal Mail pension obligations, even though those investments covered most of the £33 billion in additional liabilities that were assumed as part of the transfer.

Under the ESA95 rules then in operation, there was no recognition of the impact of assuming the additional pension obligations, and the public finances reported a £28 billion one-off gain in 2012–13 for the assets transferred, reducing the reported total

Table 6.5. Net pension obligations at 31 March 2013

Unfunded pension schemes		Funded pension schemes	
At 31 March 2013	**£bn**	**At 31 March 2013**	**£bn**
Pension fund investments	–	Pension fund investments	219
Pension obligations	(1,073)	Pension obligations	(318)
Net pension obligations	**(1,073)**	**Net pension obligations**	**(99)**
NHS	(325)		
Teachers	(259)		
Civil service and other	(197)		
Police and fire services	(141)		
Armed forces	(118)	Local authorities	(90)
Royal Mail	(33)	Other funded pension plans	(9)
Net pension obligations	**(1,073)**	**Net pension obligations**	**(99)**

Source: Whole of Government Accounts 2012–13.

deficit from £115 billion to an official deficit of £81 billion[5] in the National Accounts. This contrasts with the Whole of Government Accounts, where both the assets and the associated obligations were recognised.

During 2012–13, central government and devolved administrations paid £35 billion in pensions to former public service workers. This is £7 billion more than the £28 billion collected in current contributions from government departments, schools, the armed forces, police and fire services and their respective employees, with none of that £28 billion being invested for the future.

Local authorities and their non-teaching employees made contributions of approximately £10 billion in 2012–13, which were invested. Unlike nationally organised pension arrangements, local authority and other funded pension plans have investments equivalent to just over two-thirds of the long-term obligation as measured on a financial accounting basis, reducing the net liability recorded from £318 billion to £99 billion.

Overall, the net accounting charge for central and local government for providing pensions was £76 billion, comprising £28 billion for the increased entitlements earned by government employees during the year (net of employee contributions and non-government employer contributions such as those for GPs) and £48 billion in the unwinding of the discounting of pension obligations less investment returns on local authority pension funds. This is £49 billion more than the net amount recorded in the public finances.

In addition to the £76 billion cost recorded in the income statement, the Whole of Government Accounts recorded a £97 billion actuarial loss within the statement of recognised gains and losses, primarily as a result of a change in discount rates. This variability in the calculation of pension liabilities as discount rates change can be disconcerting, in the same way as investments in the stock market can go up as well as down. However, irrespective of whether the net pension obligation is calculated to be £1.1 trillion, £1.2 trillion or £1.3 trillion, the level of obligation to pay pensions to retired public servants in future is substantial.

[5] The official deficit also reflected amounts relating to quantitative easing of £6 billion.

Debt and other liabilities

The remaining 60% of liabilities in the balance sheet relate to government debt and other liabilities, as shown in Table 6.6.

Government debt, principally in the form of gilts but also including National Savings and local authority loans for example, amounted to almost £1.4 trillion. The majority of this debt was owned by UK investors, primarily pension funds and insurance companies, although the largest single owner of government debt at 31 March 2013 was the Bank of England.

In the National Accounts, the amount owed to the Bank of England is included as part of the national debt, while in the Whole of Government Accounts the Bank of England is considered to be part of the government as it is ultimately controlled by the government, despite its operational independence. As a consequence, this part of the national debt is eliminated, and is replaced by the inclusion of the Bank of England's own liabilities, the largest element of which is bank deposits held by commercial banks. The level of government debt holdings owned by the Bank of England and the level of bank deposits held by commercial banks are substantially higher than was the case before the financial crisis, as a consequence of the Bank of England's purchases of gilts from commercial banks as part of its quantitative easing programme to support the economy.

Trade and other payables comprised £39 billion for accrued expenditures and deferred income, £23 billion in tax and duty refunds, £17 billion due to suppliers and £31 billion relating to other payments due. The latter included £7 billion owed to the International Monetary Fund and £4 billion owed for the financing of the High Speed 1 rail link.

Provisions, or general liabilities, amounted to £131 billion at 31 March 2013. The largest items related to the £70 billion expected cost of nuclear decommissioning facilities and £24 billion for NHS clinical negligence claims, both discounted to their present values. Anticipated nuclear decommissioning costs extend over a long period, with £53 billion out of the £70 billion provision to be incurred after more than five years, with decommissioning expected to be complete in the year 2137. The balance of provisions of £37 billion relates to other matters such as payments to insolvent company pension plan members, oil and gas field decommissioning, injury benefits, medical costs, criminal injuries compensation, legal costs, compulsory purchases, transport infrastructure structural damage and property value claims, and compensation payments for termination of employment.

The balance sheet includes £37 billion in liabilities for assets constructed under the terms of Private Finance Initiative contracts and £5 billion owed for leased assets, a total of

Table 6.6. Debt and other liabilities at 31 March 2013

Debt and bank deposits		Other liabilities	
As at 31 March 2013	**£bn**	**As at 31 March 2013**	**£bn**
Gross government debt	(1,371)	Trade and other payables	(109)
Exclude: held by the Bank of England	375	Provisions	(131)
Net government debt	(996)	PFI and finance leases	(42)
Bank deposits	(334)	Other financial liabilities	(109)
Debt and bank deposits	**(1,330)**	**Other liabilities**	**(391)**

Source: Whole of Government Accounts 2012–13.

£42 billion. These amounts exclude future interest payments in present values of £62 billion. Repayment of capital and interest under these contracts and leases is expected to be around £5 billion a year. For PFI contracts, there is also a further £117 billion obligation (in present values) in addition to the amounts included in the balance sheet to pay for future services and future assets to be constructed. Overall, once operating leases are included, the government had total obligations under PFI contracts and asset leases amounting to £245 billion in present values, £199 billion of which relate to PFI contracts.

The accounts also reported that contracts had been signed to construct non-PFI assets at a cost of £38 billion, while there were £49 billion of obligations under other contracts, including to the nationalised banks, for higher education grants, to Network Rail and other railway companies, and for NHS IT and medical purchases.

Other financial liabilities included £58 billion for bank notes in circulation, £32 billion in other borrowing and £19 billion for other financial obligations.

Absent from the balance sheet were the £35 billion in debt and other liabilities of Network Rail that were excluded in line with the treatment adopted in the National Accounts under ESA95. This has now changed following a review by the Office for National Statistics in connection with the implementation of ESA10,[6] and the Treasury intends to bring these liabilities onto the Whole of Government balance sheet as well from 2014–15 onwards.

The government boundary

One of the critical decisions to be made in drawing up both the public finances within the National Accounts and the Whole of Government Accounts is the boundary between those activities and entities that are included and those that are excluded. Decisions on where the boundary lies can have very significant implications for the financial numbers presented, potentially changing them by hundreds of billions of pounds. For the National Accounts, the determination of the boundary is a decision for the Office for National Statistics to make based on the guidance set out in ESA95 or, for 2014–15 onwards, ESA10. In contrast for the Whole of Government Accounts, the assessment of the boundary will be based on the different requirements set out in accounting standards.

Government financial activities in the UK have been defined as comprising the activities of central government, the devolved administrations, local authorities and public corporations, which in most cases provides clarity as to whether an activity or entity is to be included (or 'consolidated' in accounting terminology). Government departments such as the Home Office, devolved administrations such as the Scottish Executive, local authorities such as counties, boroughs, districts and unitary authorities, and public corporations such as the Civil Aviation Authority are all considered to be part of the government for both the public finances within the National Accounts and the Whole of Government Accounts. Organisations with independent control over their finances, including universities and most charities, are outside the government boundary and so their financial activities are not included in the numbers even where they receive a substantial proportion of their funding from government.

[6] Office for National Statistics, 'Classification of Network Rail under European System of Accounts 2010', 2013, http://www.ons.gov.uk/ons/dcp171766_345415.pdf.

In the Whole of Government Accounts, government funding to an organisation outside of the boundary will be reported as a grant or subsidy. However, for a body inside the boundary, funding is effectively an internal transfer that will be eliminated, with its entire income and expenditure, as well as its assets and liabilities, consolidated into the Whole of Government Accounts instead. For example, the Bank of England is included within the boundary for Whole of Government Accounts because the government has the power to appoint and dismiss its Governor and its directors.

Accounting standards require entities to be consolidated into a set of financial statements based on the degree of control, but despite this the nationalised banks and Network Rail were not included within the government boundary for the Whole of Government Accounts in 2012–13. In the case of Network Rail, the government decided that it was outside the boundary for the National Accounts under ESA95 and chose to adopt the same treatment in the Whole of Government Accounts. However, with Network Rail being included within public sector net debt under ESA10 from October 2014, the government also intends to consolidate it into the Whole of Government Accounts for 2014–15 onwards.

The nationalised banks had assets of £2.3 trillion and liabilities of £2.2 trillion at 31 March 2013, and so if they had been consolidated, government assets would have been £3.6 trillion instead of the £1.3 trillion reported and government liabilities would have been £5.1 trillion instead of £2.9 trillion. Although the government has accepted that in future accounts it should consolidate the Northern Rock and Bradford & Bingley 'bad bank' asset portfolios, as these will not be returning to the private sector, it intends to continue excluding the operational nationalised banks while they remain in government ownership.

Current versus future activities

Any form of accounting requires a distinction to be made between what constitutes a financial transaction to be recorded within the accounts and what is considered to be a future transaction that should not yet be captured. The Whole of Government Accounts, similar to the accounts for commercial enterprises, make provision for future receipts and payments only to the extent they are a consequence of transactions that have happened before the end of the year concerned.

This extends beyond accruals accounting, which caters for the timing difference between entering into a transaction and the associated receipt or payment, to capturing other types of assets and liabilities, such as provisions for clinical negligence claims or criminal injuries compensation.

Not captured are future tax revenues and future expenditure, even where there may be a commitment or confirmed policy. For example, the commitment to pay a state pension to eligible UK residents after retirement in future years is not captured by the Whole of Government Accounts in the current period; neither is the intention to tax in the future. Another example is the future benefit from providing investment allowances to businesses, with the reduction in corporation tax receipts for the allowances themselves being reflected in the current year, but the higher corporation taxes on profits generated from those investments not being recognised until they occur in future periods.

Auditor disagreements

In the private sector, companies have significant incentives to ensure that their accounts receive a clean audit opinion. The lack of a clean audit opinion would almost certainly adversely affect a company's ability to access financial markets and could also affect its ability to trade with other companies.

Financial markets do not currently demand the same level of compliance from governments, which is fortunate as although the Comptroller and Auditor General approved the Whole of Government Accounts for 2012–13, his audit report[7] was qualified by multiple disagreements with the government on how they were prepared in relation to the following specific items:

- **Government boundary.** By generally aligning with the government boundary used in the National Accounts, the Whole of Government Accounts do not comply with accounting standards by excluding Network Rail, the nationalised banks and several other bodies from consolidation.
- **Local authority assets.** Local authority highway infrastructure assets have not been aligned to the Whole of Government Accounts policy of depreciated replacement cost, resulting in an understatement of assets of more than £218 billion.
- **3G and 4G licences.** Income from 3G and 4G licences was fully recognised in the years concerned instead of being recognised over the 20-year period of each licence. Accounting for this in line with accounting standards would result in the loss for 2012–13 being higher by £1 billion and liabilities being higher by £10 billion.
- **School assets.** Not all of the assets of local authority, voluntary and foundation schools have been captured in the Whole of Government Accounts, with the auditor estimating that there are £31 billion of assets omitted from the balance sheet.
- **Department qualifications.** The auditor indicates there are issues with, or lack of evidence to support, the accounting for academies and educational property within the Department for Education and for leased assets, inventories and capital spares within the Ministry of Defence.
- **Intra-governmental balances.** Because not all intra-government balances have been eliminated, income and expenditure may each be too high by up to £9 billion and assets and liabilities may be each too high by up to £4 billion. The potential impact on the loss for the year and the net liability position is estimated to be in the order of £1 billion.

The government has indicated that it intends to address many of these items in the future, including the consolidation of Network Rail and local authority highway infrastructure assets.

The auditor also highlights one particular area of uncertainty in the Whole of Government Accounts concerning the quantification of nuclear decommissioning liabilities. Given the time frame and the complexity of decommissioning, he notes that these liabilities could change significantly as works progress over the next 124 years.

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[7] National Audit Office, 'HM Treasury: Certificate and Report of the Comptroller and Auditor General – Whole of Government Accounts 2012-13', 2014, http://www.nao.org.uk/wp-content/uploads/2014/06/Whole-of-government-accounts-2012-13.pdf.

Timeliness

The implementation of financial accounting by the government is making good progress, but the Whole of Government Accounts for 2012–13 were published 15 months after the end of the financial year. The government plans to improve this further and the accounts for 2013–14 are expected to take around 12 months to be issued before the 2015 general election, with 2014–15 expected to further improve to nine months.

This compares with a maximum period of four months for producing consolidated financial statements for UK listed companies, with the majority taking less than two months to publish summary financial information and between two and three months to produce a comprehensive annual report and consolidated financial statements.

In order to reduce the time to produce the Whole of Government Accounts still further and produce audited financial statements within three to six months after the end of a fiscal year, the government will need to change its primary financial management processes and systems onto a financial accounting basis across government, a significant undertaking that will take several years to implement.

6.3 Using Whole of Government Accounts to strengthen financial decision making within government

> I have previously recommended that the profile of the WGA [Whole of Government Accounts] should be raised within government and for it to be used more effectively to help decision making. In 2013, the Committee of Public Accounts also recommended that the Treasury sets out how it will ensure that the Government makes much better use of the WGA to inform decisions, particularly in areas that involve long-term liabilities.
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> *Comptroller and Auditor General, June 2014*[8]

Over recent years, successive governments in the UK have made significant progress in strengthening financial management within government. This has included implementing accruals accounting, multi-year spending reviews, developing explicit fiscal objectives and the appointment of non-executive directors to departmental boards with outside financial experience. Most recently, a Director General of public spending and finance within HM Treasury was appointed to support further development of the finance function across government and to improve the quality of financial reporting.

The government is also well advanced in the development of Whole of Government Accounts, and as a consequence the UK is one of the leading countries in the world in implementing financial accounting across the public sector. The next stage, which is to embed financial accounting into the government's financial processes and systems, making it the primary method of measuring financial performance within the public sector, should provide further benefits in ensuring that the wider ramifications of

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[8] Paragraph 1.17 of National Audit Office, 'HM Treasury: Certificate and Report of the Comptroller and Auditor General – Whole of Government Accounts 2012-13', 2014, http://www.nao.org.uk/wp-content/uploads/2014/06/Whole-of-government-accounts-2012-13.pdf.

financial decisions are captured into budgets, plans and other financial reports used for making decisions at all levels of government.

The greater use of financial accounting will also enable the government to benefit from the developments in accounting and financial reporting processes, systems, financial analysis techniques and skills in the private sector. Although there will always be aspects of government accounting that are specific to the public sector, the financial experience and skills developed outside of government will become easier to utilise once a common set of financial principles and rules is embedded. The government will also be better placed to utilise standardised accounting systems and so improve the efficiency of its financial processes. As a consequence, the development of financial accounting provides a platform for strengthening financial management across government and for providing transparency and accountability for its financial performance and position.

Public finance reporting within the National Accounts and its international equivalents is currently a specialised activity, with around 200 national governments, together with their respective sub-units, involved in accounting in this way. This compares with the millions of companies and other organisations in the UK and around the world that use International Financial Reporting Standards (IFRS) or similar financial reporting frameworks as a basis for their accounting and financial reporting. The view that governments should adopt financial accounting in accordance with some form of generally accepted accounting standards is becoming more popular around the world, with a number of countries announcing plans to adopt International Public Sector Accounting Standards, which provide a similar (although not identical) financial accounting framework to the IFRS-based system adopted by the UK government.

The government will continue to need to produce and use the internationally comparable public finance numbers reported in the National Accounts for the foreseeable future, given that most other countries are still at a much earlier stage in implementing standards-based financial accounting for their own accounts. However, the key benefits of financial accounting will be seen when Whole of Government Accounts numbers become the primary measures for assessing financial performance and position used by the government both internally for financial decision-making and externally in its dialogue with parliament and the public.

The development of Whole of Government Accounts is also driving an alignment in the financial accounting used by individual bodies within the public sector in the UK, where a number of different bases have been used in preparing their accounts. This alignment will improve comparability in the reported financial performance and position of local authorities, schools, hospitals and other public sector bodies.

Using financial statements to provide insights for the future

Although historical financial statements are, by definition, historical when they are published, they provide useful financial information that can be used to support financial decision-making in addition to being used to measure progress against previous plans, budgets and market expectations.

The Whole of Government Accounts for 2012–13 provide a significant amount of financial information that can be used by the government in planning for the future and by parliament and the public in holding the government to account.

For example, the reported liabilities of £1.2 trillion for employee pension obligations included in the Whole of Government balance sheet give a measure for monitoring the scale of the government's obligations and offer the potential for improved transparency about how the government intends to fund the payment of these obligations over the coming decades. Their inclusion also enables a comparison to be made between the funded pension plans of local authorities and the unfunded pension plans operated by central government. Similarly, the scale of obligations to decommission nuclear facilities and to settle clinical negligence claims is brought to prominence by the requirement in accounting standards for estimates to be recorded in the balance sheet and then updated as circumstances develop.

These examples demonstrate one of the strengths of financial accounting compared with the National Accounts, as the balance sheet captures the effect of decisions that might flatter the current year's financial activities in the public finance numbers in the National Accounts, but which in the Whole of Government Accounts have to be recorded and reported.

Another benefit of standards-based financial accounting is that, in preparing the Whole of Government Accounts, the government's financial reporting team is required to estimate future cash flows relating to specific short- and long-term assets and obligations. These estimates can be used to support the long-term financial forecasting carried out by both the government and the Office for Budget Responsibility.

Using projected balance sheets and projected income and expenditure within financial plans and forecasts can provide a more comprehensive view of the future financial position of the government. It also strengthens the quality of financial planning through reconciling between forecasts prepared on a financial accounting basis and cash flow projections, a process which has proved to enhance the quality of both types of forecasts and hence the quality of financial plans that are used as the basis for decision-making.

Improving financial analysis

The effective use of financial accounting across government will benefit from the tools and experience developed in accounting and reporting in commercial and other organisations. This includes analysing financial trend information, comparing financial performance presented in the income and expenditure and cash flow statements as well as developments in the balance sheet between years and across multiple years. This can range from a high-level analysis of trends in the overall accounting deficit, to more detailed analyses of specific items within the accounts. Such monitoring can be used to assess performance against specific objectives set by the government, such as in achieving cost reduction plans, as well as highlighting areas that require attention by policymakers.

Such analysis will improve as the government extends its financial track record beyond the current four years of financial data embodied in the Whole of Government Accounts to date and as it starts to develop its long-term financial plans and projections on a financial accounting basis. Even with only four years of data, as shown in Table 6.7, it is possible to see that the net liabilities reported in the balance sheet have increased substantially since 2009–10, with a one-off benefit from reducing pension entitlements in 2010–11 more than offset by the significant accounting deficits recorded each year over the period.

Table 6.7. Four years of Whole of Government Accounts to 2012–13

	2009–10 £bn	2010–11 £bn	2011–12 £bn	2012–13 £bn
Income and expenditure				
Operating revenue	583	614	617	620
Operating expenditure[a]	(667)	(625)	(715)	(717)
Operating loss	(84)	(11)	(98)	(97)
Net finance costs	(79)	(83)	(88)	(79)
Net gain / (loss) on revaluations or disposals	–	–	1	(3)
Accounting deficit for the year	(163)	(94)	(185)	(179)
Balance sheet				
Property, plant and equipment	713	710	745	747
Other assets and investments	537	518	526	516
Public sector pensions	(1,135)	(960)	(1,006)	(1,172)
Debt and bank deposits	(988)	(1,097)	(1,233)	(1,330)
Other liabilities	(355)	(364)	(379)	(391)
Net liabilities	(1,228)	(1,193)	(1,347)	(1,630)

[a] Operating expenditure in 2010–11 was reduced by a £126 billion one-off benefit primarily as a consequence of changing the terms of pension arrangements for public sector employees.
Source: Whole of Government Accounts 2009–10, 2010–11, 2011–12 and 2012–13.

The Whole of Government Accounts compiled so far provoke some significant questions on the government's finances. How does the government plan to address an accounting deficit of almost 30% of total revenue? How will long-term public sector pension obligations and nuclear decommissioning costs be funded?

Analysis of capital expenditure should also be improved, as the inclusion of assets within the balance sheet provides a method for monitoring the level of infrastructure spending over time, as well the requirement to record impairments when assets are no longer useable or otherwise lose value. Financial accounting treats capital expenditure as the creation of an asset to be reported in the balance sheet, providing a different approach for monitoring how assets are utilised by the government from the treatment in the National Accounts of capital expenditure as just a different category of spending.

There are also significant benefits in preparing internal financial reports, budgets, forecasts and long-term plans on a consistent basis with the external financial reports that are used to hold an organisation accountable, placing those charged with oversight in a better position to review and challenge decisions made.

Financial analysis based on Whole of Government Accounts has the potential to change the public debate on the government's finances from a narrow focus on balancing the public finance deficit in the National Accounts to a more comprehensive discussion around how the government plans to deal with its longer-term financial challenges.

Multi-year spending reviews have proved to be a successful innovation in improving government financial management, providing a more stable environment within which to make financial decisions and providing departments with a better ability to manage their costs across several years. Whole of Government Accounts can support the government in developing from spending reviews focused on the cost of providing public services over a three- to five-year period into wider and more comprehensive financial reviews, considering the impact of financial decisions on the government's balance sheet as well, and supporting financial planning over a much longer-term time horizon.

For example, Whole of Government Accounts can be used as a framework for long-term planning, enabling enhancements to financial forecasts such as the projections included in the Office for Budget Responsibility's Fiscal Sustainability Report. Preparing projected balance sheets into the future to complement cash flow forecasts would provide significant additional information for policymakers to use in making decisions and for parliament in scrutinising the government's financial plans.

Government borrowing in the future

Investors in government debt and credit rating agencies do not require the same level of financial information to be provided by governments as they insist on from private companies issuing debt. Perhaps this is not surprising, given the sovereign ability of countries to raise taxes in the future that makes them very different from commercial enterprises.

However, debt investors know that lending to sovereign states has not always proved to be risk free and, as an increasing number of countries start to publish financial statements based on accounting standards, there is the potential for much more to be requested from governments about their balance sheets. The UK government is well positioned for this, with its development of the Whole of Government Accounts ahead of many other countries.

As many finance teams in businesses know, responding to the requests for information from lenders and credit rating agencies can be demanding. But, as they also know, that process can be helpful in improving the quality of their own understanding of their risk profile and of the robustness of their future plans. Replicating that process could offer an opportunity to improve the quality of financial planning by governments in the future.

Preventing financial engineering by government

One of the most significant developments in accounting standards over the past few decades has been in restricting the ability of companies and other preparers of financial statements to utilise financial engineering techniques to manipulate their reported financial performance and position – for example, by moving liabilities off-balance-sheet.

Successive governments in the UK have been criticised for leaving both Network Rail and PFI contracts off-balance-sheet for the public finances under ESA95. This has led to concerns that these transactions might have been entered into in order to achieve a particular reporting outcome rather than to achieve the best financial outcome for the taxpayer.

The requirement to record these arrangements on the balance sheet within the Whole of Government Accounts means that any perceived financial reporting benefit is removed under this approach, enabling those making decisions on whether to enter into such transactions to focus principally on whether they provide value for money.

Improving transparency and accountability

Listed companies are required to provide regular financial reports to investors on their financial performance under rules established by legislators and regulators to ensure the accountability of management teams to the owners of the businesses that they run. Financial information provided to investors throughout the year must be in accordance with accounting standards or, where alternative financial measures are considered helpful, they must be reconciled to the numbers used in the accounts and given no more prominence.

The discipline on companies to base their reported numbers on financial accounting in accordance with a set of independently established accounting standards is critical to the operation of financial markets, providing a way for market participants to communicate with each other and to hold companies to account.

Listed companies report on their financial performance at least twice a year, with some reporting quarterly. They will also typically hold in-depth sessions with investors and financial analysts on their strategy and financial performance. Internally, management teams will report to their boards and audit committees (and regulators where appropriate) on their budgets, forecasts and long-term financial plans. As the government accelerates the production of the Whole of Government Accounts, it will increasingly be able to provide similar briefings on its financial performance and position both to parliament and to the public.

The development of financial accounting as the primary basis for accounting by government gives an opportunity to improve the financial reports and analysis provided to parliament and the public using tools developed in the private sector, strengthening the dialogue between the government and those responsible for holding it to account. We look forward to the day, in the not too distant future, that it will be possible for the Budget to be presented on a financial accounting basis and for there to be an end-of-year financial presentation by the Chancellor of the Exchequer to the public on the Whole of Government Accounts.

6.4 Conclusion

Financial accounting in accordance with international generally accepted accounting standards provides robust useful financial information that goes beyond what is provided in the National Accounts. This is because financial performance as reported in the Whole of Government Accounts reflects expenditure on long-term obligations not included in public finance reporting within the National Accounts and the balance sheet gives a more comprehensive view of the government's financial position than public sector net debt alone.

The government is therefore to be congratulated for the progress it has made in developing Whole of Government Accounts and should be further encouraged to continue to make progress towards adopting financial accounting as the primary basis for monitoring its financial performance and position and for communicating with parliament and the public.

The increased use of financial accounting should also support the government in developing comprehensive financial reviews that use balance-sheet information as an integral part of the analysis used in making financial decisions.

In adopting the same financial language as that used by millions of people outside of government, we believe that there is a real opportunity to improve significantly the public understanding of the nation's finances. And, if financial accounting comes to be recognised and used widely by government, it has the potential to provide stronger incentives to account properly for the nation's long-run financial health when making policy.