

4. Whole of Government Accounts: an ICAEW assessment

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Summary

- The Whole of Government Accounts (WGA) are financial accounts for the public sector, prepared on a similar basis to those of millions of companies and other organisations around the world.
- The first five years of WGA have covered a dramatic period in Britain's fiscal history following the global financial crisis. They provide a more comprehensive picture of the public sector's financial performance over that time than that available from traditional National Accounts reporting by capturing a wider range of financial transactions.
- The reduction in the deficit on a National Accounts basis of 35% from £153 billion to £100 billion between 2009–10 and 2013–14 contrasts with a reduction of only 20% in the size of the annual accounting deficit to £149 billion over that same period.
- There has been a significant deterioration in the government's financial position, with net liabilities in the WGA more than doubling in five years, from £0.8 trillion at 31 March 2009 to £1.85 trillion at 31 March 2014. This reflects an increase in public sector pension obligations to £1.3 trillion in addition to the near-doubling of public sector net debt in the National Accounts from £0.7 trillion to £1.4 trillion.
- Effective financial management for the longer term involves addressing the balance sheet as well as revenue, expenditure and cash flows reported in the WGA but not in the National Accounts. A relatively high level of asset write-downs, growing pension obligations and increasing charges to cover nuclear decommissioning and clinical negligence exposures are areas of particular concern.
- The WGA also provide further insight when considering the vulnerability of the public finances to future economic shocks, with total liabilities at 31 March 2014 of £3.2 trillion, or 177% of GDP. This is substantially higher than public sector net debt, the National Accounts measure typically referred to in this context, which stood at £1.4 trillion, or 78% of GDP, at that date. The former may matter more when thinking about the government's ability to cope in the event of a future downturn.
- Improving financial management within government will become more challenging as further devolution increases the complexity of the public sector in the UK. A necessary first step must be to replace the current complex web of internal financial reporting data collection processes with a modern standardised financial consolidation system for all public sector entities, which should enable the government to obtain and utilise accurate comprehensive financial performance data from across the public sector within days rather than months.

4.1 Introduction

On 26 March 2015, the Treasury published its fifth set of Whole of Government Accounts (WGA), reporting the government's financial results for the year ended 31 March 2014 in accordance with International Financial Reporting Standards (IFRS).

These financial accounts, prepared on a basis similar to those that the government has required businesses, charities and other organisations in the UK to comply with for many decades, consolidate the activities of over 5,500 public sector bodies across central government, devolved administrations and local government in the UK.

Together with an associated commentary and explanatory notes, they provide a more comprehensive picture of the government's financial performance than that available through traditional fiscal reporting in the National Accounts. This is because the WGA capture a wider range of financial transactions than are reflected in the National Accounts, including charges for obligations incurred today that will result in cash outflows in the future, as well as integrating revenue and expenditure with a balance sheet and statement of cash flows. This is illustrated by Table 4.1.

The income statement records revenue and expenditure incurred, culminating in an accounting deficit of £149 billion for 2013–14. This is accompanied by a cash-flow statement that reconciles the operating loss of £70 billion with the net change in cash balances, and a statement of financial position, commonly known as a balance sheet, reflecting assets of £1,337 billion and liabilities of £3,189 billion at the end of that year. The statement of comprehensive gains and losses and the reconciliation of equity movements are combined in the table to provide a bridge between revenue and

Table 4.1. Summarised WGA 2013–14

Revenue and expenditure		Balance sheet	
Year ended 31 March 2014	£bn	As at 31 March 2014	£bn
Revenue	648	Property, plant and equipment	763
Operating expenditure	(718)	Other assets and investments	574
Operating loss	(70)	Debt and bank deposits	(1,451)
Net finance costs	(79)	Public sector pension obligations	(1,302)
Net loss on disposal of assets	0	Other liabilities	(436)
Accounting deficit for the year	(149)	Net liabilities	(1,852)
Cash flows		Change in financial position	
Operating loss	(70)	Accounting deficit for the year	(149)
Add back: non-cash transactions	42	Property revaluations	11
Changes in working capital	(11)	Financial revaluations	9
Operating cash outflow	(39)	Actuarial revaluations	(84)
Investing cash outflow	(55)	Comprehensive loss for the year	(213)
Cash outflow before financing	(94)	Other movements	(11)
Net financing cash inflow	125	Change in financial position	(224)
Net interest and similar outflows	(30)	Opening net liabilities	(1,628)
Net change in cash for the year	1	Closing net liabilities	(1,852)

Note: In this and subsequent tables in this chapter, positive numbers are used for revenue and assets, while (bracketed) negative numbers are used for expenditure and liabilities.

Source: Whole of Government Accounts 2013–14. These, and those for earlier years, can be downloaded from <http://www.gov.uk/government/collections/whole-of-government-accounts>.

Box 4.1. Key terms used in this chapter

Accounting deficit	The shortfall when revenue is less than expenditure in the WGA. Equivalent to the loss for the year in commercial financial statements.
Asset	A current resource from which economic benefits are expected to flow in the future.
Contingencies	Financial risks that could result in additional costs being incurred in addition to the liabilities already recorded in the balance sheet – for example, guarantees and indemnities that might be called on. Classified between contingent liabilities and remote contingencies, depending on likelihood.
Expenditure	Costs incurred, calculated in accordance with accounting standards. Excludes capital expenditure, but includes charges that are not captured by the National Accounts such as long-term pension costs. In financial statements, it is split into two components: operating expenditure and finance costs (the latter presented net of interest and similar income).
Financial accounting	A method of accounting in accordance with accounting standards, culminating in financial statements integrating revenue, expenditure, other gains & losses and cash flows with a balance sheet.
IFRS	International Financial Reporting Standards, a particular type of financial accounting based on accounting standards issued by the International Accounting Standards Board (IASB). In the UK, the government’s Financial Reporting Advisory Board (FRAB) has made some specific adaptations for public sector use.
Liability	An obligation in the form of a legal or similar requirement to make a payment in the future that arises as a consequence of a current or past event. This includes obligations to pay pensions to public sector employees arising from their past service, but does not include political promises or commitments to pay for future spending – for example, the state pension or other welfare benefits.
National Accounts	The framework used by the Office for National Statistics (ONS) for the presentation and measurement of economic activities, including rules on reporting public sector finances. Based on the European System of National and Regional Accounts (ESA), it is similar but not identical to the UN System of National Accounts. The current version, ESA10, was implemented in the UK in 2014, replacing ESA95.
Provisions	Liabilities of uncertain timing or amount, recorded at the best estimate of the likely payments to be made, discounted to current values.
Public finance deficit	The National Accounts measure for the shortfall between the totals for taxes and other income and for spending; equal to public sector net borrowing.
Public sector bodies	The UK central government, the Scottish, Welsh and Northern Ireland governments, local authorities, police & crime commissioners and the organisations that they control (except for nationalised banks).
Revenue	Taxes and other income calculated in accordance with accounting standards (but excluding interest and similar income).

expenditure and the £224 billion deterioration in the balance sheet over the course of 2013–14.

The revenue reported in the WGA for 2013–14 was equivalent to approximately £10,000 per person when divided across the 64.5 million people living in the UK at the time.¹ This was exceeded by operating expenditure of £11,100 and net finance costs of £1,200 to reach an accounting deficit of approximately £2,300 each. Assets and liabilities, measured under accounting standards, were around £20,700 and £49,400 each respectively, resulting in a net liability position at 31 March 2014 in the order of £28,700 per person.

It is important to note that the financial accounts do not fully represent the economic and social costs and benefits to British citizens from government activity. However, the amount by which liabilities exceed assets in the balance sheet provides a measure of the scale of the challenge faced by the government as it attempts to strengthen the public finances.

If used properly, financial analysis based on WGA can enable more comprehensive scrutiny around how the government plans to deal with its longer-term financial challenges than the narrower focus of the National Accounts allows, using the common financial language employed widely outside of government. Holding governments to account using the WGA therefore has the potential to improve the quality of policymaking and wider public debate.

Section 4.2 provides a high-level summary of the government's financial performance and position as set out in the revenue and expenditure statement and balance sheet in the WGA for the five years ended 31 March 2014, and how they differ from the National Accounts. This is followed by Section 4.3, which explores other insights provided by the WGA, including the cash-flow statement, changes in financial position and financial risk exposures. Section 4.4 discusses the need for improved financial accounting and reporting in an era of change and Section 4.5 concludes.

Box 4.1 sets out key terms used in this chapter that are useful in understanding financial accounting and the WGA.

4.2 Five years of WGA

On arrival in office in 1997 the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth. Urgent action was needed. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and Parliamentary scrutiny.

HM Treasury, Analysing UK Fiscal Policy, November 1999²

It was HM Treasury's analysis of fiscal policy in 1999 that resulted in legislation for the WGA,³ but it was only in 2008 that the then Labour government finalised the scope and timetable for preparing WGA. It was therefore not until after the arrival of the coalition

¹ Office for National Statistics, 'Mid-year 2014 population estimate' (extrapolated back one quarter).

² <http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/90.pdf>.

³ Section 11 of the Government Resources and Accounts Act 2000.

government, during a period of much greater economic turmoil, that the first set of modern financial statements in the form of the WGA were published.

As a consequence, the public, parliament and the government itself have the potential to be in a much better position to judge progress against the government's objective of turning around the state of the public finances following the financial crisis – provided, of course, that the WGA become a central part of the dialogue on fiscal matters.

Revenue – Expenditure = Accounting deficit

Figure 4.1 illustrates how the accounting deficit⁴ was on average £55 billion higher than the public finance deficit each year from 2009–10 to 2013–14.

The reduction in the deficit on a National Accounts basis of 35% from £153 billion to £100 billion between 2009–10 and 2013–14 contrasts with a reduction of only 20% in the size of the annual accounting deficit to £149 billion over that same period.

This can be seen from Table 4.2, which sets out the revenue and expenditure statement for the five years and also summarises the differences between the public finance deficit and the accounting deficit. These principally arise from the long-term costs of public sector pension schemes, asset write-downs and increases in provisions for nuclear decommissioning and clinical negligence claims, which are incorporated in the WGA but not the National Accounts. These differences are discussed in more detail later in this section.

The accounting deficits incurred over the five financial years ended 31 March 2014 added together were equal to 25% of revenues over the period. This is substantial, even for an organisation of the scale of the UK government.

Table 4.3 illustrates how revenue, operating expenditure and operating loss developed between 2009–10 and 2013–14.

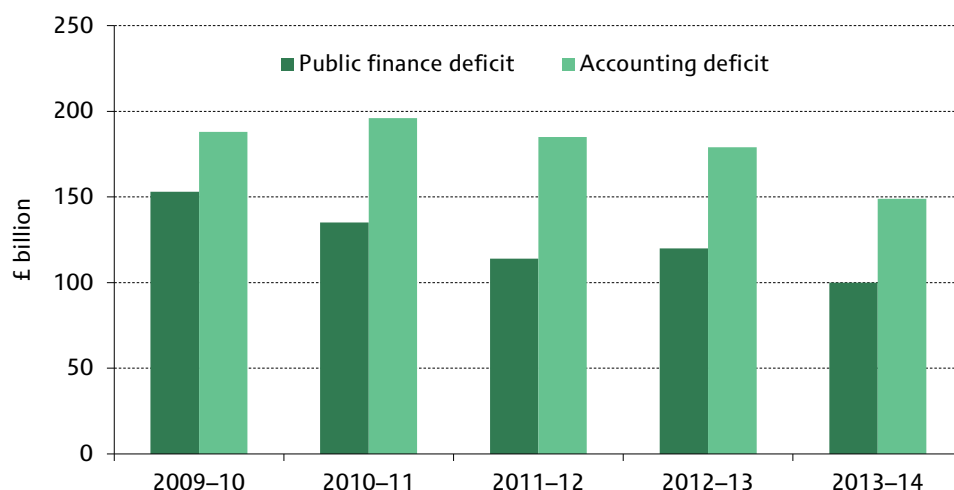
Revenue in 2013–14 was £65 billion higher than in 2009–10, but £51 billion of this increase was from inflation, so the real-terms increase was only £14 billion. This reflected real-terms declines in revenue in 2011–12 and 2012–13, despite economic growth in both those years. This contrasted with operating expenditure, where the expressed intention of the coalition government to cut spending translated into operating expenditure being £35 billion lower in real terms in 2013–14 than in 2009–10.

When combined, operating losses reduced from £109 billion in 2009–10 to £70 billion in 2013–14, comprising a net increase of £10 billion from inflation and a real-terms improvement of £49 billion.

The reduction in the level of operating losses over the period was not offset by increases in net finance costs, despite the substantial growth in debt over the period. As shown in Table 4.2, net finance costs did initially increase as debt grew, but declining interest rates subsequently had the effect of bringing net finance costs in 2013–14 back to the same level as five years previously.

⁴ Adjusted to exclude one-off items in 2009–10 and 2010–11 (see Table 4.2).

Figure 4.1. National Accounts versus WGA



Source: Office for National Statistics, Public Sector Finances October 2015, and Whole of Government Accounts 2013-14, adjusted for one-off items in 2009-10 and 2010-11.

Table 4.2. Revenue and expenditure for the five years to 2013-14

Fiscal year	2009-10	2010-11	2011-12	2012-13	2013-14
Revenue and expenditure	£bn	£bn	£bn	£bn	£bn
Revenue	583	614	617	620	648
Operating expenditure ^a	(692)	(727)	(715)	(717)	(718)
One-off items ^b	25	102	-	-	-
Net finance costs	(79)	(83)	(87)	(82)	(79)
Accounting deficit	(163)	(94)	(185)	(179)	(149)
Accounting deficit excluding one-off items	(188)	(196)	(185)	(179)	(149)
<i>Accounting deficit^c / revenue</i>	<i>32.2%</i>	<i>31.9%</i>	<i>30.0%</i>	<i>28.9%</i>	<i>23.0%</i>
<i>Accounting deficit^c / GDP</i>	<i>12.5%</i>	<i>12.4%</i>	<i>11.4%</i>	<i>10.7%</i>	<i>8.5%</i>
Public finance deficit^c	(153)	(135)	(114)	(120)	(100)
Add back: public sector net investment ^c	49	40	30	35	26
Public finance current deficit^c	(104)	(95)	(84)	(85)	(74)
Asset-related differences	(46)	(58)	(60)	(31)	(25)
Public sector pensions	(52)	(57)	(52)	(48)	(49)
Provisions	3	(6)	(5)	(16)	(10)
Other differences	11	20	16	1	9
One-off items ^d	25	102	-	-	-
Accounting deficit	(163)	(94)	(185)	(179)	(149)

^a Adjusted to exclude one-off items in 2009-10 and 2010-11.

^b One-off items comprise a gain of £25 billion in 2009-10 relating to the Asset Protection Scheme, a gain of £126 billion in 2010-11 arising from changes in public sector pension entitlements, and a loss of £24 billion in 2010-11 on writing down the value of council houses.

^c Updated for the change from ESA95 to ESA10 and for other revisions made by the ONS since the original publication of the WGA, but not for the incorporation of housing associations.

Source: Whole of Government Accounts 2010-11, 2012-13 and 2013-14; Office for National Statistics, Public Sector Finances, October 2015 and GDP November 2015; ICAEW calculations.

Table 4.3. Operating loss development

Fiscal year	2009–10 to 2010–11 £bn	2010–11 to 2011–12 £bn	2011–12 to 2012–13 £bn	2012–13 to 2013–14 £bn	2009–10 to 2013–14 £bn
Revenue in prior year	583	614	617	620	583
Inflation	17	10	11	13	51
Increase/(decrease) after inflation	14	(7)	(8)	15	14
Revenue in year	614	617	620	648	648
Operating expenditure in prior year	(692)	(727)	(715)	(717)	(692)
Inflation	(21)	(12)	(13)	(15)	(61)
(Increase)/decrease after inflation	(14)	24	11	14	35
Operating expenditure in year	(727)	(715)	(717)	(718)	(718)
Operating loss in prior year	(109)	(113)	(98)	(97)	(109)
Net effect of inflation	(4)	(2)	(2)	(2)	(10)
Net change after inflation	0	17	3	29	49
Operating loss in year	(113)	(98)	(97)	(70)	(70)

Note: Inflation based on the GDP deflator for the years shown of 3.0%, 1.6%, 1.8% and 2.1% respectively.

Source: Whole of Government Accounts 2013–14; Office for National Statistics GDP Deflator Blue Book update issued 3 November 2015; ICAEW calculations.

Table 4.4. Balance sheet for the five years to 2013–14

Fiscal year	2009–10 £bn	2010–11 £bn	2011–12 £bn	2012–13 £bn	2013–14 £bn
Balance sheet					
Property, plant & equipment	713	714	745	747	763
Other assets	537	520	525	550	574
Total assets	1,250	1,234	1,270	1,297	1,337
Debt and bank deposits	(988)	(1,097)	(1,232)	(1,330)	(1,451)
Net pension obligations	(1,135)	(961)	(1,006)	(1,172)	(1,302)
Other liabilities	(354)	(362)	(379)	(423)	(436)
Total liabilities	(2,477)	(2,420)	(2,617)	(2,925)	(3,189)
Net liabilities	(1,228)	(1,186)	(1,347)	(1,628)	(1,852)
<i>Total assets / GDP</i>	<i>81%</i>	<i>77%</i>	<i>77%</i>	<i>76%</i>	<i>74%</i>
<i>Total liabilities / GDP</i>	<i>(161%)</i>	<i>(151%)</i>	<i>(158%)</i>	<i>(171%)</i>	<i>(177%)</i>
<i>Net liabilities / GDP</i>	<i>(80%)</i>	<i>(74%)</i>	<i>(81%)</i>	<i>(95%)</i>	<i>(103%)</i>
<i>Net liabilities per person</i>	<i>(£19,600)</i>	<i>(£18,800)</i>	<i>(£21,200)</i>	<i>(£25,400)</i>	<i>(£28,700)</i>
Public sector net debt	(960)	(1,102)	(1,192)	(1,300)	(1,403)
Asset-related differences	831	872	891	904	905
Public sector pensions	(1,135)	(961)	(1,006)	(1,172)	(1,302)
Provisions	(102)	(108)	(113)	(131)	(142)
Other assets less liabilities	138	113	73	71	90
Net liabilities	(1,228)	(1,186)	(1,347)	(1,628)	(1,852)

Source: Whole of Government Accounts 2011–12, 2012–13 and 2013–14; adjusted by the ICAEW to reflect changes in public sector net debt as a consequence of the implementation of ESA10.

Balance sheet

Each revenue and expenditure statement is complemented by a balance sheet, as shown in Table 4.4. This confirms how the financial position of the UK government has deteriorated dramatically over the last five years, with increases in assets being outpaced by much larger increases in liabilities.

The main drivers were higher levels of government debt and growing public sector pension obligations, with total liabilities increasing from £2.5 trillion (161% of GDP) at 31 March 2010 to £3.2 trillion (177% of GDP) at 31 March 2014.

Table 4.4 also shows that growth in public sector pension obligations was the main contributor to the widening gap between public sector net debt in the National Accounts (which do not include these obligations) and net liabilities in the WGA.

The weakening financial position of the UK government as presented in the balance sheet is a concern. In particular, there will be significant increases in finance costs as interest rates rise, while pension obligations and other liabilities will absorb increasing amounts of cash as they are settled. As a consequence, there will be less available to spend on other policy objectives out of future tax revenues and potentially less headroom to absorb future economic shocks.

Asset-related differences

In going from the National Accounts measure for the public finance deficit to the WGA equivalent, the first step is to add back public sector net investment. This is because capital expenditure and financial investments result in the addition of assets to the balance sheet in the WGA rather than being treated as an expense as they are in the National Accounts.

Perhaps surprisingly, asset-related charges recorded in the financial accounts end up to a greater or lesser extent offsetting this add-back, as shown in Table 4.5. These charges are

Table 4.5. Asset-related differences

Fiscal year	2009–10	2010–11	2011–12	2012–13	2013–14
	£bn	£bn	£bn	£bn	£bn
Public sector net investment	49	40	30	35	26
Write-downs in					
- property, plant & equipment	(20)	(13)	(13)	(12)	(13)
- other assets	(4)	(16)	(30)	(9)	(13)
Capital grants	(16)	(18)	(13)	(12)	(11)
Depreciation	(6)	(7)	(4)	5	8
Gains or losses on disposals	0	(4)	0	(3)	4
Asset-related differences	(46)	(58)	(60)	(31)	(25)
Property, plant & equipment	713	714	745	747	763
Investment property	12	12	11	12	13
Intangible fixed assets	36	35	35	35	32
Financial investments	70	111	100	110	97
Asset-related differences	831	872	891	904	905

Note: Write-downs in the table exclude a one-off £24 billion write-down in council houses in 2010–11.

Source: Whole of Government Accounts 2011–12, 2012–13 and 2013–14; adjusted by ICAEW to reflect changes in the reported public finance deficit as a consequence of the implementation of ESA10.

real costs that are not recognised in the National Accounts, reflecting either reductions in the value of assets or the cost of giving capital grants to external parties.

For property, plant and equipment, asset write-downs or 'impairments' may arise as a consequence of physical damage, destruction or replacement, but they are also recorded when a conclusion is reached that the economic value of an asset is less than the amount it cost to construct. One example was the £1.3 billion write-down in the recorded value of the Olympic Park in 2012–13.

Total amounts written off property, plant and equipment over the five years amounted to £72 billion, an average charge of almost 2% of the carrying value each year. This is relatively high in the context of recurring depreciation charges of just over 3% a year. Without further information, it is difficult to understand whether this might be an indicator of problems in capital procurement processes, an accounting issue or inherent to the way the public sector works. It would be helpful if a more detailed analysis of the causes of asset write-downs could be provided in future WGA to address this issue. This may also be an area worthy of further investigation by the National Audit Office.

Impairments in other assets mostly relate to write-downs in the carrying value of financial investments or receivables, including recognising uncollectable taxes, impairing student loan receivables and, in this period, losses on investments in the UK banking sector.

Capital grants, which are treated as operating expenditure in the WGA because the assets concerned do not end up in the balance sheet, have declined over the period as the government has sought to reduce cash spending.

In addition to recognising property, plant and equipment in the balance sheet, the WGA also record the government's investment in commercial properties, intangible fixed assets such as IT systems and military equipment, and financial investments. The last includes equity investments in nationalised banks (£43 billion at 31 March 2014).

Pensions

The largest individual difference between the National Accounts and the WGA is in the accounting treatment of pensions. This is analysed in Table 4.6.

The scale of liabilities for public sector pensions is critically important as the government is obligated to make these payments as they fall due, restricting the cash available for other spending priorities. The net pension obligation is discounted over several decades, which means the eventual cash payments will be significantly higher than the £1.3 trillion net pension obligation recorded in the WGA at 31 March 2014.

Pension costs recorded in the National Accounts comprise payments to current pensioners and transfers to external pension schemes, less contributions received from current employees and external employers.

These cash costs are substantially less than the accounting costs of providing pensions to public sector employees recorded in the WGA, which instead reflect the growth in pension *entitlements* over the course of the year. In 2009–10 the accounting costs were almost four times as much as the net cash costs recorded in the National Accounts, while in 2013–14 they were more than double.

This is primarily due to the long-standing approach of not funding the majority of public sector pension schemes, which means that, outside of local authorities and a limited

Table 4.6. Public sector pensions

Fiscal year	2009–10	2010–11	2011–12	2012–13	2013–14
	£bn	£bn	£bn	£bn	£bn
Pension costs in National Accounts	(18)	(22)	(24)	(28)	(31)
Difference	(52)	(57)	(52)	(48)	(49)
Pension costs in the WGA	(70)	(79)	(76)	(76)	(80)
Cost of pension entitlements	(30)	(41)	(36)	(36)	(40)
Contributions received	10	10	11	8	9
Interest on pension liabilities	(59)	(61)	(65)	(59)	(59)
Investment income	9	13	14	11	10
Pension costs in the WGA	(70)	(79)	(76)	(76)	(80)
Funded pension investments	193	208	216	219	228
Funded pension obligations	(310)	(275)	(305)	(318)	(324)
Net funded pension obligations	(117)	(67)	(89)	(99)	(96)
Unfunded pension obligations	(1,018)	(894)	(917)	(1,073)	(1,206)
Pensions in WGA balance sheet	(1,135)	(961)	(1,006)	(1,172)	(1,302)

Note: Pension accounting charges in 2010–11 exclude one-off gain of £126 billion.

Source: Whole of Government Accounts 2010–11, 2011–12, 2012–13 and 2013–14.

number of other bodies (such as the BBC) with funded pension plans, there is no investment income to offset the growth in liabilities in the main public sector pension schemes.

The substantial increase in net cash payments since 2010–11 reflects an increase in payments for an increased number of retirees, combined with a fall in the number of current employees contributing as the public sector contracts in size. The £10 billion increase in annual accounting cost in 2013–14 compared with five years previously (nominal growth of 14%, compared with 9% inflation over that period) is hence much lower than the £13 billion (72%) increase in the net cash cost recorded in the National Accounts.

The government acted to restrain the increase in pension liabilities with a change in pension entitlements in 2010–11, resulting in a one-off £126 billion reduction in the obligation. Together with investment growth, the element of this relating to local authority and other funded pension schemes resulted in a lower net obligation in 2013–14 than in 2009–10, despite actuarial revaluations that have increased the liability as discount rates have fallen.

The overall net pension obligation increased from £802 billion at 31 March 2009 (not shown in Table 4.6) to £1,302 billion at 31 March 2014, an increase of £727 billion before taking account of cash payments and other movements of £101 billion and the one-off reduction of £126 billion. Of this increase, approximately half (£367 billion) was as a result of actuarial revaluations as discount rates have fallen, with the balance (£360 billion) representing the growth in net pension entitlements over the five years shown.

The government has subsequently undertaken further steps to restructure public sector pension entitlements, but the impact of these changes on the net pension obligation will

not be known until the publication of the next WGA. The government has also linked the normal pension age for public sector workers (the youngest age at which someone can usually first receive a full pension) to the increasing state pension age, which is one reason why pension payments are now expected to fall as a proportion of GDP over the next fifty years.

Provisions

Of the remaining differences between the National Accounts and the WGA, the most significant to the accounting deficit arise from the treatment of provisions for general liabilities (see Table 4.7).

These are liabilities where the amount or timing of eventual payments is uncertain. As the amounts recorded in the balance sheet are estimates, they can change as those estimates are revised as well as when new costs are incurred during the course of each year.

The largest element of provisions relates to decommissioning nuclear facilities and cleaning up nuclear waste. These have grown as the Nuclear Decommissioning Authority has continued to re-evaluate upwards its estimates of the eventual payments that it expects to have to make over the next 125 years.

Of the £34 billion in charges for nuclear decommissioning recorded in the WGA over the five years to 2013–14, £27 billion arose from revisions to these estimates. Net of spending over the period, this translated into a £22 billion or 40% increase in nuclear decommissioning provisions from £55 billion at 31 March 2009 (not shown in the table) to £77 billion at 31 March 2014.

The next most significant element relates to clinical negligence claims against the NHS. Here costs averaged around £4 billion a year over the period, as provisions grew by £13 billion or 93% from £14 billion at 31 March 2009 (also not shown in the table) to £27 billion at 31 March 2014.

Other provisions relate to a wide range of different exposures, including the Financial Services Compensation Scheme, tax refund litigation and other legal claims.

Table 4.7. Provisions

Fiscal year	2009–10	2010–11	2011–12	2012–13	2013–14
	£bn	£bn	£bn	£bn	£bn
Payments in National Accounts	(12)	(13)	(13)	(14)	(10)
Difference	3	(6)	(5)	(16)	(10)
Provision charges in the WGA	(9)	(19)	(18)	(30)	(20)
Nuclear decommissioning costs	(4)	(6)	(6)	(8)	(10)
Clinical negligence costs	(3)	(3)	(3)	(6)	(5)
Other provision costs	(1)	(10)	(9)	(16)	(5)
Provision charges in the WGA	(9)	(19)	(18)	(30)	(20)
Nuclear decommissioning	(57)	(61)	(64)	(70)	(77)
Clinical negligence	(16)	(17)	(19)	(24)	(27)
Financial Services Compensation	(4)	(4)	(4)	(4)	(4)
Other provisions	(25)	(26)	(26)	(33)	(34)
Provisions in WGA balance sheet	(102)	(108)	(113)	(131)	(142)

Source: Whole of Government Accounts 2010–11, 2011–12, 2012–13 and 2013–14.

4.3 Further insights from the WGA

As integrated financial statements, with extensive disclosures as required by accounting standards, the WGA contain information beyond the revenue and expenditure statement and balance sheet that provides further insights into the financial performance and position of the government.

Cash flows

The revenue and expenditure statement is prepared on an accruals basis, which means that it combines cash receipts and payments during the year with items of revenue and expenditure that arose from cash flows in previous periods or will be settled in cash in future periods.

As a consequence, revenue includes a mixture of tax and other receipts received in the year and amounts expected to be received at a later date – for example, accompanying a tax return. Similarly, expenditure includes a mixture of spending paid in cash during the year, accrued expenses that will be settled at a later date and prepaid expenses that were paid in advance in earlier periods. It also includes a depreciation charge on assets, which mostly arises from cash payments to acquire or construct those assets in earlier years.

This provides a more comprehensive view of financial performance than a statement based on just cash receipts and payments would provide, but means it does not satisfy the need of readers of financial statements wanting to understand how cash has been generated and used during the year.

This need is instead satisfied by a cash-flow statement, which analyses cash flows during the year between operational activities (operating receipts minus operating payments), investing activities (including capital expenditure) and financing activities (including new borrowing and the servicing of debt).

Table 4.8 summarises the cash-flow statements in the WGA for the five years to 2013–14, together with public sector net borrowing in the National Accounts.

The cash-flow statement should in theory provide a similar picture to that provided by public sector net borrowing in the National Accounts, but in practice there are a number of differences. For example, government borrowing to fund student loans is netted off against those loans within public sector net borrowing, unlike in the WGA where they are reported as part of financing and investing cash flows respectively. However, the most

Table 4.8. Cash flows

Fiscal year	2009–10	2010–11	2011–12	2012–13	2013–14
	£bn	£bn	£bn	£bn	£bn
Operating cash outflow	(82)	(49)	(19)	(9)	(39)
Investing cash outflow	(134)	(27)	(84)	(86)	(55)
Cash flow before financing	(216)	(76)	(103)	(95)	(94)
Net financing cash inflow	246	114	139	130	125
Interest and similar outflows	(31)	(35)	(37)	(32)	(30)
Net change in cash	(1)	3	(1)	3	1
Public sector net borrowing	153	135	114	120	100

Note: The operating cash outflow in 2012–13 benefited by £27 billion from cashing in Royal Mail pension scheme investments.

Source: Whole of Government Accounts 2010–11, 2012–13 and 2013–14.

significant differences arise from financial interventions in the banking sector following the financial crisis, as these were excluded from the principal measure used for public sector net borrowing in the National Accounts.

Net financing cash inflow, the WGA measure for new borrowing, illustrates the scale of financing required by the government to fund its operations during the five years to 2013–14, including the exceptional circumstances of 2009–10 when more than a quarter of a trillion pounds was borrowed in a single year.

This means that over the past five years the government has raised a total of £754 billion in new finance. Almost half of this, £363 billion, was used to fund a total of £198 billion in operating cash outflows and £165 billion in interest and similar payments. The balance was used to fund £235 billion in capital expenditure and £151 billion in other investing cash outflows, principally in financial interventions to rescue the banking sector, together with a £5 billion increase in cash balances.

Even if the need to finance capital expenditure and financial investments is excluded, the position is far from rosy. In 2013–14, for example, operating cash flows were £69 billion short of the level needed to cover interest and similar payments.

Table 4.9 analyses investing cash outflow, the WGA measure for investment activity, and also reconciles it with the public sector investment measures in the National Accounts.

Investing cash outflow comprises capital expenditure, student loans and net movements in other financial investments, partially offset by sales of non-financial assets. Averaged over the five years to 2013–14, it reflected average cash outflows for capital items of £47 billion a year, loans to students of £7 billion and net increases in other financial investments of £27 billion, before taking into account an average of around £3 billion in receipts each year from the sales of non-financial assets.

The average for financial investments was distorted by financial interventions in the banking sector during the financial crisis. These, together with capital grants (treated as an operating cash outflow in the WGA), were the principal contributors to the differences

Table 4.9. Investing cash flows

Fiscal year	2009–10 £bn	2010–11 £bn	2011–12 £bn	2012–13 £bn	2013–14 £bn
Payments for capital expenditure	(46)	(51)	(54)	(44)	(40)
Sales of non-financial assets	3	5	2	2	5
Student loans	(4)	(6)	(7)	(9)	(9)
Financial investments	(87)	25	(25)	(35)	(11)
Investing cash outflow	(134)	(27)	(84)	(86)	(55)
Public sector net investment	(49)	(40)	(30)	(35)	(26)
National Accounts depreciation	(30)	(31)	(33)	(34)	(35)
Public sector gross investment	(79)	(71)	(63)	(69)	(61)
Add back: capital grants	16	18	13	12	11
Sales of non-financial assets	3	5	2	2	5
Financial investment differences	(74)	21	(36)	(31)	(10)
Investing cash outflow	(134)	(27)	(84)	(86)	(55)

Source: Whole of Government Accounts 2010–11, 2012–13 and 2013–14; Office for National Statistics, Public Sector Finances, October 2015.

between public sector gross investment in the National Accounts and investing cash outflow in the WGA.

Cash balances can vary significantly each month, but the balance at the end of each of the last five years has been relatively stable at between £20 billion and £25 billion. This is equivalent to slightly less than two weeks' expenditure by the public sector, highlighting the critical dependence of the government on being able to access financial markets to continue to operate.

Changes in financial position

Table 4.10 reconciles the movements in the balance sheet over each of the five years shown, demonstrating how net liabilities more than doubled from £0.8 trillion at 31 March 2009 (not shown in the table) to £1.85 trillion at 31 March 2014.

Table 4.10. Changes in financial position

Fiscal year	2009–10	2010–11	2011–12	2012–13	2013–14
	£bn	£bn	£bn	£bn	£bn
Accounting deficit	(163)	(94)	(185)	(179)	(149)
Property revaluations	7	21	20	7	11
Financial revaluations	11	(2)	(2)	5	9
Actuarial revaluations	(287)	100	1	(97)	(84)
Comprehensive loss	(431)	25	(166)	(263)	(213)
Other movements	(16)	17	5	(18)	(11)
Change in financial position	(447)	42	(161)	(281)	(224)
Opening net liabilities	(781)	(1,228)	(1,186)	(1,347)	(1,628)
Closing net liabilities	(1,228)	(1,186)	(1,347)	(1,628)	(1,852)

Note: Accounting deficit is inclusive of one-off items in 2009–10 and 2010–11 (see Table 4.2).

Source: Whole of Government Accounts 2010–11, 2011–12 and 2013–14.

This deterioration was the result of weak economic growth, reflected in repeated accounting deficits. It was exacerbated by sizeable negative actuarial revaluations, which principally arose from the movement in the corporate interest rates used to discount pension liabilities. As these have fallen (apart from in 2010–11), there have been consequent increases in the pension liability. The sheer scale of the undiscounted pension obligations means that relatively small changes in the discount rate can have a very large impact on the balance sheet.

Against the scale of the accounting deficits and pension liability changes, neither property revaluations, principally from inflationary increases in the carrying value of infrastructure assets (as they are recorded at depreciated replacement cost), nor financial revaluations, arising from fluctuations in the market values of non-pension investments, had a significant impact.

Financial risk exposure

One area where the government did make progress in improving its financial situation was in reducing its exposure to financial risks, as indicated by Table 4.11.

While contingent liabilities increased to 16% of a year's revenue before falling to 10% over the period to 31 March 2014, remote contingencies fell dramatically from around 150% of a year's revenue at 31 March 2009 to 16% as guarantees and indemnities provided to support the financial sector during the financial crisis subsequently expired.

Table 4.11. Contingencies

Fiscal year	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
	£bn	£bn	£bn	£bn	£bn	£bn
Contingent liabilities	-	41	50	101	88	63
<i>As a share of a year's revenue</i>	-	7%	8%	16%	14%	10%
Remote contingencies	851	434	331	162	74	105
<i>As a share of a year's revenue</i>	~150%	74%	54%	26%	12%	16%

Note: 2008–09 contingent liabilities and revenue not available.

Source: Whole of Government Accounts 2010–11, 2011–12 and 2013–14.

Combined, the remaining exposures amounted to just over a quarter of a year's revenue at 31 March 2014.

Contingent liabilities of £63 billion at 31 March 2014 included credit guarantees provided to exporters, potential clinical negligence claims and taxes subject to challenge, amongst other exposures. The balance of £105 billion in remote contingencies at 31 March 2014 included £50 billion in exposures to international financial institutions and the EU.

These measures, while more comprehensive than the National Accounts, do not capture all aspects of the public finances in practice. While the most explicit guarantees to the financial sector have expired, it remains likely that the government would stand behind the banking sector if it once again ran into big enough problems, an exposure not measured in the WGA. Such unmeasured commitments also need to be considered when assessing whether actions to improve the stability of the financial system, such as increased capital adequacy requirements, have reduced the risk to the taxpayer of a future financial crisis.

4.4 Using WGA to improve financial management in an era of change

Over recent years, successive governments in the UK have made significant progress in strengthening financial management within government. This has included implementing accruals and resource accounting, multi-year spending reviews, developing explicit fiscal objectives and the appointment of non-executive directors to departmental boards with outside financial experience. More 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.

Despite this progress, decision-making within the public sector continues to be hampered by a lack of timely comprehensive financial information.

Replacing the current complex accounting structure with best-practice financial reporting and accounting would contribute to the government's ability to improve the fiscal position of the country, at the same time as delivering radical change across the public sector. This would involve extending WGA from a supplementary annual external financial report to form the basis for comprehensive internal monthly financial reporting throughout the public sector, including providing consolidated financial reports to the Cabinet.

In last year's Green Budget,⁵ we described some of the specific benefits of extending the use of financial accounting across the public sector, including:

- better financial analysis, through the use of techniques and systems developed for businesses and other organisations already using financial accounting;
- using the balance sheet to inform financial decision-making, with a consequent longer-term focus on the impact of those decisions;
- driving alignment across public sector bodies, with more consistency in accounting and internal financial reporting enabling improvements in their ability to work together to deliver public services;
- restricting the scope for financial engineering through adopting accounting standards that are set independently of government;
- improving transparency and accountability – for example, through the development of financial reports and presentations similar to those that listed companies use in communicating with their shareholders.

Financial accounting is about much more than providing a more comprehensive set of financial reports in the form of the WGA. The standardisation of financial systems and processes enhances financial control. Structured financial data support better decision-making, forecasting and budgeting. And the use of a common financial language with the outside world increases transparency and accountability.

Greater use of financial accounting would 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.

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 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. Some countries, such as New Zealand, have already adopted WGA as their primary form of accounting.

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, not least because most other countries are still at a much earlier stage in implementing

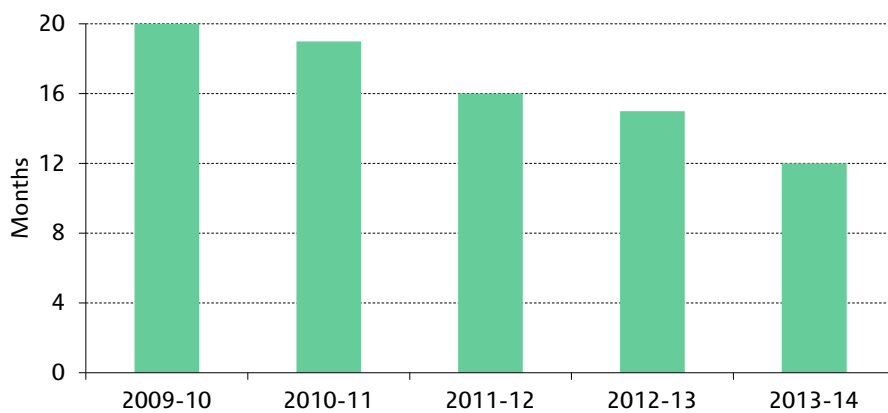
⁵ R. Hodgkinson and M. Wheatcroft, 'The government's financial accounts: an ICAEW perspective', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, IFS Report R106, 2015, <http://www.ifs.org.uk/publications/7530>.

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.

Progress made, but still some way to go

One key aspect of improving financial management in the public sector relates to the progress made in implementing WGA, including the time it takes to produce them as shown in Figure 4.2. Accounting policies and practices are being aligned, the quality and breadth of financial information available are being improved and, more importantly, the WGA have started to be actively used within government to support strategic financial decision-making.

Figure 4.2. Time to produce the WGA



Source: Whole of Government Accounts 2009–10, 2010–11, 2011–12, 2012–13 and 2013–14.

However, the government continues to struggle to produce the WGA in a period much less than twelve months, compared with a period of around three months typically achieved even in very complex multinational private sector organisations.

The more modest target of reducing the time to produce the next WGA from twelve to nine months has not been achieved. This is partly because current financial processes are not designed to support timely reporting, as well as because of specific issues in a number of departments. One particular difficulty this year arises from the challenges being experienced by the Department for Education as thousands of schools convert into academies and they are transferred from local government to central government control.

Turning round a back-to-front accounting system

The current framework for accounting within central government is based on resource accounting. This is a hybrid form of accounting that uses financial accounting at a detailed level, but which is then adjusted onto a National Accounts basis for financial reporting and management purposes.

In this process, some of the key information available in public sector bodies' detailed financial accounts, such as the balance sheet, is stripped out or not collected, leaving departments and the Treasury with a limited subset of the financial information available to use in its operational financial decision-making.

Ironically, the process of preparing WGA means that, many months later, departments and other bodies have to reverse the hybrid adjustments they made initially for their departmental statutory accounts or to conform with National Accounting rules and instead complete the financial accounting process they originally started with. It is also only at this stage that they collect a full set of financial accounting information from many thousands of public sector organisations, almost all of which use financial accounting on a regular basis for their own internal financial management.

This explains one of the major reasons for the time it takes to prepare the WGA. Rather than prepare financial information each year-end in a single process, building on the output of regular internal monthly financial reporting processes, each department prepares a series of different reports involving separate information collection exercises.

Best practice would involve collecting all the required financial data in a single standard and routine process and preparing financial reports together rather than separately. Such a streamlined process would also enable a single audit exercise to confirm the accuracy of the financial information presented, rather than the multiple exercises currently required.

Improving financial systems

There would be substantial benefit to the government from implementing comprehensive internal monthly financial reporting, in line with best practice across the private sector.

Currently, the government does not have a full range of financial information when making operational or strategic financial decisions. It has only limited visibility of financial performance across the public sector, with no access to balance-sheet information on a monthly basis. This lack of timely, accurate and comprehensive financial information hampers the effectiveness of financial management within Whitehall.

The foundation for change would be a modern standardised financial consolidation system, providing for a comprehensive set of financial data to be reported by the thousands of public sector bodies on a monthly basis. Such a system would provide individual spending departments, and the Treasury, with a significantly improved and timelier set of financial information on which to base decisions, while also strengthening financial management across the public sector by aligning the way financial performance is measured.

This does not mean eliminating reporting of the public finance deficit, public sector net debt or other National Accounts measures, which provide important information about the government's liquidity and debt obligations and also provide a basis for international comparisons. Instead, it means using these as part of a wider and more comprehensive set of financial reporting measures when making decisions.

4.5 Conclusion

The first five years of WGA have proved that it is possible for the government to prepare financial statements in a similar form to that adopted by commercial and other types of organisations. They enable a more comprehensive assessment of progress against the government's objective of improving the public finances than is possible using National Accounts measures, using the development in revenue and expenditure, the balance sheet and the cash-flow statement over time.

The WGA illustrate how only limited progress was made in the five years to 31 March 2014 in reducing the accounting deficit, which reduced by 20% compared with the headline 35% reduction in the public finance deficit reported in the National Accounts. There was a significant deterioration in the financial position reported in the balance sheet, with net liabilities more than doubling to £1.85 trillion at 31 March 2014, while operating cash flows were negative in each of those five years.

Effective financial management for the longer term involves addressing the balance sheet as well as revenue, expenditure and cash flows reported in the WGA but not in the National Accounts. A relatively high level of asset write-downs, growing pension obligations (£1.3 trillion at 31 March 2014) and increasing charges to cover nuclear decommissioning and clinical negligence exposures are areas of particular concern, with the level of asset write-downs potentially worthy of further investigation.

The WGA also provide further insights when considering the vulnerability of the public finances to future economic shocks, with total liabilities at 31 March 2014 of £3.2 trillion, or 177% of GDP. This is substantially higher than public sector net debt, the National Accounts measure typically referred to in this context, which stood at £1.4 trillion, or 78% of GDP, at that date.

Although it is also possible to use net liabilities (which captures assets as well as liabilities) as a measure of fiscal vulnerability, it is important to understand that in practice most assets on the balance sheet are essential to delivering public services and so in practice not easily realisable for cash. As a consequence, total liabilities may be a better indicator given it represents obligations to make payments in the future ahead of other fiscal priorities: the greater they are, the more constrained the government will be in dealing with a future economic downturn.

Adopting best practice

Recent governments are to be congratulated on their commitment and achievements to date in implementing WGA. However, there is more to WGA than preparing an external financial report once a year: they also provide an opportunity for the government to replace its current non-standard hybrid system of resource accounting with modern financial reporting processes.

The government has set out best practice in financial reporting, accounting and management in its official guidance on good corporate governance. This requires listed companies to present a fair, balanced and understandable assessment of their position and prospects, based on strong financial systems – systems that include comprehensive internal monthly financial reports at all levels, and clear line of sight on the financial consequences of decisions.

Strong public governance requires firm financial foundations. It is time for the government to adopt best practice and embed WGA into those foundations.