FI/01/3/A

The Scottish Parliament

FINANCE COMMITTEE

AGENDA

3rd Meeting, 2001 (Session 1)

Tuesday 6 February 2001

The Committee will meet at 10.00 am in Committee Room 2 to consider the following agenda items:

1. **Committee Business:** The Committee will consider whether to take agenda items 2 and 6 in private.

2. **Inquiry Into Resource Accounting and Budgeting:** The Committee will consider how it wishes to handle agenda item 3.

3. **Inquiry Into Resource Accounting and Budgeting:** The Committee will take evidence from—

   Trevor Jones, Head of Scottish Executive Health Department and Chief Executive of the NHS in Scotland

   Ian Russell, Deputy Chief Executive, Scottish Power

   John Sizer, Chief Executive, Scottish Funding Councils for Further and Higher Education.

4. **Housing (Scotland) Bill:** The Committee will consider the provisions of the Bill which introduce new or increase existing expenditure charged on or payable out of the Scottish Consolidated Fund (under Standing Orders Rule 9.12).

Not before 11.30 am

5. **The Budget (Scotland) Act 2000 (Amendment) (No. 2) Order 2001 (Draft):** The Committee will debate Motion S1M-1600 in the name of Angus MacKay to approve the draft order.

6. **Increasing the Effectiveness of Committees :** The Committee will consider the Conveners' Liaison Group paper "Increasing the effectiveness of committees".

Callum Thomson
Clerk to the Committee

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The papers for this meeting are:

Agenda Item 2

Paper from Professor Irvine Lapsley	PRIVATE PAPER *to follow*

Agenda Item 3

Paper by Ian Russell	FI/01/3/1
Paper by John Sizer	FI/01/3/2

Agenda Item 4

Housing (Scotland) Bill	FI/01/3/3
Explanatory Notes	FI/01/3/4
Policy Memorandum	FI/01/3/5

Agenda Item 5

The Budget (Scotland) Act 2000 (Amendment) (No. 2) Order 2001	FI/01/3/6
Scotland's Budget Documents – Scotland's Spring Budget Revisions	FI/01/3/7

Agenda Item 6

Conveners' Group Liaison paper: Increasing the Effectiveness of Committees.	PRIVATE PAPER

**EVIDENCE SUBMITTED BY SCOTTISHPOWER TO
THE SCOTTISH PARLIAMENT FINANCE COMMITTEE
ON 6 FEBRUARY 2001**

SUBJECT : RESOURCE ACCOUNTING AND BUDGETING

Use of management information at ScottishPower

Thank you for asking ScottishPower to submit evidence in connection with the Committee's review of resource accounting and budgeting. We would like to deal with our observations in three sections:

- **What** are the most appropriate measures of business performance and how does ScottishPower identify these?

- **Who** reviews management information at ScottishPower and **when** does this happen?

- **How** ScottishPower have improved the quality of our management information systems over the past few years?

Starting with what management information, in our experience an effective management information system involves the identification of data that can be turned into relevant and timely information to support decision making, understanding of business performance and an early warning system for both opportunities and risks – done properly this is likely to be small proportion of the total data within the organisation, very much a case of 'less is more'.

At ScottishPower deciding what data is relevant starts with the business plan which is an annual process of reviewing and confirming our company strategy. The business plan sets out our vision for our organisation by identifying the primary objectives and allocation of resources over the period of the plan to meet the requirements of shareholders, customers and our people.

The objectives and targets for the first year of our plan are then embedded within an annual budget prepared by our businesses, reviewed and agreed with Corporate and ultimately approved by the Board.

The budget process helps us to identify key performance indicators for our businesses. These KPI's are monitored by management on a timely basis throughout the year including, for example:

- Financial measures such as revenue, costs, profit and cash flow.

- Operational measures such as customer numbers, power station efficiency, guaranteed standards.

- People measures such as manpower, salaries, overtime and absenteeism; and finally,

- Measures of shareholder value such as share price movements and earnings per share.

This process of converting business plan objectives into appropriate measures to review performance against targets, and cascading this through the different levels of our organisation enables us create a bridge between the strategic plan and day to day operational performance.

Moving on to our monitoring processes, at ScottishPower we have a fairly well defined Performance Framework, including a timetable set annually in advance which enables the regular review of key measures of performance against budget through monthly management accounts, quarterly forecasts of the year end results and other operational reports.

This review process makes the most appropriate use of the different layers of management, including an Executive Management Committee consisting of executive directors and Business Boards for each of our businesses which sit below our main Board. The EMC meets on a fortnightly basis, Business Boards monthly and the main Board eight times a year.

The management information reviewed by Business Boards is more operational in nature than that which reaches the EMC which in turn is used as a filter to ensure that the Board receives the right information at the right time to support strategic decisions, comply with best practice Corporate Governance and to confirm, where necessary, any management action being taken to pursue business opportunities or bring performance back into line with targets.

At operational business levels some management information can be reviewed on a daily or weekly basis. For example, in our Energy Supply business which is responsible for consumer sales, marketing and customer services, billing and cash receipts would be reviewed on a daily basis whereas it is our standard practice to prepare reports on sales and lost customers weekly.

Fundamental to our Performance Framework is therefore the timeliness of the management information review process; daily, weekly, monthly, historical or forward looking. As a consequence a lot of time is spent before the start of the next financial year on preparing and agreeing the annual calendar or schedule which underpins the Performance Framework.

Over the past few years ScottishPower has been continually re-evaluating and changing the management information that goes to the Business Boards, EMC and main Board. This process tends to co-incide with the preparation of business plans and budgets and has led to the following developments:

- Clarification of management accountabilities and delegated authorities ensuring that these are clearly matched with responsibility for delivery of business performance.

- More emphasis on non-financial measures of performance with a focus on identifying key value drivers, the causes of improved business performances more than the effects.

- The growth of our forecasting process as a key activity and the concentration on forward looking projections and actions to deliver rather than historical data of what has happened in the past.

- The use of a risk management process, including risk and control frameworks and integration of external and internal audit activity to ensure early identification of new risks and appropriate measures to monitor management thereof.

- Improved IT systems so that the process of collating, consolidating and presenting management information is automated wherever possible.

- In addition, the presentation of our management reports his been regularly adjusted to include more use of graphics, ratios and colour to convey messages quickly and clearly - more user friendly than pages of numbers. Throughout our organisation we present management reports using a traffic light system which at a glance highlights indicators which are above or below target performance.

A consequence of all of this activity is that the Board now looks at much less management information than previously, but what it sees is significantly more relevant and timely to support decisions and review performance. There is also confidence that we have an effective monitoring and assurance process underneath this which ensures that what the Board looks at is supported by a robust performance framework and a risk management process which helps us avoid late surprises and unexpected variances within our results.

So to summarise, our experience at ScottishPower is that an effective management information system requires:

- Information not data – in our experience less can be more.

- Alignment between the strategic plan and day to day KPI’s.

- A mixture of financial and non-financial measures.

- Timetabling which supports the Performance Framework.

- Risk management processes which ensure the continued relevance of the chosen measures of performance.

- User friendly reports to convey messages and decisions required more clearly.

We hope you have found this overview helpful to developing the use of management information within the Scottish Executive and we would be happy to take any questions you may have.

Ian M Russell
29.1.01

SCOTTISH FUNDING COUNCILS FOR FURTHER AND HIGHER EDUCATION

Evidence to the Scottish Parliament Finance Committee Inquiry into Resource Accounting and Budgeting

Professor John Sizer CBE
Chief Executive

1. Introduction

I have been invited to give my general views on:

(i) Resource Accounting and Budgeting;

(ii) the ways in which capital accounting should or could assist managers; and

(iii) how the move to RAB and 'whole of government accounts' will affect the Funding Councils.

I do so in a personal capacity from the perspective of a NDPB chief executive but also from my background in management accounting. I agreed with Professor Lapsley I would provide a short paper to inform discussion.

I am assuming that the Committee has a broad understanding of RAB and is familiar with the recommendations on RAB in the Financial Issues Advisory Group Report (Section 4 Accounting Arrangements and Annex F Resource Accounting and Budgeting). FIAG, of which I was a member, observed 'the key issue is the opportunity to change management behaviour' (para 4.9). I will explore further this observation.

2. Resource Accounting and Budgeting

RAB, or more logically RBA, should be seen as two elements of a Resource Management and Accounting System (RMAS) to ensure economic, efficient and effective management of public funds. In Figure 1 I have summarised the elements of RMAS including resource budgeting and resource accounting. It illustrates:

(i) the relationship between planning, decision making, responsibility and programme budgeting, control and performance measurement;

(ii) the relationship between financial information and quantitative and qualitative performance measures and measurement;

(iii) the need for relevant financial information for planning, decision making, both short term and investment decisions, and for control; and

(iv) why RAB are two key elements of the RMAS because RAB focuses on resources to be utilised and resources that have been utilised rather than solely on cash to be spent and cash that has been spent.

When FIAG observed that RAB provided the opportunity to change management behaviour I believe it was conscious that RAB has to be considered in the context of Figure 1. This change will not occur unless managers fully understand the nature of RMAS and it is recognised that the behavioural aspects of the system are as important as the technical and system aspects.

3. Ways in which Capital Accounting should or could assist managers

The Committee will recognise that the capital accounting aspects of RAB, both depreciation charges and interest charges, raise some difficult and complex issues, particularly for departments and NDPBs with capital intensive programmes. The information flowing from Capital Accounting should be valuable to managers provided they fully understand its nature and limitations, and the purposes for which it is relevant. If this is not the case, there is a danger that it may confuse managers and lead to incorrect decisions resulting in resources being allocated or applied sub-optimally, particularly if there is a failure to fully understand relevant decision cost concepts, ie incremental costs and revenues, opportunity costs, and sunk costs. Furthermore, in the same context, it is important that managers understand the implications of apportioning common costs to programmes and the purpose these apportioned costs can be used for.

3.1 Tangible fixed assets

Briefly, a tangible fixed asset is an asset that has a physical substance and is held for use on a continuing basis in a department's activities. It is a resource that is consumed for a period in excess of one year and all expenditure on the acquisitions or creation of fixed assets is capitalised on an accrual basis. Subsequent expenditure to ensure that a tangible fixed asset maintain its previously assessed standard of performance is charged to the annual operating cost statement, as it is revenue expenditure.

The HM Treasury Resource Accounting Manual requires tangible fixed assets to be valued at the lower of replacement cost and recoverable amount. Depreciation should be provided for all fixed assets by allocating the cost (or relevant amount) less residual value of the assets as fairly as possible to the periods expected to benefit from their use (ie being the resource consumed or to be consumed during the accounting period).

It will be recognised that there is for many fixed assets, such as buildings, roads, plant and equipment and other infrastructure, an important relationship between the level of revenue expenditure on preventive and corrective maintenance and the productive life and capacity of fixed assets. *Therefore,* *depreciation charges for the consumption of resources and maintenance expenditure are intimately inter-related.*

It will also be recognised that attempts to calculate replacement cost can run into problems of changing technology, which may render an existing fixed asset technologically obsolete or significantly reduce its productive life. A replacement asset based on a modern design or technology may have different costs, capacity and efficiency; technological developments are resulting in new equipment with lower capital and running costs, increased capacity and greater efficiency. Indices and insurance values are widely used to determine replacement cost, indices and insurance values may not fully reflect design and technological developments. I have always preferred the term assumed current cost. Frequently, from a RAB perspective what is being measured is the charge at current price for the original resource that will be, or has been, consumed during a period not the charge that would arise if the asset was replaced. The assumed current cost is not usually the same as the replacement cost because the fixed asset would not be replaced with the same fixed asset; nor is it the relevant cost for replacement, sale and lease back, leasing or disposal decisions. The present value of incremental cash flows is required for such decisions. **So RAB depreciation charges, as observed in the FIAG Report, are appropriate for the provision of information on the total cost of operations so that actual or planned costs can be related to planned and programme outputs and outcomes.** They are relevant to decisions concerning the alternative uses of fixed assets; as FIAG said, as well as for information on the fixed and current assets at the disposal of managers. However, it could be argued that if the fixed assets have no alternative use, the original cost is sunk, and the opportunity cost is zero or the disposal cost. Hence the need to be careful about understanding the nature of depreciation charges.

It is also important to differentiate between the measurement of a manager's performance, the evaluation of the effectiveness of a past investment in fixed assets, and decisions about the future of that investment. A manager's performance can only be measured in relation to the assets under his/her control and a manager may not have been party to decisions on past investments in fixed assets that give rise to current costs. He/she may have limited control over whether these inherited fixed assets should be divested. On the other hand the appropriate senior management should regularly assess whether an asset should be disposed of, and whether it should be replaced, as part of a system of Life Cycle Management of Physical Assets. **Life cycle costing information, including costs of preventive and corrective maintenance, is relevant to such decisions not replacement cost depreciation charges.**

To summarise, provided managers recognised that it is difficult to produce accurate assessments of the current values of fixed assets and the depreciation charges reflecting the cost of consuming the resource utilised, or to be utilised, during an accounting period, RAB accounts are superior to cash accounting in providing relevant financial information for resource allocation decisions and for reporting on the relationship between resources consumed and outputs, outcomes, benefits and impacts. However, unless managers fully understand relevant decision cost concepts, there is a danger they will misuse RAB fixed asset values and depreciation charges to inform investment decisions and life cycle asset management decisions. They may also challenge the validity of the basis of determining depreciation charges, particularly if they are also charged for the cost of capital.

3.2 Charging for the cost of capital

The Treasury Resource Accounting Manual states that the cost of capital charge will apply to all assets and liabilities in the balance sheet. The charge for each item in the balance sheet is calculated as a percentage of the average net book value of that item over the year. Hence the capital charge is intimately related to the basis of determining the replacement cost of fixed assets. The manual also states the cost of capital charges at the government's standard rate ensure an appropriate 'return on taxpayers' equity'. I find this a difficult concept in that equity capital implies risk capital and an appropriate return cannot be considered in isolation of the risk arising from the nature of the assets and the use to be made of them. Therefore, a standard rate does not seem appropriate. It also implies that taxpayer's equity is the sole source of government financing. Furthermore, the standard rate is not a measure of the opportunity cost of alternative uses of taxpayers' equity (funds). Taxpayers' equity also implies the taxpayer can realise his investment!

The concept has some parallels with the residual income concept used for divisional profit performance measurement in the private sector. Managers are encouraged to invest in assets which will generate a return greater than the interest charge and thus contribute to residual income. However, it is not normal for parent companies to require subsidiaries to pay the capital charge. In this sense it is appropriate for managers to include the interest charge in information on planned and actual cost of programmes so that costs can be related to planned and actual programme outputs and outcomes. This will be important when considering evaluating alternative resource configurations of current and fixed assets and revenue expenditures to deliver a programme.

However, in many instances the charge will be a function of the method of determining the replacement value of fixed assets. Whilst the use of indices for determining the replacement cost of fixed assets may be adequate for external reporting to the Parliament and the public, managers may argue they are not sufficiently robust when assessing the resources required for their programmes and their performance in managing those programmes. Accounting values and charges based on original cost have an appearance of reality to operating managers. The danger is that as moves are made away from depreciation charges and cost of capital based on the original cost of assets, a system may develop that seems to responsible managers to be a 'game of playing at numbers'. Hence the importance of managements:

(i) understanding the limitations of historical cost accruals accounting;

(ii) recognising the nature and limitations of capital charges for depreciation and cost of capital in resource accounts based on replacement costs of fixed assets;

(iii) understanding the purposes to which the RAB information can and cannot be used; and

(iv) understanding and addressing the behavioural and management development implications of RAB.

4. Effect on the Funding Councils

The move to RAB and 'whole of government' accounts has had limited impact on the Funding Councils. Since the establishment of the SHEFC in 1992 the Council has operated an integrated accruals accounting and cash management system. The Funding Councils annual financial statements have been prepared and reported on an accruals accounting basis since their establishment. They have an integrated system of planning, budgeting and reporting similar to that summarised in Figure 1, which cascades down through a responsibility accounting system and reports upwards through to the joint committee of the two Councils to the Councils. The Councils' systems are described in the evidence given to the Enterprise and Lifelong Learning Committee Inquiry into the Governance of the Scottish Qualifications Authority[1].

Although the Councils jointly are responsible for the effective management of approximately £1 billion of the Scottish Parliament's funds, the Councils are not capital intensive as illustrated in Table 1. Therefore Capital Charges for Depreciation and Interest Charges for Cost of Capital are not significant; that is not to say that there is not an appropriate focus on managing cash, fixed assets, and current assets and liabilities.

5. Summary

I have written this short paper as a basis for discussion and from a managerial perspective. I have no doubt that the replacement of Cash Accounting with RAB is essential and that in the longer term the benefits will outweigh the limitations that I have identified. However, I have emphasised the importance of it not simply been seen as a budgeting and accounting system but as an integral part of a system of Resource Management and Accountability. If it is not seen in this wider context, if the behavioural and management development aspects are not recognised, then there is a danger that it will be seen as 'something the accountants do' and 'the opportunity to change management behaviour' and culture may not be realised. To misquote Peter Drucker, without effective communication all the RAB revolution will produce is data not information. Furthermore, failure to understand the

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[1] Enterprise and Lifelong Learning Committee 6th Report, 2000, Report on the Inquiry into the Governance of the Scottish Qualifications Authority, pp 213-217 and 220-245

underlying assumptions and methodology, the nature of the financial information RAB generates, and the uses to which that information can and cannot be used, could lead to misuses rather than more effective uses of public funds.

January 2001

FI/01/3/2
Figure 1

RESOURCE MANAGEMENT AND ACCOUNTABILITY SYSTEM

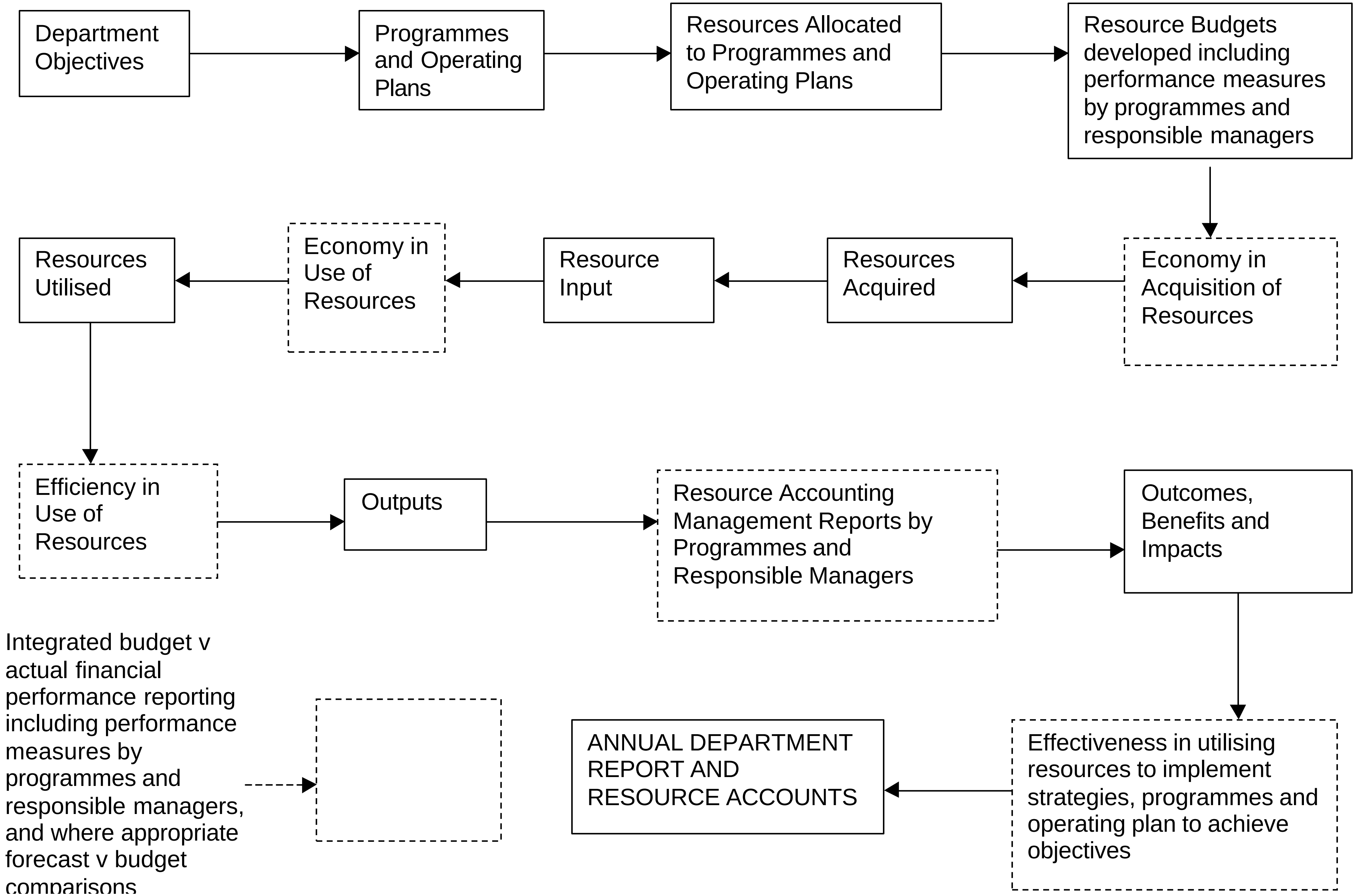

TABLE 1

SCOTTISH FUNDING COUNCILS FOR FURTHER AND HIGHER EDUCATION

SUMMARISED FINANCIAL INFORMATION

	SHEFC y/e 31/3/2000 £000	SFEFC 15 mths ended 31/3/2000 £000
Grant in Aid for:		
Distribution to Institutions	599,157	222,956
Council Running Costs	2,378	2,351
Total	£601,535	£225,307
Balance Sheet @ 31/3/2000		
Fixed Assets	382	493
Current Assets	8,951	7,117
	9,333	7,610
Current Liabilities	1,036	51
Net Assets	£8,297	£7,559
Cash included in Current Assets	£8,192	£2,168
Capital Charges		
Depreciation	156	89
% of Council Running Costs	(6.6%)	(3.8%)
Notional Interest Payable on Net Assets excluding Cash	25	162
Total	181	251
% of Council Running Costs + Notional Interest Payable	7.5%	10%
% of Total Grant in Aid + Notional Interest Payable	0.03%	0.11%