FINANCE COMMITTEE

Tuesday 13 February 2001
(*Morning*)

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FINANCE COMMITTEE
4th Meeting 2001, Session 1

CONVENER

*Mike Watson (Glasgow Cathcart) (Lab)

DEPUTY CONVENER

*Elaine Thomson (Aberdeen North) (Lab)

COMMITTEE MEMBERS

*Mr David Davidson (North-East Scotland) (Con)
*Donald Gorrie (Central Scotland) (LD)
*Mr Adam Ingram (South of Scotland) (SNP)
Dr Richard Simpson (Ochil) (Lab)
*Andrew Wilson (Central Scotland) (SNP)

*attended

WITNESSES

Hugh Hall (Chartered Institute of Public Finance and Accountancy Scotland)
Grant Macrae (KPMG)
Dr Jean Shaoul (University of Manchester)
Leslie Wilson (Historic Scotland)

CLERK TO THE COMMITTEE

Callum Thomson

SENIOR ASSISTANT CLERK

Anne Peat

ASSISTANT CLERK

Gerald McInally

LOCATION

Committee Room 1

Scottish Parliament

Finance Committee

Tuesday 13 February 2001

(*Morning*)

[THE CONVENER *opened the meeting at 10:14*]

The Convener (Mike Watson): I call this meeting of the Finance Committee to order. I apologise for the slight delay—I had to deal with an urgent telephone call.

We have apologies from Dr Richard Simpson.

I remind members, guests, advisers and everyone else that pagers and mobile phones must be switched to silent mode.

I ask the committee to agree to take agenda items 2 and 5 in private.

Members *indicated agreement*.

The Convener: We move on to agenda item 2.

10:15

Meeting continued in private.

10:45

Meeting continued in public.

Resource Accounting and Budgeting

The Convener: We return to public session for item 3. I am pleased to welcome Hugh Hall, the chairman of the Chartered Institute of Public Finance and Accountancy Scotland. I also welcome Dr Jean Shaoul from the school of accounting and finance of the University of Manchester. This is her second attempt at attending a meeting of the Finance Committee—she made an abortive attempt to join us last month.

We have received papers from both witnesses, for which we thank them. I will ask them to make opening statements, following which we will ask questions.

Hugh Hall (Chartered Institute of Public Finance and Accountancy Scotland): I am grateful for the opportunity to speak to the committee. As the convener said, I am chairman of CIPFA Scotland, but my day job—my paid job—is director of strategy, performance and regulation at Scottish Homes, one of Scotland's larger non-departmental public bodies. Although the paper that I have submitted focuses on generalities, I will be happy to deal with housing matters as well, should members find that helpful.

I do not intend to give a lengthy introduction and am quite happy to move quickly into questions. Members will gather from my paper that we positively welcome the developments that resource accounting and budgeting will bring, such as improved stewardship and accountability, improved decision making—both short and long term—and a greater focus on consumption and value, rather than on cash spend. Those are positive developments in government accounting.

The issues that must be dealt with lie in the practical implementation of resource accounting and budgeting. In my paper, I spend a little time discussing some of those issues. If resource accounting and budgeting is done properly, how we do business as public bodies will benefit. I will say no more at the moment.

Dr Jean Shaoul (University of Manchester): Good morning. Thank you for inviting me—I hope that I am able to help you.

At the University of Manchester, I carry out financial analysis of business and public policy and I have examined the privatisation of the utilities, privatisation in the NHS and, more recently, private finance initiatives and public-private partnerships. I have done work on London Underground and on the partial privatisation of air traffic control services. More locally, I have done work on Edinburgh royal infirmary.

It is apparent from my paper that I have great reservations about resource accounting. I am concerned that the private sector financial reporting techniques that are being applied are totally inappropriate. Financial reporting has developed over the centuries to allow people to report on the generation, realisation and distribution of profit to shareholders. That is not why we have a variety of activities in the public sector and it is not clear to me why resource accounting should have much relevance to the public sector. From the perspective of internal decision making, I am concerned because of the perverse outcomes that may arise in service provision.

We must examine capital charging resource accounting, which raises longer-term, wider external implications for the other public policy measures—outsourcing, leasing, PFI and PPP—that are being introduced. We will have little effective control over, or ability to scrutinise, public expenditure. Finally, I draw your attention to the fact that more than 50 per cent of public expenditure is external. That will rise sharply and, as we move down that route, there will be very little effective scrutiny. Resource accounting encourages that.

Elaine Thomson (Aberdeen North) (Lab): Mr Hall, in your paper you welcome the introduction of resource accounting and budgeting but say that the difficulties are in implementation. That fits in with what other witnesses have said. On a number of occasions the committee has discussed how financial reporting that is related to outcomes can be developed, how that reporting can be related to the stage when budgets are put together, and how things can be more accurately measured so that we proceed clearly towards stated policy objectives with financial reporting that reflects that. Do you think that the difficulties in doing that are fundamental or only part of the transition to implementing RAB?

Hugh Hall: The issues are fundamental. The first is about measuring outcomes in relation to aim; the second is technical. In my paper, I argue for going back to first principles. A non-departmental public body is given a range of responsibilities—Scottish Homes must deliver certain things on behalf of the Executive. We should be able to put together a budget that tells us what sorts of resources we require to achieve those outcomes. We should then construct the technicalities around that—the mechanics should come later. I have some sympathy with what Jean Shaoul is saying about RAB because sometimes you get the feeling that the mechanics of it are driving the agenda. That is why I emphasised going back to first principles—asking what we are trying to do and what resources we need.

We must focus on the asset base required and the recurrent resources needed over the longer term. If we are to be successful we must take a longer-term perspective and not think just about next year's budget. Annuality has been the bane of public sector accountants' lives for many years because it is artificial. We are in a long-term business. In housing we are talking about buildings that will—we hope—last for 50 or 60 years, so we must look at resources in that light. For example, there is lending on the back of housing stock, so a business-like approach must be taken—it is not sufficient to look at things on an annual basis.

Outcomes allow you to focus on resources and make proper decisions in the short and the long term. The measurement aspects are a challenge, particularly when there are impositions from above. People seem to believe that we are talking about funny money, that it is not real, so their behaviour changes accordingly and they do not want to play the game. If we can budget in a grown-up way, a way that people can relate to, and not get too bogged down in the technicalities, we can then let decision making, rather than technicalities, be the driver.

The Convener: The committee has questioned how easy it will be to ensure that those involved in RAB are properly trained and able to carry it out. Mr Hall, in your paper you say that if RAB is to be universally accepted, it must

"stand up to reality checks—in terms of its credibility".

You then refer to "stakeholder buy-in". Is that in the managerial sense, in that those directly involved are seen as stakeholders? You look surprised, Mr Hall. If that is not what you mean, what does "stakeholder buy-in" mean?

Hugh Hall: I think the stakeholders extend beyond the managerial team and include the public in general.

The Convener: So in the case of Scottish Homes that would extend to a tenant?

Hugh Hall: Absolutely. A stakeholder is anyone who has an interest in the business. Therefore, information must be meaningful at different levels. Some of the difficulties come in tailoring information to audience. The information that MSPs—or the committee—require for making decisions at the macro level will be different from the information that a tenant wants on what investment is going into the property where they live and what that will mean for rent levels. It is about trying to get the right balance between providing meaningful information to stakeholders and getting bogged down in bureaucracy.

I was very taken with what Ian Russell told the committee last week about how less is more. I agree: qualified accountants should do a lot of the analytical and interpretative work behind the scenes. MSPs or individuals are not interested in that work, but in what the information means.

The Convener: Is there serious stakeholder involvement in RAB at the moment? Are the credibility checks in place?

Hugh Hall: No—not remotely.

The Convener: Not even at manager level?

Hugh Hall: Not even at manager level. It may be disenchantment or disengagement, but whether it is intentional or otherwise, I do not think that people relate the number crunching to what they are trying to achieve. In the various sectors I have been involved in, people are more interested in what they are delivering, in the resources they can get in real time for what they have to achieve. They are not thinking ahead to what something means for the consumption of a particular asset or what will be done about a replacement.

People tend to think of immediate requirements rather than take a longer-term perspective. That is why the move to a more outcomes-based starting point is helpful: outcomes tend to be driven by medium to longer-term considerations rather than the more immediate. We do not have that at present—and RAB and its technicalities is a complete turn-off; it is not something that people relate to easily.

The Convener: We are finding that in this committee.

Hugh Hall: I find that when I am in meetings with senior civil servants or senior officials of Scottish Homes, there are two kinds of response to the technicalities. One is cynicism and disengagement; the other is the emperor's new clothes approach—people kid on that they know what RAB is about when in fact their level of knowledge is fairly superficial. That is why I argue for awareness; we must make RAB sexy, something that people will engage with and relate to what they are trying to achieve. That is the trick—whoever can do that wins a watch.

Andrew Wilson (Central Scotland) (SNP): That is a good way to put it. Part of the reason for the inquiry is to get our heads round what has been going on. Finding out precisely what RAB means is not easy. Take the social rented housing sector, in which you are involved, for example. If a project to procure 1,000 houses in a housing association borrows from the private sector, capital charging is implicit in the repayments to pay off the interest on the borrowing and the capital. There is the loan and the charge on it is essentially the interest charged by the bank. That is straightforward and, as you say, it focuses on outcomes and allows us to see what we are getting for the capital charge.

I understand—please correct me if I am wrong—that if the cost of building the same group of houses was borrowed from the public sector, a value would be calculated to which a 6 per cent capital charge over several years would apply. That would form the comparison between paying back what was borrowed and the capital charge on that borrowing. Is that, broadly speaking, what happens?

11:00

Hugh Hall: That is what happens in housing associations—it is all real money and the factor is based on real loans. We expect housing associations to make provision for future liabilities. That is done with a business-like, long-term approach, with a clear view of what that means for rental income.

Scottish Homes is still a landlord and values houses on the basis of what we call existing use—tenanted market value—which is not historic cost, but the income streams for those properties over 30 years less the costs of maintenance and capital works. That is the net value that is used in our accounts. Scottish Homes also has loans, so it does not suffer capital charges, but it pays interest, which is currently above the 6 per cent rate of capital charges. The repayment of those loans is built into our accounts.

I understand that local authorities base their valuation on the discounted market value—the right-to-buy value, less discounts. That is within the context of the housing revenue account, which does not suffer capital charges because the loan charges that it incurs exceed capital charges.

Andrew Wilson: So local authorities are unaffected by RAB?

Hugh Hall: Yes.

Andrew Wilson: I get confused. For example, if a market value is based on what can be achieved in rent, that market value is affected by the fact that the social rented sector, which has borrowed from the private sector, includes in its rent a capital repayment at private borrowing rates. That obviously affects the market value of public sector housing too. Essentially, if the market value rather than the cost of replacement is used, the cost of capital is double counted.

We had the same thing with the water authorities. If value is calculated on the basis of the market income stream, that market income stream will be influenced by the fact that people in the social rented sector pay rents that already repay capital. Do you see what I am getting at?

Hugh Hall: No.

Andrew Wilson: If that valuation is used in the public sector, it is affected by the market out there for rents that are affected by private money. I am struggling to understand why, under any circumstances, one would calculate RAB capital costs using anything other than the cost of replacing the capital. Why would one calculate those costs on the basis of income stream? That might not be so relevant to housing, but it is certainly important in the water industry.

Hugh Hall: Grant Macrae is going to speak to you about water in a moment and he will be able to give you chapter and verse on that. From a housing point of view, my understanding is that there is no double counting. The capital charge is, de facto, the loan charge.

Andrew Wilson: Your point is that no one in housing is affected by RAB because they are already paying loan charges.

Hugh Hall: That is the case.

Andrew Wilson: Why is that not done generally? It seems perfectly logical.

Hugh Hall: Scottish Homes and local government have some control over loans. We are talking about real money. I am not sure whether we can draw a parallel between those organisations and other public sector organisations, such as hospitals and schools.

One of the points that I made in the paper is the extent to which we want to empower people and to cascade decision making. If we cascade decision making and the power to raise loans down to different parts of the public sector, it is reasonable to expect that the same sort of system that operates in the housing environment will result. If we retain control of lending and borrowing and so on at the top level, it is not possible to draw parallels with housing.

Andrew Wilson: That is useful.

Why is the interest greater than 6 per cent? Are you saying that loans were taken out at interest rates of more than 6 per cent in the past?

Hugh Hall: Yes. Our loans at Scottish Homes go back a number of years. Some of them are at higher rates than others.

The Convener: It may be difficult to relate the two substantially different approaches that you are taking, but in your paper, Dr Shaoul, you said that the question of capital charging and so on

"challenges the myth of public sector management inefficiency."

When you talked about an increase in the extent to which public expenditure is external, you said that there was very little effective scrutiny of that external public expenditure. Does not that make it more appropriate that resource accounting and budgeting is introduced? I understand what you say about the difference between the private and the public sectors, and about the public sector not being profit-driven, but can you explain why you feel that, despite the fact that so much public expenditure is external, it is still inappropriate for RAB to be applied?

Dr Shaoul: In many outsourcing and leasing agreements—the ones that come to mind are the big information technology projects—the public sector will make annual payments for a number of years. Those payments are supposed to be linked to performance. It is not entirely clear how one can measure performance in any realistic way and, furthermore, tie that to the payment mechanism. In many cases, it turns out that the risk that was thought to have been transferred when contracts went badly wrong has not been transferred. The public sector—or the public at large—pays the cost. For many reasons, it is not possible to terminate the contracts. That in turn means that there is no ultimate sanction of terminating a contract for legal reasons—because the contract was not good enough—or for practical reasons, such as in the case of Lambeth Council, which members may not be familiar with.

Throughout the country, councils outsource their housing benefits payment mechanisms. All the big contractors—all well known companies—had trouble with that. That had a knock-on effect on the public sector, which did not receive the rent for the landlords and other related services. The landlords said, "We'll take no more homeless tenants until you pay up—you are in arrears. You can put them out to bed and breakfast." That in turn created further expenditure; that was one aspect of what happened in Hackney. Although Lambeth Council had a watertight legal contract, it could not terminate it because the Capita Group was also managing some of the council's other contracts.

To get back to the point, if contracts cannot be terminated, there are no sanctions to enforce proper standards of performance. To all intents and purposes, there is an open-ended commitment to pay out public money, over which there is, effectively, no control. In other words, that is a licence to keep putting more and more public money into things that do not work. I am extremely concerned about that. RAB accounting will encourage that, as other witnesses have said. It is designed to encourage a move towards leasing-type agreements.

The Convener: We will come back to some of those points. Does any member wish to come back on that last point?

Andrew Wilson: I can understand how you can construct the argument that RAB is designed to produce dependence on outsourcing for capital provision or services. Can you run us through that? Why is RAB designed to push capital provision off the balance sheet?

Dr Shaoul: It is designed to enable that to happen, but that is why it is important to look at capital charging not on its own, but in the context of wider public policy, one policy of which is effectively to say to councils and other public agencies that PFI is the only game in town, deny them access to normal public procurement, and encourage public agencies down the outsourcing route. The significance of resource accounting is that, because there must be a charge for capital, that creates an income stream—or an expenditure stream—that can be diverted to leasing or outsourcing. In that sense, it does not matter.

Andrew Wilson: There is a sum of money within the budget that is to be allocated for capital payments, but that assumes that the cost of procuring the capital assets is cheaper in the private sector than it is in the public sector.

Dr Shaoul: That is the assumption, but the reality is somewhat different. The higher cost of capital, profit margins that must be met and enormously expensive transaction costs, such as fees for lawyers and accountants, make it expensive.

Andrew Wilson: You do not need to sell me on that argument. My point is that your argument that RAB provides an incentive for people to use PFIs implies that the 6 per cent return on the value of assets is higher than would be achieved as a cost of capital for the same assets and returns in the private sector. If the 6 per cent were cheaper, would not you stay in the public sector?

Dr Shaoul: If there is no public provision for capital, RAB encourages people to go down that route.

Andrew Wilson: The money is in the budget and it is allocated as a capital charge. For example, the figure is £1 billion in the Scottish budget. Your argument is that £1 billion is buying roughly 6 per cent of capital assets in the public sector, so there is an incentive for that to be used to go private.

Dr Shaoul: Yes.

Andrew Wilson: We need to be convinced that that is the case—I cannot see how that is the case if 6 per cent is cheaper than what is available in the private sector.

Dr Shaoul: The 6 per cent return—as we know from the PFI hospitals—is in practice lower relative to the level of resources that one would get. In the example of the new Edinburgh hospital, more would be paid in capital elements of the PFI charge for a 20 per cent smaller hospital than would be paid for at the current hospital. I keep coming back to the fact that in reality, you will pay more for less.

Donald Gorrie (Central Scotland) (LD): I wish to query a couple of the points that Dr Shaoul raised. On page 5, paragraph 4, you say that contrary to public opinion, the figures show that hospitals use their assets better than Marks and Spencer plc, the Forte Hotel Group and BUPA. Why is it the case that the world at large thinks that the health service is not well run, but that those organisations—until recently, in the case of Marks and Sparks—are well run? You said that the figures are different, but can you explain why there is apparently superior management in the national health service?

Dr Shaoul: I said that the asset utilisation figures show the superiority of the public sector; such figures are conventionally taken to show capital efficiency. Why do I think that the public sector is more efficient in its use of assets? I am not sure whether it is efficient. I suggest that it is more economical, but it has, effectively, been capital-starved for at least 25 years.

To be frank, most schools and universities are a bit grotty—there are no fancy BMWs in the car park, so to speak. The effect of capital rationing is that the assets have been sweated. That is the difference.

11:15

Donald Gorrie: I am not quite sure whether I understood correctly the first full paragraph at the top of page 6 of your submission. Are you suggesting that the system penalises smaller hospitals? Could you run through that idea?

Dr Shaoul: It appears that the hospitals that have the most difficulty are those that have incomes that are lower relative to their capital base. By and large, smaller hospitals—such as a tertiary cancer hospital—specialise, but they may have a lot of expensive equipment. Hospitals such as those in the south-west or in Cumbria serve geographic areas that have relatively small and dispersed populations. That makes it difficult for those hospitals to break even.

Donald Gorrie: In your view, would resource accounting make those difficulties greater or smaller for the public sector?

Dr Shaoul: The effect of capital charging on hospitals is an example of how resource accounting would work. As Hugh Hall indicated, it is important to recognise the enormous diversity in the public sector, which provides statutory services that are not provided for profit by the private sector—that is why they are public sector services. It does not seem to me that resource accounting is a relevant way in which to record expenditure and I expect that it will have other, perverse implications and effects in other parts of the public sector that I have not examined, or of which I have no knowledge. I cannot predict those effects, but I can imagine them.

Donald Gorrie: We usually get things wrong, so we will also get this wrong: is that your argument?

Dr Shaoul: Those are your words.

Mr David Davidson (North-East Scotland) (Con): Part of the argument that one could have about the performance and use of assets could be based on an initial evaluation of those assets. Perhaps assets in the public sector have been undervalued, rather than being valued at their replacement cost. However, we must replace assets if we are to continue to provide services. In your paper, you state that many assets were given free to the public sector. However, if they were acquired using the resources of the public—in other words, if they were in public ownership—I presume that there was a cost attached to them at some point.

Why do you envisage that the assets of many institutions—hospitals are one type, but you also mentioned universities and so on—should be recorded artificially? You seem almost to be writing them off at the beginning—thus RAB would not work well.

Dr Shaoul: If you want to make resource accounting or accounting for capital work, you would have to put a lot more money into the system. During Hugh Hall's comments, I was struck by the realisation that the discussion was about cash-strapped services.

I tried to demonstrate with the tables that are at the end of my submission, and in a back-of-an-envelope way, the extent to which I believe those services are underfunded. I also tried to demonstrate the problems with the consistent upward valuation of assets which, in turn, increases the amount of income that is required to make resource accounting work. If we go down the route of leasing and PFI, money will leak out of the system rather than being recirculated within it. Previously, it was intended that capital charging would circulate money within the health economy or whatever.

I have absolutely no idea whether assets are undervalued or overvalued. However, private sector managers of hospitals have said that they could not deliver a return to their shareholders as easily—if at all—if they were valued on their current replacement cost, as happens in the national health service. Those are practical issues with very practical implications.

Mr Davidson: Even if we left everything where it was without PFI, how would we fund replacement of assets in the public sector, when that is not free of charge?

Dr Shaoul: We would finance it the old way—with grants—and via taxation.

Mr Davidson: Mr Hall, your submission talked about the bean counters taking over RAB. I am particularly interested in the culture of decision making and how people at different levels in organisations accept RAB. If RAB has a mesmeric effect on somebody who is trying to deliver an outcome, that means that they will not use it as a tool. They will be starved of the information that they need in a form that they can use to make better decisions about whatever they have been asked to do.

How are you going to get over that problem? What should we be doing? What are the warning signs that we should be flagging up throughout the public sector? As Dr Shaoul said, health service managers regularly complain of a shortage of both capital and revenue, because the system does not recognise demand. Resources exist and people have to get a return on them, but the system does not recognise increased demand unless there is a new funding flow. There is a mess in the culture. How can we get over it?

Hugh Hall: That is why I suggest that we get back to first principles. It is basic stuff. There is relevant, meaningful information that people can relate to. We must be careful about behavioural responses. If you create a system such as RAB—which has artificiality about it—people will respond accordingly, but that is no reason for not going down that route. The concepts of accrual accounting and of recognising value, consumption and future costs are all important. We all want to know not simply what we are consuming now, but what we might have to consume in future.

If we can have a meaningful dialogue with people, we can relate that to their business and ask what resources they need to do their job effectively, what resources they might need as they move forward and when they might need to replace assets. We need to take a medium to longer-term view. Andrew Wilson mentioned the housing sector, which runs businesses effectively on a daily basis, but does so in full recognition of what the future impacts on the businesses are likely to be. Housing associations make predictions using valuations and other professional inputs, saying, for example, "Well, in year 10, we will require central heating", and make provision for that.

There are occasions when organisations cannot spend now because they do not have the wherewithal, but it is at least a starting point to recognise that, at some time, those commitments will have to be met. That basic and very simplistic approach is something that we must try to engender in the culture of the public sector. We are still bogged down in annuality and in meeting immediate targets rather than concentrating on longer-term outcomes.

Mr Davidson: How do you use RAB to deal with technology jumps that are almost unforeseen, but which come upon us very quickly, as can happen in the hospital sector?

Hugh Hall: That is very difficult, but we must ensure that depreciation policies are fit for their purpose. If you acquire kit that you believe will not have a long life, you must recognise that and build that into your considerations. Such considerations would be written off over a shorter period.

For example, some housing stock might be technically deficient in some way, and valuers might say that it has a useful life of only 10 or 20 years. That would have to be recognised, and managers would have to think about what that might mean for future investment plans. Sometimes, the houses will still be standing and fit for their purpose—places whose comfort the tenant can still enjoy after 10 years. That asset will continue to be used for a longer period than that which was originally specified by the valuers. If there is at least recognition—at the point at which a manager puts together their accounts and business plan—of the fact that there might be future commitments, that is a starting point.

The next step is to ask how provision might be made for such eventualities, which could involve investing for year 5, year 10, year 15 and so on. That is a balancing act, which is done by people from Parliament and others all the way down the line. They must make decisions on how to invest in the long term, on whether they consume and spend on a revenue basis and on whether to invest in one area rather than in another. At least they have the basic building blocks and wherewithal to make such meaningful decisions, which are informed by the information that is available.

Elaine Thomson: How fundamental a change will RAB represent for the Scottish Executive and the various public sector agencies? How far away are they from producing the information that you have been discussing, which is based on what is required and is focused on outcomes, rather than being based on inputs and so on.

Hugh Hall: You should put such questions to Peter Collings and other people in the Scottish Executive, rather than to me. I am not aware of the Executive's state of preparedness.

As I mentioned in my paper, the state of preparedness is one of the issues with regard to the technical ability that is required to implement RAB. That is less of a consideration, however, I know that a new financial system is being introduced at the Scottish Executive, and I know that it is being designed around the need to be RAB-compliant. That side of things is relatively straightforward; the technicalities of deciding which inputs should be used is another matter.

The big issue is one of culture—training, increasing levels of awareness and so on. It is interesting that the evidence that the committee has taken has tended to be from accountants, or from people with that bent. I am not sure if this is part of your plans, but you might wish to speak to some chief executives, managers and heads of division within the Scottish Executive, and ask them how prepared they feel. In my paper, I have effectively given the committee a list of questions to put to them.

The Convener: We will bear that in mind when the aforementioned Mr Collings comes before us presently.

Hugh Hall: I am thinking not so much about Peter Collings, but more about some of the people who are not immersed in RAB. That would give members the answers that they are looking for.

Dr Shaoul: I would like to explain how the system is not working in the context of the national health service, and I will give the committee one concrete example.

I went to a hospital that had been in enormous financial crisis, with monthly inspections being carried out by the National Audit Office. I approached a member of the hospital accounts staff, and said, "You seem to have resolved your crisis—you've got a big increase in your income."

"Oh," said the accountant, "that was funny money. That was basically to fix the books." I did not believe her. I checked with the NAO—in a different context—and it confirmed that that was going on. I said to someone from the NAO, "The system doesn't work," to which the response was, "Well, it's inappropriate for the health service." Several people at the NAO said the same thing.

I said, "It follows, then, that the accounts are meaningless, and that the income that the hospital says it is getting isn't real income." At that, the accountant nodded. That is the system that is being introduced.

The Convener: Are you aware of whether the system that you have just described is used anywhere else in the public sector—outwith the health service?

Dr Shaoul: I cannot speak with authority about other organisations, but from the perspective of public accountability, I find that kind of practice quite bizarre and perverse.

The Convener: That is an interesting point—we will have to come back to that at some stage.

Mr Adam Ingram (South of Scotland) (SNP): Surely the acid test of RAB is to consider the outcomes where the system has been applied. In the national health service, RAB was introduced as part of the internal market reforms and that was the forerunner for its introduction to the remaining public services. You are arguing forcibly, Dr Shaoul, that the outcomes have been perverse. We have a scenario in which the introduction of RAB means that some assets are sweated, while other equipment is not being used. NHS trusts have to account in a private sector manner and introduce car parking charges and so on. The level of service to the public is being reduced. Am I in the right vein here? Would you argue that the same kind of perverse outcomes would be likely if the system were introduced to the rest of the public sector?

11:30

Dr Shaoul: I think so. The outcomes of the past 10 years are not what the public wanted, expected or hoped for.

Mr Ingram: What are the prospects of changing the culture in the real world?

Hugh Hall: We have examples—for example, housing associations and registered social landlords—that show that the principles of RAB can work effectively. The alternative is that we stand still and stick with annuality and the cash-based system. We would therefore be bereft of meaningful and appropriate management information and there would probably be less accountability over the piece. There are many lessons to be learned from the implementation of RAB in the NHS. We should learn from the examples that Jean Shaoul and others have cited, to ensure that we design a system that is fit for its purpose and that takes the best lessons from the organisations that have implemented RAB effectively. The alternative is to slip back into annuality, and to thinking about things in terms of fiscal years, and not in terms of how to operate a business.

Mr Ingram: Is a capital charge of 6 per cent appropriate?

Hugh Hall: No.

Mr Ingram: Why is the capital charge 6 per cent?

Hugh Hall: The capital charge should reflect the actual charge. The difficulty is that there is artificiality about the capital charge. I say in my paper that in taking decisions at a macro level, for example, if 6 per cent is the level of capital charge, the accountability and responsibility should remain at that level. Decision making should be considered at that level and not pushed down the line. It is unfair to expect people at the front line to account for something that is not necessarily of their making. The organisations—the hospital trusts and so on—have had something artificial imposed upon them.

It would be ideal if some sophistication could be introduced into the system, whereby borrowing could be related to funding the asset base much more realistically. If hospitals, schools and so on were allowed access to borrowing on an actual basis, they would be charged accordingly. However, that does not sit comfortably with how we do business in the public sector, where decisions on borrowing and so on for a number of different services are taken at the macro level and not at the business level. There is an issue there, but I urge the committee not to allow the weaknesses of the NHS system—which was introduced for particular purposes—to colour its judgement about whether to proceed with RAB, with all of its benefits of improved decision making and accountability.

Donald Gorrie: Mr Hall, I wish to ask you about your previous comments. You talked about cascading. Attractive metaphors should be forbidden in politics, because they are dangerous. Is there any chance of an effective accounting system—RAB or anything else—cascading down so that the people who are managing, for example, a sports centre or housing have a grip on the budget and opportunities to do things better, or is it possible to start from the bottom up rather than the top down and ask, "How do we get this manager to manage more effectively and get the cost set out so that he can improve things?"

Hugh Hall: It is an iterative process. It goes back to the outcomes that you are trying to achieve, and the infrastructure that best serves that purpose. It may be that there are some activities that should be managed at a national level, some at a local authority level and some at a community level. One must decide what is the best organisational structure, what sort of governance arrangements need to be in place and what sort of resource system has to accompany that. That is the way that I would address it, so to that extent, it is top down, but the drivers that kick in are bottom up. The responsibility for resource consumption, accountability and decision making is cascaded down. You empower organisations to run their businesses.

Part of the difficulty with RAB is that you attach responsibility and accountability without empowerment. You create a behavioural response that is either lack of interest or disenchantment, because you have charges imposed on you, but you do not have the power to accept or reject them or look at alternative sources of finance. It is about getting a match between the extent to which you empower and accountability and decision making.

Donald Gorrie: At the moment, all that seems to cascade down are the bizarre rules imposed by the Treasury. Lots of clever people spend their time working out ways of getting round those rules instead of operating them in a half-decent fashion. Perhaps we should get rid of the top and start at the bottom.

Hugh Hall: No, we have to create mutual understanding. Sometimes the rules are designed by accountants like myself, or people who are remote from what is happening on the ground. We need to get both sides together and have a meaningful dialogue between the people who are designing the system and those who have to operate within the system.

That has not happened much in the context of RAB, but it needs to happen. Rather than one side doing one thing and one side doing another, get the parties together and reach a mutual understanding, in which I need to understand your business as someone who delivers and you need to understand the mechanics. If we put our heads together we might get somewhere.

The Convener: I will take Andrew Wilson, and then I will change the set-up slightly. It might be worth while if we bring in Grant Macrae and Leslie Wilson, while allowing Hugh Hall and Jean Shaoul to stay here to answer further questions as issues emerge. If Mr Macrae and Mr Wilson prepare themselves to come forward, as Andrew Wilson deals with his question, we will try to change over seamlessly, although that may be beyond our means.

Andrew Wilson: Just pretend you are on the Des O'Connor show.

This morning has been extremely useful to our inquiry, because it has helped to clarify a number of matters in my head, although I do not know if colleagues feel, as I do, that it is difficult to resolve the remaining questions. I agree completely with Hugh Hall about the benefits of getting away from the annual budget process, paying for your capital assets over the long term, and looking at how you replace them and the outcomes that you are getting from them. I also agree with Jean Shaoul's comments about the potentially nonsensical aspects of creating a capital asset, applying a charge to it and passing the budget without, apparently, making changes to the budget. I remain to be convinced about RAB's effects on the system. Would it help Hugh Hall's processes, while damaging those of Jean Shaoul?

Any witnesses are free to correct me if my understanding of the position is wrong. A value has been placed against the assets of the Scottish Executive and its related departments and agencies, but we have yet to discover how that asset valuation was conducted. A 6 per cent cost will be applied to the asset valuation, and that cost will be covered by a sum of about £1 billion that the Treasury has allocated from outwith the Barnett block. We have yet to work out how that sum of money has been created. From now on, and on an annual basis, the Barnett formula will be used to allocate changes to the capital cost funding that has been introduced.

However, I do not understand how that would get us anywhere near the points that Hugh Hall made, nor do I understand how it pushes us towards some of the critical elements in PFI that Jean Shaoul mentioned. I understand the points that Jean made about the NHS—an exact parallel applies to the rest of the Scottish public sector, in as much as a 6 per cent capital charge will be applied and money has been passed to the NHS from the Treasury to cover that charge. Looking forward, we are interested in the dynamics that that action has unleashed and in how the budgets will be varied in future. I do not believe that anything has been affected in year 1.

Hugh Hall: It is smoke and mirrors—perhaps all will become clear when we get hold of Government accounts and we are able to see the full figures in their glory. At present, there is artificiality about the system. I agree that we should consider better ways of carrying out the work, if such ways can be found. A useful starting point would be to set off on the road of beginning to consider consumption, investment and so on, which must be considered. We should make that useful start, rather than setting RAB in tablets of stone and modifying our behaviour in accordance with it—there is a risk that that will happen.

RAB was imposed on the NHS from on high, which might have created some of the problems that Jean Shaoul highlighted. We should take a deep breath and say, "Okay, we are trying to achieve better decision making and accountability, we want people to take a long-term view and we want to look at things in relation to investment, borrowing, revenue consequences, whole-life costs and so on. How might we use the different mechanisms at our disposal to do that? We came up with the 6 per cent notion—we're going to charge you, but we will take it off the other end. That is simply our mechanism for kick-starting the process, and we will revisit it as we learn and as we get better intelligence."

That sort of approach would be okay, but from what I perceive in some sectors, RAB has simply been imposed and set in tablets of stone and people have been told that they are going to use it whether they like it or not. People become disenchanted and cannot relate RAB to their business. It would be good if we were able to prevent that from happening with Government accounts and to prevent some of the nonsense that happened in the NHS. People must realise and respect that. They should be saying, "Wait a minute. What does all this mean?" and be big enough to ask the questions, rather than allowing their behaviour to be conditioned by a set of numbers that have been imposed by the Treasury or by the Scottish Executive.

We must have that dialogue and we must give people the confidence that they need to make those challenging statements. A complete sphere of training, development and cultural change must be thought through, but, at present, consideration of such matters is not keeping pace with technical developments.

11:45

Dr Shaoul: Andrew Wilson asked why a system of capital charging leads to PFI/PPP solutions. That occurs, firstly, because a revenue stream that is, as it were, labelled for capital has been created that can be used for leasing, renting or some other source of capital. Secondly, at least at first, leasing or PFI seems attractive as you then get the assets off-balance sheet. That is another whole question that we do not want to go into here and that appears to have changed in the case of hospitals and schools. Thirdly, as with RAB, the Government has largely required hospitals and schools to be financed via PFI/PPP. Because most services in the public sector have been reconstituted as business units with private sector accounting and with accounting for capital via capital charging systems, they are now structured and established in ways that allow them to do that. That could not have been done before the introduction of capital charging—it was a kind of groundwork or framework change. As I said in my paper, effectively the non-cash-generating public services are being reconstituted as nationalised industries.

The Convener: Thank you. I now welcome Leslie Wilson, director of finance for Historic Scotland, and Grant Macrae, who is a partner in KPMG but is here in a personal capacity.

Leslie Wilson (Historic Scotland): Historic Scotland is a next-steps agency or an on-vote Executive agency, so we are a subsidiary of the Scottish Executive in that we actively undertake our role but our accounts are consolidated into those of the Scottish Executive. As someone with a background in the private sector, I do not think that RAB as an accruals accounting method should mean difficulties for day-to-day management. After all, managers outside Government are accustomed to managing budgets on a time-frame basis. The average manager's budget is based on the job that he has to do and the resources allocated to allow him to achieve his objectives. He can do that without consideration of the effects of capital charges on a day-to-day basis.

RAB will experience birth pangs in the effective monitoring of performance for the whole organisation through the primary accounts, in the income and expenditure or operating accounts, in the balance sheet and in the cash flow statement. The challenge is for senior management to understand the principles on which those accounts are built. Senior management must try to control the big picture, while lower levels of the organisation will be working within narrower definitions.

At senior management level some new concepts will have to be understood—the two most difficult will be capital charges and working capital, a subject that I have not heard mentioned this morning. Management will have to learn how those concepts interact with the primary accounts. Income and expenditure will look very familiar, except that capital charging is built in. The balance sheet presents a new set of challenges: the concept of constructing a balance sheet and being mindful of the working capital impact on that. The cash flow statement will be less familiar; it will report on the capital being spent and on other activities. The demanding control will be capital charging. You will have noted from other evidence the consequences of using a revaluation methodology, including annual indexing systems, and that if no compensating allowances are given, the effect could be a downward pressure on resources. The extent to which management is alert to that and to how to cope with it will be an early issue in the implementation of RAB.

To date, capital charging in Historic Scotland has only been seen in budget plans for 2001-02, the coming financial year. As I noted in my written submission, most capital charges will be taken into the annually managed expenditure account for two years, before transferring to the departmental expenditure limit account. We therefore have two years in which to learn how to manage capital charges effectively.

In my written submission, I referred to the debate about non-operational heritage assets. The matter has been resolved, to the extent that non-operational heritage assets are excluded from the balance sheet and from the capital charging consequences. Had the alternative view of inclusion and valuation of those assets succeeded, the effect could have been significant, both to the balance sheet and to the credibility of resource accounting in organisations such as Historic Scotland.

I turn now to the effect on the organisation of the introduction of RAB. I can only speak for Historic Scotland. It is too early to state the full consequences. I can only report that the matters requiring management action are proceeding. That includes changing the annual accounts and training the appropriate tiers of management. That exercise will continue for some time to come, as people become increasingly familiar with the effects of RAB.

New reports have had to be written for day-to-day purposes. Managers will continue to be responsible for controlling expenditure within approved allocations, just as they always have been. HS has adopted the tack of managing capital charges centrally, which illustrates the emphasis that I put on the role of senior management. The cash balances—the bank account—have always been managed centrally, and that will continue to be the case in Historic Scotland.

There are also accounting issues surrounding the implementation of RAB that will depend on the interpretation of the rules. Timing differences could affect spend, and could potentially breach expenditure control limits. In my written submission, I have explained how that could happen to grant awards. I also mentioned the funding of indexation and revaluation, and the effects of that.

A year from now, there will be competing demands of managing to approved request-for-resources limits and also to net financing requirement targets. There will need to be understanding from all sides in order to learn from that experience. There will be some interesting effects.

In a year's time, the next spending review—SR 2002—will commence. It will be a purely resource budget process. Not only that: the year 1 planning, for 2003-04, will be the first year for which capital charges will pass through the DEL accounts.

I have tried to illustrate some areas that hold possible complexity with regard to resource accounting. At the organisational strategic level, it is not only the people who plan and administer who will have to contend with the effects: those who monitor performance will be obliged to recognise how the accounting treatment, as defined in the resource accounting manual, will be a factor in determining whether resources have been well managed.

Grant Macrae (KPMG): I thank the committee for including me in its consultation. I have been involved with a wide range of public sector bodies for about 25 years, but I believe that you want me to focus on the water industry.

I support the Scottish Executive's move to resource accounting and budgeting. It follows best practice elsewhere and, in particular, overcomes the current annuality problems and the focus on cash transactions between 1 April one year and 31 March the following year, regardless of whether that was for financing, capital or revenue purposes.

Most of the bodies that are funded through the Scottish Parliament already operate on an accruals accounting basis. The Scottish Executive's move to RAB will assist monitoring throughout the year.

I particularly welcome the emphasis on bringing assets on to the balance sheet at appropriate values. Assets can be recorded either at historical cost or at their current value to the organisation. The two methods can produce very different figures. For example, a local authority may have spent money over many years on building or modernising a house, which would show up as a historic cost. However, the value of that house today to the local council is either the amount that it would fetch on sale to a tenant or the amount that a housing association would pay for it, which is likely to be the net present value of future rental streams from that house.

The situation is similar in the water industry. It is difficult to know how much has been spent on the water and sewerage infrastructure over the past 100 years. When the three water authorities were formed in 1996, the asset values were based on how much debt could be serviced from the then net income stream. Since then, considerable sums have been spent on upgrading those assets, some of which have been financed from revenue and some from borrowing. Now we are asking how much those assets are worth to the business today, given all that expenditure. The answer to that question has to be linked to the net income streams of the future.

If much expenditure is still being incurred on infrastructure to meet the demands of legislation, quality and efficiency, we must ask whether that expenditure will increase the net income streams of the future. That could be achieved by increasing income, by reducing costs or by a blend of the two. That will force long-term planning.

If income streams increase, the asset value on the balance sheet will increase. If, on the other hand, they do not, the expenditure will have to be written off against revenue as it is incurred. If only increased values are funded by borrowing, the blend of funding capital and revenue between current water charges and borrowing must be addressed, as indeed must working capital. Water industry managers are responsible for running the three water and sewerage businesses in the most efficient manner possible. The water industry commissioner and the Competition Act 1998 will both impact on how they do so.

Non-domestic customers are already seeing the effect of competition, which is likely to be an on-going issue. To enable the businesses in Scotland to compete against the rest of the industry, the water authorities will need to be able to take commercial decisions and implement them at the right time. My concern about how that interacts with RAB centres on the requirement to achieve a fixed rate of return on assets each year. Other businesses will produce fluctuating rates of return in line with trading conditions. I would not be concerned about average returns being sought, as at present, but a requirement to deliver a fixed rate each year may not be in the best interests of the public sector, either as shareholders or as consumers. Across the public sector, great care is required to arrive at asset values that reflect realities and lead to sensible decisions for the future.

Another matter from my paper that I want to touch on is the impact of including all liabilities in the accounts. Many parts of the public sector have dealt with some obligations, particularly pensions, on a pay-as-you-go basis. New accounting requirements will make the liabilities more visible, which I think is a good thing, as it recognises reality. However, the various rules and regulations may need to be amended to distinguish between obligations funded over the current year and those in later years. Local authority consent-to-borrow controls operated by the Scottish Executive have, for many years, operated on a cash basis. Now seems to be an appropriate time to move them over to an expenditure or accruals basis.

I am a great supporter of introducing private sector accounting standards—the UK generally accepted accounting principles, known as UKGAAP—to the Scottish Executive and to public sector bodies in Scotland. Through the technical committees of the Institute of Chartered Accountants of Scotland and CIPFA, I have been pressing for that for some time. Implementing RAB will undoubtedly be a challenge but I believe that, once in place, it will deliver significant benefits to public sector managers and add to accountability for use of resources, as well as assisting in decision making.

The Convener: I thank Mr Macrae and Mr Wilson for those opening remarks. In your evidence, Mr Wilson, you outlined the question of non-operational heritage assets and said that you did not consider them appropriate for inclusion in the balance sheet because of the unreliability of the cost of maintaining them and the likelihood of there being no market for them. That clearly applies to Historic Scotland. Are you aware that it applies to other central Government agencies?

Leslie Wilson: The other examples that I can think of are museums and galleries, which have valuable historic pieces. I cannot think of any other Scottish body quite like Historic Scotland, with its monuments, which is what I was referring to.

The initial challenge was that the Financial Reporting Advisory Board was clearly of the mind that everything should go on to the balance sheet. There is an element of good logic in that. The trouble is that it would be expensive to value properties—the commission charges to the district valuer or a private sector valuation officer would have cost a great deal of money. Ultimately, Historic Scotland's decisions about maintaining monuments and where best to put its resources are not taken on the basis of financial considerations.

RAB has to be regarded as one of a number of tools that are used by management to determine the best use of resources. Finance is not the only resource—there are one's assets and the fact that monuments are visitor attractions and a strong stimulus to the success of the Scottish tourism industry. To spend money obtaining a valuation that would not contribute to future decision making was considered to be a poor use of resources. With some difficulty, we won that argument.

12:00

The Convener: Is it right that only assets with an income stream should be included on agencies' balance sheets?

Leslie Wilson: We include not just assets that have an income stream, but all assets that we use on a business basis, such as offices. The depots in which the masons and others who manage and look after monuments work are charged in conventional terms to the balance sheet.

Mr Davidson: I will address Mr Macrae. I am particularly interested in the views on net present value that you expressed. Obviously, calculations of rental streams in the commercial rental market are based on the net present value of the asset and so on. Are you suggesting that, in the public sector, future income streams should be discounted by known requirements for investment? For example, in the water industry, there are huge infrastructure requirements to upgrade water and sewage pipes. We do not know how the cost of that will pan out. We want to get away from annuality. I accept your argument that it is difficult to average out the cost over time. Although that would be okay in a business, it would be difficult for a Government, which has to try to balance its books. Are you talking about a model in which known required investment in the public sector is taken away from the value of the income streams? Is that how one would produce a valuation of the asset on which to charge whatever Government thinks should be charged? What about areas where huge investment may not be required? Are you talking about different levels of charge for different public services?

Grant Macrae: I will tackle the first part of your question first. The long-term infrastructure renewals programme has been worked out by the water authorities across Scotland. They have a good idea of how much will be spent over the next 20 or 30 years and are allowing for renewals in their cost base for future years. They can calculate cost as the overall on-going costs of running the business plus the estimated charge each year for infrastructure renewals. That will produce their net income. They are allowing for renewals.

How water authorities set tariffs may have a bearing on this question. Ideally, they might like to carry out some infrastructure renewals on a different time scale from what the tariffs make possible. If they have to produce a net income result that achieves a rate of return, they will have to phase everything to get the tariffs and infrastructure renewals to match. That may be different from the commercial ideal of how that process should be carried out.

Mr Davidson: What about applying your model of asset valuation to areas in which there are not huge infrastructure costs? For example, teachers carry around knowledge and skills that are not easy to price on a balance sheet. How are they costed into the model?

Grant Macrae: It is very difficult to do that. There has been much debate over many years about whether a manufacturing company, for example, should put a value on its brands. In a sense, you are asking about the same idea: the value of intellectual property. It is very difficult to value that knowledge, not least because, as it is in someone's head, its value disappears the moment that person leaves the organisation.

Mr Davidson: Should the education authorities price a model that allows for the purchase of replacement teachers or teachers of new subjects?

Grant Macrae: That is the ideal. The authorities must address the cost of investment to move away from the traditional means of teaching—be that in schools, further education colleges or universities—towards technology-based forms of learning. That involves a huge up-front cost, but a lower on-going cost. It is right that a value is placed on that investment, which is written off over the estimated life of the asset.

Mr Davidson: You have mentioned a three-year rolling budget. Will you explain that?

Grant Macrae: At the moment, the three water authorities have an average rate of return target that must be achieved over about three years. That makes it much easier to cope with the fluctuations of running a commercial business that has ups and downs. Over the term, the authorities have a realistic target to aim for and to be measured against.

The problem with the RAB approach is that it seems to set a one-year target alone. When businesses operate partly on a demand-driven basis, an annual target makes it difficult to achieve all that they are expected to do and to invest for the future. If the authorities' performance were measured over three years or longer, it would be much easier to hold them accountable for delivery against a plan.

The Convener: Would that comply with Hugh Hall's comments about the problems of annuality and outcomes? Are you in favour of three-year rolling targets for borrowing or financial targets?

Hugh Hall: That depends on the purpose. In housing, social landlords take an even longer perspective for decisions about investment and borrowing. The decisions that need to be taken and the time scale for doing that varies from business to business. That is why we allow the business, rather than a condition that is imposed from above, to be the major driver.

The Convener: So there is flexibility that depends on the agency or organisation that is involved.

Hugh Hall: That is, ideally, what we want; it is achievable.

Andrew Wilson: I have a question for Mr Wilson. It is good to have a practitioner to go through the process. Did Historic Scotland have any assets registered in the "National Asset Register" before this year?

Leslie Wilson: Yes. When the original exercise was conducted four years ago, we made a major contribution to it.

Andrew Wilson: Were all your assets included?

Leslie Wilson: To the best of my knowledge, yes. You may be asking whether non-operational heritage assets were included. I cannot remember precisely what the rules were at the time, but we fulfilled the criteria that were expected of us in making a submission to the register.

Andrew Wilson: That is what puzzled me. I do not know whether it is one of your assets, but does Edinburgh Castle, for example—which is mentioned in your submission—count as an operational asset?

Leslie Wilson: The income-generating parts, such as the shops, the restaurant, the cafeterias and bookshops, count. There is also a large suite of offices on the top floor of Crown Square, which is charged to the balance sheet.

Andrew Wilson: I take it that the asset value of a shop at Edinburgh Castle is that of the shop itself, yet the income stream results only from the existence of the unvalued and difficult-to-value large rock with a castle on it. I do not see how that is sensible.

Leslie Wilson: The district valuer calculates the valuation of the shop by the classic means of throughput turnover.

Andrew Wilson: Exactly.

Leslie Wilson: It is treated as a shop in its own right—as a business aspect to the organisation.

Andrew Wilson: It is not important for the committee's inquiry to dwell on that aspect for too long, but you are saying that things that are difficult to value, such as monuments or castles—those whose replacement value is not obvious—have not been valued, because you have decided that you cannot value them.

Leslie Wilson: We have not spent the money valuing them.

Andrew Wilson: You did for the "National Asset Register".

Leslie Wilson: No. We submitted what was an asset; we did not have to include valuations in that register. At one stage, I carried out an estimate with the district valuer to see what the entire cost of valuing everything would be. We concluded that it would amount to something in excess of £100,000. It would not be a good investment for a small organisation such as Historic Scotland to spend £100,000 without gaining anything in return. I think that you would be criticising me right now had I done that.

Andrew Wilson: Quite. I was not saying that you were wrong. However, you have gone through the process of valuing the operational assets.

Leslie Wilson: All operational assets are valued.

Andrew Wilson: How often will you update that?

Leslie Wilson: There is a five-year rolling programme. It has been running since we first produced our annual accounts in 1993-94.

Andrew Wilson: Is that done on the basis of market value?

Leslie Wilson: It is done by the district valuer according to his rules and the guidance that he receives in his professional capacity. We do not influence what he determines in any way.

Andrew Wilson: As the chairman of CIPFA, is Hugh Hall able to say whether district valuers carry out that function across the public sector?

Dr Shaoul: It certainly was not the case in the health service.

Hugh Hall: We are talking primarily about district valuers, although other experts are used depending on the circumstances. The housing sector uses commercial firms rather than the district valuer.

Leslie Wilson: There is no restriction on who the valuer might be. It is sensible and convenient to use the district valuer, who will have long experience of the public sector.

Andrew Wilson: The approach is obvious when you have a rental income stream from houses and an income stream from a shop. However, I am bemused as to how you value a hospital on that basis. Do you use a replacement value?

Dr Shaoul: The district valuer is required to value the buildings on the basis of their replacement value.

Andrew Wilson: So you use replacement value for hospitals, but income streams for houses and income from the tariff for water.

Grant Macrae: I can clarify the position in Scotland in respect of the NHS. The last time that the health portfolio was valued, it was done by an independent firm, which reported to the management executive and the individual health boards and trusts. That was based on the value of individual properties. In the water industry, the basis of valuation is value in use. That is reached by discounting the net present value of the income streams.

Leslie Wilson: Not all buildings are income generating. Offices, for example, are valued as the equivalent of commercial premises. We are paying for the equivalent of an office suite in the centre of Edinburgh.

Andrew Wilson: Are you saying that, where there is an income stream, you value on the basis of a discounted income stream and that, where there is no income stream, you value on the basis of replacement.

Leslie Wilson: Yes.

Donald Gorrie: I have a specific question, which I will follow by a more general one. Mr Wilson's paper uses the phrase,

"when capital charging arrives in full".

What does that mean? What is the dread event that is about to occur?

Leslie Wilson: Capital charging has two phases. The first phase begins on 1 April 2001 and runs for two years. The charges go through an account called the annually managed expenditure—AME—account, which, as somebody said earlier, means that the Treasury will underwrite the capital charging costs for two years. That is outwith the measured funding of the department or agency, which goes through a separate account; the departmental expenditure limit—DEL—account. For two years, the charges will go through the AME account and will be picked up by central Government. After two years, the resources that are given to the agency to manage its business will account in full for capital charging and that money will go through the DEL account.

In one sense, it is a technicality, which is probably why the committee is regarding me somewhat quizzically. The Treasury has recognised that capital charging could have many unexpected effects. For example, it could be difficult to determine what the capital charge would be in certain circumstances—bearing in mind Andrew Wilson's point about different ways in which to value assets. The view has been taken that it would be useful to allow a two-year moratorium on the impact. After that time, capital charges will go through the DEL account and will fall under the responsibility of the management of that account.

12:15

Donald Gorrie: I think that I understand a little bit of that.

My general question is to Mr Wilson and Mr Macrae, but the other witnesses might want to address it. Is there any chance of producing an accounting system that does not distort decision making? Will RAB assist in that or should we use something else? The thought of somebody spending two minutes trying to put a value on a hilltop fort or stone circle is baffling. During my years as a councillor, we changed from leasing machinery to buying it out of capital to buying it out of revenue because of the Treasury rules that applied at the time. Those changes distorted decision making.

Mr Macrae raised the issue of pension costs. The fact that fire service and police pensions are not funded properly has an enormous effect on the budgets of those services and of councils. Do you think that we will ever have a sensible system?

Grant Macrae: Utopia is hard to predict. I think that the change from the value-in-use approach to a value-in-assets approach will encourage people to decide whether an investment is worthwhile and whether the impact of that will be borne by today's consumers, rather than by tomorrow's. Forcing that sort of decision through will be important. I am concerned about how that blends with having to achieve a steady-stream rate of return, because I do not think that the two fit together. If one puts too many obstacles in the decision-making tree, something is going to give. If one is trying to run a trading business, it is unrealistic to assume that the market conditions will not produce a volatile rate of return at some stages over a number of years. A flat rate of return is not commercial and, if the Government is going to own a commercial trading arm, it will have to monitor the performance of that against the rest of the businesses that compete in that form.

In the water industry, there is a basis for comparison with what is happening in England and Wales. I do not need to go into the detail of the fluctuation that that sector has experienced over the years, but it is indicative of the impossibility of producing flat rates of return. In other parts of the public sector that are more under the Government's control, it is possible to request steady rates of return. Conversely, it is quite difficult to achieve a flat rate of return in the national health service, which is demand driven. The accounting systems can do only what is possible around that framework.

Leslie Wilson: No accounting system will be perfect. The one that we have has been hundreds of years in its development. The biggest changes have happened during the past 20 or 30 years with the arrival of the Accounting Standards Board. The trick in understanding accounts is not to read them at the large level, but to understand their significance at specific levels. Unfortunately, people who are busy with many day-to-day activities do not have the time to understand the finer nuances—I am grateful for that, of course, because that is why we have accountants.

Hugh Hall: We should walk before we run. The prospect of valuing heritage assets and intellectual property such as brands and so on should be put to one side. You mentioned pensions; our accounts can tell you what Scottish Homes' pension liabilities are. We pay those commitments annually, using the management costs that are made available to us by the Scottish Executive. As long as we have that information in the accounts, somebody who picks up those accounts will be able to identify a long-term liability. We can then start to make decisions about whether to continue to meet those liabilities through an annual payment process or whether—if some additional funding happens to be available—to purchase an annuity and pass that over to somebody else to take on the future commitments. The base information must be there for us to make sensible judgments.

Grant Macrae: One of my few concerns about the detailed rules and regulations in relation to RAB is how complicated they might be. The form of reporting may not be easily understood unless people are properly trained in it. I believe in simple, straightforward accounting reporting. Anybody's annual report and accounts should be laid out so that a non-accountant can understand what the figures mean. The explanations that go with them should be designed with that in mind.

Elaine Thomson: Almost everybody who has talked to the committee about RAB has mentioned the need for a change in attitudes and culture in relation to the imposition of RAB, and what kind of training would be adequate for that. Mr Hall referred to that this morning. I notice in the paper that Mr Wilson gave to us that, although his staff have spent considerable time training, they will require further training. As an organisation that is going through the process, how important has training been for Historic Scotland? What message about the importance of training and attitudinal change do you have for other organisations that must still go through the transition?

Leslie Wilson: It is very important indeed. There are two levels to that. I and the other experienced, qualified accountants that work with me on the subject have had to receive training to get our minds round what RAB is about. Generally, to get the general principles across, staff training has been focused on those who manage budgets and who are responsible for funding. People who have been working on a cash accounting system that has an attractive simplicity to it need to have it explained to them what accruals accounting means. That is essential for acceptance of RAB. When we put in any system in any situation, the credibility of that system needs to have time and effort devoted to it, so that people buy into it and begin to understand it and take full advantage of it.

There is a continuing need for training. With the best will in the world, the morning after training, when people step out of the classroom and back into day-to-day pressures, the memory of some of the finer points of that initial training are put aside until a situation arises in which there is a need to reinforce a point and re-learn it. We are conscious that training is, in the first instance, merely awareness raising about the general principles of resource accounting. However, later on there will be far more need to understand the finer points. That stage might come in the autumn, as managers begin to question what has happened to the budget and what actions they must take for the rest of the year.

We must remember that we have been set two targets on resource accounting. The first is that resources will be allocated—we have to manage below that limit, in the classic government fashion. The second target is the net financial requirement, which really means the amount of cash that the agency—in my case—will have available to it to spend in the year. Two exercises are going on all the time. In the later part of this first full year of RAB, the need to meet the competing requirements of those two targets could have an effect on what we choose to do. There will be a training exercise to explain to managers the implications of the decisions that we are taking towards the year's end.

Mr Davidson: I have a fairly simple question. In your expert opinion, has the Government understood the complications and the initial impacts on, rather than the outcomes for, the various bodies that it manages?

Leslie Wilson: I am not sure what "the Government" means in that sense. I would like to think that it is true that the practitioners understand the finer nuances. There is a need for a wider understanding of some of the implications, such as the cash resources conflict, because I am not sure that that is fully understood. However, those who designed RAB were aware of what was coming.

Grant Macrae: I think that the people who designed RAB have a good idea of what is involved. A huge education process is required to ensure that the civil servants at Victoria Quay and elsewhere understand the significance of the change. They are not all trained accountants. In fact, there are relatively few accountants. A lot depends on the briefing by, for example, the Civil Service College to all civil servants. That is so that they understand the implications, what happens when RAB is working well and the warning signs when it is not working well, and how to deal with things when they go wrong. Forewarned is forearmed.

Mr Davidson: Do Hugh Hall and Dr Shaoul have anything to add?

Dr Shaoul: I can add only the anecdote that when I have tried to speak to the RAB unit about particular questions, I have been told, "That is a technical question. You will have to ask somebody else." I concur, in that I am not sure how well trained in and cognisant of the issues civil servants are.

Hugh Hall: There is clarity in the principles of what we seek to achieve in the longer time frame. Practical implementation has been under-provided for, from where I am sitting. We all have a lot to do to address those issues, if we are to reap the benefits of RAB. My institute has a contribution to make; we also have a contribution to make as practitioners, but we have to do more about the practicalities of implementation. It is an evolutionary process, rather than a big bang, but there is a propensity for people to underestimate how fundamental the change is.

Mr Davidson: Are you suggesting that there is a need for slippage in the implementation time scale?

Hugh Hall: I do not know whether slippage must be built in. We should go at a speed with which the stakeholders are comfortable; if that means slippage, that means slippage. We have operated for decades and centuries without RAB. We should not be in a huge rush to implement it. I would prefer that we implemented it well over a longer term, than that we implemented it badly over a shorter time scale. If, in the committee's evidence gathering, you identify that there is much work to be done in terms of practical implementation, we should adjust the time scale accordingly.

We should walk before we run; let us implement RAB incrementally. The main point is that it should work and that it should be meaningful and useful. Ideally, RAB should be implemented sooner rather than later, because the sooner we get some of the outputs from RAB that we can use in our decision making, the better. However, it must be meaningful.

The Convener: I would like to ask Dr Shaoul a final question. You say in the rather apocalyptic conclusion to your paper, with regard to the analysis that you have done on the NHS, that it

"does not augur well for the introduction of capital charging elsewhere."

You talk about the matter becoming a "political struggle". You will appreciate, if you have seen some of the evidence that the committee has taken, that your view swims against the tide. That evidence—with some qualifications, as Hugh Hall outlined—has welcomed RAB. Is it inevitable that moves towards RAB will continue? Is there any way in which it can be modified to deal with some of the serious problems that your analysis has turned up, and which you think will affect other parts of the public sector?

Dr Shaoul: I do not feel competent to suggest practical ways in which the impacts of RAB can be minimised, other than to alert people to the fact that there have been very sweeping consequences for the NHS, which have been perceived widely as problematic. I do not feel competent to make concrete suggestions.

The Convener: I invite any of our witnesses to add final comments before we bring this part of the meeting to a conclusion.

Hugh Hall: We ignore Jean Shaoul's apocalyptic view at our peril, but as I said, we should not let it stand in the way of progress. We need to learn lessons from the implementation of RAB in other areas, but it is more important to keep our eye on the ball and on what we are trying to achieve. Let us learn all the lessons that we can from the NHS, the private sector, and a variety of sources. Let us feed that into the machine so that we get a more meaningful accounting system in due course.

The Convener: This has been a very useful, long and detailed session. I thank the witnesses for their written evidence, and for being here in person to assist our inquiry.

We are running a bit later than intended, although I am sure that members will agree that it was worth allowing that item to run on for the interesting responses that we received. I wish to test colleagues' opinions on the time constraint that we are under, because this room is being used for another meeting at 1 o'clock. We have two agenda items to go. Callum Thomson tells me that we need to deal with agenda item 5 today, but that we could delay item 4, which is on future inquiries. Shall we go on to item 5, and see how we are placed at the end of it?

Members *indicated agreement.*

The Convener: We agreed that item 5 would be taken in private, so the official reporters can take a rest after this lengthy session.

12:31

Meeting continued in private until 12:51.

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