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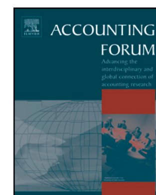

Accounting for producer needs: The case of Britain's rail infrastructure

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ABSTRACT

Academic studies of the industries privatised in Britain since the mid-1980s have focused on regulation and performance. This paper discusses the impact of changes in accounting policies within the British railway industry, which has been almost completely neglected in the literature to date.

The paper analyses the financial reporting of the railway infrastructure from 1992 to 2004: under state ownership, then as a listed company and finally as a 'not-for-dividend' entity. At each stage the accounting treatment of the infrastructure assets has been subject to major manipulation to suit the needs and convenience of the industry's management – not the users.

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1. Introduction

The performance of the British railway industry since privatisation has attracted increasing attention among the public, in the mass media, and in the academic literature, including the accounting literature. Much of the latter has been highly critical of the privatised industry, in various ways, but, somewhat strangely, its actual financial reporting has largely escaped critical commentary. Various writers have used the financial reports of the industry's entities to assess their performance but have largely avoided analysis of the accounting policies adopted therein. This paper aims to provide such commentary, by analysing how the physical infrastructure of the industry, the track, signalling and stations, etc. which constitute the bulk of its fixed assets, have been reported in financial statements since the last days of state-owned British Rail in the early 1990s. Railways are a quintessentially capital-intensive industry with particularly long-life assets: decisions on asset valuation and capital consumption are of crucial importance to the accounting numbers. Since the early 1990s these assets have undergone a series of drastic changes of ownership and purpose. They were transferred from an integrated state-owned railway corporation (British Rail) to a distinct (but still state-owned) infrastructure company (Railtrack) in 1994 in the run-up to privatisation. Shortly afterwards, Railtrack was floated in 1996 and for five years was an FTSE100 company; after the collapse of Railtrack in 2001 the assets were acquired by the peculiar 'not-for-dividend' entity that is Network Rail. This offers a particularly relevant case study in financial reporting: explaining how, if at all, these changes affected the accounts.

The generally accepted position on financial statements is, to quote a standard text, that they 'show the results of stewardship of management, or the accountability of management for the resources entrusted to it' (Ernst & Young, 2013,

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p. 47). Standard-setting bodies have explicitly adopted 'User Needs' i.e. the idea that the needs of the external users of financial statements should ultimately determine, via intermediate steps, their form and content, as the starting-point of their conceptual frameworks. Thus the *Statement of Principles* of the then UK standard-setting body explains that the

> objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions (ASB, 1999a, p. 16).

Prescribed accounting treatments, as set out in financial reporting standards are to be derived from this objective, thus adherence to the former by companies is deemed to achieve the latter.

If one considers accounting to be a 'relatively independent art [whose] roles and consequences [are] primarily moderated by the cognitive properties of its immediate users rather than the setting in which it is placed', it is not apparent that the accounts being considered here should have changed, but it has long been recognised that such a view is inadequate to understand or explain the workings of accounting in action (Hopwood, 1983, p. 288). Consequent studies of accounting change have focused on (for example) the relationship between accounting change and changes in organisational structure and culture as part of the process of privatisation (Skaerbaek & Melander, 2004); or how the changed external environment consequent on a firm's privatisation drives change in its financial reporting (Thompson, 1993).

A different perspective is offered by the Positive Accounting Theory (PAT) associated with Watts and Zimmerman (1986) who argue that the 'various parties' involved in selecting accounting policies or procedures do so as 'to maximise their own welfare (i.e. their expected utility)' (p. 3). Two situations highlighted by Watts and Zimmerman are particularly pertinent to the subject of this paper: (1) where management remuneration is dependent on accounting numbers (e.g. earnings), managers will choose policies that enhance current reported earnings; and (2) conversely, where a firm is politically sensitive or its prices are regulated, managers will adopt income-decreasing policies to avoid political interference or to justify price increases (pp. 208–10; 231–3; 235).

The paper now proceeds as follows: the next section reviews some past studies of change in the financial reporting of privatised utilities; Section 3 briefly reviews the structural changes in the British railway industry between 1992 and 2006 and how these affected the ownership and control of its infrastructure assets; Section 4 examines how these assets were reported in the financial statements of the entities that owned these assets in that period; and Section 5 contains some discussion and conclusions.

2. Literature review

The privatisation programme of the British Government in the 1980s led to a number of academic studies: Vass (1992) and Kilpatrick and Lapsley (1996) review regulation of privatised utilities, and a number of writers have studied particular industries, including Harrison (1982) and Barnes (1988) on BT/telecommunications; Baldwin (1984) and Vass (1993) on water; Estrin, Marin, and Selby (1990) on electricity supply; and Price (1986) on the gas industry. These have tended to focus on regulation and performance of the privatised entities and pay little attention to financial reporting practice, although Vass (1992, p. 305) does note the 'enthusiasm' with which some nationalised utilities 'embraced Current Cost Accounting (CCA) in the 1980s as a means of reducing reported profit' to deflect criticism of price increases. He also discusses the regulatory use of asset valuation, and whether this should be based on current or historical cost but does not discuss specific accounting policies of particular entities. McInnes (1990a, p. 318) notes that the nationalised UK gas industry had implemented changes to accounting policies (including accelerated depreciation rates, immediate write-off of some exploration costs which had previously been capitalised, and ceasing to capitalise interest on new construction) that reduced 'the reported net income and the reported rate of return' for every year between 1969 and 1974. These changes, he argues, were made in order to justify price increases. The gas industry management had no direct pecuniary interest involved, but they did have an incentive to increase the industry's cash flow, via price increases, and so gain autonomy *vis-à-vis* the government, an argument that is consistent with Watts and Zimmerman's position regarding politically sensitive firms.

McInnes (1990b) examines in detail the South of Scotland Electricity Board (SSEB) in 1978–88. The SSEB proposed price increases in 1978, arguing these were needed to meet its statutory duty to break even. The Price Commission, a government body which had to approve the increases, criticised some of the accounting policies adopted by the SSEB, for example, that the estimated operating lives of generating assets were between 17% and 50% longer than the estimated remaining lives used for calculating depreciation, and the supplementary depreciation which SSEB charged in its accounts from 1977/78 (p. 62). McInnes argues that these income-decreasing changes are consistent with positive accounting theories – that companies subject to regulation will adopt income-decreasing policies to justify price increases.

Other authors have analysed organisational change consequent on privatisation. For example Ogden and Andersen (1999) investigate the ways by which senior management effected the 'strategic change' involved in transforming a water company after privatisation. This centred on 'changes in accounting information systems', but not financial reporting (pp. 91–92). Conrad (2005) reviews post-privatisation organisational change in British Gas, and analyses the impact of regulation on accounting systems and systems of accountability, but says relatively little about accounting policy. But she does point out that before privatisation British Gas published only CC (Current Cost) accounts [which reported lower profit figures than HC (Historical Cost)] and afterwards continued to publish CC accounts with supplementary HC information. In 1985, shortly

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