

- 6.001 The term “capability” can be used to embrace a number of organisational characteristics. However, a critical aspect of an organisation’s capability is its ability to produce the required outputs. “Capability expenditure”, as we have defined it in paragraph 3.042, is the expenditure that the Government must incur to establish or extend an organisation’s ability to produce outputs.
- 6.002 At present, Parliament receives very little information about the capability of Crown-owned organisations. There is no legislation which requires that such information be provided. However, Parliament has a direct interest in knowing whether or not those organisations can do the job expected of them.
- 6.003 In this chapter, we discuss Parliament’s interest in capability, addressing issues such as:
- the way in which output prices can affect capability and the consequent implications for Parliament’s approval of supply;
 - who should be accountable for capability and how;
 - the extent to which capability can and should be measured and reported; and
 - the relationship between capability, performance and risk.

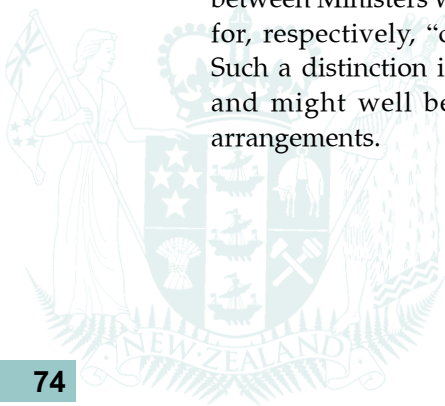
What Is the Relationship Between Capability and Supply?

- 6.004 The current regime of parliamentary appropriation reflects the long-held belief that it is desirable for Parliament to exercise ultimate control over the resources available to the Executive. Crown revenues are one resource – assets owned by the Crown are another.
- 6.005 However, the full tally of the resources available to the Executive is not reflected simply in Crown revenues and the monetary value of its physical assets. It also includes all the key capabilities of the agencies which the Crown owns, and over which the Executive can exercise effective control.

- 6.006 Capabilities can be built up or run down without such changes necessarily being evident in the organisation's financial statements. For example, departments may invest in human resource development without that investment being evident on a balance sheet. To the extent that the Executive is able to convert capability resources into current consumption without a transparent appropriation for the purpose, it may be escaping Parliament's control of supply.
- 6.007 In Chapter 3, we discussed briefly some of the differences between the ownership interests of the Executive and those of the private sector. In particular, the Executive's ownership interest often manifests a strong element of trusteeship. To the extent that undesirable changes in capability may have occurred, but remain unmeasured and undisclosed, Parliament cannot hold to account either the Executive's trusteeship or a chief executive's stewardship.

Who Should Be Accountable for Capability?

- 6.008 In general, it is fruitless to purport to hold individuals to account for events or outcomes over which they have little or no control. We will return to this observation in the last chapter – which deals with risk – but we note here that it also has implications in relation to capability. Indeed, the two are closely related. Generally, when capability is eroded, then risk increases.
- 6.009 As we have already mentioned in paragraph 3.010, the Public Finance Act 1989 and the *Estimates* make a distinction between Vote Ministers and Responsible Ministers. At first sight this suggests that a simple distinction can be made between Ministers who should apply for and be accountable for, respectively, “current” and “capability” expenditure. Such a distinction is at least implied in the present regime and might well be made more explicit in some future arrangements.



- 6.010 The Public Finance Act 1989 makes explicit provision for appropriations for capital contributions to departments and Crown entities (and also capital withdrawals, although these are seldom used), and the purchase of assets by the Crown. However, although such appropriations affect capability generally, they are made in the context of a Vote. They are sought by the Responsible Minister in a Vote for which the Responsible Minister is also the Vote Minister.
- 6.011 We believe that Parliament may also wish to give consideration to defining more precisely the role of a Responsible Minister in relation to capability – in terms that go beyond the narrow scope of financial management. Parliament may also wish to require a “before and after” account of how that responsibility will be, or has been, discharged.

What Does Parliament Need to Know About Chief Executives’ Stewardship of Capability?

- 6.012 An important principle underpinning the Public Finance Act 1989 is that managers should be given the freedom to manage (subject, of course, to moderating considerations of due prudence). The application of this principle was not intended to provide public sector managers with unfettered license. Rather, it was to enable them to make economically rational decisions about the best use of resources, unconstrained by rigid, centrally imposed regulation.
- 6.013 We are convinced that this aspect of the 1989 reforms has almost always been beneficial and we would not wish to see the present freedom of managers unnecessarily constrained. However, we also believe that Parliament has a legitimate concern in ensuring that each government department has the capability it needs to produce the outputs required of it – or that it has made credible plans to acquire that capability and will be supplied with the necessary resources to do so.

- 6.014 Parliament has found it useful to supplement the financial information provided about current expenditure with non-financial information about departmental performance. It may also see value in supplementing the financial information provided about the stewardship of assets with non-financial information relating to other key aspects of capability. Such information could be provided in departmental forecast reports³⁴ and in annual reports.³⁵

Can Capability Be “Measured”?

- 6.015 Organisational capability has been the subject of a good deal of theoretical and empirical research. There is little doubt that it is difficult to measure and report definitively. To be meaningful, capability must be considered in the context of the particular objectives that must be achieved – for the self-evident reason that the capability to achieve one objective does not automatically imply the capability to achieve another.
- 6.016 Further, it is important that all key aspects of capability be measured, because many or all of an organisation’s systems can be seriously affected by the breakdown of just one aspect of its capability.³⁶
- 6.017 Finally, it is important to understand that capability cannot be measured as a simple quantity, such as height or weight. Assurance about capability, if it can be given, would be assurance that the organisation is likely to be able to achieve particular specified objectives – given particular resources and operating in particular circumstances.

34 There seems to be no overwhelming reason why an obligation to provide this information should be confined to departments. It could also be required of other selected Crown entities and public organisations, especially those subject to financial review by select committees.

35 This potential improvement has already been identified by the Finance and Expenditure Committee, in the 1997 report on its *Inquiry into Departmental Reporting to Parliament* (parliamentary paper I.3c, page 8). The Committee recommended that *departmental chief executives be required to account for the stewardship of their departments in annual reports in order that select committees can evaluate the performance of departments from an ownership perspective.*

36 For example, a critical aspect of the organisational capability of a Crown research institute is the quality of its personnel. If key personnel are lost, the organisation’s capability may collapse, notwithstanding that all other aspects remain intact.

6.018 We have been giving careful consideration to ways in which organisational capability might be comprehensively described, and how assurance about capability might be provided. Although our work is not yet complete, we have identified at least four aspects of capability that we believe can and should be measured and reported. They are:

- balance sheet assets (already required);
- human resources;
- information and control systems; and
- output production methods.

6.019 We have some observations to make about each of these aspects.

Balance Sheet Assets

6.020 The valuation and disclosure of balance sheet assets (cash on hand, physical assets, etc) is regulated by GAAP which has been developed from, and is supported by, a considerable body of professional experience. Of the four categories in paragraph 6.018, balance sheet assets constitute the only aspect of capability for which there is an agreed method of measurement.³⁷

6.021 Our principal concern with assets relates not to any particular difficulty with their measurement, but to the possibility that the appropriation process may impose undesirable constraints on the ability of chief executives to manage their departments. The quantum of a department's assets is fixed by the appropriation of its opening balance sheet and thereafter is adjusted by specific appropriations for capital contributions or withdrawals. Section 11 of the Public Finance Act 1989 enables a department to use the proceeds of the sale of assets to purchase other assets, but the department may not, without further appropriation, end a financial year with a greater holding of assets than it had when it began that year.

³⁷ There are some technical problems and controversies even with this dimension of capability.

- 6.022 In determining how best to achieve operational efficiencies, a private sector manager generally will be free to employ the optimum mix of capital, labour and other production factors, and to adjust that mix as necessary. However, section 11 constrains the amount of capital that departmental chief executives can employ. We question whether this constraint has proved useful in practice.
- 6.023 It seems to us that the economic benefits that are thought to flow from constraints on the Crown's capital investment in departments could usefully be re-examined in the light of possible inefficiencies arising from sub-optimal mixes of capital and other factors of output production. One possibility to ease the present restrictions would be to permit fiscally neutral transfers of appropriations from classes of outputs to capital contributions (by Order in Council) along the lines of the transfers between classes of outputs permitted by section 5 of the Public Finance Act 1989.

Human Resources

- 6.024 The importance of human skills has long been acknowledged and a number of attempts have been made to develop a method for valuing an organisation's "human capital". These have not yet met with widespread acceptance. However, there is a range of widely used methods for analysing and sizing jobs, and for determining the skills needed for competent performance.
- 6.025 We do not believe that it is necessary or useful to reflect human resource capability in conventional financial statements.³⁸ However, we are convinced that key aspects of human resource capability are measurable and can usefully be reported in accountability documents. These could include, for example, staff numbers, staff qualifications, turnover rates in critical positions, lead times for acquiring operational experience.

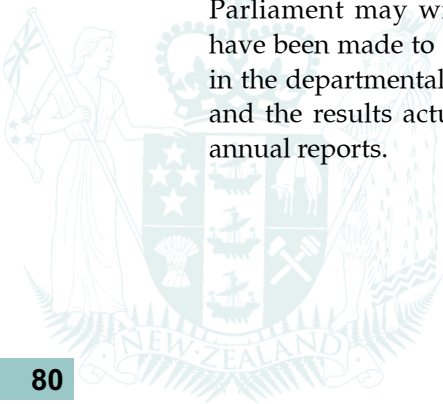
38 This issue is contentious, especially in relation to trading operations. See, for example, Sviaby, K. E., *The New Organisational Wealth: Managing and Measuring Knowledge-Based Assets*, Berrett-Koehler, 1997. It is very important for most government organisations because important sources of their value to society lie in organisational knowledge, the quality of personnel, and other intangible assets.

Information and Control Systems

- 6.026 Increasing attention is being given to assessing the capability of information systems. We have been concerned at the number of examples where expensive information system projects could not be completed – or, having been completed, failed to deliver the expected benefits. The depreciated cost of an information system will ordinarily be reflected in the balance sheet. However, its operational value is usually less easy to determine.
- 6.027 Nonetheless, methods exist for valuing information and information systems. We are convinced that key aspects of the capability of information systems are measurable and can usefully be reported in accountability documents. These could include, for example, assessments of the extent to which the information system addresses key information needs, the system’s reliability, and the timeliness with which information is available to inform key management decisions. We also believe that Parliament would welcome some means of assessing whether or not the considerable capital sums appropriated for large information technology projects have been justified by their value to the purchasing organisation.
- 6.028 The same general observations can be made about control systems which, in many ways, are particular applications of information systems. Again, we believe that the capability of control systems can be measured and that assurance about the quality of an organisation's control systems could usefully be included in its annual report.
- 6.029 For example, over recent years we have been making assessments of financial and service performance information systems and controls. We have reported these assessments to Ministers, and to select committees in the context of financial reviews. We believe that Parliament has found this information useful. We see value in making the process more formal and improving the information provided to Parliament about these important aspects of capability.

Output Production Methods

- 6.030 If all other aspects of capability are fixed, a department or agency can achieve greater productivity only by improving the efficiency of the methods by which it produces its outputs. Since the Public Finance Act 1989 came into force, departments have been placed under pressure to improve the efficiency of their operations. Output price reviews are ongoing, but we believe much has already been achieved.
- 6.031 However, at present there is no agreed means by which departments can establish realistic limits on the efficiency of their present output production methods. In the absence of this information, they are likely to have difficulty in resisting demands to achieve additional efficiencies. When realistic limits have been reached, the probable result of demands for additional efficiencies is poorer quality outputs. Given the current weaknesses in output specification and performance measurement, the loss of quality may not be readily apparent unless damaging or disastrous events begin to occur. We will explore this issue further in the final chapter.
- 6.032 It seems to us, however, that there are two possible approaches that could provide some remedy:
- First, where a number of departments or agencies produce similar outputs, benchmark comparisons can be made.
 - Secondly, departments can model and simulate key production processes to test their capacity and identify their limitations.
- 6.033 Where departments and agencies are required by the Government to achieve additional production efficiencies, Parliament may wish to satisfy itself that credible plans have been made to do so. Such plans could be sketched out in the departmental forecast reports or statements of intent, and the results actually achieved could be detailed in the annual reports.



Capability and Forecasting

- 6.034 An issue that concerns us is the absence of any clear relationship between changes in the forecast quantity of demand-driven outputs and changes in either output appropriation or a capital contribution to adjust capability.
- 6.035 The amounts sought in the *Estimates* are, of course, ultimately determined by the Executive. However, as we observe in paragraph 6.031, there are limits to the extent to which departments can reasonably be expected to absorb organisational changes or achieve additional efficiencies. If they are not supplied with the necessary resources, their ability to produce outputs sought is placed at risk. In general, it seems reasonable to expect that if a department is required to make substantial changes to the nature or quantity of its outputs, there will be consequential appropriations to adjust capability.
- 6.036 In making this observation, however, we are also concerned at the reliability of workload forecasting by some departments. On occasion, actual workloads have shown such forecasts to have been significantly inaccurate. Unless the Executive and Parliament can have reasonable confidence in the reliability of such forecasts, they will be unable to make informed decisions about adjustments to supply.

Summary of Conclusions

- 6.037 In our view, Parliament needs better information than it currently receives on the capability of Crown-owned organisations. The improvements needed relate to information on the existing capability of these organisations, and the funding of changes to capability. In addition, the accountabilities relating to organisational capabilities – both of the Responsible Minister and the chief executive – need to be clarified.
- 6.038 Work is currently being undertaken on how capability should be measured and reported. Although the work is not yet complete, we believe it is possible now to give Parliament some useful information on at least four dimensions of capability – balance sheet assets, human resources, output production methods, and information and control systems.

- 6.039 We also believe it is highly desirable that Parliament receives information that relates changes in workload demand to changes in capability. This has consequences for the accuracy of workload forecasting.
- 6.040 Capability is related to risk and the management of capability is related to the management of risk. We explore some issues concerning risk management in the final chapter.

