Cross-government

Open-book accounting and supply-chain assurance
Summary

1 This report is about the information that government uses to manage its contracts. Supply-chain assurance is how a client gathers information to understand what is going on inside its suppliers. Open-book accounting is a particular type of supply-chain assurance where suppliers share information about the costs and profits of a specific contract with their client. In this report, we make a distinction between the use of open-book and the need for public transparency over profits:

- The government can use open-book accounting to understand the specific costs and profits of its major contracts as an important tool in managing those contracts.

- It is in the public interest to have public transparency over the general level of profitability that government suppliers are able to achieve. This can give some confidence, when combined with other information, that the system of public procurement is working. Yet the profit of a specific contract may be commercially confidential as knowing it would allow competitors to price future work.

Background

2 There has been an increased interest over the past few years in how open-book accounting can help government manage its contracts. It gained particular prominence with the over-billing on the Ministry of Justice’s electronic monitoring contracts, and the subsequent realisation that poor contract management was systemic across government. This led to a loss of faith in the government’s ability to manage suppliers adequately. We have charted this history in our recent reports on contract management.

3 Open-book accounting came to be seen as a way of improving trust in the government–supplier relationship. In particular, suppliers’ profits came to be seen as a way to read the health of public procurement. A reasonable profit can be a sign of a healthy commercial relationship, but too high or too weak a profit can be a sign that something is not working in the service, the contract, or the market.
4 Interpreting these profits is not easy; a reasonable profit is difficult to define and varies between types of service, the risk to the supplier, and the market. Although there is now a greater acceptance that open-book should be used, we often find uncertainty and confusion as to how and for what purpose. This arises from a general lack of guidance on what those charged with using open-book should try to achieve, how they should validate and interpret information received and how they should use open-book information in practical ways.

The approach of this report

5 This report focuses on how open-book can be used and for what purpose. We surveyed the current use of open-book accounting across government. We revisited learning from the Ministry of Defence, who have been using a form of open-book accounting to manage UK single-source suppliers for more than 45 years.

6 We also went outside central government to see how others were using information to manage their supply chain. We asked professional institutes and government for examples of where good practice lay. Based on this we visited nine case study organisations to find out how they used information in managing their supply chains.

7 The report starts with an assessment of the current practice of using open-book within government (Part One), looks at the practice in the Ministry of Defence and outside central government (Part Two), and goes on to give recommendations for how government can improve the use of open-book, as part of its efforts to improve government’s contract management (Part Three).

8 We are grateful for the help of the case study organisations who volunteered their time to take us through how they manage their supply chains. We conducted this particular element of our work in the spirit of appreciative enquiry. Because we are generally not their auditors we did not seek to validate what we were told and we do not intend this report to provide any assurance on the case studies, their business or the way they manage their suppliers.

9 Our evidence and methodology are set out in more detail in Appendix One. We set out the case studies in further detail in a separate volume.1

Conclusions

10 Contract management is not a desk job. We are reminded of this in all the best practice and the worst failures we see. For government to be accountable for contracted-out public services; for it to understand its suppliers; for it to exercise oversight; and for it to promote value for money, it requires its contract managers to take a ‘hands-on’ approach and go to see for themselves what their suppliers are doing.

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11 Although we asked for examples of organisations that used open-book well, the examples we were given often looked very different from how we understand open-book in central government. Across our case studies we found a range of different approaches being used. None used open-book in isolation and some did not look at their suppliers’ costs and profits at all. However, we noted two consistent lessons from these case studies:

- First, they all had clear strategies for their supply-chain assurance, even if they did not call it such. Each focused on equipping themselves with the information they needed to manage the specific risks and issues of their business.

- Second, we consistently heard that scrutiny by the client was expected and that good contract managers see it as their job to be inquisitive about both what and how their supplier is delivering.

12 We have often recommended open-book accounting be used more. We continue to do so. This means using open-book as part of clear supply-chain assurance strategies – being clear about the purpose of open-book. It also means using open-book for more than its traditional use in cost-plus or target-price contracting – where the supplier’s fee is not fixed but depends on their costs. Open-book is vital for managing such contracts, and is used in both the public and private sector to do so. These contracts are typically used where there is significant uncertainty, a lack of competition, or the organisation wants to retain control.

13 There is something particular about public sector contracting that makes open-book relevant to other contracts as well.

- First, there is the issue of public accountability. Supplier profits are relevant, if difficult to interpret, to the question of whether public value is being achieved. Furthermore, the right to open-book information reinforces third-party inspection rights and enables government scrutiny of contracts when things go wrong. This in turn enables public scrutiny and strengthens existing National Audit Office (NAO) legal rights of access to these contracts and suppliers.

- Second, the use of open-book can enable better commercial decision-making and aid in commercial negotiations. It removes an element of information asymmetry between the supplier and the government and can help with changes and extensions, as well as refining the contract when it is re-let. This is particularly relevant for public services due to the nature of public procurement and the types of contracts that are often used. Our studies show that upfront competition is not always sufficient to deliver value for money in public service contracts. Contracts tend to be longer in the public sector, because they cannot be rolled over without a new competitive process; public value is harder to measure and define in a contract specification; and technology, the market and the requirement inevitably change during the course of the contract. This can lead to fixed-price contracts that come to resemble cost-plus contracts as each variation is priced by reference to the suppliers’ costs.
14 But open-book must also be used wisely. As open-book is extended to other contracts, there is a risk that government will start to adopt cost-plus mechanisms, such as profit caps and gain-share mechanisms, solely to avoid embarrassment about suppliers’ profits. This would be changing the suppliers’ risks, rewards and incentives, which would not necessarily reflect what government is trying to achieve. It would be a missed opportunity if open-book accounting focused management time on the suppliers’ profits instead of achieving the wider objectives of the contract.

Recommendations

15 Based on the learning from our case studies, our own experience of auditing government contracts and our own use of open-book, we recommend:

a Every major government contract needs a supply-chain assurance strategy. The information required to manage the contract needs to link to the type of contract, what is being provided, and the risks of providing it. We identified five simplified approaches that organisations can use to manage the information requirements of contracts, each with a different purpose. These can be combined. The approaches should be set out at the pre-procurement stage and will probably form part of the contract management plan.

b Government needs to include the roll-out of increased supply-chain assurance as part of its commercial skills programme. This is about more than the skills to undertake open-book accounting itself, however. Rather, it is about the broader issue of civil service commercial capability and willingness to get involved in managing contracts in greater detail. Changing what the client monitors within the supply chain may require it to change its own culture, so it gives consistent signals to suppliers about what it is interested in.

c The Cabinet Office should set up a task force of government, suppliers and other stakeholders to explore how to establish a common standard for open-book data. Suppliers complain that government asks for open-book information in a variety of different formats. This makes it difficult for them to produce the data and for contract managers to interpret it. It also allows profits to be presented in a variety of different ways. A common standard for how suppliers should present their costs, particularly allocations, would standardise practice and help reduce the room for manipulation. The Ministry of Defence already uses such a standard.
Government should negotiate the retro-fitting of open-book access rights into old contracts, where appropriate. Our survey showed that government has access to open-book data in only 31% of its contracts. In 2002, following NAO work, HM Treasury successfully negotiated such a retrospective agreement for PFI contracts and the sharing of refinancing gains.

The Cabinet Office should provide better guidance for interpreting suppliers’ costs and profits. This should include how to understand the way profits vary and how to interpret a supplier’s business model. Government needs to develop a more sophisticated understanding of these profits, so that it can improve the incentives in its contracts and its negotiations with suppliers. This should be incorporated into government’s commercial skills training.

Departments need to integrate open-book requirements into the procurement of contracts and use open-book with other information. Like any data, open-book accounting requires comparatives to be meaningful. This could be trend analysis, budget variance analysis or comparator benchmarks. Furthermore, to give a meaningful representation of value, financial information from open-book should be combined with other types of information, such as quality, performance and productivity. These comparatives and other data cannot be easily added after the contract has started, so should be set out before procurement begins.