National Audit Office

Managing financial resources to deliver better public services

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 240 Session 2007-2008 | 20 February 2008

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Comptroller and Auditor General
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18 February 2008

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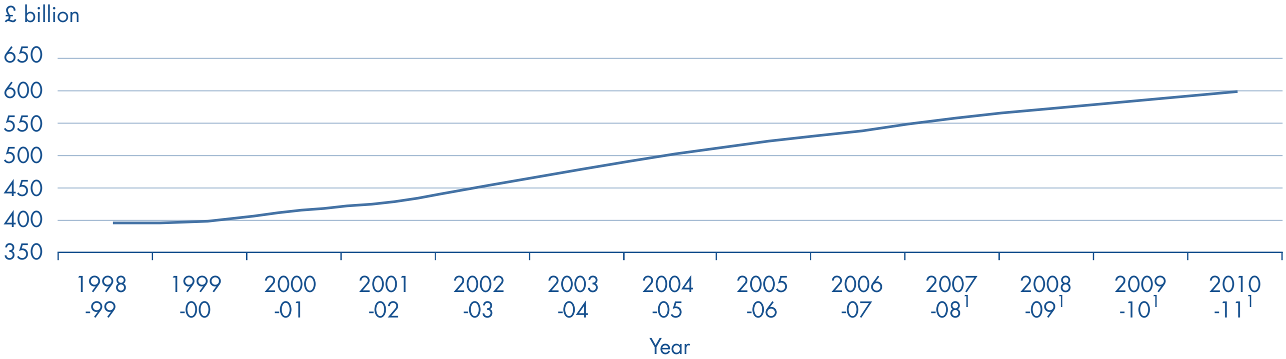
Strong financial management capability can help departments to meet the challenges they face in delivering public services.

Total Managed Expenditure

Central government expenditure has increased each year since 1998-99 in real terms. Following the announcement of the results of the 2007 Comprehensive Spending Review, this trend is set to continue.



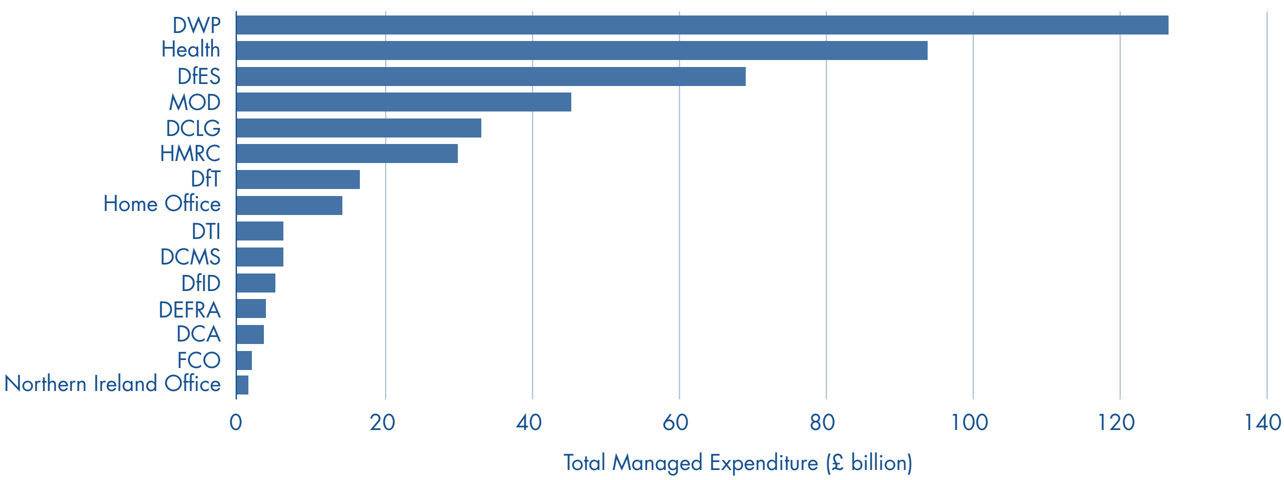
Source: National Audit Office, based on HM Treasury's Public Expenditure White Paper for years 2001-02 to 2006-07 and projections contained in the 2007 Pre-Budget Report and Comprehensive Spending Review for years 2007-08 to 2010-11. All prices are at 2005-06 levels

NOTE

1 Projected Figures.

Distribution of financial resources across Whitehall

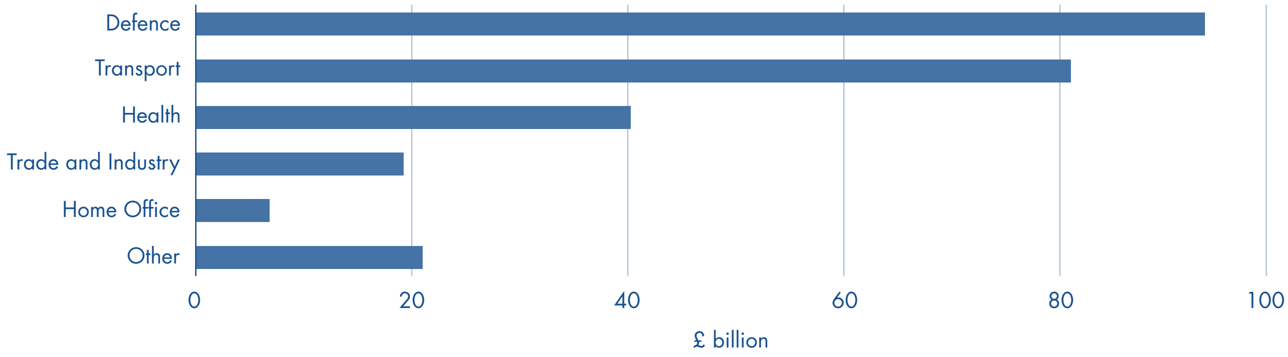
The Department for Work and Pensions, which distributes social security benefits, is responsible for the most significant portion of this expenditure. Other major spending departments include those responsible for health, education and defence.



Source: HM Treasury Provisional Outturn White Paper 2006-07and HM Treasury

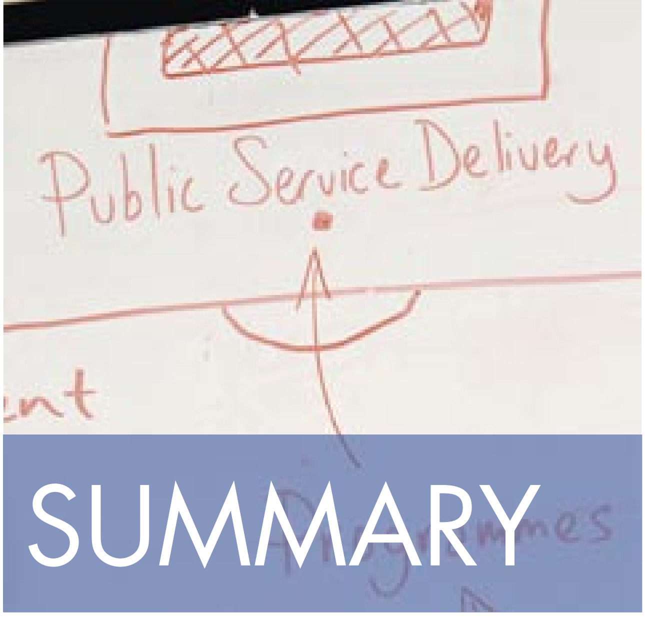
Central Government assets

Departments also own significant assets. The Ministry of Defence's military sites and equipment and the Department for Transport's motorway and trunk road network in England make up a significant proportion of this asset base.



Source: HM Treasury National Asset Register 2007

Challenge	The ways that strong financial management capability can help
Changing priorities: Ministers may announce new departmental priorities at any time in response to national or global political developments.	It is a constant challenge for all departments to be flexible enough to reallocate their finite resources in response to announcements of new priorities, while maintaining high standards of service delivery across the full range of its activities. The response to the increased threat from terrorism is an example of such changing priorities.
Long term changes in society: Our ageing population, globalisation and climate change will change the environment in which departments operate.	Strong forecasting skills and awareness of the impact of the UK's ageing population will increase the likelihood that resources are allocated effectively. For example, it is estimated that the NHS in England will need to make sure it can provide dementia services for more than 750,000 people in 2020, compared to 560,000 in 2006-07.
Unpredictable demand for services: Demand for public services is not consistent. It changes in response to political, social and economic developments.	In the event of the collapse of a major employer such as happened to MG Rover in 2005, local demand for jobcentre services can increase dramatically. In such circumstances, good financial planning and forecasting become especially important.
Customer satisfaction: The citizen is increasingly demanding more convenient access to public services.	The delivery of innovative methods of service delivery often requires IT-enabled business change. Project managers and budget holders who possess effective financial resource management skills will be well-placed to identify and control risks to the project timetable and budget.
Complexity of service delivery: Public service delivery involves a number of bodies from the public, private and voluntary sectors.	The Department for Children, Schools and Families' oversees the education of over 8 million children in over 25,000 schools across the country. Each school has its own budget and is responsible to one of 150 Local Authorities. Departmental decision-making requires clear and confident oversight of how resources are used by these delivery partners.



SUMMARY

1 By 2010-11, central government spending is forecast to grow to £678 billion per year.[1] This represents £11,000 for every person in the United Kingdom. It is the challenge for departments to convert these resources into public services that meet the expectations of service users, while also providing value for money for the taxpayer. Departments' capability to manage their financial resources effectively is crucial to whether they are able to succeed in meeting this challenge.

2 From the smallest transaction to the largest programme, financial resource management is relevant to every aspect of a department's business. At one extreme, the Department for Children, Schools and Families must understand how primary schools are using their budgets to raise standards of education. At the other, the Department must track the £45 billion allocated to its programme to rebuild or refurbish every secondary school in England.

3 In addition to their current activities, effective financial resource management can also help departments meet future challenges. For instance, our ageing population will radically change how financial resources will need to be allocated across the public sector. It is expected the NHS in England, for example, will need to provide dementia services to more than 750,000 by 2020, compared to 560,000 today.[2]

4 This report examines how capable departments are at managing their financial resources, and what impact efforts to improve capability have had on financial resource management performance **(Figure 1)**. It follows a report published by the Comptroller and Auditor General in 2003 and a related 2004 report by the Committee of Public Accounts.

5 Overall, departments have made visible progress in improving the management of their financial resources. We consider the three key areas where departments need to make further progress are:

- Improving the finance skills of staff outside of the finance department;
- Linking financial and operational performance information to improve service delivery and achieve better value for money; and
- Improving the reliability of forecasts of future resource needs.

1 Improving skills and awareness, and the use of techniques and practices can improve financial resource management performance

Skills and awareness

Progress made in establishing financial resource management skills and awareness across departments – Part Two.

→

Techniques and practices

Progress made by departments in using advanced techniques and practices to manage their financial resources effectively – Part Three.

→

Impact of progress

Impact of efforts to improve financial resource management across central government – Part Four.

Source: National Audit Office

Departments are more aware of the importance of sound management of financial resources, but ensuring staff are sufficiently skilled remains a challenge

6 The increased number of professional Finance Directors on departmental Boards has enhanced the focus on financial performance at senior management level. In some departments, such as the Department for Business, Enterprise and Regularity Reform, this has been accompanied by a department-wide culture which increasingly recognises the importance of sound management of financial resources. At present two departments[a] do not have a qualified Finance Director and a further four departments[b] do not have their Finance Director on the Board.

7 The lack of financial skills and awareness amongst many non-finance staff remains a significant barrier to improving financial resource management across government. With better skills, non-finance staff are able to manage their budgets and fulfil any necessary reporting requirements more effectively. HM Treasury, working with six major departments, has taken steps to fund the development of material enabling departments to improve financial skills and knowledge among non-finance staff. However, take up of the new learning opportunities on offer has been patchy and the Cabinet Office does not yet have a robust way of measuring the number of civil servants who now meet the Professional Skills for Government standard for financial management.

8 Most departments do not routinely incorporate objectives relating to the management of financial resources in the performance appraisal system for either Permanent Secretaries or senior civil servants. Those departments that regularly assess the financial resource management skills of their senior managers were found to be more able to nurture a culture in which the management of financial resources is of central importance.

Departments have implemented accruals-based systems but could do more to evaluate the cost-effectiveness of their programmes

9 Departments have made significant progress in using accruals-based accounting and budgeting systems since our previous study. This has allowed departments to better understand how they are using their financial resources, for example by offering more detailed information to manage their assets and liabilities. Departments have used this information to help identify under-utilised assets and to dispose of those no longer required. The public sector disposed of assets valued at £18.5 billion between 2004-05 and 2006-07 against its objective of realising £30 billion by 2010-11. Central government has contributed £4.7 billion to this total.

10 The use of accruals-based systems, together with the impact of HM Treasury's Faster Closing Initiative,[3] has helped departments to improve their external financial reporting. In 2007, only three departments and one department pension scheme failed to meet the summer recess target for presenting accounts to Parliament[c], whereas in 2003 only nine departments met the summer recess target and six departments failed even to present their accounts to the National Audit Office by the statutory November deadline.

a The two departments that do not currently have a qualified Finance Director are the Ministry of Defence and the Crown Prosecution Service. The Permanent Secretary of the Ministry of Defence stated to the Committee of Public Accounts on 3 December 2007 that the successor to the current Finance Director would be a professionally qualified accountant. The Finance Director of the Crown Prosecution Service is one year in to the Chartered Institute of Management Accountants' two-year accelerated route to qualification.

b The four departments who have a professionally qualified Finance Director without a place on the Board are the Department for International Development, and the regulators, the Office of Fair Trading, the Office of Gas and Electricity Markets and the Water Services Regulation Authority (OFWAT). The Department for International Development's Finance Director is represented on the Board by the Director-General for Corporate Services, although the Finance Director is generally present when the Board discusses financial issues. The Board also contains two qualified finance professionals. Although the Finance Directors of Office of Fair Trading, the Office of Gas and Electricity Markets and the Water Services Regulation Authority (OFWAT) do not have permanent seats on their departmental Boards, the relatively small expenditure of these departments is generally discussed at Board level with the Finance Director present. The Office of Gas and Electricity Markets Board also has a qualified Accounting Officer and Chief Executive.

c For 2006-07, the Home Office, the Department of Health, the Department of Health Pension Scheme and the Department for Environment, Food and Rural Affairs failed to meet the summer recess target for presenting their accounts to Parliament.

11 Internal reporting has also benefited. Nearly all departments now have accruals-based financial information systems, compared to around one in four at time of our last report. However, progress could be made in improving the timeliness and accuracy of internal reporting:

- Only 39 per cent of departments we surveyed said that their in-year reports were produced and forwarded to the Board within ten working days after the period end, the standard used by HM Treasury in assessing departments during their Financial Management Reviews. At the time of our survey, the Office of Fair Trading was able to produce limited in-year reports for its Board within three working days, although the Office now produces more sophisticated in-year reports eight days after the period to which they relate. At the Ministry of Defence, while financial reports are available within 17 working days after the period end, the Board prefers to receive reports that have been reviewed by the Finance Director accompanied by proposals for action where necessary. This extends to 43 working days after the period end, the average time taken to produce and forward to the Board in-year reports.
- Many departments reported problems with the accuracy and timeliness of primary data from which in-year reports on financial and operational performance are produced.

12 Departments could do more to link improved financial management information to information about the quality of public services being delivered. If departments know exactly what has been spent on what programmes and to what effect, they will be better able to assess whether they are achieving value for money and engage more intelligently with delivery partners. Most departments are not sufficiently well placed to do this as they have made limited progress in integrating financial and operational performance information. More than half of departments still report financial and operational performance information to the Board separately. Non-Executive Directors in our workshops expressed frustration that it is not routine for key decisions to be based on a comprehensive assessment of both financial management information and data on service performance.

Departments need to improve their forecasting capabilities

13 Departments are benefiting from using financial resource management techniques to improve how their businesses are preparing for future challenges. For example, almost all departments now have detailed business and capital investment plans.

14 However, departments could do more to improve their forecasting capabilities. Poor forecasting can lead to departments exceeding their Departmental Expenditure Limits or conversely, where unanticipated underspends are not identified sufficiently early, losing the opportunity for unspent funds to be reallocated to other key priorities. We interviewed several Finance Directors and budget holders who had concerns about how well departments forecast future resource needs. In addition, some departments continue to produce forecasts that vary significantly from the actual expenditure then incurred only a few months later. Typically, these departments significantly underspend against their forecasts.

15 Reforms to the end of year funding process may no longer incentivise departments to manage their budgets in a way that represents optimum value for money. In 1999-2000, under the End Year Flexibility initiative (EYF), departments were given the flexibility to carry forward unspent funds from one year to another (partial EYF was in place before this). This was intended to reduce the trend of departments spending their remaining budget wastefully in the fourth quarter of the financial year to safeguard their budget for subsequent years.

16 Drawdown of EYF has always been subject to the approval of HM Treasury. In light of the tighter fiscal environment, HM Treasury has exercised greater control over the amount departments can use from their balances of unspent funding brought forward from previous years. This has led to several departments losing confidence in the system. There is a risk that the system now offers departments insufficient incentives to avoid wasteful spending of excess funds towards the end of the financial year.

Recommendations

1 *Issue: The lack of financial skills and awareness amongst non-finance staff remains a significant barrier to improving the management of financial resources across government. If inadequately skilled, non-finance staff will be unable to manage their budgets effectively.* The Cabinet Office should work with departments to establish how many senior civil servants and staff at Grade 7 meet the standard for the financial management core skill, as laid out in the Professional Skills for Government framework. Departments should then use their staff appraisal processes to ensure that all staff at Grade 7 and above can demonstrate that they meet this standard. HM Treasury should continue to provide technical expertise in the design of training material.

2 *Issue: Some departments still do not have a qualified Finance Director at Board level despite HM Treasury's requirement that all departments have one by December 2006. In our view, this risks financial resource management being given insufficient professional leadership at the very top of departments.* As a matter of urgency, there should be a qualified Finance Director at Board level in every department.

3 *Issue: Senior managers in many departments are not provided with the incentives to promote sound management of financial resources. This makes it unlikely effective financial resource management will become embedded into departmental cultures.* Senior Managers should be properly accountable for their financial resources and incentivised to use them efficiently and effectively. As a first step, departments should include an assessment of their management of financial resources within the performance appraisal system for Permanent Secretaries and all senior civil servants.

4 *Issue: Departments could do more to improve their forecasting capabilities to ensure they are adequately prepared for future challenges to delivering public services*. HM Treasury spending teams should work with departments to reduce the number of departments whose final outturn varies by more than five per cent against their final resource Departmental Expenditure Limit and by ten per cent against their final capital Departmental Expenditure Limit.

5 *Issue: Some departments have lost confidence in HM Treasury allowing them to draw down resources carried forward from one year to the next. This might weaken incentives for departments to avoid wasteful spending of excess funds at the end of the financial year.* HM Treasury should review the system of End Year Flexibility to ensure that it provides the right incentives to improve departments' use of their financial resources. In particular, HM Treasury needs to communicate with departments earlier and more clearly about how much underspending from previous years departments can use.

6 *Issue: Departments are not sufficiently well placed to integrate financial and operational performance information, making it difficult to evaluate the value for money of their businesses.* Departments should present integrated financial and operational performance data to the Board to enable them to compare the cost of their principal outputs and to improve the evidence on which they base resource allocation decisions.

7 *Issue: Many departments do not always ensure that a full assessment of the financial implications of policy proposals is included in all submissions to Ministers and Board members.* In order to strengthen departments' focus on value for money, every policy proposal submitted to Ministers and Board members should include a full assessment of its financial implications.

8 *Issue: Departments do not always make best use of non-Executive Directors.* HM Treasury should assess how well departments have developed clearly defined roles for their non-Executive Directors on their Boards and consider how the Corporate Governance Code can be refreshed to enable non-Executive Directors to challenge and support departmental activity effectively.

PART ONE

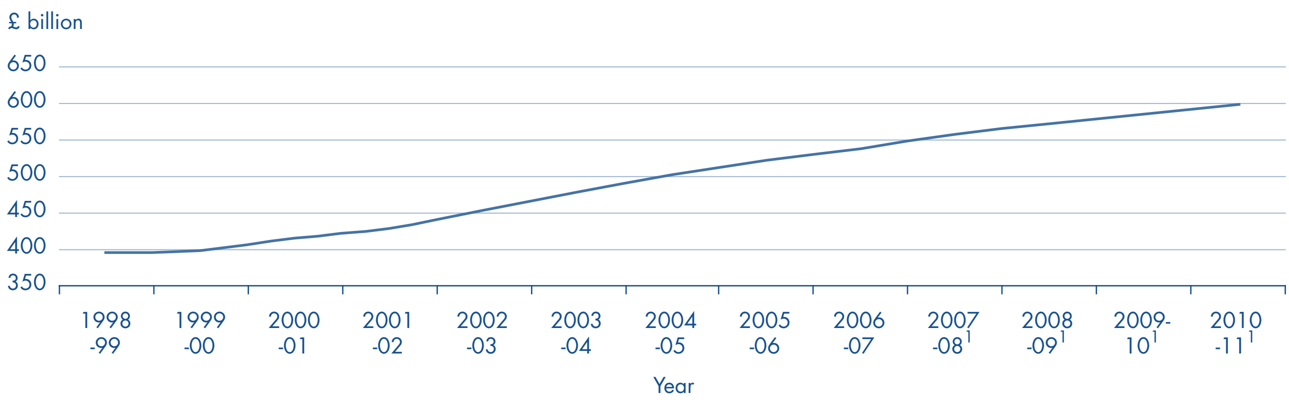
The importance of managing financial resources

Central government departments are managing considerable financial resources in an increasingly challenging environment

1.1 The Comptroller and Auditor General's 2003 report *Managing resources to deliver better public services*[4] found that there was potential for departments to improve the management of their financial resources. In particular, the report concluded that departments would benefit significantly from making further progress in moving from cash-based to accruals-based accounting and budgeting systems. The Committee of Public Accounts made a similar conclusion in its report on the same subject.[5] Appendix 2 details the full recommendations from the Committee's report.

1.2 Since publication of the 2003 report, government spending on public services has grown by 33 per cent to £558 billion in 2006-07[6], and accounts for 42 per cent of Gross Domestic Product, compared to 39 per cent in 2002-03. **Figure 2** shows that it is forecast to continue to grow in real terms.[7] In addition, central government manages assets worth £441 billion.[8] Strong management of these resources is central to ensuring that departments deliver their objectives efficiently and effectively and provide the taxpayer with value for money.

2 Total Managed Expenditure has been increasing in real terms since 1998-99 and is projected to do so during the next three year spending period



Source: National Audit Office, based on HM Treasury's Public Expenditure White Paper for years 2001-02 to 2006-07 and projections contained in the 2007 Pre-Budget Report and Comprehensive Spending Review for years 2007-08 to 2010-11. All prices are at 2005-06 levels

NOTE

1 Projected figures.

1.3 Departments face many challenges in managing their financial resources effectively, many of which are similar to those which existed in 2003. These include:

- **complexity of service delivery:** Public service delivery involves a wide range of bodies from the public, private and voluntary sectors;
- **changing customer needs:** Users of public services are increasingly demanding more convenient access to services;
- **unpredictable demand for services:** Demand for public services is not consistent. It changes in response to political, social and economic developments;
- **long-term changes in society:** Globalisation, our ageing population and climate change all present significant long-term challenges for how the public sector best uses its financial resources; and
- **changing priorities:** Ministers may announce new departmental priorities at any time in response to national or global developments.

The diagram in the 'Key Facts' section at the front of this report shows in more detail how strong financial resource management is essential to maintaining high standards of service delivery in the face of these challenges.

1.4 It is now even more important that departments are able to manage financial resources effectively. On 9 October 2007, the Chancellor of the Exchequer announced the results of the 2007 Comprehensive Spending Review which sets out departments' priorities for the spending period 2008-09 to 2010-11. For many departments the settlements are tighter than in previous spending reviews. For example, the resource Departmental Expenditure Limits for the Department for Work and Pensions and HM Revenue & Customs are planned to be lower in 2008-09 than in 2007-08 in nominal[9] terms. The Chancellor also announced that departments will be expected to achieve £30 billion in value for money savings by 2011, on top of savings of £21.5 billion that departments are expected to deliver as part of the 2004 Spending Review.

1.5 In addition, to meet the cross-cutting nature of the challenges facing government today, departments are being expected to use their resources more collaboratively to meet policy goals. Departments' new Public Service Agreements reflect this. Many of the 30 Public Service Agreement targets are shared between departments. Progress towards the joint targets will be greatly aided by effective management of financial resources between departments.

HM Treasury has the lead responsibility for ensuring sound management of financial resources in central government

1.6 HM Treasury oversees expenditure by departments and monitors achievement of Public Service Agreement targets. As part of this role, HM Treasury has a high-level objective of achieving world class standards of financial management in government.[10] HM Treasury has outlined the concept of World Class Financial Management in various documents including Managing Public Money[11], its manual on how to handle public funds of all kinds, and the framework which it used to conduct its Financial Management Reviews of departments **(see Figure 3 overleaf)**. For the purposes of this report, we have condensed the range of characteristics of world class financial management in a table shown at Appendix 3.

1.7 Some of the characteristics of world class financial management outlined in Appendix 3 relate to developing a departmental culture which fully recognises the importance of managing financial resources. Others are focused on improving the practical application of advanced techniques; for example, bringing together financial and operational performance information. HM Treasury, alongside the Cabinet Office, has introduced a number of initiatives aimed at addressing both the cultural and the practical aspects of departments' management of financial resources. The key initiatives are detailed in Figure 3.

1.8 The remainder of this report is divided into three parts:

- Part 2: The development of the skills and awareness necessary for effective management of financial resources.
- Part 3: The extent to which departments make effective use of more advanced techniques to improve the management of their financial resources.
- Part 4: The impact of improving financial resource management.

3 Key Initiatives introduced by HM Treasury and Cabinet Office to improve the management of financial resources

Initiatives encouraging a stronger culture of financial resource management across government	
Code of good practice on corporate governance	In July 2005, HM Treasury introduced the Code, setting out the framework for the overall direction and control of departments, agencies and non–departmental public bodies. Its aim is to improve governance by focusing on resource management, delivery and risk.
Managing Public Money	In October 2007, HM Treasury published *Managing Public Money*, a manual of the principles and key controls which should govern the deployment of public funds, replacing *Government Accounting*.
Professional Finance Directors	In July 2004, HM Treasury set a target that all Finance Directors of departments should be professionally qualified and should have a seat on the departmental Board by December 2006.
Fast Stream in finance	In 2006, HM Treasury introduced a finance specialism to the Civil Service Fast Stream programme. During the programme, participants train for a professional accountancy qualification alongside their other duties.
Accelerated route to a financial qualification	HM Treasury has also worked with the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Chartered Institute of Management Accountants (CIMA) to develop a course allowing senior managers with experience in a finance role to accelerate their progress towards gaining a professional finance qualification.
Professional Skills for Government	The programme, launched in September 2005 and led by the Cabinet Office, includes financial management as one of six core skills. The programme is designed to improve skills at middle and senior civil service grades. It incorporates the development of core financial management competencies and minimum standards for finance professionals. HM Treasury has been involved in the development of initiatives to improve finance skills in central government, including *Finance Skills for All* (see Figure 6) and the finance option to the Civil Service Fast Stream (see Figure 5).
Government Hundred Group	Since 2004 HM Treasury has hosted regular meetings of Finance Directors of the largest departments (the Finance Directors Working Group) and of all Finance Directors to encourage best practice. In June 2007, this was extended when HM Treasury created the Government Hundred Group, a network of senior finance professionals from departments, executive agencies and non-departmental public bodies whose aim is to exchange views, encourage best practice and act as a mutual support network.
Financial Management Advisory Panels	Following a June 2006 conference with financial management advisers to government, HM Treasury set up the Financial Management Advisory Panels. The Panels aim to publish their advice on best practice in Spring 2008.
Initiatives encouraging better practices and techniques	
Three-year budgets	Since 1998 HM Treasury has allocated budgets for three-year periods[1], giving departments greater certainty over their future funding, and has agreed Public Service Agreements with departments against which it may measure their performance.
The 2007 Comprehensive Spending Review	The 2007 Comprehensive Spending Review brought about significant reform to the Public Service Agreement Framework. The vast majority of Public Service Agreement targets are now shared by more than one department, although individual departments' responsibilities are detailed in their Departmental Strategic Objectives. As part of this initiative, departments are required to provide an assessment of what it will cost to achieve these objectives.
End Year Flexibility	In 1999-2000, HM Treasury gave departments full flexibility to carry forward unspent funds between years. This was intended to discourage departments from using resources towards the year-end in a sub-optimal way, where previously they would have lost any unspent funds in subsequent years.
Faster Closing	In 2002, HM Treasury set departments the target of laying their resource accounts in Parliament before the summer recess. The initiative aimed to address the problem that accounts finalised after the mid-July recess cannot be laid until Parliament has returned in October, thereby reducing their usefulness[2]. In addition, in order to finalise their accounts earlier, departments would need to improve their in-year systems and processes.
Resource Accounting and Budgeting	Since 1999-2000, departments have been required to produce resource accounts on an accruals basis, which involves matching expenditure to the period in which costs were incurred (rather than paid), and fully recognising the cost of owning assets (such as buildings). Budgets moved to a full Resource Accounting and Budgeting (RAB) basis from 2003-04. Previously, budgets and accounts had simply shown the amount of cash spent and received by a department in a particular year. Resource accounting and budgeting is intended to provide a more accurate picture of the cost of departmental activity and improve in-year financial reporting.

3 Key Initiatives introduced by HM Treasury and Cabinet Office to improve the management of financial resources *continued*

Initiatives encouraging better practices and techniques *continued*

Financial Management Reviews	In 2005, HM Treasury conducted Financial Management Reviews of all 45 central government departments. These examined accountability structures, planning and budgeting, the production and use of financial information, the effectiveness and efficiency of the finance function and departments' working relationships with HM Treasury. HM Treasury presented a memorandum setting out the common themes of the Reviews to the Treasury Select Committee in April 2006
Better alignment of budgets, Estimates and accounts	HM Treasury is currently working on a project, announced by the Prime Minister in the "Governance of Britain" Green Paper (Cm7170) in July 2007, designed to achieve better alignment between departments' budgets, estimates and resource accounts. The aim is to create a single, coherent financial regime that: ■ improves the effectiveness, efficiency and transparency of the process; ■ enhances accountability to Parliament and the public and underpins the Government fiscal framework; ■ incentivises good value for money; and ■ supports delivery of public services. HM Treasury aims to start implementing changes from 2010-11 onwards, subject to resolving legislative and other issues.

Source: HM Treasury and the Cabinet Office

NOTES

1 Only expenditure not expected to vary significantly is budgeted on a three year basis. The maximum expenditure allowed on this basis is known as the Departmental Expenditure Limit. More volatile expenditure, such as benefit payments, is still budgeted each year, and is known as Annually Managed Expenditure.

2 For example, Professor David Heald in *The implementation of Resource Accounting in UK Central Government, Financial Accountability and Management* (May 2005) highlights how a failure to provide timely financial information has a negative impact on public accountability and raises doubts about the extent to which accounting information is used for managerial purposes.

1.9 We gathered evidence on these issues by conducting:

- a survey of 37 government departments. A sample of the departmental returns, including those of the top ten spending departments, was reviewed by the National Audit Office's Financial Audit Directors to ensure they provided a fair assessment of the departments' management of financial resources;
- interviews with six Finance Directors, representing the diversity of government departments;
- interviews with budget holders within departments;
- two workshops with non-Executive Directors of departments;
- analysis of published data on budgets, expenditure and asset holdings; and
- examination of financial reports to departmental Boards, departmental risk registers, and the memorandum on Financial Management Reviews prepared by HM Treasury for the Treasury Select Committee in April 2006.

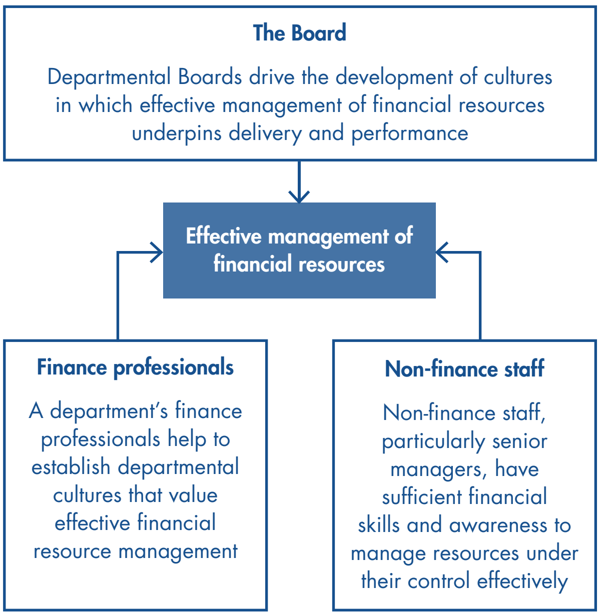
For more details on the methodology, see Appendix 1.

PART TWO

Developing the skills and awareness necessary for effective financial resource management

2.1 **Figure 4** shows that management of financial resources is the responsibility of everyone in a department. In this section of the report, we consider whether departments – at Board level, in the designated finance teams and more generally amongst non-finance staff – are developing the necessary skills and awareness for effective financial resource management.

4 Effective financial resource management requires action from all parts of a department



Source: National Audit Office

The presence of more qualified Finance Directors on departmental Boards has increased the focus on sound management of financial resources

2.2 In 2004, only 39 per cent of departmental Finance Directors held a recognised finance qualification.[12] Sir Peter Gershon's 2004 review of public sector efficiency identified strong financial management as being essential to the efficient use of resources and a prerequisite to the successful delivery of major efficiency programmes. This reflected not only best practice in the private sector and wider public sector, but also the best-in-class practice that the Gershon Review saw in a small number of departments. As a priority, the Review recommended that the financial management of departments be strengthened by making it a requirement that all departments have a professional Finance Director reporting to the Permanent Secretary with a seat on the departmental Board by December 2006.[13] All the evidence the Review team saw confirmed that such appointments provided leadership of the efficiency agenda, strong internal challenge to a department's business and a catalyst for driving change.

2.3 In the 2004 Spending Review, HM Treasury made this a requirement with which all government departments had to comply.[14] Although departments have made good progress towards meeting this requirement, six central government departments still lack a professionally qualified Finance Director at Board level.[15] These six departments accounted for over eight per cent of total central government expenditure, over £45 billion, in 2006-07. Of these six departments, the Ministry of Defence is the largest, accounting for seven per cent of total central government expenditure. It appointed its Finance Director to the Board in June 2004. At a recent hearing of the Committee of Public Accounts, the Permanent Secretary of the Ministry of Defence stated that the successor to the current Finance Director would be a professionally qualified accountant.[16]

2.4 Most departments regard the requirement that they have a qualified Finance Director on the Board as the most useful initiative on financial resource management to come from the centre of government. It is considered to have significantly raised the profile of financial resource management at the most senior level of the department. In addition, a number of non-Executive Directors described how this had raised the profile of financial resource management on the Board and throughout the department.

2.5 Since this requirement was set, many departments have appointed Finance Directors from outside central government. Budget holders in departments where this has occurred, such as National Savings & Investments, believe their appointment has brought about new and beneficial practices. For example, financial and operational performance reports are clearer and more concise. Non-Executive Directors at our workshops described clarity of reporting as being crucial to their ability to digest management information prior to a Board meeting. Furthermore, a number of them, in some cases possessing significant financial management experience themselves, spoke positively about the capability of the Finance Directors with whom they work.

The number of professionally qualified staff is increasing but recruitment of finance professionals to government remains a significant challenge

2.6 Since 2006, HM Treasury has collected data on qualified finance professionals working in government departments. The total number of qualified finance professionals in government departments, agencies and non-departmental public bodies has increased from 3,656 in 2006 to 3,959 in 2007, a rise of eight per cent. The number of senior civil servants holding a professional finance qualification increased by more than 30 per cent, to 404. Furthermore the proportion of staff working in a designated finance team who held a financial qualification increased from 12.6 per cent to 14.3 percent between 2006 and 2007. However, not a single Permanent Secretary holds a professional finance qualification. While their role is significantly different to that of Permanent Secretaries, in November 2005, a quarter of Chief Executives of FTSE 100 companies were qualified accountants.[17] Since 2005 32 Ministers have attended financial and risk seminars organised by the National School of Government.[18]

2.7 HM Treasury has worked closely with CIPFA and CIMA to develop an accelerated route for civil servants with some financial experience to attain a professional finance qualification. Participants on this programme sit the same exams as other candidates but are able to accelerate their qualification through exemptions from early papers based on prior knowledge.

2.8 HM Treasury is also working with departments to professionalise finance in central government at entry level. In 2006 a finance option to the Civil Service Fast Stream was introduced. Eighteen people joined the programme in its first year. Fast Stream participants who choose to take the finance option train for a recognised professional accountancy qualification from one of the institutes represented on the Consultative Committee of Accountancy Bodies alongside their other duties. While graduates of this programme will not be expected to spend their whole career in the finance function, HM Treasury and Finance Directors hope that this initiative will breed a new cadre of financially-literate general managers in the civil service as well as convince some talented staff that finance is an attractive career path in the civil service. **Figure 5** provides an example of how a participant on the programme has found the programme to be of benefit.

5 HM Treasury has added a finance option to the Civil Service Fast Stream programme

We spoke to a Fast Stream in finance participant from the Department for Business, Enterprise and Regulatory Reform, as well as a senior finance officer from the department itself. Both spoke positively about their experiences of the programme. In particular, the Fast Stream participant said that "a good level of financial understanding combined with policy knowledge is imperative, helping me to effectively monitor and analyse the performance of a government department and its delivery bodies." He also stated that the programme has "raised awareness that a finance-oriented career need not mean a career solely within the finance function". The finance officer from the Department for Business, Enterprise and Regulatory Reform regarded the Fast Stream in Finance as an important element in the department's drive to improve financial skills and awareness.

Source: National Audit Office

2.9 Departments have difficulty recruiting and retaining qualified finance staff. Forty per cent of Finance Directors selected this as one of the top three barriers to improving the management of financial resources. The most common reason given by Finance Directors and non-Executive Directors was the fact that departments cannot offer qualified finance professionals the same levels of remuneration that are available elsewhere.

HM Treasury, the Cabinet Office and departments have taken steps to improve the skills and awareness of non-finance staff, though it is unclear how effective they have been

2.10 It is important for financial skills and awareness to reside not only in the finance team but throughout a department. Strong financial awareness amongst non-finance staff will help to improve the quality and timeliness with which financial and operational reports are produced at programme or business unit level. This in turn will assist the finance function when preparing reports for the whole department. Improved financial awareness will also enable non-finance staff to realise the importance of strong financial resource management, thereby raising its profile in the organisation.

2.11 In our survey of departments, 69 per cent of departments cited 'poor financial awareness amongst non-finance staff' as one of the three most significant barriers to improving resource management from a list of eight, making it the most frequently cited barrier. HM Treasury also identified this as an area which requires attention in both the summarised report of its 2004-05 Financial Management Reviews and its 2007 Annual Report.

2.12 In August 2005 HM Treasury commissioned consultants FTC Kaplan to conduct a review of departments' internal finance courses. The consultants found that only the courses in the Ministry of Defence and those offered by the National School of Government met the required standards for finance as a core skill under the Professional Skills for Government programme.

2.13 Following the review, HM Treasury and the National School of Government, in conjunction with six of the biggest spending departments developed a tiered training programme known as *Finance Skills for All* **(see Figure 6)**. Attendance on the programme is voluntary, however, and departments may continue to provide their own training courses.

2.14 The number of senior civil servants and Grade 7 staff who have registered and completed the e-learning platform, remains low. According to data from the National School of Government, in 44 per cent of departments not a single senior civil servant has completed tier 1. However, the one department where more than ten per cent of senior civil servants had completed the course found it to be useful in embedding improved financial management skills throughout the organisation **(see Case Example 1)**. Furthermore, two departments, the Department for Work and Pensions and the Foreign and Commonwealth Office, have included Finance Skills for All as part of their wider business transformation programmes.

2.15 Results of our survey and interviews with Finance Directors and budget holders show that many departments provide their non-finance staff with financial training. However, the standard of these courses varies across central government departments. Some have financial training courses integrated into department-wide financial management change programmes, others provide no internal courses and have not shown significant take-up of *Finance Skills for All*.

CASE EXAMPLE 1

Promoting finance training for non-finance staff at all levels of an organisation

Soon after its launch, the Department for Transport made completion of the *Finance Skills for All* e-learning course mandatory for Board members and senior civil servants. By May 2007, every Board member, including the Permanent Secretary, had completed the course. The Department's survey return shows that 88 per cent of senior civil servants had registered for the course and 69 per cent had completed it.

Budget holders that we spoke to said that the course was not excessively burdensome and, although they felt that they already had strong financial skills, they found it useful.

The Department's Finance Director explained that sponsorship and support from the top of the organisation was a crucial driver for the take-up it achieved. Our survey shows that it has also had an impact lower down the Department, with 27 per cent of staff at Grade 7, and 16 per cent of staff at grades below Grade 7 having registered for the course by May 2007. Budget holders explained to us that this initiative helped to make it clear that strong financial resource management is a corporate priority.

Source: National Audit Office

6 HM Treasury and the National School of Government have developed a tiered finance training programme called *Finance Skills for All*

Tier 1	Tier 2	Tier 3
Tier 1 involves ten learning modules that are completed online. Civil servants can check whether or not they already have the skills taught in each module by using the self-assessment tool. All ten modules can be completed in less than eight hours and are available to staff in all central government departments free of charge. It cost £450,000 to develop.	Once users' training needs have been identified, they are addressed by attending half-day classroom-based courses on each of the ten modules that the user did not complete successfully. These courses are run by the National School of Government. The National School of Government has made the content of these courses available to departments free of charge, to enable them to develop courses that comply with the standards required by the Professional Skills for Government programme.	Tier 3 is a series of two-day courses designed to extend financial resource management skills further and link them to the other core skills in the Professional Skills for Government programme. The courses were designed by HM Treasury and are run by the consultants FTC Kaplan.

Source: HM Treasury and the National School of Government

2.16 Some Finance Directors stated that their reason for not fully endorsing *Finance Skills for All* within their department is that the content duplicated that of their own courses. Others explained that it does not match the requirements of the department as well as their own courses. For example, the Finance Director of National Savings & Investments stated that, in his opinion, much of *Finance Skills for All* goes beyond the requirements of some of the people in his department. He informed us that he would be conducting a gap analysis against his department's own needs and would select the most relevant elements of the course and build a tailored internal training programme around them.

2.17 In addition to *Finance Skills for All*, the National School of Government runs two and three day courses on financial management that are available to all civil servants, and which meet the requirements of the Professional Skills for Government programme.

2.18 In 2005 the Civil Service Management Board set central government the target that 75 per cent of senior civil servants should demonstrate each of the six core skills in the Cabinet Office's Professional Skills for Government programme by September 2007. Finance is one of these core skills. The Cabinet Office originally based its assessment of progress towards this target on self-assessment questionnaires. The last of these was conducted in April 2006 and showed that nearly 70 per cent of respondents felt that they had already met the core skills criteria in financial management. However, the Cabinet Office does not trust the reliability of the data and so has abandoned the self-assessment questionnaires. It is currently working with consultants to create a new strategy for evaluating the impact of Professional Skills for Government more generally, based on sample surveys and interviews with practitioners to assess the impact of improving skills upon key performance indicators of success. This work is not yet complete.

Several departments are taking positive steps to build relationships between the finance department and non-finance areas

2.19 Our survey shows that over 70 per cent of departments consider the finance team to be either 'strong' or 'very strong' at building relationships with other areas of the department. However, several budget holders and non-Executive Directors suggested that finance needs to think more about delivery requirements rather than just financial information.

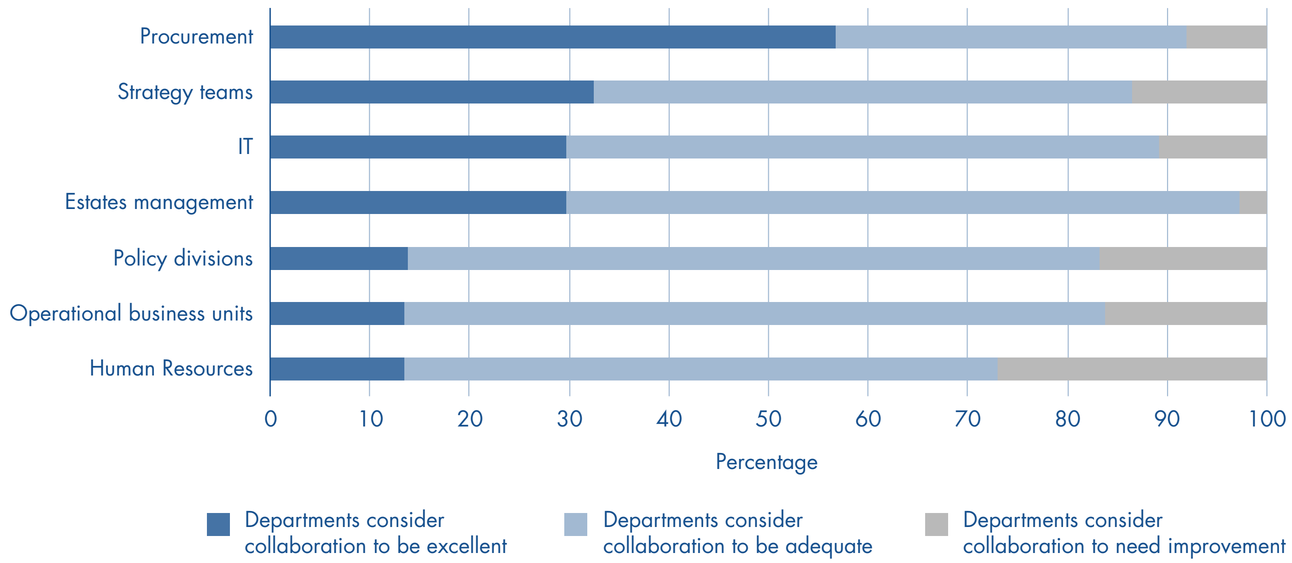
2.20 The survey also shows that departments consider that the finance team could collaborate more effectively with other areas of the business, particularly Human Resources **(see Figure 7 overleaf)**. Twenty seven per cent of departments consider that collaboration between finance and Human Resources 'needs improvement'. This is a significantly higher proportion than for relationships between finance and any other business function.

2.21 Only 14 per cent of departments consider collaboration between the finance team and both policy and operational business units to be 'excellent'. Interviews with budget holders and Finance Directors revealed that increasing both the financial awareness of non-finance staff and the finance team's awareness of the department's delivery objectives would help to build more constructive relationships between the two. **Case Example 2** shows how two departments, one large and one relatively small, have developed these relationships to improve mutual understanding between finance and non-finance areas, and how this has been of benefit. Both approaches involve embedding members of the finance function within business units. Non-Executive Directors from departments with embedded finance staff in business units consider this to be one of the main drivers of effective resource management.

Financial resource management is becoming more central to departmental cultures, although more progress would be achieved if senior civil servants' performance appraisals included criteria related to the management of financial resources under their control

2.22 Financial management is not currently central to organisational culture in the civil service. For example, we noted that the 2006 senior civil service survey run by the Cabinet Office[19] asked respondents to evaluate the effectiveness of their organisation across a range of subjects, for example how well departments manage staff performance. None of the questions related either to managing financial resources or whether the department is achieving value for money.

7 There is scope for departments to develop further the relationship between the finance function and other areas of the department



Source: National Audit Office survey

2.23 Finance Directors and non-Executive Directors told us that it is the departmental Board that drives the development of a strong finance culture. Those Finance Directors who feel that they have a supportive Permanent Secretary or equivalent explained how valuable this had been in convincing the whole organisation that strong financial resource management was crucial to the department's success.

CASE EXAMPLE 2

Business partners: Improving both the skills of non-finance staff, and the finance department's awareness of the business

The **Finance Director of National Savings & Investments** has recently restructured the finance function, placing finance staff known as 'business partners' in operational and project areas to act as a link between finance and the rest of the business.

Business partners support budget holders on financial management matters and provide on-the-job training for non-finance staff. For example, business partners have recently focused on improving the quality of accruals recorded at the end of the month. This has reduced the amount of time the finance department spends correcting the information it receives from the business and, as a result, the Executive Management Team can now discuss the department's financial position eight days after the month's end rather than 20 days as previously.

Group Finance: Dedicated financial management support to budget holders

The **Department for Business, Enterprise and Regulatory Reform** has also taken steps to integrate finance more closely with operational and policy areas. Each of the Department's five main business areas has a dedicated finance team which supports budget holders on matters such as planning, forecasting, production of monthly and quarterly reports and emerging issues and risks. These finance teams have an overview of a significant but manageable portion of the department, and are therefore able to identify opportunities for reallocation of resources within the business group.

A member of each business area's finance team sits with individual budget holders and their teams to provide them with advice about day-to-day financial resource management activities. The budget holder that we spoke to found this particularly useful.

Budget holders and the Finance Director informed us that this structure has been highly beneficial. For example, it has facilitated tight budgetary control during a period in which the Department has a resource settlement from HM Treasury which is reducing in real terms, and when a large proportion of its budget is ring-fenced.

Source: National Audit Office

2.24 Finance Directors, budget holders and non-Executive Directors feel that a strong finance culture could be further developed were the Board to provide itself and budget-holders with more accountability for financial resources and more incentives to manage them effectively. Our survey shows that departments regard the lack of incentives as the second most significant barrier to improving resource management. Non-Executive Directors also singled this issue out when asked to explain where they felt the barriers were.

2.25 Permanent Secretaries are normally the department's Accounting Officer and are ultimately accountable for the department's overall performance. *Managing Public Money*, HM Treasury's guidance on ethical stewardship of resources, states that accounting officers should ensure that the organisation operates effectively and to a high standard of probity in financial management matters. However, financial matters do not automatically feature in Permanent Secretaries' performance assessment criteria. Each Permanent Secretary defines his or her criteria in consultation with the Head of the Home Civil Service, the Cabinet Office and HM Treasury. In order that resource management features more prominently in the future, from 2007-08 the Cabinet Office is to involve HM Treasury earlier in the process.

2.26 In addition, financial management matters are not automatically included in the performance assessment criteria for senior civil servants or budget holders. The Cabinet Office is currently reviewing the performance assessment framework for the senior civil service and while it is expected that finance will be present within that framework, it will not be a mandatory element for the whole senior civil service. However, one department's budget holders informed us that responsibilities related to financial management are included in their terms of reference, while a budget holder at another department informed us that his bonus depended on how well he managed the resources under his control.

Departments have benefited from the advice and challenge provided by non-Executive Directors, but more can be done to strengthen governance in other areas

2.27 The majority of Finance Directors consider non-Executive Directors to have improved standards of financial resource management in departments by using their experience to provide robust, independent challenge to the Board. In particular, several Finance Directors commented on how beneficial it was to have a non-Executive Director with knowledge of financial resource management as Chair of the Audit Committee. They stated that Audit Committees have been more effective as a result.

2.28 Our survey shows that this independent expertise is present in a significant majority of departments:

- 97 per cent of Audit Committees are chaired independently; and
- 91 per cent of Audit Committees have at least one member who holds a recognised accountancy qualification.

Furthermore a non-Executive Director of the former Department for Education and Skills, and a number of departmental Finance Directors stated that having at least one non-Executive Director with a background in finance and at least one with detailed knowledge of the department's operations worked well.

2.29 Most non-Executive Directors consider that their role as critical friend, advisor and consultant to the department is appropriate and enables them to be effective. However, a small number of Finance Directors and non-Executive Directors felt that the precise remit of non-Executive Directors would benefit from greater clarification. Some Finance Directors were disappointed by the lack of impact achieved by their non-Executive Directors.

2.30 During our workshops, non-Executive Directors agreed that they would benefit from more assistance from their departments' Internal Audit functions. There was also consensus that departments often find it difficult to recruit high calibre staff (for example Fast Stream participants) to fill internal audit posts and Internal Audit does not sufficiently address key departmental risks. HM Treasury updated the Audit Committee Handbook in March 2007 and is currently undertaking a review of Government Internal Audit Standards. The first stage of this review, which considers the scope for, and implications of, adopting international auditing standards, is to be completed in March 2008.

Improving departments' use of techniques and practices for managing financial resources

3.1 This part examines the extent to which departments are making effective use of advanced resource management techniques. It examines the extent to which departments understand their existing financial position and make appropriate preparations for the future.

Understanding the current position entails:

- Moving to accruals-based accounting systems
- Integrating reporting of financial and operational performance information
- Ensuring in-year reporting is timely and reliable
- Managing the departmental balance sheet effectively
- Exercising effective oversight of executive agencies and non-departmental public bodies

Preparing for the future involves:

- Drawing up robust plans and forecasts
- Assessing policy proposals and operational and investment decisions
- Managing financial and operational risks effectively
- Using appropriate incentives to drive required behaviours

Understanding the current position

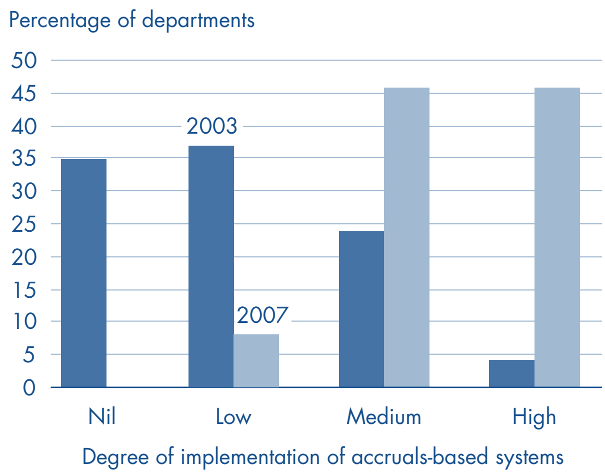
Departments have made significant progress in moving from cash-based to accruals-based accounting and budgeting systems

3.2 Departments began to implement accruals-based accounting systems in 2001-02 in order to obtain better information on how resources are being used by understanding the true costs of providing services (rather than simply what is paid out in cash) and of owning assets. We found in our survey that 17 departments had implemented accruals-based systems to an extent which offered high potential to improve their resource management compared with two in 2003. In addition the number of departments that had made limited progress in implementing accruals-based systems had reduced from 33 in 2003 to three in 2007[20] **(Figure 8)**.

Departments have made limited progress in reporting the comparative cost-effectiveness of each of their programmes by integrating financial and operational performance information

3.3 By integrating financial and operational performance information departments will have a clearer picture of how much is being spent on which programmes and to what effect. Departments cited the ability to better match inputs to outputs as one of the four factors most likely to improve their management of financial resources. This

8 Departments have made good progress in implementing accruals-based accounting and budgeting systems



Source: National Audit Office survey and National Audit Office report (2003), Managing resources to deliver better public services (HC 61) enables them to better assess the unit costs for each key output and so gauge the impact of switching resources between priorities both in financial and operational terms. While we found examples of departments who had made significant progress **(Case Example 3)**, many departments have much to do in order to produce integrated performance reports. In response to our survey, 57 per cent of departments still report financial and operational performance separately to the Board. Departments will therefore need to work hard to be able to comply with HM Treasury's recent requirement that they state the cost of achieving each of their Departmental Strategic Objectives.[21]

The quality and timeliness of in-year reporting to the Board on the financial and operational performance of the organisation remain mixed

3.4 Departmental Boards and senior management need prompt and reliable information regarding the financial and operational performance of their department. Where adequate information is not available, departments are unable to assess whether their resources are being deployed effectively and whether they are achieving value for money in respect of the services they provide. For example, our examination of the work by the Department for Work and Pensions to help disabled people find a job[22] found that 'the Department's knowledge and understanding of what providers deliver is poor, largely because management information…is of insufficient quality'.

3.5 Many departments reported problems with the accuracy and timeliness of the primary data from which in-year reports on financial and operational performance are produced **(Figure 9)**. Some non-Executive Directors reported that their departments often experienced difficulties in obtaining the necessary information for them to assess financial and operational performance across the departmental family. While government agencies and non-departmental public bodies have the primary responsibility for managing their own financial resources, it is important that these bodies report reliable high-level performance information to their parent departments promptly. These weaknesses in primary data increase the risk that key decisions regarding the use of departmental resources may be based on flawed information.

3.6 Only 39 per cent of departments we surveyed said that their in-year reports were produced and forwarded to their Boards within ten working days after the period end, the standard used by HM Treasury in assessing departments during their Financial Management Reviews **(Figure 10)**. At the time of our survey, the Office of Fair Trading was able to produce limited in-year reports for its Board within three working days, although the Office now produces more sophisticated in-year reports eight days after the period to which they relate. At the Ministry of Defence, while financial reports are available within 17 working days after the period end, the Board prefers to receive reports that have been reviewed by the Finance Director accompanied by proposals for action where necessary. This extends to 43 working days after the period end, the average time taken to produce and forward to the Board in-year reports. The Department is aiming to improve the timeliness of its financial reporting, but considers it necessary to balance the need for more timely information against the significant and costly changes that would be required to the Department's financial systems. Non-Executive Directors reported that the primary reasons for delays in producing in-year reports were inadequate information systems and difficulties in gathering information from sponsored bodies. Some felt that the delays in producing in-year reports meant they were often insufficiently prepared about the relevant issues by the time of the Board meeting.

3.7 While most departments routinely report basic financial information to the Board, many report on a number of key aspects of organisational performance infrequently, if at all. For example, 84 per cent of departments report year-to-date expenditure against budget on a monthly basis but only 28 per cent offered a monthly analysis of expenditure by operational target. Without up-to-date, reliable information on the relative performance of programmes it is difficult for departments to know how best to reallocate resources in-year to address changing priorities.

CASE EXAMPLE 3

Using integrated financial and operational performance information to make better resource allocation decisions

Historically, the Army Training and Recruitment Division achieved savings by cutting costs without robust information regarding the impact on operational performance. This reflected a lack of understanding of the link between the resources consumed and the services delivered.

The Division developed an Output Costing Management System to allow a new overall plan to be developed based on services delivered as well as on resources consumed. The System has allowed the Division to identify the key cost drivers of its business activities. Previously it had wrongly assumed costs were always directly proportional to numbers of trainees on each course. In addition, the Division is able to re-allocate resources between programmes based on the level of services being provided, and to compare costs across different programmes.

The improved information offered by the System led the Division to redesign some courses and to revise the prices charged for others, to better reflect the cost of providing the training. There is also a better working relationship between finance and planning staff. For example, finance staff now have a greater involvement in the decision-making process.

Source: Army Training and Recruitment Division

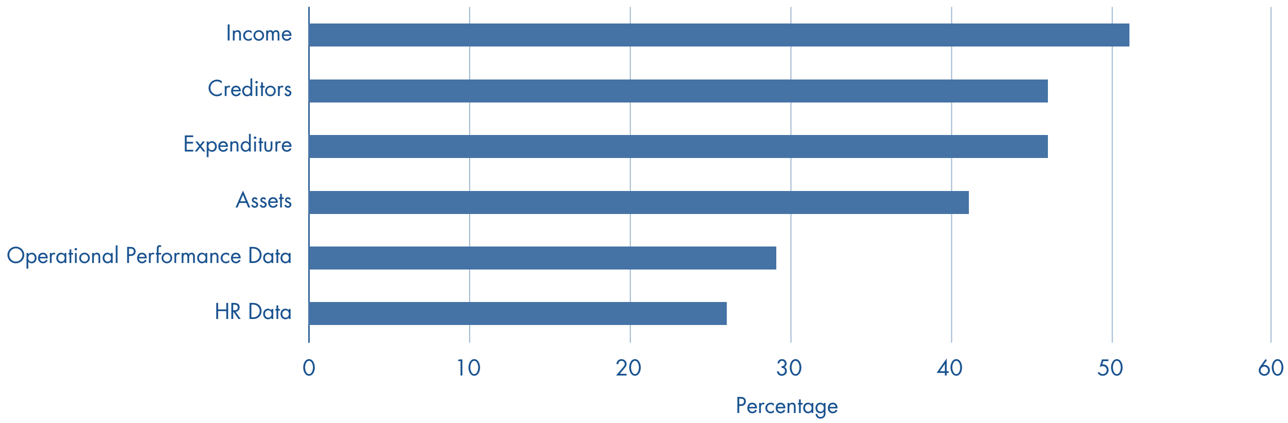
3.8 A further challenge for departments is the increasing importance of accounting for the wider impact of its activities. For example, departments' outputs and outcomes may have environmental and social costs as well as a financial cost. Organisations such as the Accounting for Sustainability Project (of which the National Audit Office is a member) are developing frameworks and methodologies for such calculations.[23] However, in our survey of government departments, only 41 per cent of departments said that they usually gave an assessment of the likely social, economic and environmental impacts in submissions to Ministers or Board members for policy proposals.

Some departments need to make further progress in managing their assets and liabilities

3.9 The implementation of accruals-based accounting in central government required departments to produce balance sheets. In addition the Office of Government Commerce required departments to draw up property asset management plans in accordance with a standard good practice template by December 2007[24] and as part of the 2007 Comprehensive Spending Review HM Treasury has required departments to produce asset management strategies covering the acquisition,

9 Many departments experience problems with timeliness and accuracy of the data used to report their financial and operational performance

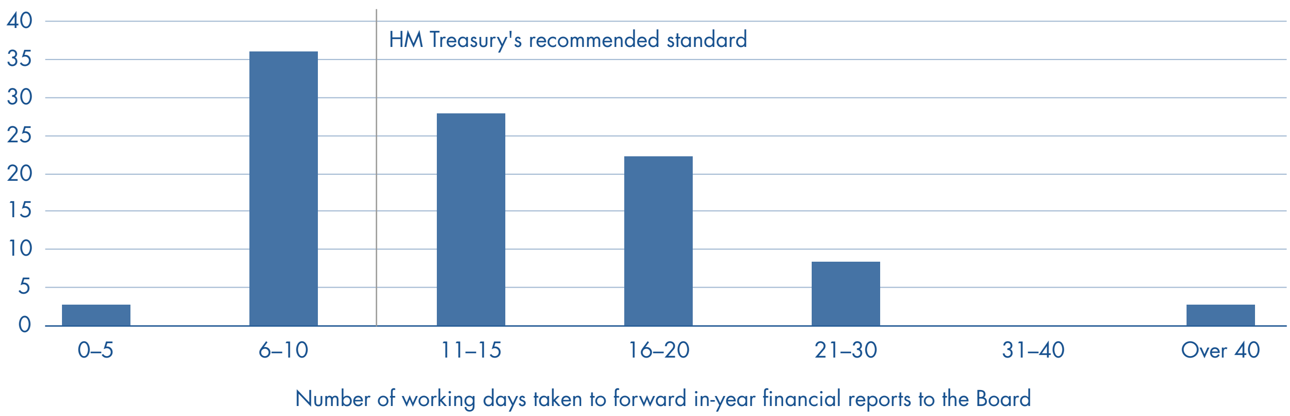
Percentage of departments whose primary data related to various business areas was almost always accurate, and whose in-year reports are invariably produced from up-to-date data



Source: National Audit Office survey

10 Sixty per cent of departments take more than ten working days after the period end to produce in-year financial reports and forward them to their Boards

Percentage of departments



Source: National Audit Office survey

maintenance, deployment and disposal of their asset base.[25] As a result, departments now have better, more detailed information with which to obtain value for money from the deployment of their assets and resources and to better manage their liabilities.

3.10 However, in response to our survey 19 per cent of departments (who collectively manage assets of £23 billion)[26] rated themselves as weak at managing their balance sheet. There is also scope for further improvement in the reporting of balance sheet information to departmental Boards. Of the departments who stated that information on tangible assets is highly important to their operational delivery, only 35 per cent forward a balance sheet to their Board on a quarterly basis.

Most departments operate uniform financial performance reporting systems in respect of their executive agencies and non-departmental public bodies but some problems remain with the timeliness and reliability of the information reported

3.11 HM Treasury identified during their Financial Management Reviews that there was scope for enhancing the 'group' focus by the Board on the overall management of plans, budgets and financial risks across the departmental group.[27] Departments have made some progress in enhancing their oversight of their executive agencies and non-departmental public bodies. Eighty eight per cent of those departments that sponsor such bodies report the financial performance of the core department and all of its sponsored bodies on a uniform basis.[28] This makes it easier to compare the performance of each organisation.

3.12 However, 56 per cent of departments reported that the primary reports produced by some executive agencies and non-departmental public bodies differed from the format or content adopted by the parent department, requiring manual intervention to produce a uniform report. While this in part reflects the nature of the activities of some executive agencies and non-departmental public bodies and their remit as a separate organisation, there seems to be further scope for standardising reporting across the group in some departments.

3.13 While we found examples of departments that had developed robust reporting arrangements in respect of their agencies and non-departmental public bodies **(Case Example 4)**, some Finance Directors and non-Executive Directors highlighted difficulties they had experienced in collecting timely, reliable performance information from their sponsored bodies. Some Finance Directors and non-Executive Directors said that they found it difficult to convince their sponsored bodies of the impact that their financial performance had on the overall financial position of the departmental group.

In controlling current spending, HM Treasury works well with departments in a complex system of funding

3.14 The Government sets policies in the context of two fiscal Rules; the Golden Rule and the Sustainable Investment Rule. The Golden Rule states that over the economic cycle, the Government borrows only to invest and not to fund current spending. The Sustainable Investment Rule states that net public debt as a proportion of Gross Domestic Product will be held over the economic cycle at a stable and prudent level over the economic cycle. Other things being equal, net debt will be maintained below 40 per cent of Gross Domestic Product over the economic cycle.

3.15 To ensure that the Rules are not broken, HM Treasury enforces a system of controls on what government departments can spend. When requesting resources from Parliament, departments must be clear about what those resources will be spent on; for example, whether it is resource expenditure or capital expenditure. In addition, portions of departments' budgets are 'ring-fenced' for certain government priorities, precluding departments from spending this money on anything else. Several

CASE EXAMPLE 4

Designing in-year reporting to improve oversight of arm's length bodies

The (then) Department for Education and Skills revised its Corporate Performance Report to:

- integrate reporting of operational and financial performance more closely;
- standardise the reporting of the performance of arms-length bodies; and
- use graphics and summaries to make the presentation clearer.

The report contains a standardised page on each of the Department's arms-length bodies. It sets out measures of financial performance together with commentary and Red/Amber/Green ratings for a range of aspects of operational performance (such as achievement of delivery targets, efficiency, and customer perception of the body). This format enables Board members to assess and challenge the overall performance of each body more easily and so drive improvements to their efficiency and effectiveness.

Source: National Audit Office

Finance Directors expressed frustration at the length of time they spend explaining to non-finance staff how this control environment works. Interviews with budget holders also revealed that they find this aspect of budget management particularly challenging. Part of the role of departmental expenditure teams within HM Treasury is to support departments in this. Our survey results show that departments value this guidance and advice, with only 8 per cent considering that is not at all useful.[29]

3.16 HM Treasury introduced the Combined On-line Information System (COINS) to consolidate the previously diverse reporting requirements they made of departments. Most Finance Directors interviewed recognised HM Treasury's need for uniform information in order to manage resources across central government. To improve the accuracy of the data on the system, HM Treasury now requires returns to be signed off by Finance Directors in order to improve accuracy, an initiative which Finance Directors generally welcomed.

Preparing for the future

Departments need to improve the reliability of their forecasts and develop robust future business plans

3.17 Several Finance Directors highlighted the particular difficulties in preparing reliable forecasts for project expenditure due to the large number of projects that fall behind schedule or run over budget resulting principally from the continuing shortage of project management skills in central government. The difficulties facing departments in setting reliable budgets have been highlighted in several recent NAO reports (for example our study examining the setting of the budget for the 2012 Olympics).[30]

3.18 The framework for the Financial Management Reviews devised by HM Treasury suggests that in order to clearly identify their future priorities, opportunities and risks, departments should aim to have a rolling three-year corporate business plan. However, 43 per cent of departments either had no business plan or, if they did, it only covered a single year. Additionally, 50 per cent of departments either had no capital investment plan, or had one that covered only a single year. Developing a robust medium-term business plan, such as that created by St Helens Metropolitan Borough Council **(Case Example 5)** can help departments deliver their services more efficiently and effectively.

Many departments do not ensure that proposals for policy and operational changes contain robust financial information

3.19 There is a risk that departments' decision-making processes do not pay sufficient attention to value for money issues. Only 41 per cent of departments stated that policy proposals forwarded to decision-makers invariably included a full financial appraisal. In addition, only 20 per cent of departments considered that policy decisions were invariably based on a thorough assessment of the financial implications.[31]

3.20 The picture is similar in relation to operational decisions. Only a third of departments stated that submissions to decision-makers in relation to key operational decisions invariably included a full financial appraisal. Sixteen per cent of departments considered that decisions based on these submissions were based on a thorough assessment of the financial implications.

CASE EXAMPLE 5

Linking medium-term financial and operational delivery planning to reduce deficits without affecting service quality

St Helens Metropolitan Borough Council introduced a three year financial strategy to address ongoing budgetary problems and the poor linkage between financial planning and service delivery.

The strategy adopted a zero-based approach, whereby all the costs of each department were challenged by officers from elsewhere in the Council and benchmarked to those of similar local authorities. Key cost drivers were identified for each service.

The strategy clearly set out service priorities, detailed three-year budgets for each service and explicitly linked financial plans to operational performance indicators. No performance framework had previously been used but now the full council receives a quarterly report integrating financial and operational performance information. Expenditure and service performance are considered together by strong and effective council scrutiny committees.

Since the introduction of the strategy, an £11 million deficit in council finances has been eliminated. Services standards have also improved. The Audit Commission currently rate all of the services provided as being three stars or better and the overall Comprehensive Performance Assessment for the Council is four stars.[1]

Source: National Audit Office summary of content provided by the Audit Commission

NOTE

1 Councils are rated by the Audit Commission against a scale of one to four stars, four being the highest rating.

Most departments have made progress in managing financial risks, but some report infrequently to the Board in respect of the risks identified

3.21 Departments identify the key financial risks to their organisation and have a clear picture of the likelihood and impact of these risks crystallising. Most departments (65 per cent) maintained a discrete financial risk register while others operated an integrated financial and operational risk register in order to manage risks holistically. Most departments usually identified the main financial and operational risks when submitting proposals for key operational decisions. However, 36 per cent of departments reported to the Board in respect of their financial risks either annually or not at all. Where risks are not properly managed the likelihood of programmes being delivered in an effective and efficient manner is greatly reduced. Our report on the Rural Payments Agency[32] found that better risk management would have significantly reduced the disruption and distress caused by the deficiencies in the administration of the EU Single Payment Scheme.

3.22 Every department was able to identify their key financial risks in their response to our survey. The most commonly cited risks were difficulties in maintaining the quality and extent of services while staying within the tight Spending Round settlement, lower than expected income (for example, from asset disposals) and the risk to the parent department posed by anticipated pressures on the budget of a funded body.

3.23 In our review of a sample of departmental risk registers, we found many departments adopting good practice, for example by clearly assigning each risk to a responsible owner and identifying a date by which progress was required. Others quantified all risks in financial terms, assigned a numerical risk rating and routinely provided full narrative commentaries. The Department for Business, Enterprise and Regulatory Reform maintained an opportunities register alongside its risk register, which kept the Board aware of the prospects for external factors to have both positive and negative impacts on performance.

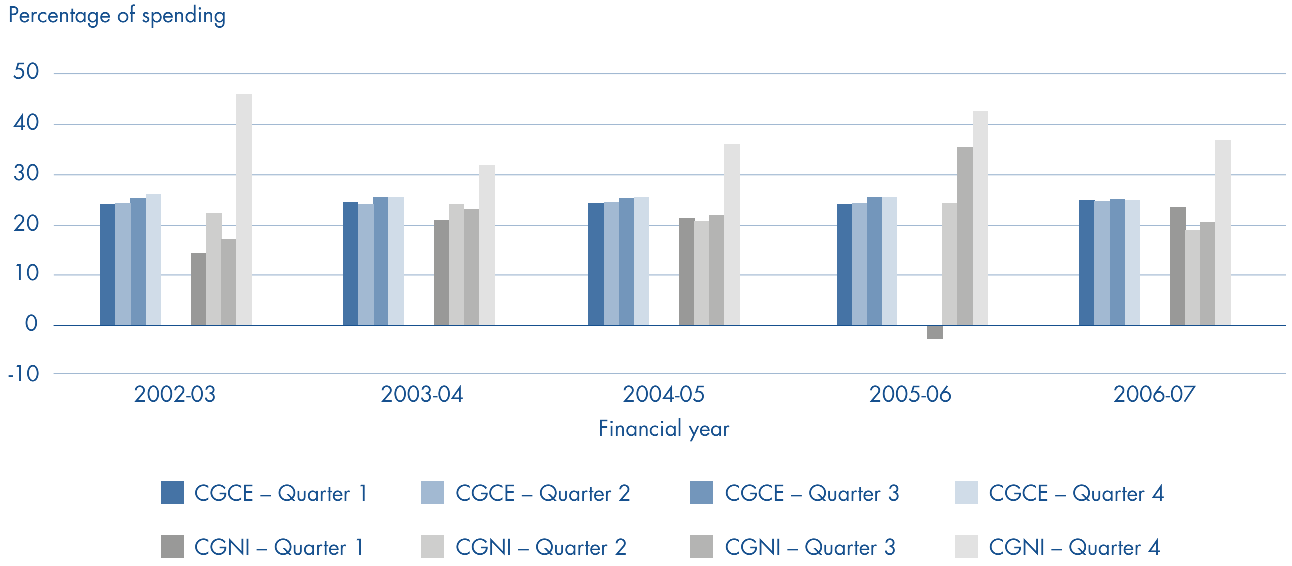
The End Year Flexibility arrangements have encouraged departments to spend money more evenly during the year but some are losing confidence in the scheme

3.24 Full End Year Flexibility (EYF) was introduced by HM Treasury in 1999-2000 (limited EYF was available before that). It aimed to encourage departments not to spend any remaining budget in the last months of the financial year on non-essential items in the expectation that they would be able to draw down (through the supplementary estimate system) any unspent funds carried forward from one year to the next.

3.25 Our analysis of Central Government Current Expenditure (CGCE)[33] between 2002-03 and 2005-06 found that departmental expenditure was marginally higher in the final quarter in three of the four years examined although not in the most recent year, 2006-07 **(Figure 11)**. Spending in respect of Central Government Net Investment (CGNI)[34] continued to be disproportionately heavy in the final quarter of the year in each of the five years from 2002-03 to 2006-07, accounting for 37 per cent of total spending in 2006-07.

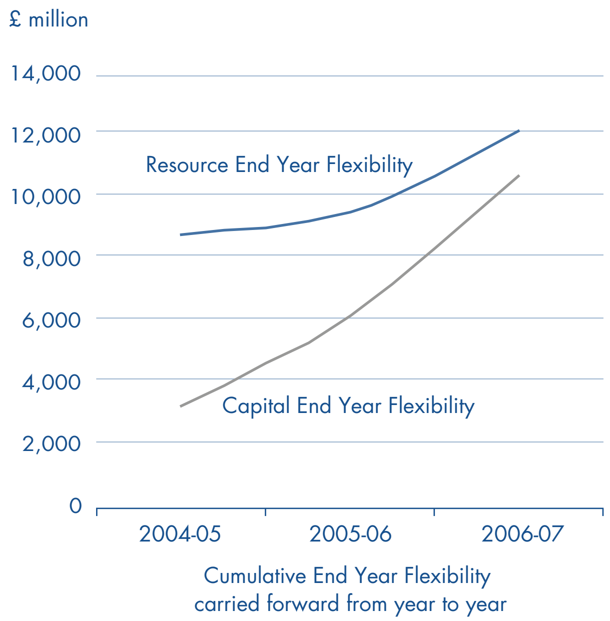
3.26 Departments are carrying forward increasing sums from one year to the next under the End Year Flexibility arrangements **(Figure 12)**. The amount carried forward in respect of capital spending at 31 March 2007 represents almost a quarter of planned capital expenditure for 2006-07. In some departments the amounts carried forward as End Year Flexibility are so large that it is uncertain whether the amounts carried forward will ever be spent. For example the stock as at 31 March 2007 for the Department of Health in respect of capital was £4.5 billion compared with planned expenditure for 2006-07 of £5.3 billion. However, the Department is confident that it will use its reserves of End Year Flexibility. While capital investment since 1999-2000 has grown from £1 billion to £4 billion in 2007-08, funding has grown even more rapidly. With lower growth in funding expected over future years, the Department believes that the accumulated End Year Flexibility reserves will be used to maintain the higher level of capital investment.

11 Spending on investment continues to be heaviest in the fourth quarter of the financial year



Source: HM Treasury

12 Amounts carried forward as End Year Flexibility are increasing faster for capital expenditure than resource expenditure



Source: HM Treasury

3.27 Drawdown of EYF has always been subject to HM Treasury approval as part of the Supplementary Estimates process. HM Treasury's budgeting guidance states that EYF take up will be scrutinised on the basis of need, realism and the wider fiscal position. In recognition of the tighter financial environment, HM Treasury have applied these controls more strictly in the last two financial years. There is no published guidance or fixed rule which sets out how much departments are entitled to draw down. Several departmental Finance Directors reported that the increased uncertainty regarding how much they will be allowed to draw down from amounts carried forward from previous years as End Year Flexibility has disrupted their resource management planning. In our survey 35 per cent of departments identified the lack of certainty regarding the amount they would be allowed to draw down as the most significant barrier to their being able to make full use of End Year Flexibility. However, it is important that departments and HM Treasury retain confidence in the End Year Flexibility system in order that under- and over-spends can be properly managed and to disincentivise unnecessary fourth quarter expenditure.

3.28 Conversely, we found examples of departments who have drawn down End Year Flexibility during the year to meet perceived funding pressures but whose final expenditure was actually less than their original Departmental Expenditure Limit provision set at the outset of the year. This suggests poor forecasting or in-year monitoring by some departments.

The impact of improved management of financial resources

4.1 In Parts Two and Three, we found that while there is scope for further improvement, departments have made progress in building their capabilities and applying techniques and practices to better manage their financial resources. In this Part, we consider the impact of improving resource management in central government. In particular, we consider the impact on:

- the number and scale of material variances between actual and forecast spend;
- the allocation of resources to operational objectives;
- the efficiency with which departments carry out their activities; and
- how well departments report their financial performance externally.

Departments have not shown significant improvement in forecasting their total resource needs

4.2 It is important that departments forecast reliably the resources they need to operate their businesses and adjust these forecasts in-year to reflect reported performance to date and changes in external circumstances. Our examination of under- and over-spending by departments did not find evidence that departments have significantly improved their forecasting and in-year monitoring of expenditure since our 2003 study.

4.3 As **Figure 13** explains, departments obtain their resources through HM Treasury asking Parliament for money at the start of the financial year and then revise the forecast of their requirements during the course of the year. To consider how reliably departments are able to forecast their resource requirements, we compared their final provision with the amounts they actually spent for both resource and capital expenditure. Departments' final opportunity to request supplementary resources is through the Spring Estimates which are presented to Parliament in February and authorised by Parliament in March, just a few weeks before the end of the financial year.

4.4 Since 2001-02, fewer departments have allowed their expenditure to exceed their estimate and so fewer departmental annual financial statements have been qualified[35] on the grounds of an Excess Vote **(see Figure 14)**.

4.5 Departments have improved their forecasting of Annual Managed Expenditure[36], reducing the variance between their actual and forecast expenditure from £3.7 billion (2.3 per cent) in 2002-03 to £0.4 billion (0.2 per cent) in 2006-07.

13 Departments receive their resources through the 'supply procedure'

Parliament gives statutory authority for both the consumption of resources and for cash to be drawn from the Consolidated Fund, the Government's general bank account at the Bank of England. This process is known as the supply procedure:

Main Estimate

The Main Estimates set out departments' expected spending on each of its major activities and are presented to Parliament by the Financial Secretary to the Treasury 25 working days after the Chancellor of the Exchequer's Budget Statement. This is normally in April or May of the financial year to which they relate. They are approved by Parliament in July.

Supplementary Estimates

Departments have up to three opportunities to request additional financial resources during the financial year, known as supplementary estimates. Summer supplementary estimates are presented to Parliament in June. Following parliamentary debate they are approved by Parliament along with the main estimates in July and before the summer recess.

Winter supplementary estimates are presented to Parliament in November and are debated and approved by Parliament in December.

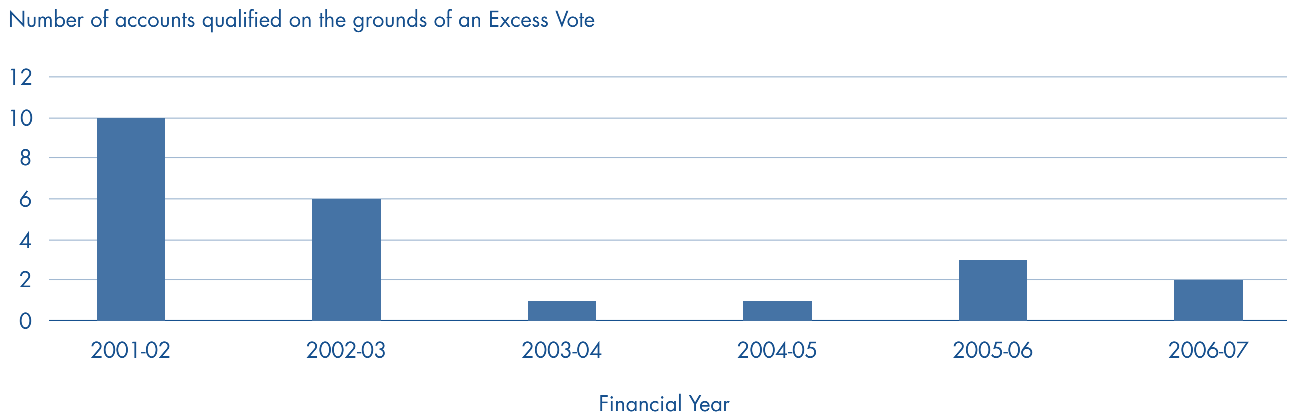
The spring supplementary estimate is the final opportunity for departments to request additional resource from Parliament. They must be presented to Parliament in February and are debated and approved in March.

Final Provision

The total resources voted in by Parliament following the spring supplementary estimates is known as Final Provision. Should a department's expenditure exceed the amount voted to it by Parliament, it must request the necessary additional resources in the form of an **Excess Vote**. If the Excess Vote is granted, the department's annual financial statements will automatically be qualified by the Comptroller and Auditor General.

Source: HM Treasury

14 Few departments have had their annual financial statements qualified on the grounds of an Excess Vote in recent years



Source: National Audit Office

4.6 We found less of a discernible trend, however, over the period from 2002-03 to 2006-07 in the reliability of departments' final forecasts **(Figure 15)** in respect of their resource Departmental Expenditure Limits.[37] Four departments have under spent by more than five per cent in three or more of the five years of our analysis. These departments are HM Treasury, the Department of Trade and Industry, the Department for Culture, Media and Sport[d] and National Savings & Investments. Of these, the departments of Trade and Industry (£5.5 billion) and Culture, Media and Sport (£1.5 billion) had the largest resource expenditure in 2006-07. Over the period from 2002-03 to 2006-07, total underspending in excess of five per cent on resource expenditure by all departments was £1.8 billion.

4.7 Under-spending can be consistent with good financial management where it reflects a decision by a department to carry forward funds to future years or where a department has secured efficiency savings. But it can also be the result of poor forecasting. Forecasting can be especially difficult for some departments. For example, National Savings & Investments' costs depend largely on the level of sales it achieves which varies significantly with market conditions. This was demonstrated in 2006-07 when interest rate rises created particularly high demand for its savings products. To reduce excessive net financing[38], the Department reduced its marketing expenditure, resulting in its underspend in that year.

4.8 The underspends of HM Treasury over the period of analysis primarily related to lower cost of capital charges on investments in the Bank of England and the Royal Mint.[e] A reduction in such non-cash costs does not enable funding to be transferred to other priorities, however. In addition, HM Treasury identified that it was going to underspend in other areas against Estimates from the respective Spending Reviews, but the Estimates process did not allow it to reduce its provisions below the original Estimates.

4.9 There has been a marked upward trend in the aggregate under-spend in respect of capital expenditure between 2002-03 and 2006-07 **(Figure 16)**[39]. Three Departments under-spent by more than ten per cent in four or more years between 2002-03 and 2006-07. These departments are the Departments for Constitutional Affairs and Culture, Media and Sport[f] and the Home Office. Of these the Home Office (£1 billion) and the Department of Culture, Media and Sport (£276 million) had the largest capital expenditure in 2006-07. Over the period from 2002-03 to 2006-07, total under-spending in excess of 10 per cent on capital expenditure by all departments was £4.9 billion.

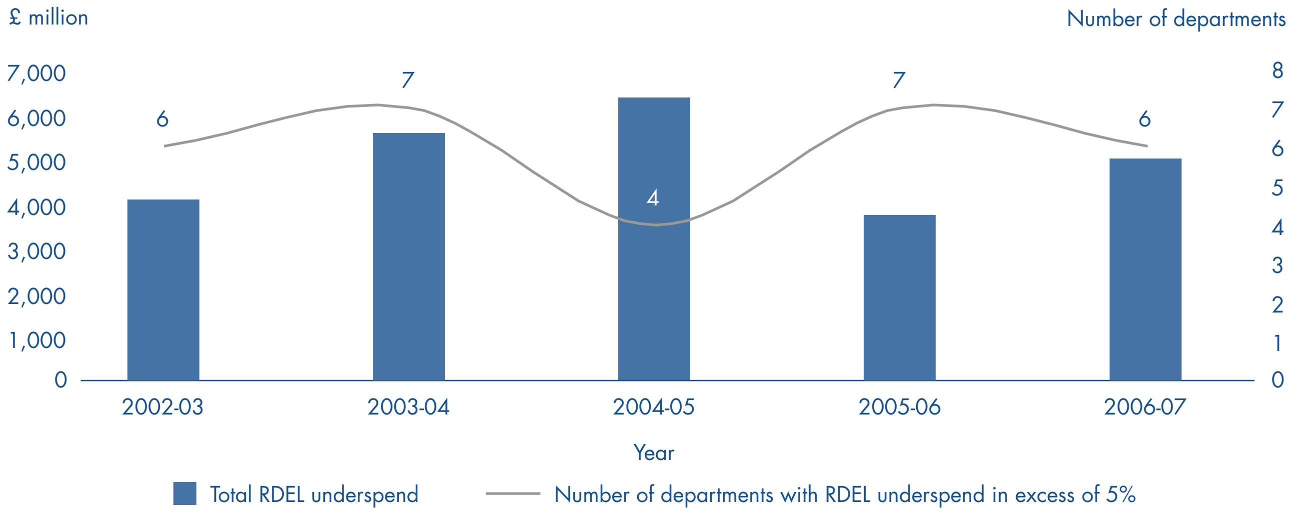
4.10 The Committee of Public Accounts has a hearing to examine the reasons for all departments who over-spend and therefore require an Excess Vote, but there is less scrutiny of departments who request significant increases in resource through their Main or Supplementary Estimates (or whose actual expenditure is significantly lower than their final forecast). The House of Commons Liaison Committee was critical of the quality of information supplied by departments in the Estimates Memorandum which set out the principal reasons for and likely operational impact of the changes to the budgets proposed in their Supplementary Estimates.[40] The lack of scrutiny of the robustness of departments' Main and Supplementary Estimates might present a perverse incentive for departments to, for example, build in an unnecessary level of contingency to their main and supplementary Estimates to ensure that they do not require an Excess Vote.

d Since 2005-06 the Department of Culture, Media and Sport has significantly reduced the variance between the Final Provision for its resource Department Expenditure Limit and its outturn expenditure. The underspends in excess of five per cent all occur in the first three years of the five years under review. Over 2005-06 and 2006-07 the Department underspent by an average of 3.4 per cent against its Final Provision.

e Non-cash costs are costs where there is no cash transaction but which are included in a body's accounts to establish the true cost of all the resources used.

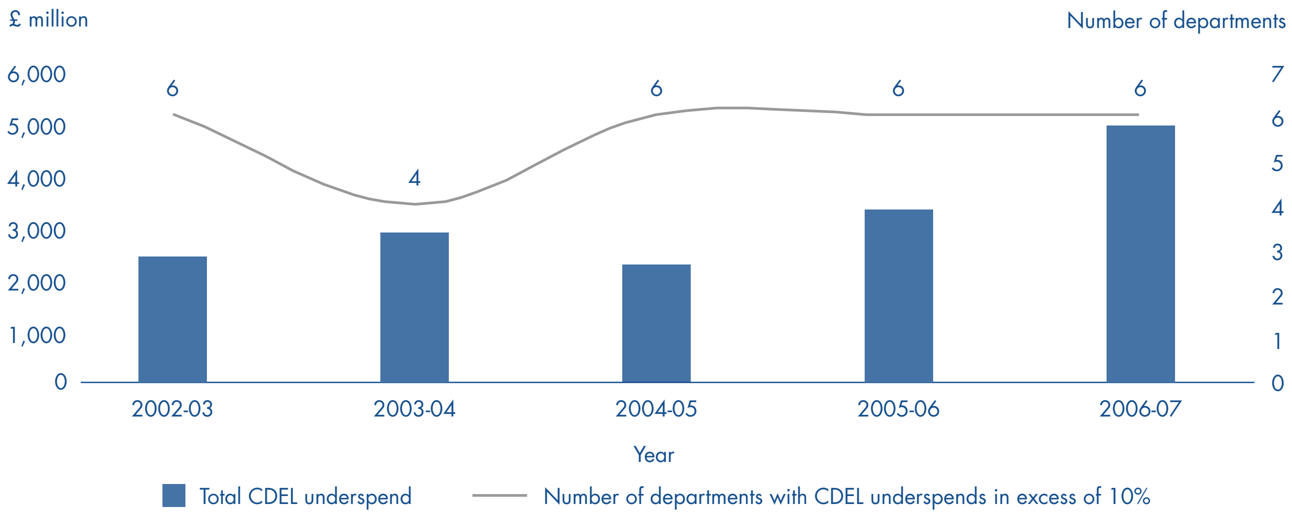
f Since 2005-06 the Department of Culture, Media and Sport has significantly reduced the variance between the Final Provision for its capital Department Expenditure Limit and its outturn expenditure. Between 2002-03 and 2004-05, the average underspend was 35.1 per cent. Between 2005-06 and 2006-07, the average underspend was 11.6 per cent.

15 Over the last five years there has been no discernible trend in the volume and frequency of under-spends against Resource Departmental Expenditure Limits



Source: HM Treasury Public Expenditure White Papers 2002-03 to 2006-07

16 The volume of under-spends against Capital Departmental Expenditure Limits is increasing



Source: HM Treasury Public Expenditure White Papers 2002-03 to 2006-07

It is not clear that departments are using the improved information available to re-allocate resources when necessary

4.11 Departments feel able to switch resources from low performing to high value activity, scale back or cease programmes **(see Figure 17)**. In addition, 84 per cent of departments were able to identify at least one example of when financial and performance information had been successfully used to inform major in-year decisions on how best to allocate resources. For example operational managers in HM Revenue & Customs proposed a significant re-allocation of resource to tackle increasing losses caused by VAT Missing Trader Intra Community Fraud after assessing the likely impact on performance elsewhere. This resulted in increased detection and prevention of the fraud while the impact on other business activities remained within the forecast limits.

4.12 However, such resource allocations do not occur regularly. There was a consensus among the non-Executive Directors in our workshops that reallocating resources occurs too infrequently. They asserted that while senior management in departments increasingly have access to the necessary information to make this kind of decision, action is often not taken. Non-Executive Directors believed this was especially true in the case of terminating programmes, even on high risk projects which had fallen well behind deadline and were over budget, sometimes because departments felt it necessary to honour public spending commitments.

4.13 This mixed picture is also reflected in the judgements made in the Department Capability Reviews led by the Cabinet Office. Department Capability Reviews assess how well-equipped departments are to meet delivery challenges. In particular, strong financial resource management would help departments score well in respect of two aspects of capability reviewed; first, whether a department is equipped to 'plan, resource and prioritise' and, second, whether it is able to 'manage performance'.

4.14 Figure 18 shows that of the 17 departments which have been the subject of a Review, only seven were regarded as being 'well placed'[41] at being able to 'plan, resource and prioritise' and only four at being able to 'manage performance'. Only the Department for Business, Enterprise and Regulatory Reform[42] and the Department of Health were regarded as being 'well placed' in both areas. By benchmarking themselves against their peers and against established best practice frameworks[43] departments can pinpoint the key areas for improvement and monitor their progress in doing so.

Departments are realising efficiencies, although more could be done to improve the measurement of reported savings

4.15 An organisation that manages its financial resources effectively is able to identify and realise opportunities to improve its efficiency. In 2004, to encourage departments to secure efficiency improvements, the Government adopted recommendations made in Sir Peter Gershon's review of public sector efficiency. Departments were set the targets of securing £21.5 billion of annual efficiency savings and 84,000 headcount reductions by 31 March 2008. At October 2007, departments had reported more than £20 billion of annual efficiency savings and 70,000 headcount reductions.

4.16 As a result of the Programme there is now a greater focus on value for money issues among senior staff and there are many examples of improvements in the way public services are being delivered. For example, the Department of Health has achieved £1.2 billion of annual efficiencies by reducing the price at which it reimburses pharmacists and GPs for some of the NHS drugs they dispense. In another part of the Programme, the Home Office has secured more than £200 million of efficiencies through procuring asylum accommodation more effectively.[44]

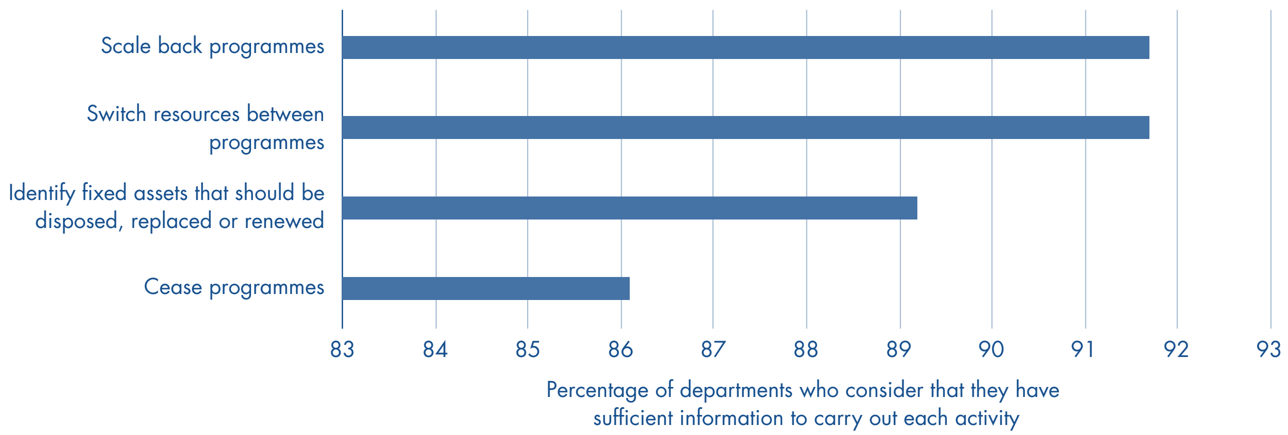
4.17 However, while there is clear evidence of positive change across the public sector, some reported efficiency gains still carry a significant risk of inaccuracy. We concluded that, of the £13.3 billion reported at the time of our most recent review:[45]

- £3.5 billion (26 per cent) fairly represented efficiencies made;
- £6.7 billion (51 per cent) represented efficiency but carried some measurement issues and uncertainties; and
- £3.1 billion (23 per cent) may have represented efficiency, but the measures used either did not yet demonstrate it or the reported gains may have been substantially incorrect.

4.18 In principle, the value for money targets set for departments in the 2007 Comprehensive Spending Review should encourage departments to reallocate resources away from activity which is not adding to overall departmental objectives. Collectively, departments must secure £30 billion of value for money savings by 2011. This is in addition to the savings they achieved as part of the Efficiency Programme from the 2004 Spending Review. In the new framework, departments will be able to report savings made by ending or reducing activity in low priority areas as part of their efficiency targets, provided that they meet their Departmental Strategic Objectives. In the Efficiency Programme, departments could not count savings which had adverse impacts on service quality even where the service no longer supported a department's overall objectives. Allowing such 'allocative efficiencies'[46] should encourage departments to make more links between operational and financial performance information.

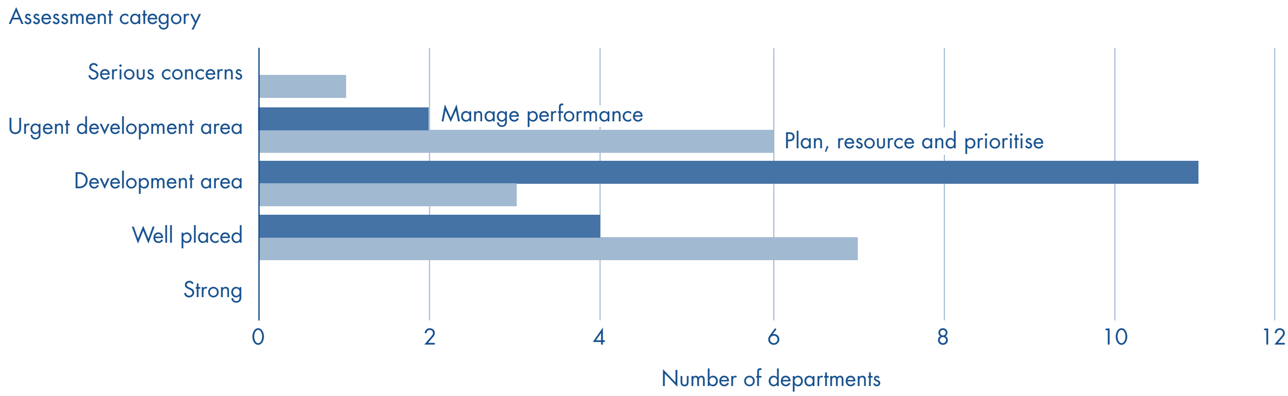
4.19 Alongside the Efficiency Programme, accruals-based accounting practices have provided departments with more detailed information to manage their balance sheet. Departments can use this information, for example, to identify under utilised assets and to dispose of those no longer required.

17 The majority of departments consider that they have sufficient financial and performance information to scale back or terminate programmes



Source: National Audit Office survey

18 The Departmental Capability Reviews show that there is room for improvement in areas that depend on strong management of financial resources



Source: National Audit Office analysis of data from Cabinet Office Capability Reviews: Findings and common themes

4.20 The January 2007 edition of the National Asset Register lists all fixed assets owned by central government (valued in total at £337 billion) and details all acquisitions and disposals since 2001. The public sector disposed of assets valued at £18.5 billion between 2004-05 and 2006-07 against its objective of realising £30 billion by 2010-11.[47] Central government has contributed £4.7 billion to this total, with receipts from sales of assets having increased from £961 million in 2002-03 to £1.6 billion in 2006-07.[48]

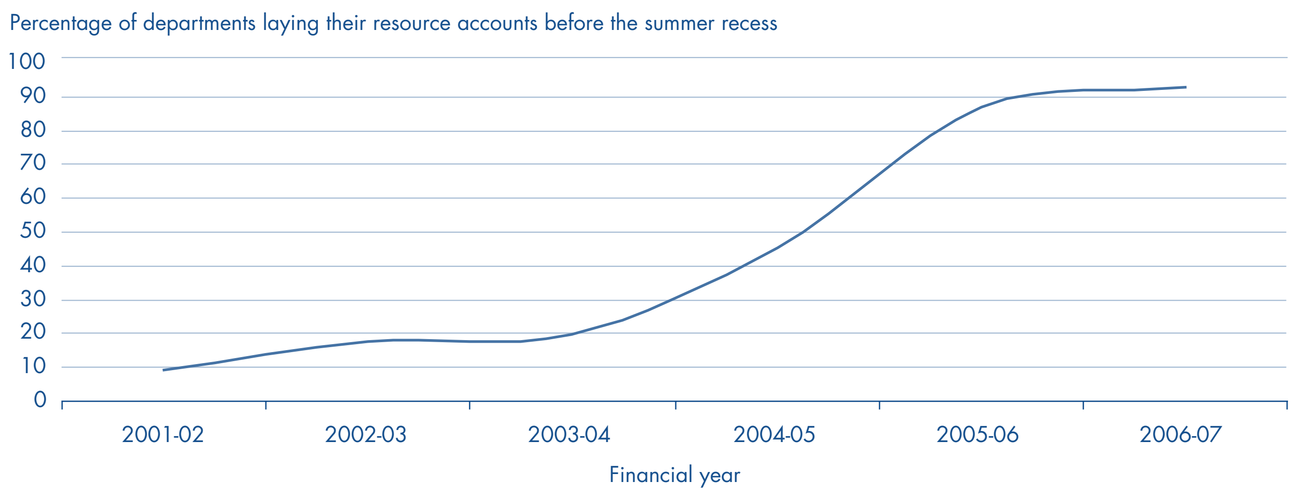
Departments have made considerable progress in the timeliness of reporting financial information externally, though a small number of resource accounts are still being qualified each year

4.21 In 2003 HM Treasury introduced the Faster Closing initiative to encourage and assist departments to lay their final audited accounts before Parliament prior to its summer recess. This enables Parliament to scrutinise accounts earlier, enabling speedier identification of issues and errors. In addition, a department's ability to close its accounts faster is a useful indication of the effectiveness of in-year accounting procedures and systems.

4.22 Since its introduction, the number of departments submitting their resource accounts by the summer recess has risen substantially **(see Figure 19)**. In 2006-07 only three departments and one department pension scheme failed to meet the summer recess deadline. In 2002-03 six departments did not even manage to render their accounts to the National Audit Office for audit by the statutory deadline of 30 November.[49]

4.23 Looking forward, with the introduction of International Financial Reporting Standards (IFRS), departments face a significant challenge in maintaining their improved performance in external reporting. In 2008-09, all financial statements in central government will have to be prepared in accordance with International Financial Reporting Standards. The treatment of some items will change under the new financial reporting regime. For example, HM Treasury is developing guidance on how departments should treat Private Finance Initiatives under IFRS. Departments will need to ensure that their finance functions have the skills and capacity to adapt their practices to the new standards. In addition, they will have to make sure that the resources required to apply the new accounting standards do not put at risk other core activities of the finance department.

19 Significantly more departments are laying their resource accounts before the summer recess



Source: General Report of the Comptroller and Auditor General, 2002-03 – 2006-07

4.24 Each year there continues to be a small number of departments that have their annual financial statements qualified for reasons other than an Excess Vote.[50] Although departments have made progress in this area, a small number still have more to do to prepare unqualified financial statements.

4.25 While departments report their financial health through the publication of their resource accounts, the main means of reporting their operational performance is through their Annual Report and Autumn Performance report. Just as it is important to report integrated in-year operational and performance information internally, integrating these external reports more closely gives Parliament and the general public a better idea of what is being delivered with financial resources at departments' disposal.

4.26 During fieldwork we saw examples of progress in this regard **(Case Example 6)**.

CASE EXAMPLE 6

Examples of good practice in external reporting

The Ministry of Defence

The Ministry of Defence's Annual Report and Accounts has combined its annual performance report and resource accounts since 2002-03. In 2007 it won the 'Building Public Trust Award' for 'telling it how it is' for the second consecutive year, setting a standard to which other government departments should aspire. The Ministry's Annual Report reports clearly on both financial and operational performance matters and provides a detailed and useful commentary on the financial health of the organisation.

Department for Communities and Local Government

The Department for Communities and Local Government's Annual Report for 2006 includes a chapter on managing resources. It provides analysis of expenditure against each of its Public Service Agreement targets, strategic priorities and main programmes, including easily comprehensible charts. Helpfully, this chapter directly follows the content regarding the Department's performance against its strategic objectives, making it easy for the reader to compare financial and operational performance.

Department of Trade and Industry

In 2007, the Department of Trade and Industry released its final annual report and resource accounts in one volume, meaning that the report publishes both the Department's financial and operational performance in the same document. The report also provides a helpful introduction to the resource accounts which explains the parliamentary supply process and the differences between the various Treasury control limits. This enables the reader to better understand the resource accounts and to use them to assess the Department's financial and operational performance.

Source: National Audit Office

APPENDIX ONE

Methodology

1 This report is based on:

- a survey of 37 central government departments;
- an analysis of data published by HM Treasury on departments' annual budgets and expenditure since 2002-03;
- an analysis of high level indicators of departments' management of their financial resources including:
  - Excess Votes;
  - the laying of audited annual accounts prior to the summer Parliamentary recess; and
  - over- and under-spends against each of the annual expenditure limits;
- an analysis of the in-year reports, Board meeting minutes and risk registers produced by six government departments;
- two workshops with non-executive directors of central government departments;
- semi structured interviews with Finance Directors or Directors General for Finance from six government departments;
- semi structured interviews with nine senior budget holders from six government departments;
- the collection of examples of good practice from central government and the wider public sector; and
- a literature review of relevant published material including articles from academic journals, and reports from the public and private sectors.

2 We sequenced the fieldwork to enable the emerging findings from elements carried out at the start of the fieldwork to inform those carried out later. For example, our initial analysis of data published by HM Treasury and our survey were carried out at the start of the fieldwork phase. The emerging findings from these elements contributed to the selection of departments for subsequent elements of the fieldwork (such as the interviews of Finance Directors, invitees for the workshops for non-Executive Directors and the examination of departments' in-year reports, Board meeting minutes and risk registers). By incorporating evidence from the earlier elements into the content of the later elements we were able to obtain more detailed evidence regarding the key issues covered by the study and to cross-reference our findings.

Survey of 37 central government departments

3 We sent a questionnaire to 37 government departments in April 2007. The departments surveyed represent more than 99 per cent of government resource and capital expenditure. Some smaller departments were excluded from the sample.

4 The questionnaire covered a wide range of issues under five broad themes:

- The production and use of better financial and performance information.
- Planning.
- Board level oversight of departmental resources.
- Matching expenditure more closely with service needs.
- The role, leadership, skills and capacity of the finance function.

Each questionnaire was agreed by Finance Directors of departments. A sample of returns, including those of the top ten spending departments, was reviewed by the National Audit Office's Financial Audit Directors to ensure they provided a fair assessment of the departments' management of financial resources.

We achieved a 100 per cent return rate, receiving returns from all 37 of the departments in our sample.

Analysis of HM Treasury data on departmental budgets and outturn

5 We analysed data published by HM Treasury and the Office for National Statistics regarding departmental budgets and expenditure. The main sources were:

- The Public Expenditure Statistical Analyses (PESA). This annual report brings together recent outturn data, estimated outturns for the latest year and budgetary plans over the whole range of UK public expenditure.
- The Public Expenditure Outturn White Paper (PEOWP) for the years 2002-03 to 2006-07 inclusive. This report is published each July and includes a comparison of provisional outturn figures for departmental expenditure with their original and final provision and details of the use made by departments of End Year Flexibility.
- The Winter and Spring Supplementary Estimates for the years 2002-03 to 2006-07 inclusive. These reports detail the extent of and reasons for in-year adjustments to the original estimates submitted by departments.

Selection of departments for the qualitative elements of the study

6 We devised a framework to help us select departments for the qualitative elements of our methodology. The purpose of this was to ensure that these elements mapped the diversity of the population; that is the 37 government departments included in our survey sample. The interviews with Finance Directors and budget holders and the examination of departmental papers were based on the same purposive sample. The invitees to the workshops for non-Executive Directors were drawn from a wider sample, principally to ensure an optimal number were able to attend each event. In each case the sample used was compliant with our framework which was designed to ensure that the sample included departments with the following characteristics:

- A department with a relatively high resource Departmental Expenditure Limit (and a department with a relatively low Limit).
- A department with a relatively high capital Departmental Expenditure Limit (and a department with a relatively low Limit).
- A department with a relatively large asset base (and a department with a relatively small asset base).
- A department with many associated agencies and non-departmental public bodies and one with relatively few or none.
- A department with no recent history of account qualifications or Excess Votes, who routinely submit their resource accounts promptly and whose final outturn in respect of their Departmental Expenditure Limits shows relatively low levels of variance to their final provision (and, conversely, a department that has experienced difficulties with several of these factors).

An analysis of the departmental papers relating to resource management produced by six government departments

7 We examined a sample of departmental papers relating to the management of resources within the six government departments in our qualitative sample in order to assess the suitability of the format and content and to identify best practice. The documents examined included:

- copies of the financial and operational performance reports submitted to the two most recent Board meetings;
- copies of the minutes for the two most recent Board meetings; and
- the financial risk register for the department.

Workshops with non-Executive Directors of central government departments

8 We held two workshops with non-Executive Directors of government departments (on July 10 and 19). The workshops were attended in total by nine non-Executive Directors, each representing a different department. We selected non-Executive Directors who had significant financial experience (based on examination of their on-line biographies and following discussions with our colleagues in NAO Financial Audit teams) and whose departments covered the full range of characteristics detailed at paragraph 6. Several of the non-Executive Directors chair their department's Audit Committee.

The workshops focused on the following themes:

- Budgeting and in-year reporting of financial and operational performance information.
- Integration of financial and operational performance reporting.
- The impact of financial and performance reporting on decision making.
- Financial implications of policy, operational and investment proposals.
- Departmental culture.
- Role of the non-Executive Director.

The workshops were chaired by Steve Freer, Chief Executive of CIPFA and non-Executive Director and Chair of the National Audit Office's own Audit Committee. They were facilitated by Ipsos MORI. The topic guide for the workshops was tested in an interview with a non-Executive Director who was unable to attend either workshop. We arranged for the workshops to be recorded and our analysis of the events was based on a transcription of the recording and a summary report of the events prepared by Ipsos MORI.

Semi-structured interviews with departmental Finance Directors

9 We conducted interviews with the Finance Directors from the six departments selected in our purposive sample detailed at paragraph 6 above. The content of the interviews drew on the emerging findings from the survey (and the department's own survey response) and from our initial analysis of published data on departmental expenditure. The same themes were addressed in all six interviews although some individual questions were tailored to the specific circumstances of the department in question. The interviews were recorded and our analysis is based on the transcript of that recording.

The interviews took place in July and August 2007.

Semi-structured interviews with senior budget holders

10 We conducted interviews with nine budget holders of programmes within the departments selected for our purposive sample detailed at paragraph 6. We selected the programmes based on our examination of the full range of programmes with which the department was involved, taking into account the recommendations of our colleagues in NAO Financial Audit teams. Some of the interviewees were budget holders of frontline service delivery programmes, some budget holders for business units, while others were budget holders for capital investment programmes such as IT change programmes. The same themes were addressed in all interviews although some individual questions were tailored to the specific circumstances of the department in question. The interviews were recorded and our analysis is based on the transcript of that recording.

The interviews took place in July and August 2007.

APPENDIX TWO

Recommendations from previous PAC report

2003 PAC Report Recommendations	Progress since 2003
Departments need to better understand resource accounting and budgeting if they are to manage their resources effectively and get the best out of the financial freedoms granted by Treasury in recent years.	Departments have made good progress in implementing accruals-based systems. We found that the number of departments that assessed themselves as having made limited progress in implementing accruals-based systems had reduced from 33 in 2003 to three in 2007.
The Treasury should identify and promote examples of good practice in resource management and the benefits that have been derived, to encourage others to follow suit.	HM Treasury has made progress in this area; for example by creating the Government Hundred Group of senior finance professionals from the top 130 or so spending bodies in government and have also published *Managing Public Money*, a document which sets out the main principles for dealing with resources in the public sector.
Departmental Boards need to address unproductive activities where these are identified.	While most departments feel they have sufficient information to switch resources between priorities, scale back or cease failing programmes, it is unclear whether all departments are using the available management information to do so in practice.
Accruals-based financial reports should feature as a specific agenda item at monthly departmental Board meetings, and at Audit Committees.	Our survey found that almost a third of departments discussed finance at Board meetings every two months or even less frequently. The Boards of three of the ten departments with the highest resource Departmental Expenditure Limits only discuss their organisation's financial position quarterly.
Departments should take positive steps, including succession planning, staff transfer or direct recruitment, to meet the Treasury's requirement for their Finance Directors to be qualified accountants, or staff with equivalent skills and a proven track record.	Although departments have made good progress towards this, two departments still lack a professionally qualified Finance Director.
Departments should make better use of End Year Flexibility and extend their use to agencies and other delivery partners.	Departmental planning has been helped by the introduction of End Year Flexibility and most departments have extended draw down of End Year Flexibility to their agencies and non-departmental public bodies. However, there is a risk that departments are losing confidence in the system due to increased uncertainty regarding whether they will be able to draw down from the stocks of End Year Flexibility built up.
Departmental Boards should use resource accounts to make sure their assets are used efficiently, disposing of those that are surplus to need.	Departments are broadly on course to meet their target of realising £30 billion from asset disposals by 2010-11. However many departments rarely report balance sheet information to their Board in-year and so further improvement in the monitoring of the usage of assets seems necessary.
Departments should take steps to improve the management of debtors and creditors, inventory and cash.	Nineteen per cent of departments rated themselves as weak at managing their balance sheet. Our survey showed that a significant minority of departments felt that some more central support to help them improve their management of assets and liabilities would be helpful.

APPENDIX THREE

Characteristics of world class financial management

Characteristic of world class financial management of resources	Examples of effective behaviours and practices	Risk to value for money
Leadership and governance		
Led by senior management, financial resource management is at the core of a department's culture.	A robust system of governance exists to offer challenge and support, for example through authoritative, financially-able non-Executive Directors. Senior managers drive the development of financial skills for staff outside of finance.	Non-finance staff fail to recognise the importance of managing budgets effectively and do not ensure that they achieve value for money in providing services.
Decision making		
Decisions are based on robust assessments of the financial and operational implications of all policy, operational and investment alternatives.	Integrated financial and operational performance information is available when needed by decision makers. Decision makers are financially literate, and call on expert assistance when necessary.	Departments may commit themselves to a programme whose actual cost turns out to be significantly more than what was estimated, thereby causing the suspension or cancellation of other programmes.
Planning		
Departments hold a clear, medium-to-long-term vision which identifies risks and opportunities, which enables them to maintain a flexible approach to service delivery.	All key outputs are costed, so that decision-makers understand the financial and operational impact of reallocating resources. The likelihood and financial and operational impacts of organisational risks are quantified, and there is a clear plan for how best to mitigate them.	Without a robust planning process, fully costed outputs, and strong risk management processes, departments may allocate too much resource to some programmes and not enough to others. This may result in departments failing to fulfil all of their delivery objectives.

Characteristic of world class financial management of resources	Examples of effective behaviours and practices	Risk to value for money
Monitoring and forecasting		
Departments understand their financial and operational performance, and are ready for future demands on their businesses.	Information systems provide timely and reliable data to track delivery and financial performance. Updating forecasts is part of core business, with underlying assumptions challenged as a matter of course by senior managers. The likelihood and financial and operational impact of organisational risks are routinely monitored.	Poor monitoring and forecasting of expenditure may result in departments under- or over-estimating the resources necessary to provide their services. An underestimate may mean that insufficient or poor quality services are delivered. An overestimate may result in an under-spend, missing the opportunity to reallocate unused resources to other priorities.
Reporting		
Reporting financial and operational performance which is clear, timely and reliable, and meets the needs of all stakeholders.	Providing internal and external reports with clear statements of performance against financial and operational objectives. Invariably preparing year-end accounts promptly and achieving unqualified audit opinions.	Weak external reporting may result in damage to the reputation of the department leading to increased ministerial and parliamentary scrutiny and difficulties recruiting and retaining staff. Weak year-end reporting may also be indicative of weak in-year accounting practices and systems.

NOTE

This table was developed by the National Audit Office summarising work done by the Audit Commission on the concept of World Class Financial Management (see http://www.audit-commission.gov.uk/reports/NATIONAL-REPORT.asp?CategoryID=&ProdID=28EA23C8-7712-49dd-8E9F-BA32D9063E2B).

GLOSSARY

Accruals accounting	Accruals accounting records departments' expenditure and income as it is incurred or earned rather than when amounts are paid or received (as was the case with cash accounting).
Annually Managed Expenditure	Public expenditure that is managed annually because it is less easy to estimate or control by the department over a longer period. For example, expenditure on benefits is highly demand-led and budgeted for on an annual basis.
Balance sheet	A financial statement, which shows the assets, liabilities and capital of an organization on a particular date, normally the end of the accounting period.
Capital spending	Expenditure on fixed assets.
Cash accounting	A method of accounting which records cash payments and cash receipts as they occur within an accounting period.
Creditors	Any individual or organisation to whom money is owed by the department.
Combined On-line Information System (COINS)	Online information system introduced by HM Treasury to consolidate previously diverse reporting requirements made of departments.
Control total	Departmental budgets are divided into a series of categories which define what that portion of the budget can be spent on. The total for each category is known as a Control Total. The four totals are resource Departmental Expenditure Limit, Near-cash in Departmental Expenditure Limit, capital Departmental Expenditure Limit and Administration.
Debtors	Individuals or organisations which owe money to the department.
Departmental Expenditure Limit	The three year budget provided to departments covering activities where it is possible to forecast the level of demand and resource three years in advance. Departmental Expenditure Limits identify separate elements for capital and current spending. A separate budget (known as Annual Managed Expenditure) is provided on annual basis to those departments with specific expenditure which is difficult to forecast.
Departmental report	Departments publish their departmental reports following the end of their operational and financial year on 31 March. The reports set out progress against departmental objectives and performance targets and are an important part of the process by which departments publicly account for themselves. In addition to producing printed copies, departments are required to make versions of their reports available on their public websites.

Depreciation	A measure of the wearing out, consumption or other reduction in the useful life of a fixed asset whether arising from use, passage of time or obsolescence through technological or market changes. The cost is charged to the revenue section of the resource account, and so is a charge against current expenditure.
Efficiency	The rate at which inputs are turned into outputs. A department can be said to be more efficient if it is achieving the same quality and quantity of outputs at lower cost; or getting more output at the same cost.
End Year Flexibility	A mechanism to allow unspent provision in the Departmental Expenditure Limit in one year to be carried forward to the next to encourage good financial management.
Excess Vote	If circumstances lead to an excess of expenditure above that agreed ('voted') by Parliament, the necessary additional provision is sought in an Excess Vote.
Financial liabilities	A contractual obligation to deliver cash or another financial asset to another entity (for example to pay for goods or services received).
Fixed assets	Assets held over a period of time to help deliver services (for example buildings).
Parliamentary Supply Procedure	The arrangements for control of expenditure where Parliament approves departments' requests for resources.
Public Service Agreements	Set out what a department will deliver in the form of measurable targets over the period of a Spending Round, in return for the budget voted to it.
Resource accounting	A method of recording expenditure as it is incurred and income as it is earned during an accounting period based on accruals method of accounting. In central government resource accounting replaced cash accounting which recorded payments and receipts when they were paid or received. Resource accounts are prepared annually and present the financial results of a department for the relevant financial year.
Resource budgeting	Resource budgeting involves using resource accounting information as the basis for planning and controlling public expenditure. Unlike the previous cash based approach, it requires departments to consider the costs of capital consumption, and to match their costs to the time of the related service delivery activity.
Spending reviews	Spending reviews set out the budgets to be managed by departments for the next three years and the outcomes to be achieved with those budgets. Comprehensive Spending Reviews were held in 1998 and 2007 and Spending Reviews in 2000, 2002 and 2004.
Total Managed Expenditure	The total of resources allocated to a department in any one year is known as Total Managed Expenditure, comprising the Departmental Expenditure Limit plus Annually Managed Expenditure.

ENDNOTES

1 HM Treasury. *Pre-Budget Report and Comprehensive Spending Review* (2007). Total central government spending includes funding transferred to the devolved assemblies. According to the Office for National Statistics, the UK population in 2006 was 60.6 million.

2 NAO Report. *Improving services and support for people with dementia* (HC 604, 2006-07).

3 In 2002, HM Treasury set departments the target of laying their resource accounts before Parliament before the summer recess. The initiative aimed to address the problem that accounts finalised after the mid-July recess cannot be laid until Parliament has returned in October, thereby reducing their usefulness.

4 NAO Report. *Managing Resources to Deliver Better Public Services* (HC 61, 2003-04).

5 *Managing resources to deliver better public services. Committee of Public Accounts* (25th Report 2003-04, HC 181).

6 Includes executive agencies and non-departmental public bodies.

7 Real terms refers to figures that have been adjusted for changes in the purchasing power of money.

8 Office for National Statistics. *United Kingdom National Accounts: The Blue Book* (2007).

9 Nominal terms refers to the values of the resources in each year without accounting for adjustments in price levels over those years.

10 HM Treasury. *Annual Report* (2007).

11 HM Treasury. *Managing Public Money* (2007).

12 *Managing resources to deliver better public services. Committee of Public Accounts* (25th Report 2003-04, HC 181).

13 Sir Peter Gershon, CBE. *Releasing resources to the front line: An independent review of public sector efficiency* p 26 (2004).

14 HM Treasury. *Spending Review White Paper* p 23 (2004).

15 HM Treasury.

16 *Hearing of the Public Accounts Committee on the privatisation of QinetiQ*, 3 December 2007.

17 ICAEW website, http://www.icaew.com/index.cfm?route=146193.

18 Public Administration Select Committee. *Skills for Government* (9th Report 2006-07, HC 93).

19 The last senior civil service survey was conducted in October 2006 and is usually conducted biennially. It is designed to find out what the senior civil service thinks about leadership in the senior civil service, working in the senior service and what improvements can be made.

20 NAO Report. *Managing Resources to Deliver Better Public Services* (HC 61-I, 2003-04) and the National Audit Office survey for this report. The three departments that had made limited progress in 2007 were the Department for Education and Skills, the Department for International Development and the Office of Fair Trading.

21 Departmental Strategic Objectives are the overarching aims of departments as specified in the 2007 Comprehensive Spending Review.

22 NAO Report. *Gaining and retaining a job: the Department for Work and Pensions' support for disabled people* (HC 455, 2005-06).

23 The Accounting for Sustainability Project is a cross-sectoral group with members from the public and private sectors including accounting institutes. The project was set up in 2004 by the Prince of Wales to help organisations measure the environmental and social costs of their actions and enable these broader and longer-term factors to be taken into account more effectively in accounting and decision-making. The project's website can be found at www.accountingforsustainability.org.

24 Office Of Government Commerce: *High Performing Property Implementation Plan*.

25 HM Treasury. *Managing Public Money.*

26 National Audit Office analysis of departmental Resource Accounts.

27 HM Treasury note to the Treasury Select Committee following the first round of Financial Management Reviews.

28 National Audit Office survey.

29 HM Treasury's project to better align budgets, Estimates and resource accounts should help to simplify the reporting requirements placed on departments.

30 NAO Report. *The budget for the London 2012 Olympic and Paralympic Games* (HC 612, 2006-07).

31 National Audit Office survey.

32 NAO Report. *Department for Environment, Food and Rural Affairs, and Rural Payments Agency: the delays in administering the 2005 Single Payment Scheme in England* (HC 1631, 2006-07).

33 Office for National Statistics and HM Treasury. *Public Expenditure Statistical Analyses* (2007). Central Government Current Expenditure is the expenditure by central government bodies excluding capital expenditure.

34 Office for National Statistics and HM Treasury. *Public Expenditure Statistical Analyses* (2007). Central Government Net Investment is the amount spent by central government bodies on capital items less the depreciation on those items and amounts received in respect of asset disposals.

35 The Comptroller and Auditor General provides departments with a qualified opinion of its annual financial statements if: (a) he does not believe that they give a true and fair reflection of the departments' financial situation, (b) they reveal that public resources have not been spent on that which Parliament expected (c) the National Audit Office has been unable, or prevented from gathering sufficient evidence with which to provide assurance or (d)the department requires Parliament to provide it with resources in excess of what was estimated.

36 Annual Managed Expenditure is expenditure on items which are inherently difficult to forecast (for example social security benefits). This expenditure is not subject to three year budgets (as Departmental Expenditure Limits are) but instead is managed annually. This analysis covers departmental AME and non-cash items.

37 HM Treasury *Public Outturn White Papers for 2002-03 to 2006-07*. We compared the outturn for expenditure against the resource Departmental Expenditure Limit to the final provision. Our comparison of the number of departments whose outturn varied by more than ten per cent against final provision covered all departments with a resource Departmental Expenditure Limit exceeding £100 million. Our analysis excludes devolved authorities (for example, the Welsh Assembly) and bodies that are not government departments. Underspends have been stated in real terms (see endnote 7).

38 Net financing is the balance of sales, repayments and costs and is the amount of money National Savings & Investments provides to the government to help it manage the national debt once interest, Premium Bonds prizes, matured investments and other repayments are made to customers.

39 HM Treasury *Public Outturn White Papers* for 2002-03 to 2006-07. We compared the outturn for expenditure against the capital Departmental Expenditure Limit to the final provision. Our comparison of the number of departments whose outturn varied by more than ten per cent against final provision covered all departments with a capital Departmental Expenditure Limit exceeding £100 million. Underspends have been stated in real terms (see endnote 7).

40 House of Commons Liaison Committee. *Estimates Memoranda 2005-06* (HC1685, 2005-06).

41 Department Capability Reviews consider a department 'well placed' when it is in a position to address any gaps in capability for future delivery through practical actions that are planned or already underway and is making improvements in capability and expected to improve further in the medium term.

42 Formerly the Department for Trade and Industry.

43 For example, the CIPFA Financial Management Framework and the efficiency and effectiveness indicators for finance functions published by the UK Audit Agencies in *Value for Money in public sector corporate services* available at www.public-audit-forum.gov.uk.

44 The Home Office had reported these £200 million of efficiencies by October 2006 (NAO Report. *The Efficiency Programme: A second review of progress* (HC 1561, 2006-07). By September 2007, the Home Office had reported a total of more than £500m in relation to asylum support costs. The additional savings have not been subject to review by the National Audit Office.

45 NAO Report. *The Efficiency Programme: A second review of progress* (HC 1561, 2006-07).

46 HM Treasury. *Pre Budget Report* (2007).

47 HM Treasury.

48 HM Treasury and the Office for National Statistics. *Public Expenditure Statistical Analyses* (2007).

49 In 2006-07, three departments, the Home Office, the Department of Health and the Department for Environment, Food and Rural Affairs, plus the Department of Health Pension Scheme did not meet the summer recess target for submitting their resource accounts.

50 During the period 2002-03 to 2006-07, the number of account qualifications for reasons other than an Excess Vote has varied from one (in 2004-05) to four (in 2005-06). In 2006-07, there were two.

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